BNY MELLON
WEALTH MANAGEMENT

Case Study

Pass-Through Entities: What a Sale Looks Like Under Current vs. Proposed Tax Law

For owners of closely held businesses who are considering a sale, timing is everything—especially in an election year. Recent proposals suggest an increase in individual tax rates, including a possible jump from 20% to 39.6% in the long-term capital gains rate for high-income taxpayers[1]. This could have a significant impact on the after-tax sale of certain businesses.

Pass-Through Entities[2] in Focus

Sole proprietorships, S Corps[3], partnerships, LLCs and trusts are considered "pass-through entities" for tax purposes, as the income tax attributes pass through to the individual or entity owner's tax bracket.

The illustration below (Exhibit 1) compares the federal income tax on operating profit under current law and the tax proposal, assuming a business owner is in the highest bracket, with over $1 million in income. For an ongoing business, the net profit would be taxed under the proposed rate of 39.6%, resulting in a tax of $1.98 million. Under the current rate of 37%, the tax would be $1.85 million. That is roughly a 7% increase in tax, excluding the possible elimination of certain deductions such as the 20% small-business deduction.

Exhibit 1: Pass-Through Entities

	Current Law	Proposal
Gross Receipts	$30M	$30M
Deductions	$25M	$25M
Pre-Tax Profit	$5M	$5M
Tax	$1.85M	$1.98M
After-Tax Profit	$3.15M	$3.02M
Tax Difference	**7% Increase**	

As illustrated in Exhibit 1, that is a 4% decrease in after tax profits.

A Closer Look

The tax rate on the sale of assets depends on the nature of each asset; for example, any gain on inventory or accounts receivable are taxed as ordinary income, as are gains on the sale of intellectual property with the exception of certain patents. Depreciated property like machinery is taxed as ordinary income while capital assets like goodwill or investments in stocks and bonds can be taxed at favorable capital gains rates if held for greater than one year. The allocation of asset categories requires a diligent professional review when negotiating the terms of the sale. That said, if the highest rate of tax on ordinary income and long-term capital gains is the same per proposed legislation, less emphasis may be placed on these allocations.

If the business in the example above were sold at 5x gross profit, or $25 million, what would the tax be under current and proposed tax law?

Exhibit 2: Asset Sale

	Current Law	Proposal
Sale Price	$25M	$25M
Depreciated Cost Basis	$3M	$3M
Ordinary Income Assets	$5M	$5M
Capital Assets	$17M	$17M
Tax/OI	$1.85M	$1.98M
Tax on LTCG[4]	$3.4M	$6.732M
Net Proceeds	$19.75M	$16.29M
Difference	**$3.46M**	

As illustrated in Exhibit 2, the difference would be $3.46M, which is approximately a 17% reduction in proceeds under the proposed plan.

Summary

We cannot predict if and when any of these proposals will be enacted or what variations or modifications to rates, brackets, credits, deductions or incentives would be included. That said, it may be helpful to look at the possible impact on business net profit or net proceeds from a sale.

If your business is in a position to be sold, current economic and market conditions may make this a more favorable time. Work with BNY Mellon Wealth Management to guide you and ensure optimal results.

[1]Vice President Biden has proposed tax increases both on C Corps and on individuals. Some of the basic provisions are as follows:

- Increase in the highest individual tax rate from 37% to 39.6% (the top rate in 2017) for taxpayers earning more than $400,000.
- Increase in the tax on long-term capital gains and dividends from 20% to 39.6% (23.8% to 43.4%), including NII(4) for income above $1 million.
- Increase in the corporate tax rate from 21% to 28% and a reinstated 15% minimum book tax. There would also be an increase in the tax rate on foreign profits.

[2]Pass-Through Entities include Sole Proprietorships, partnerships, LLCs, S Corps, and trusts including QSSTs and ESBTs. The Small Business Administration reports that the legal form of small employer businesses are comprised mainly of 48.9% S Corps, 11.9% partnerships and 13.8% sole proprietorships.

[3]S Corps are a special class and sometimes structured as a stock sale, so careful consideration should be given to built-in gains if the S Corp was previously converted from a C Corp.

[4]Certain taxpayers are subject to an additional 3.8% tax on net investment income if not actively involved in a trade or business.

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