MERGERS& ACQUISITIONS

Right Time to Sell, Before Taxes Go Up

By Beatrice Mitchell

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The first half of 2020 witnessed a sharp decrease in M&A activity, due in part to the impact of the pandemic on the economy. However, we believe that the upcoming election and potential tax law changes will be major drivers of a sharp upswing in middle market M&A activity over the balance of the year.

Despite the backdrop of Covid-related economic uncertainty, our conversations with business owners indicate that many are furiously engaged in estate planning exercises. Indeed, for many middle market business owners, exit planning and estate planning go handin-hand, as often most of their net worth is tied up in their businesses.

A potential doubling of the capital gains tax bill upon a sale has forced many owners to contemplate selling their businesses before any legislative changes are implemented.

As such, many owners are anxious to complete a transaction before year-end, while tax rates are certain to remain low. We experienced a similar dynamic of increased seller activity toward the end of 2012, when the top Federal capital gains tax rate was poised to rise from 15% to 20%.

Overall, our current tax environment is very favorable by historical standards – the current maximum capital gains rate (excluding the Net Investment Income Tax) of 20%, is at one of the lowest levels in the past 75 years. However, this low-tax environment may be short-lived.

Driven by increased Covid stimulus spending and lower tax revenues, the U.S. budget deficit is projected to reach a record $3.3 trillion for the fiscal year ending September 30, 2020. The projected deficit amounts to 16% of GDP and will be the largest annual deficit as a percentage of GDP since World War II. As a result, the Federal government is under intense pressure to raise taxes to fund these deficits.

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Further, the upcoming election could bring a party shift to both the Presidency and Congress, which would almost certainly lead to significant changes in the tax code. Indeed, Joe Biden's initial proposed tax plan calls for several major changes, including but not limited to:

- Restoring the highest marginal household income tax rate to 39.6%, and
- Taxing capital gains at the same rate as ordinary income for taxpayers with incomes of above $1 million and potentially eliminating capital gains carry-overs upon death.

Thus, under Biden's initial tax proposal, business owners could soon see a near doubling of their maximum capital gains rate (20% vs 39.6%). Additional changes to the tax code could further impact sellers' estate planning and motivate them to pursue transactions today. Viewed from the perspective of net after-tax proceeds, a doubling of the top marginal capital gains rate effectively means that sellers need to achieve a ~30% increase in EV/EBITDA multiples to remain even. Clearly, many private business owners are choosing to explore a sale in a market of known taxes and known multiples rather than facing the uncertain future.

Hence, it is no surprise that potential tax changes, which could well occur as a result of the upcoming elections, may serve as a catalyst for intense year-end deal activity involving owners of private companies.

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