June 3, 2021

Tax Increases are Coming – The only Question is How Much and When

To our friends and clients,

Over the past few days, the Biden administration has signaled an aggressive position of making tax increases retroactive to April 2021. This is alarming for those hoping to close transactions in 2021, since Biden has proposed raising capital gains rates from 23.8% to 43.4%. In addition, the proposed tax plan raises corporate rates from 21% to 28% and the top ordinary income tax rates from 37.0% to 39.6%.

As we have talked to political operatives and those closely monitoring the political process, though, there appears to be serious doubt over the President’s ability to get these tax increases through Congress. The slim Democratic majority in the House and the split in the Senate won't necessarily provide Biden enough voting strength to get some of the more drastic measures – like a retroactive tax increase – through. Below are a few statements from political commentators on the upcoming tax increase legislation:

- “The retroactive tax increase on capital gains will be difficult to get through Congress in its current form given Democrats’ thin majorities and lawmakers’ rare history for raising taxes without giving people a fair warning.”
  - John Gimigliano, leads federal tax legislative services at KPMG LLP

> appearance of an uncertain outcome, when in fact (most of) the participants are in on the joke. The votes simply are not there."
> *- Joel Wood, Senior Vice President, Government Affairs, CIAB*

Keeping these realities in perspective, we should also acknowledge that tax increases are coming. While they might not be retroactive, and they won't likely end up as high as the rates Biden has proposed, there will most certainly be tax increases for ordinary income (at the top tax bracket), capital gains (for households with income over $1 million), and corporate income. What impact will these tax hikes have on agents and brokers in our industry? Several results are likely:

1. Agency/Brokerage valuations may decline: Corporate tax increases will reduce after-tax cash flow for C-corporations – which includes the public brokers. Individual tax increases will reduce after-tax cash flow for owners of pass-through entities (S-corporations and LLCs). When shareholders get to keep less of the profit, valuations decline. We saw valuations increase when corporate and individual taxes were reduced under Trump and we should be prepared to see it go the other way now.

2. The record-high levels of acquisition activity will moderate: We only have to look back to 2013 to see the drop in activity after a moderate capital gains rate increase from 2012. Deal activity declined by 36% in 2013 from 2012. The drop could even be more significant in 2022 if capital gains increases are paired with valuation declines from income tax hikes.

3. Brokers will get back to focusing on growing their business: With sales of their firms being less appealing, privately held agents and brokers will become more focused on investing in and growing their businesses (and keeping them private long term or looking to sell their firms down the road in a more opportune tax environment).

4. Tax-free mergers will become more attractive: Tax-free mergers will be more appealing as a means to combine with another firm while avoiding the current capital gains hit. This structure will allow firms to continue to pursue scale, a trend we've seen across the industry in recent years.

5. ESOPs will get renewed attention: ESOPs benefit from a tax provision (1042) that allows a seller of stock to an ESOP to roll the proceeds into certain qualifying replacement securities and defer capital gains taxes until those securities are later sold. This will appeal to some looking to sell but who want to wait until we have better tax rates under a future administration.

6. Alternative transaction structures: With ordinary income rates only going up slightly, it is possible that more transactions will be structured with sellers getting ordinary income tax treatment and buyers getting full deductibility of the purchase consideration. In addition, buyers that can offer a tax-free rollover on equity consideration will have an advantage in the marketplace.

7. Synthetic equity (e.g. stock appreciation rights, phantom stock, etc.) will become more common as a perpetuation tool: Agency equity has typically been the preferred perpetuation tool among key employees because long-term appreciation in their equity is perpetuation tool. Synthetic equity's natural advantages – it is tax-free to the recipient when issued, can be structured to vest upon the achievement of performance metrics, and synthetic equity payouts are deductible to the issuer – are all reasons why synthetic equity might enjoy a renaissance in our industry.

The extent to which the above will occur will be in direct proportion to the severity of the tax increases and how the tax laws are written. Stay aware of what is happening as this unfolds and position yourself and your firm to respond accordingly. We have survived tax increases in the past and we can do so in the future.

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