

## **Op-ed: Changes in capital-gains-tax rate will affect private-business owners**

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As the United States moves down the election trail toward a presidential decision in fall 2008, the impact of a possible slowdown in the economy, changes in the mergers-and-acquisitions markets and changes in tax rates are all important factors for investors and business owners to consider.

The credit crisis of summer 2007 and the rollercoaster ride of the stock market over the past four months have the financial community scratching its collective head over what the markets will look like for the foreseeable future. One major issue that Boenning & Scattergood Inc. believes will be addressed after the upcoming federal election, however, is the capital-gains rate. With the current capital-gains-tax level scheduled by law to increase to 20 percent in 2011 from today's rate of 15 percent, the essential question is whether incremental changes will be enacted by the next holder of the presidency.

In pondering an answer to this question, we start by harkening back to the words of former President John F. Kennedy in 1963: "The tax on capital gains directly affects investment decisions, the mobility and flow of risk capital ... the ease or difficulty experienced by new ventures in obtaining capital, and thereby the strength and potential for growth in the economy."

The irony of Kennedy's words as he called for major changes in the tax system was that, as a Democratic president, he was unable to get congressional support for a reduction in the capital-gains rate. It is unlikely that his successors in the party will be affected by the same level of pressure as Kennedy was in 1963, as the three leading Democratic contenders have called for increases in the capital-gains rate if elected president.

While U.S. Sen. Hillary Clinton has declined to state her position on capital gains, other Democratic hopefuls — John Edwards and Sen. Barack Obama — have called for higher capital-gains rates. Edwards favors a rate of up to 28 percent for wealthier Americans, while Obama supports a 20 percent capital-gains rate. In any case, it is clear that the current capital-gains rate of 15 percent is in serious jeopardy.

While some tax professionals believe that tax changes could become effective in 2009-10, most believe such changes are likely to occur as currently contemplated in 2011, as President George W. Bush's administration's tax cuts expire. An effective date in 2009 seems unlikely because a retroactive tax hike would be largely though not entirely without precedent. As a result, most political and tax experts believe there will remain about a two-year window in which taxpayers will be able to continue to take advantage of capital-gains rates at 40-year lows.

For business owners considering selling their companies within the next several years, the after-tax impact on their bottom lines is that it may behoove them to consider such an event sooner rather than later. A quick walk through the numbers illustrates the rationale.

Assume a company's earnings before interest taxes, depreciation and amortization (EBITDA) was \$5 million. If the acquisition value of the business was seven times EBITDA, the company would achieve a value of \$35 million. After tax, assuming rates of 15 percent in 2007 and 28 percent in 2010, the net proceeds to the business owner would equate to approximately \$29.8 million and \$25.2 million, respectively. The reduction is significant to the business owner, equating to a more than 15 percent reduction in net proceeds or \$4.6 million. When taking into account the loss associated with the time value of money differential between selling now and in two years — or when the capital gains rate is increased — the total loss in value grows to more than 25 percent.

When viewed over a longer horizon, the statistics related to the capital-gains rate are even more daunting. The current capital-gains rate of 15 percent is at the lowest level over the past 40 years, and an increase under a Republican or Democratic administration is likely. Ironically, only once over that 40-year period has an increase in the capital-gains rate resulted in increased revenue in the U.S. Treasury. However, regardless of the perceived implications, business owners should expect an increase in the capital-gains rate at the earliest in 2009 and at the latest in 2011 and make their business decisions accordingly.

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