



Today in Finance for October 24, 2007

Cap Gains Vote Could Spark Small Biz Selloff

If Congress decides to raise the tax on capital gains, it may be prudent for small business owners to sell off assets now.

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October 24, 2007

Although the national elections are still more than a year away, finance chiefs of smaller companies may want to start thinking about how new tax policy may affect their merger and acquisition plans. Already, there have been rumblings in Congress to raise the tax rate on long-term capital gains for corporations and higher-tax bracket individuals from the current 15 percent to 20 or 25 percent.

If that happens, some owners of smaller businesses may want to dispose of their companies before a hike in the capital gains rate eats into deal proceeds, said Tom Bonney, founder and managing director of CMF Associates, a financial advisory firm for small- and mid-size companies. A recent analysis by CMF shows that if the capital gains rate rose to 25 percent in 2009, a business owner would have to generate 24 percent more value in his company over the next two years to match the after-tax value of the company if it was sold today under the 15 percent rate.

The difference in value is linked to two issues, explained Bonney: a rise in the capital gains rate would increase the owner's tax bill on the sale of the business; and the subsequent hit in net proceeds to the seller would be compounded by a loss in the time value of money over the two-year period.

For example, consider a company with \$5 million in EBITDA (earnings before interest, taxes, depreciation, and amortization) that is sold for \$42.5 million, or 8.5 times its EBITDA. An EBITDA multiple of 8.5 is considered typical for companies with less than \$25 million in revenues, according to a recent report in Piper Jaffray's M&A Monitor. At the 15 percent capital gains rate, the owners would pay \$6.4 million in taxes and end up with \$36.1 million in after-tax value. However, at

a 25 percent capital gains rate, the owners would pay an additional \$4.2 million in taxes, or \$10.6 million.

Now assume that the seller would have been able to invest the 2007 proceeds at an 8 percent interest rate to generate an additional \$6 million in investment income over the two-year period. Commented Bonney: "\$4.2 million in additional capital gains taxes and \$6 million in foregone investment income provide a strong incentive to sell your business today if you believe that tax rates will be increasing in the future."

Bonney expects to see some sort of Congressional action related to the capital gains rate after the 2008 election. "I think the post-election sentiment in Congress will be [focused on] repudiation of the political, social, and economic policies of the Bush Administration." Indeed, he pointed out that critics of private equity and hedge fund managers are already clamoring for Congress to tax investor profit, also called "carried interest," as compensation rather than capital gains.

Even if Congress takes no action at all, the capital gains rate is set to increase in 2011, unless the current law is repealed. The Tax Reconciliation Act, which was signed into law in 2006, is slated to boost the 15 percent rate to 20 percent in four years. That alone may spur more business owners to consider a company sale sooner than later, Lehman Brothers tax expert Robert Willens told CFO.com. "It is a classic recommendation that we've seen [advisors make] through the years whenever tax rates are scheduled to increase," contended Willens.

In effect, "taxpayers are encouraged to 'accelerate' income, and I don't expect this time to be any different," Willens said. In fact, he went further: "I think we'll be seeing sales of businesses and other capital assets primarily for the purpose of taking advantage of the lower rates." Willens opined that sales will occur even though there is no other compelling reason to sell the business or asset. "That's how powerful an incentive taxes are with respect to these decisions," he asserted.

Willens does not believe, however, that publicly traded companies will experience nearly as much sell-off incentive as privately held businesses. That because, for the most part, shareholders — who would benefit from the lower rate if the company was sold — are a different constituency than the management and board members who would be making the decision to sell the company. In the case of a

closely held corporation, management and ownership are not only vested in the same people, but sometimes are the same people. That would mean both owners and management would benefit from a sale.