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Selling Advantage / Reinvestment Advantage The Low or No Tax Rates of Capital Gains & Dividends

Introduction

Many people from general employees, to business people, to investors don't have enough of an understanding of the tax rules and tax rates to effectively utilize the U.S. tax code in their favor. Among all of the tax rules, an understanding of two key tax rates is vital for investors and business persons to lower their taxes. The two tax rates critical to business people and investors relate to dividends and capital gains. Dividend rates and capital gains rates have gone through such changes that most investors and business people are unaware of the current tax rates. Being that many sophisticated individuals lack this knowledge, people are missing out on many current opportunities to take gains at a tax free or nearly tax free rate.

Capital Gains

The capital gains tax rates have gone through a labyrinth of changes over the past 10 years. In fact, the changes have been so rapid and out of the ordinary, many business people and investors are at a loss when asked what the capital gains rates are currently and how they apply to taxes generally.

To start, the tax rate on capital gains was, until recently, 20% on long term capital gains (those investments held for over 12 months). The short term capital gain rate was, and still is, the same rate as ordinary income.

Changes were made, modifying the rates to 15% for upper bracket taxpayers and 5% for lower bracket

Continued on page 2

A CASE STUDY

In a private letter ruling, the IRS has held that an amended restrictive sales agreement did not constitute substantial modification under the Internal Revenue Code.

In this case, a husband and wife owned all of the voting stock in an S corporation and their children owned all of the nonvoting stock. As shareholders, the children entered into a restrictive sales agreement

with the corporation that limited their ability to sell, give, assign, or transfer their shares. The corporation was also given the option to purchase the children's shares for book value or a price stated in a notice to the corporation that the shares were being transferred. The corporation and the shareholder wanted to amend the agreement so that it applied only to

Continued on page 3



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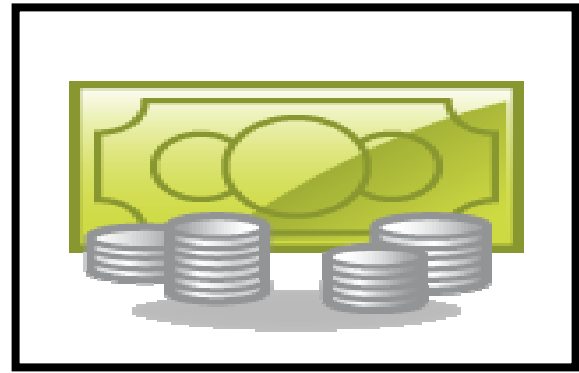
taxpayers subject to the extent total taxable income (including the capital gain) stays within the 15% ordinary income bracket (\$63,700 Married Filing Joint in 2007 and \$65,100 Married Filing Joint in 2008). The initial sunset provision was set for December 31, 2008. Since then, the sunset has been extended for capital gains until December 31, 2010. Of additional importance, THE 5% RATE FOR LOWER TAX BRACKET TAXPAYERS IS NOW 0% from January 1, 2008 through December 31, 2010!!!

Dividends

As late as December 31, 2002, dividends were taxed at the taxpayer’s ordinary rate. Since January 1, 2003 and through December 31, 2010, dividends are taxed at capital gains rates. This also means that dividends to lower bracket taxpayers are 0% for the next three years. The 15% rate for upper bracket taxpayers applies in 2008, 2009, and 2010. In 2011, the provision is set to expire and dividends will return back to ordinary rates, unless Congress makes the current law permanent.

Conclusion

To understand tax rules is to better understand the art of business and investing. As taxpayers, it is beneficial to take advantage of the lower tax rates for the 2008, 2009, and 2010 tax years. For business owners looking to retire, the implications go even further. Potential retirees can sell their businesses over the next three years and face a very low tax liability, as opposed to selling their business in the tax year 2011 and beyond. While the tax cuts might be made permanent, the changing political environment leaves everything up in the air. The current situation is such that closely-held business owners should carefully examine their retirement goals and plan on acting swiftly if they plan to retire, exit, or otherwise succeed a business interest to the next generation of owners. Additionally, while the capital gains tax rate makes for a good incentive to sell, the low dividends tax rate gives the taxpayer the chance to reinvest the money into dividend income producing property, allowing for a 0% or otherwise low tax rate during the next three years for all invested properly. The professionals at The Center routinely aid those planning to exit or succeed their businesses to a buyer or the next generation.



