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INVESTMENT BANKERS

INSIGHT REPRINT
PERSPECTIVES ON THE CAPITAL MARKETS
SUMMER 2008

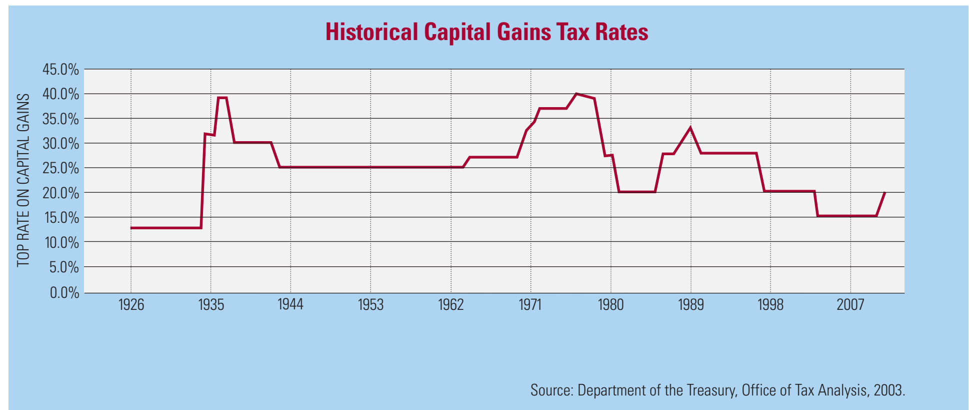
Capital Gains Tax Rates Up = Value of Businesses Down?

Will increasing the top capital gains tax rate harm sellers of businesses?

by Ray D. Rezab and Brian J. Kremen

Given the discussion in today's political environment about whether to extend, make permanent, change or scrap President Bush's tax cuts, an issue that merits analysis is whether an increase in the top capital gains tax rate will depress business values.

All business owners are acutely aware that an increase in the capital gains tax rate will result in lower net-after-tax proceeds when they sell their businesses. What we think is a more interesting question is whether higher tax rates will have an additional indirect and negative effect on the value of the underlying business, due to an increase in the cost of capital for buyers of businesses.



BACKGROUND ON CAPITAL GAINS TAX RATES

Earlier this decade, Congress passed the Jobs and Growth Tax Relief Reconciliation Act of 2003 ("2003 Tax Act") to spur investment and rekindle the economy. Immediately prior to the 2003 Tax Act, long-term capital gains (arising from the sale of capital assets held for more than one year) were taxed at 20% for higher income bracket taxpayers (25% or above). Additional rules governed gains on the sale of capital assets acquired after December 31, 2000, and held for more than five years. These were taxed at a maximum rate of 18%.

The 2003 Tax Act temporarily cut the top capital gains tax rate, effective from May 6, 2003 through the end of 2008, from 20% to 15% for higher income bracket taxpayers and for recipients of qualified dividends from C corporations, and ended the 18% rate for five-year holding period property. The 20% rate was mandated to reappear in 2009. However, the 15% rate was extended through 2010, due to the passage in May 2006 of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA).

As depicted in the graph above, the top tax rate on capital gains has varied widely over the past 80 years. For most of that time, the top rate has been at least 25%. It peaked in 1976-77, and since then has followed a general downward trend to the current 15%, the lowest rate since before and during the Depression.

President Bush has advocated making these tax cuts permanent on numerous occasions, and did so again in the most recent budget submitted to Congress. However, the consensus is that the current Congress is more likely to raise the capital gains tax rate, possibly before it is due to expire at the end of 2010.

THE LINKAGE OF TAXES, COST OF CAPITAL, AND VALUE

All business owners recognize that the net proceeds from the sale of a business will be less if the capital gains tax rate is increased. What may not be as clearly understood is that, if buyers believe they ultimately will be taxed at higher rates, they must reduce their purchase offers in order to maintain the same return on investment.

Accepted valuation theory states that the value of a business is a function of the after-tax cash flows it generates, discounted by an appropriate risk-adjusted, after-tax rate of return. As tax rates on income or capital gains change, the cost of capital changes, as does the present value of the business's future cash flow stream.

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To more fully understand the effect of increased taxation on the cost of equity capital, we first analyzed how much of a decrease in initial investment (or value) would occur as a result of increasing the capital gains tax rate, to keep the after-tax return to the investor constant. The top chart on page two illustrates that effect for a 5% and a 10% increase in the capital gains tax rate (from a base rate of 15%). As one would expect, the prices of higher-risk investments are more negatively impacted by higher capital gains rates.

