

Entrepreneurs and Impending Changes in Capital Gains Taxes

Do you know how changes in the tax law may affect your returns?

July 15, 2010

Determining whether or not to raise institutional equity capital is one of the most significant decisions an entrepreneur will make. There are a number of considerations to take into account, including the capital needs of the business, the personal financial goals of the entrepreneur and other shareholders, availability of capital and the goals and reputation of the capital provider. If an entrepreneur is considering achieving liquidity through a partial sale of his or other shareholders' ownership interests, one critical factor is the effect of taxes. Taxes are a major determinant of the returns on any investment, and especially for an entrepreneur whose company is often his or her primary vehicle of wealth creation.

Two significant changes to the tax code are likely to occur in the next few years, both of which will directly affect entrepreneurs. First, the Bush tax cuts passed by Congress in 2001 and 2003 are set to expire at the end of 2010. Second, the recently enacted Healthcare Reform Bill calls for additional taxes on all investment gains starting in 2013. Our intent in this paper is not to take a position on the wisdom of these changes in the tax code, but rather to highlight how we believe an entrepreneur should take taxes into consideration when contemplating a capital raise.

Please note that this paper is for informational purposes only and should not be construed as legal or tax advice. Also, this paper is not a comprehensive analysis of the tax implications of raising equity capital. You should consult with your own legal and tax advisors before taking action with respect to the matters discussed in this paper.

The Bush Tax Cuts

Congress passed a number of tax cuts during the Bush administration, but this discussion will focus on the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA). The JGTRRA continued the trend set by the Bush administration's first round of tax cuts in 2001 by lowering the tax rates on long term investment gains. The Act phased in lower capital gains tax rates over time, with the final stages of the tax cut becoming effective on January 1, 2008. However, there was also a sunset provision written into the bill, such that the lower tax rates are scheduled to expire on January 1, 2011. Given the current political and fiscal environment, these tax cuts are unlikely to be extended for those with annual incomes over \$200,000, and the expiration stands to significantly increase the tax burden on entrepreneurs and other shareholders seeking to sell part or all of their ownership stakes in private companies. A summary of the capital gains tax rates is shown below.¹

January 1, 2008 - December 31, 2010 Capital Gains Tax Rates						
Holding Period (yrs.)	Marginal Income Tax Rate					
	10%	15%	25%	28%	33%	35%
<1	10%	15%	25%	28%	33%	35%
>1	0%	0%	15%	15%	15%	15%

January 1, 2011 Capital Gains Tax Rates					
Holding Period (yrs.)	Marginal Income Tax Rate				
	15%	28%	31%	36%	39.6%
<1	15%	28%	31%	36%	39.6%
>1	10%	20%	20%	20%	20%

Investment Return Case Study

To see how these impending changes in tax rates might affect you, consider our hypothetical example of John Q. Entrepreneur. John's current company is growing and he is considering raising equity capital to fuel further growth in his business. However, he also has much of his net worth tied up in his business and is considering selling a part of his ownership stake to "take some chips off the table" and allow him to achieve some diversification of his personal net worth. John started the business with a small investment of personal funds and has "boot-strapped" the business ever since, such that he has a very low tax basis for his personal investment. He is very aware of the impending increase in capital gains tax rates and wants to maximize the value of his after-tax proceeds from this "minority recapitalization."

First, some additional background information: John is currently in the 28% tax rate bracket, which correlates to an income between \$82,400 and \$171,850 if filing singly and between \$137,300 and \$209,250 if married and filing jointly for the 2010 tax year. The Obama administration has indicated that it does not want to raise taxes on individuals earning less than \$200,000 and couples earning less than \$250,000, so for the purposes of this exercise we will assume that John remains in the same tax bracket

¹ Tax Foundation: <http://www.taxfoundation.org/files/fedcapgainstaxrates-20080527.swf>

for 2011 as well. John founded his company three years ago, which places him in the 15% long term capital gains tax bracket for 2010 and the 20% capital gains tax rate bracket in 2011.

Let's also assume that John's company is currently generating \$5 million in operating cash flow, or "EBITDA", annually and would be valued by an institutional equity investor (for purposes of an equity investment that would purchase a minority ownership interest in the business) at 7.0x EBITDA. If an outside investor is willing to purchase 10% of his business, at what rate does John's company need to grow EBITDA in 2011 in order to overcome the effective increase in the tax rate?

Returns Analysis			
<i>\$ millions</i>	2010	2011	
		No Growth	Growth
EBITDA	5.00	5.00	5.31
Valuation at 7.0x EBITDA	35.00	35.00	37.19
Capital Raised	3.50	3.50	3.72
After Tax Proceeds to John	<u>2.98</u>	<u>2.80</u>	<u>2.98</u>

The above chart highlights the tax effect on John's returns. If his company's valuation remains constant, his after-tax proceeds will be reduced by \$175,000, which can be seen by comparing the first column to the second. The third column shows the increase in EBITDA (assuming the same EBITDA multiple) necessary for John to maintain his after tax proceeds with the change in tax rates from 2010 to 2011. John would have to increase EBITDA by \$310,000 or 6.25%. While 6% is below the growth rate of many of the companies we meet and below the level of growth that most entrepreneurs aspire to, even at an assumed growth rate of 25% the first three months of the year would be spent simply maintaining shareholder value rather than increasing it.

However, this analysis is too simplistic in that it does not account for the present value of the 2011 proceeds. Using a 10% discount rate, the necessary EBITDA growth rate to overcome the additional tax burden quickly grows to 16.9%.

