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SPECIAL REPORT

THE CAPITAL GAINS TAX RATE: IS CHANGE ON THE HORIZON?

As a business owner, you may not be inclined to keep yourself informed of every change in the tax law. However, the current battle over the capital gains tax rate would certainly be one to watch. A capital gains tax is a levy charged on the profit realized on the sale of an asset. While the most common capital gains are realized from the sale of stocks, bonds and precious metals, of far greater consequence is the impact of the capital gains tax when a valuable business is sold.

The 2003 Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) reduced the maximum capital gains tax rate from 20% to 15% for long-term capital gains (investments owned for at least 12 months). This reduction could represent an exceptional tax-saving opportunity to investors and business owners looking to sell their holdings, given that the rate has not been below 20% in the past 60 years.

The five-percentage point reduction made possible by the JGTRRA was not a permanent change, however. Originally set to expire in December 2008, President George Bush signed the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), thereby extending the lower rate until 2010.

Although the lower rate is not due to expire for another three years, the recent power shift in Congress has once again brought the capital gains tax rate into question. Not only does Congress have the ability to extend the favorable rate, it also has the power to raise the rate before its planned expiration in 2010. When the Democratic Party regained control of both the House and Senate in November 2006, the red flag on capital gains was raised once again.

It would not be unusual for a Democratic Congress to raise the capital gains tax rate. The bi-partisan political battle regarding tax cuts has been long-standing. Proponents of a lower rate, usually Republicans, argue that reducing these rates bolsters the economy by encouraging investment in promising enterprises and promoting the sale and transfer of property.

Supporters also believe that by reducing "double taxation" (investments first taxed as regular income, that are taxed again at the time of sale as capital gains), those considering new investment strategies would have extra incentive to make additional investments. Armed with these arguments, supporters believe the favorable rates should be made permanent. However, opponents – typically Democrats – believe that the lower rates create tax shelters and benefits for the wealthy, resulting in revenue loss for the government. They are inclined to vote for a raise in the rate.

This dissension among political parties has caused rates to fluctuate widely in the past, rising as high as 35% and changing an average of every 4.5 years. Now that we are entering the fourth year of the lowest rate in recent history, and given that the Democrats are once again in control in Congress, not to mention that a presidential election (and possibly a party-shift in the White House) is on the horizon, tax advisors are predicting that rate increases are more likely to occur; at a minimum, the 15% rate is expected to revert to 20% in 2010.

An increase in the capital gains tax rate has important implications to business owners when it's time to sell the business. A higher capital gains rate can substantially reduce the net returns to business-owner sellers. With rates currently – and perhaps temporarily – at a historic low, financial services companies suggest that now may be an optimal time to consider selling a privately held business. We realize that the decision to sell a business is neither purely tax-driven, nor even a purely financial consideration. Business sales are usually motivated by personal factors. However, because we estimate that it can take anywhere from 6-18 months to sell a private business (on average, one year), we suggest that business owners thinking of selling in the near-future should prepare now, so they can take advantage of what we believe to be an excellent and probably impermanent opportunity.