To determine how higher capital gains tax rates would affect the price buyers should be willing to pay for businesses, we applied this concept to an average company in which two-thirds of the post-sale capital structure is debt. The bottom chart illustrates the effect on the enterprise value of the business under varying capital gains tax rates and holding periods.

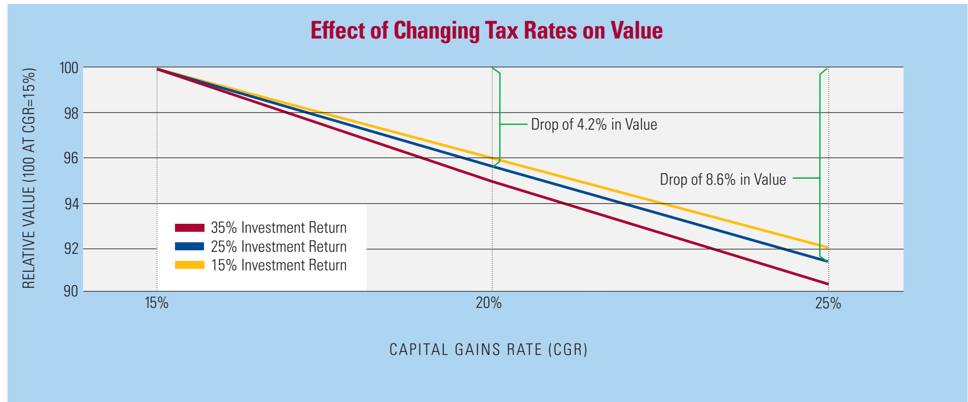
Greater leverage in the buyer's capital

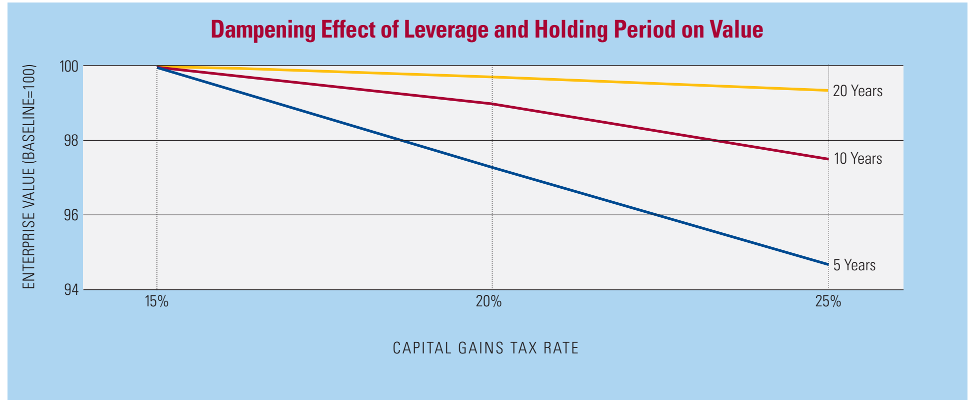
(continued p.2)

structure and longer holding periods each dilute the impact on value of a higher capital gains tax rate. This is primarily due to the time-value of money.

All buyers would not be affected in the same way. In the case of a public corporation, which is taxed at a single corporate rate and for which the holding period of an acquired business is expected to be long, the effect is lessened. Likewise, the effect is minimized for investors that are tax-exempt entities, such as pension funds and endowments.

Because the economy consists of many different types of entities that are subject to a variety of taxes and tax rates, it is almost impossible to precisely ascertain the actual amount of value reduction that results from an increase in the top capital gains tax rate. Nevertheless, taxes of all kinds create friction that causes a drag on investment returns. An increase in the capital gains tax rate undoubtedly will have this effect. Although prospective sellers of businesses should consider the immediate and direct reduction of after-tax proceeds due to higher capital gains rates, they should not lose sight of its subtle influence on the cost of capital and the resulting consequences for the value of the business. ❖





Zachary Scott
INVESTMENT BANKERS

1200 Fifth Avenue, Suite 1500
Seattle, Washington 98101

www.ZacharyScott.com

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Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

Mark D. Working
206.224.7382
mworking@zacharyscott.com

William S. Hanneman
206.224.7381
bhanneman@zacharyscott.com

Frank S. Buhler
206.224.7383
fbuhler@zacharyscott.com

Michael T. Newsome
206.224.7387
mnewsome@zacharyscott.com

Ray D. Rezab
206.224.7386
rrezab@zacharyscott.com

Doug Cooper
206.224.7388
dcooper@zacharyscott.com

Jay Schembs
206.838.5524
jschembs@zacharyscott.com

Brian J. Kremen
206.838.5526
bkremen@zacharyscott.com