Returns Analysis w/ Discount Rate			
<i>\$ millions</i>	2010	2011	
		No Growth	Growth
EBITDA	5.00	5.00	5.84
Valuation at 7.0x EBITDA	35.00	35.00	40.91
Capital Raised	3.50	3.50	4.09
After Tax Proceeds to John	2.98	2.80	3.27
PV After Tax Proceeds to John at 10% Discount Rate	<u>2.98</u>	<u>2.55</u>	<u>2.98</u>

The Healthcare Bill

There has been a large volume of commentary on the implications of the Healthcare Reform Bill over the last several months. One troubling impact for most entrepreneurs will be the extension of Medicare taxes to all investment gains. This will effectively add an additional 3.8% to the long term capital gains tax rate beginning in January 1, 2013.²

There are some additional wrinkles to this rule, however, that make it slightly less clear cut. The law has been written so that it only applies to individuals whose Gross Income is greater than \$200,000 for individuals or \$250,000 for couples. Also, the rate is applied to the *lesser* of an individual's modified Adjusted Gross Income (AGI) in excess of the income thresholds or an individual's net investment gains.³ For example, if an entrepreneur's AGI is \$350,000 and her capital gains proceeds are \$50,000, the 3.8% rate would be applied to the \$50,000 in capital gains, not the \$150,000 by which her income exceeds the individual high-earner threshold.

Unfortunately, any benefit from this "lesser of" approach largely disappears in scenarios where there is a large cash payout to private company shareholders like those typically associated with a successful recapitalization or sale of the business. So let's adjust our example from above to highlight the potential tax implications for a 2013 minority recapitalization of 10% of the business at valuation of 7.0x \$5 million in EBITDA. If our entrepreneur John earns wages of \$300,000 and is unmarried in 2013, all of his additional earnings will be eligible for the Medicare tax rate. Disregarding any deductions, his AGI would be \$3.8 million and he would owe Medicare taxes on all but the first \$200,000 below the income threshold. This comes out to an additional \$136,800 in taxes in 2013.

2013 Tax Analysis	
	2013
Income from Wages	\$ 300,000
Capital Gains	3,500,000
Adjusted Gross Income	3,800,000
Income Threshold	200,000
Earnings Affected by Medicare Taxes	3,600,000
Additional Medicare Taxes Owed	<u>\$ 136,800</u>

To explore the Medicare tax changes a little further, we have extended the previous example from the capital gains discussion. We can use the same scenario, but this time we will compare John's proceeds in 2010 to his proceeds in 2013. With the exception of someone who has investment losses to offset his capital gains, the Medicare tax rate will always be applied to at least the entire investment gain associated

² http://money.cnn.com/2010/3/22/news/economy/medicare_tax_increase/

³ Deloitte *Tax News & Views*, http://www.deloitte.com/view/en_US/us/Insights/Browse-by-Content-Type/Newsletters/tax-new-views/af337a0e9fb87210VgnVCM100000ba42f00aRCRD.htm

with a successful exit. The charts below show how the cumulative change of 8.8% in the capital gains tax rate affects returns from 2010 to 2013. Again, the third column shows the EBITDA necessary to maintain after tax proceeds in the face of increasing tax rates. This represents a total growth in EBITDA of 11.6% or a compound annual growth rate (CAGR) of 3.7%.

Cumulative 2011 Cap Gains Increase and 2013 Medicare Tax Returns Analysis			
<i>\$ millions</i>	2010	2013	
		No Growth	Growth
EBITDA	5.00	5.00	5.58
Valuation at 7.0x EBITDA	35.00	35.00	39.04
Capital Raised	3.50	3.50	3.90
After Tax Proceeds to John	2.98	2.67	2.98

When a discount rate is applied, the gap between current EBITDA and the level necessary to maintain after tax returns grows even further. In the below scenario, a 10% discount rate requires total EBITDA growth of 48.5% or a CAGR of 14.1% just to maintain shareholder value in light of the increasing tax burden.

Cumulative 2011 Cap Gains Increase and 2013 Medicare Tax Returns Analysis w/ Discount Rate			
<i>\$ millions</i>	2010	2013	
		No Growth	Growth
EBITDA	5.00	5.00	7.42
Valuation at 7.0x EBITDA	35.00	35.00	51.96
Capital Raised	3.50	3.50	5.20
After Tax Proceeds to John	2.98	2.67	3.96
PV After Tax Proceeds to John at 10% Discount Rate	2.98	2.00	2.98

Conclusion

We certainly don't believe that an entrepreneur should make significant changes in the long term plans for his or her business based only on likely changes in the tax code. There are many reasons to consider partnering with an experienced and reputable financial partner who can help you build your business to its maximum potential. There are also reasons unrelated to taxes that might prompt an entrepreneur to seek partial liquidity for himself or other shareholders, including "peace of mind" or allowing outside shareholders no longer involved with the business to pursue other interests. However, if you or your shareholders are currently considering a capital raise and/or would like to consider realizing some liquidity on part of your investment over the next 12 months, it may well make sense to accelerate the timing to beat the December 31, 2010 deadline. Even if you have a longer term horizon (e.g. perhaps you are considering a recapitalization in the next 3 years) there is now an extra incentive to think about obtaining at least partial liquidity before the increase in Medicare taxes on January 1, 2013. And, remember, the tax rate increases discussed above are only those we know about today and only those occurring at the federal level. Given the fiscal burdens facing both the federal and state governments and current political realities, it seems highly likely that successful entrepreneurs will face even greater tax burdens than those contemplated in this paper in the fiscal years after 2010.

If you would like to learn more about Ballast Point Ventures, please visit our website at www.ballastpointventures.com. We would also be happy to speak with you further about the issues raised in this paper and also tell you more about our long term, relationship-oriented approach to partnering with talented entrepreneurs who are building outstanding private growth companies.