HOW LONG SHOULD IT TAKE TO SELL MY BUSINESS?

In my experience, even when the business is priced to sell, this can vary widely depending upon the industry sector, the size of the business, the unique character of the business and its owner, and even the general state of the economy.

Generally, when the selling price is likely to be in excess of \$1M, I advise my selling clients to plan on the process taking about a year to 18 months, though in some industries – particularly construction related – it could take much longer.

Typically, it takes a couple of months to gather, analyze and summarize all of the relevant information about the business that a serious buyer will want to see. In this process, the M&A advisor make have some suggestions for the seller about how to improve the appearance/ marketability/ selling price of his business, and they may mutually agree to keep the business off the market until the

Continued on page 3

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nonvoting shares of stock owned now or in the future by any shareholder. The IRS found that the proposed amendment did not constitute substantial modification because it was consistent with the terms of the agreement, was clarifying in nature, and did not affect the quality, value, or timing of any rights under the agreement. As a result, the agreement was exempt from special valuation rules.

Editor's Comments: Families that own or operate subchapter S corporations are well advised to have some sort of buy/sell agreement. In the present situation, such an agreement did exist. Thus, when the family wanted to modify the agreement, the IRS agreed and said it was okay.

Finally, remember, subchapter S corporations can have voting and non-voting stock as long as all of the provisions are the same. It is interesting that the revision to the buy/sell agreement would only apply to the non-voting stock and not to the voting stock. The IRS was of the opinion that the distribution rights did not change, but only the sale rights were altered.

Points of Interest

- **The two tax rates critical to business people and investors relate to dividends and capital gains.**
- **. . . many sophisticated individuals lack this knowledge, people are missing out on many current opportunities to take gains at a tax free or nearly tax free rate.**
- **Potential retirees can sell their businesses over the next three years and face a very low tax liability as opposed to selling their business in the tax year 2011 and beyond.**

seller has time to implement some of these suggestions.

From the time the business and the marketing materials are ready, it will likely take several months to identify and pre-screen qualified buyers. Typically, the larger and more specialized the business, the fewer qualified buyers, and the longer it may take to connect with them. After some preliminary discussions, serious buyers will want to meet face-to-face with the seller and tour the facilities before making an offer, and these visits take time to set up.

Once the buyer and seller have entered into a preliminary purchase agreement, the buyer's due diligence begins which can take from 30 – 60 days, and sometimes longer. During this time, the buyer will also be finalizing his financing and both parties' attorneys/ advisors will be finalizing the purchase agreement and all of the related documents to "paper" the transaction. This typically requires a lot more time and effort than either party imagined.

Even after the deal closes, the buyer may require the seller to stay on in an employment/ consulting capacity for 6 months to several years.

Since this entire process can easily take up to a year or even longer, it's a good idea to start planning at least 2-3 years in advance to prepare your business for sale, and select an experienced M&A advisor to assist in the process.

If you know of a business owner who's thinking of selling or buying a business and who might benefit from a free consultation with us, have them contact me, or any of the M&A professionals at www.bradwaygroup.com

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Frequently Asked Questions...



Q: My father just passed away. Will I have to pay estate taxes on the value of the estate?

A: The estate is responsible for the estate taxes due on the gross value of the estate. This year, if the estate is worth \$2,000,000 or more, the estate must file an estate tax return and probably pay applicable taxes as well. Next year, the appropriate gross estate exemption is \$3,500,000 and in 2010 the estate tax exemption is unlimited.

Q: How do I deduct expenses from an estate to arrive at the true value of the estate?

A: The estate can deduct estate expenses from the estate itself using form 706 or it can use form 1041 to deduct expenses from the income of the estate.

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