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INSIGHT REPRINT
PERSPECTIVES ON THE CAPITAL MARKETS
SPRING 2012

Tax Rates Affect Returns to Business Owners

Due to a changing tax environment, businesses earnings and value must increase just to stay even.

by Frank S. Buhler

Barring legislative action this year, the tax environment will become more punitive in 2013. To remain even, owners will need to earn more profits to offset higher taxes, and values of businesses will have to increase to yield the same after-tax proceeds in a sale. While no business owner should make a decision on the sale of a business solely as a function of tax policy, these significant changes merit a review of ownership transition plans with an eye toward maximizing after-tax proceeds. Owners who have established a time "window" during which they are considering ownership transition should evaluate their specific situation and determine if the impending changes matter to them. The old axiom, "it's not what you make, it's what you keep," remains relevant.

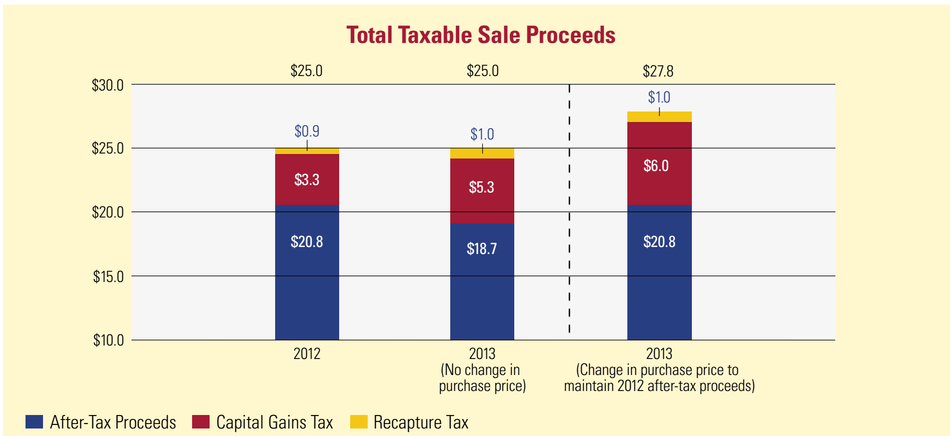
THE LIST OF CHANGES INCLUDES:

- Higher tax rates on capital gains, qualified dividends, and ordinary income;
- New Medicare taxes on net investment income, including capital gains, as part of the funding for the Patient Protection and Affordable Care Act ("ObamaCare"); and
- Higher tax rates on estate transfers and a reduction in the exemption from estate tax.

The chart below compares the current tax rate structure to the framework scheduled to go into effect on January 1, 2013.

Three meaningful changes will impact the after-tax proceeds from the sale of a Company, or dividends received from C-Corporations, starting in 2013.

▪ ***Capital Gains*** The effective tax rates on capital gains will increase from 15% to 23.8% (a combined federal rate of 20% capital gains + 3.8% Medicare tax), representing a 58.7% increase relative to 2012.



It appears likely that the 17-year run of declining capital gains rates will end in 2012, thereby decreasing the after-tax value of businesses. The scheduled upwards adjustment of ordinary income tax rates will also have a significant impact on the cash flow retained for business operations owned in pass-through entities (Sub-S, LLC, and partnerships).

▪ ***Depreciation Recapture*** The typical transaction structure for the sale of a business organized as an S corporation, a limited liability company, or a partnership, is the sale of assets or, in the case of an S corporation, of stock with an election (338(h)10, for those tax aficionados) that treats the sale of stock as an asset sale for tax purposes.With either of these structures, buyers gain the ability to amortize goodwill for tax purposes and re-depreciate fixed assets over the assets' assigned life. The sale may result in the recapture of depreciation, which occurs when the tax basis of assets is below market value. Such recapture, up to the original cost of the asset, is treated as ordinary income and will be taxable at ordinary income rates. In 2013, the highest marginal ordinary income rate will jump to 39.6%. The various investment tax incentives available over the last few years have allowed for immediate write-off or rapid depreciation of new capital expenditures. As a result, many companies now have a large gap between the tax basis and current fair market value of fixed assets, thereby exacerbating the effect of the increase in ordinary income tax rates.

▪ ***Qualified Dividends*** Owners of C-Corporations currently pay tax at a rate of 15% on dividends. In 2013, the qualified dividend rate will expand to a combined rate of 43.4% (39.6% ordinary income rate + 3.8% Medicare tax), representing an increase of 189% over tax rates in 2012.

The above chart illustrates the effect on a seller in a sale transaction with a $25 million capital gain and depreciation recapture of $2.5 million. Higher tax rates in 2013 will reduce

Income Type	Tax Year		Change	
	2011-2012	2013	Absolute	%
Ordinary Income	35.0%	39.6%	4.6%	13.1%
Long Term Capital Gains	15.0%	20.0%	5.0%	33.3%
Qualified Dividends	15.0%	39.6%	24.6%	164.0%
Medicare Tax on Net Investment Income	0.0%	3.8%	3.8%	NA

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the net sale proceeds by $2.1 million. All else being the same, the purchase price for a transaction completed in 2013 would have to be approximately $2.8 million greater than the same transaction completed in 2012 to result in the same after-tax proceeds.

In addition to higher effective income tax rates, the tax and exemption structure for estates will also change. The chart below provides an overview of changes to federal estate tax exemptions and rates.

The most significant changes to the estate tax include the simultaneous tax rate boost to 55% and the lowering of the exemption from $5 million to $1 million. Business owners should investigate ways to use up their maximum exemption this year regardless of their ownership transition schedule.

Income Type	Tax Year 2011-2012	Tax Year 2013
Estate Tax		
Maximum Rate	35.0%	55.0%
Exemption ($000's)	5,000	1,000
Gift Tax		
Maximum Rate	35.0%	55.0%
Exemption ($000's)	5,000	1,000

It appears likely that the 17-year run of declining capital gains rates will end in 2012, thereby decreasing the after-tax value of businesses. The scheduled upwards adjustment of ordinary income tax rates will also have a significant impact on the cash flow retained for business operations owned in pass-through entities (Sub-S, LLC, and partnerships). Business owners should continuously be evaluating their ownership transition plans based upon changes to the operating environment, including the tax environment. In that light, we recommend that owners request their tax advisors to assess the impact of the pending tax rate changes on their business and on the amount of after-tax proceeds realizable in a sale. ❖

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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.

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