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Taxing decisions boost more merger and acquisition deals

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Anticipated changes to the tax code and an abundance of capital from the private equity market are setting up a spike in local and national mergers and acquisitions later this year, industry insiders say.

Barring any intervention from Congress, which observers say is unlikely, the cuts to the capital gains tax created by President Bush's 2003 tax package will expire at the end of the year.

Under the new tax environment, taxes on capital gains will increase from 15 percent to 23.8 percent, a 58 percent gain, according to a report by Houston-based investment bank **GulfStar Group Inc.**

"That has a significant impact in the net amount that sellers are going to get," says Jason Ferguson, managing partner at Houston-based accounting firm **Calvetti, Ferguson & Wagner PC**. "You take a $10 or $20 million transaction and you tack on 10 percent additional tax, that's seven figures."

Kent Kahle, managing director at GulfStar, says the likelihood of the old tax rates coming back is high, and with the prospect of lower returns in 2011, sellers are pushing to get deals closed before the end of the year.

"If you are an entrepreneur or a family owned business owner and you are expecting to do some type of liquidity event in the next few years, why wouldn't you try to do it in 2010 when your capital gains rates are lower?" says Kahle.

The tax change looms at a time when some industry observers are already seeing an upward trend in transactions.

Tom Edens, principal and founder of Houston-based M&A advisory firm **Marion Financial Corp.**, says that the marketplace saw the ramp up in deal volume begin in the fourth quarter of 2009.

"We've already had closings (this year) equal to last year," he says.

During the first quarter of 2010, middle-market M&A deals nationwide gained momentum, according to an April report by Robert W. Baird & Co., a Milwaukee-based wealth management and private equity firm. A total of 1,216 deals closed during the period, a 62 percent jump over the same period in 2009, dollar volume through the same period rose 74 percent compared to the year-earlier period.

DECLINES IN 2011

Once new tax rates are in place, although, volume may dry up.

Kahle says that a recent conference organized by the Association for Corporate Growth in May, keynote speaker Arthur Laffer said he predicted a three to four percent decline in gross domestic product in 2011 driven largely by higher taxes curtailing consumer and corporate spending. That would bring on a steep drop in M&A activity through 2011, said Laffer, a noted economist and former economic adviser to President Ronald Reagan.

Some dealmakers are even placing language in their contracts to mitigate the uncertainty over the looming tax hike.

"We have an engagement letter with a client that's outstanding right now, and one of the conditions is that we must get the transaction closed by the end of the year," says M&A advisor Edens.

Edens, whose firm work mostly in the financial services space, adds that the door may be closing fast on companies looking to finalize a deal before the year-end, as the process usually takes longer than five months.

That may create some congestion toward the end of the year for M&A professionals, says Donald Brodsky, partner at the Houston office of Cleveland-based law firm **Baker Hostetler** LLP.

"M&A lawyers shouldn't make any big New Year's Eve plans," Brodsky says.

OTHER FACTORS

The capital gains impact isn't the only factor driving the expected increase in deal volume, however.

Tax changes affecting carried interest, the performance-based compensation to the general partner of a private equity group or hedge fund, are also on the Congressional to-do list. The **U.S. House of Representatives** on May 28 passed a bill stating that 50 percent of this compensation would be taxed at typical rates from 2011 through 2013, or about 35 percent, instead of the current capital gains rate of 15 percent. That percentage would then rise to 75 percent of carried interest taxed as ordinary income after 2013. The revised rate would be 23 percent should the 2003 Bush cuts expire as expected.

The Senate is taking up the proposal this week.

Some observers expect it could try to lower the proposed House split from 75 percent ordinary income to 65 percent, and down to 55 percent involving the sale of assets held a minimum of seven years.

“If those rates were to go up, that could affect how private equity and hedge funds structure their deals,” says Brodsky.

Some of those funds might convert into corporations to avoid the tax shift or others might rearrange their portfolios prior to the change, cleaning them out in a torrent of sales, Brodsky adds.

Besides the two tax-related issues, the other reason why M&A activity may increase through the second half of 2010 is the fact that so much unused private equity capital has been sitting on the sidelines due to the continued uncertainty hanging over financial markets since the recession.

“There’s a tremendous amount of pent-up private equity capital — over $400 billion — as well as the return of cash flow lenders, which were pretty much not providing funding in 2009 for smaller transactions,” says GulfStar’s Kahle.

In addition to the accumulated dry powder, Ferguson says asking prices are becoming more in line with the market so more deals are in the works. Though he says the capital gains issue is still the major driver in the rush to get deals done this year, the fact that the disconnect between buyers and sellers that was so prevalent through 2009 is waning has helped usher transactions through.

Says Ferguson, “The sellers have finally started to be convinced that they are not going to get the same multiple they got in 2006 and 2007,” says Ferguson.

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