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# *Business Valuation in the Wake of the Tax Cuts and Jobs Act*

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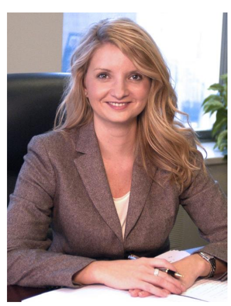

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# *Business Valuation in the Wake of the Tax Cuts and Jobs Act*

INTRODUCTION

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## *Business Valuation in the Wake of the TCJA*

INTRODUCTION

- ***Tax Cuts and Jobs Act passed on December 20, 2017, enacted on December 22, 2017***
  - This tax reform legislation was based on numerous attempts over more than 20 years to reform the U.S. Tax Code, over many Presidential administrations and Congressional sessions
    - The most recent attempts are based on the Tax Reform Act of 2014, introduced by Dave Camp, Chair / House Ways and Means Committee
    - The core elements and goals of the 2015 drafted legislation set forth in the *Unified Framework for Fixing Our Broken Tax Code* (Sept 27, 2017)

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## *Business Valuation in the Wake of the TCJA*

### INTRODUCTION

- ***Consideration for companies and business owners***
  - Future impact on businesses and cash flow
- ***Consideration for legal counsel***
  - Impact on estate planning
  - Impact on potential disputes
- ***Consideration for valuators***
  - As will be discussed today, the impact on approaches utilized and assumptions relied upon

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## *Business Valuation in the Wake of the Tax Cuts and Jobs Act*

### RELEVANT TAX REFORM PROVISIONS FOR VALUATION CONSIDERATIONS

## Business Valuation in the Wake of the TCJA

### RELEVANT TAX REFORM PROVISIONS FOR VALUATION

- ***Provisions that will impact valuation:***
  - Corporate and Individual Tax Rates
  - Limitations on the Deductibility of Interest
  - Capital Expenditure Cost Recovery
  - Research and Experimental Expenditures
  - Net Operating Losses
  - Temporary Sunset Provisions



## Business Valuation in the Wake of the TCJA

### RELEVANT TAX REFORM PROVISIONS FOR VALUATION

- ***Reduced Individual Marginal Income Tax Rates***
  - An individual taxpayer who receives business income from a pass-through business entity is taxed on that income at the regular individual income tax rates
  - For the 2017 tax year, the highest marginal income tax rate for individuals is 39.6%
  - For tax years beginning after December 31, 2017 through December 31, 2025, the maximum marginal tax rate is 37%

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### RELEVANT TAX REFORM PROVISIONS FOR VALUATION

- ***Corporate Income Tax Rate Reduction***
  - Permanently reduced to a 21% flat rate (graduated rates ranging from 15% to 35% under prior law)
  - Effective for tax years beginning after December 31, 2017
  - Proration of rates under Section 15 for tax years spanning effective dates of change (fiscal year corporations)
    - Some question as to whether these rules even apply to the corporate rate

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### RELEVANT TAX REFORM PROVISIONS FOR VALUATION

- ***Business Interest Limitation***
  - Significantly changes traditional deduction for business interest
  - Limited to sum of business income, floor plan financing interest and 30% of taxpayer's "adjusted taxable income"
  - Exception for small businesses ($25 million gross receipts test)
  - "Real Property Trade or Businesses" can elect to be excluded from the limitation (once made, election is irrevocable) – trade-off is to forgo bonus depreciation

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## Business Valuation in the Wake of the TCJA

### RELEVANT TAX REFORM PROVISIONS FOR VALUATION

- ***Business Interest Limitation***
  - Amount of interest not allowed as deduction may be carried forward indefinitely (restrictions apply for pass-through entities)
  - Applies to partnerships and S corps at "pass-through entity" level
  - Disallowed interest (for pass-through entities) cannot be carried forward; it is treated as "allocated excess business interest" to be dealt with at the partner or shareholder level

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### RELEVANT TAX REFORM PROVISIONS FOR VALUATION

- ***Changes to Bonus Depreciation Rules***
  - Bonus depreciation rate increases to 100% for property placed in service after September 27, 2017 and before January 1, 2023
  - The rate will phase down each year until it expires after 2026
  - Removes "qualified improvement property" as separate category
  - Eliminates the requirement that only "new" property is eligible
  - Special rules apply for certain industries and businesses

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## *Business Valuation in the Wake of the TCJA*

### RELEVANT TAX REFORM PROVISIONS FOR VALUATION

- ***Section 179 Expensing***
  - Permanently increases dollar limitation to $1 million and investment limitation to $2.5 million
  - Effective for tax years beginning after December 31, 2017
  - Expands definition of eligible "qualified real property"

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## *Business Valuation in the Wake of the TCJA*

### RELEVANT TAX REFORM PROVISIONS FOR VALUATION

- ***Research and Experimental Expenditures***
  - The TCJA effectively eliminates the "current " deduction alternative for research and experimentation
  - Expenses incurred after 2021, deduction remains, but reduced accounting options, effective for expenses incurred after 2021

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## Business Valuation in the Wake of the TCJA

### RELEVANT TAX REFORM PROVISIONS FOR VALUATION

- ***Net Operating Losses (NOLs)***
  - Historically, a net operating loss was permitted to be carried back two years and carried forward 20 years to offset taxable income in such years.
  - Different carryback periods were applied with respect to NOLs arising in varying circumstances.

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## Business Valuation in the Wake of the TCJA

### RELEVANT TAX REFORM PROVISIONS FOR VALUATION

- ***Net Operating Losses (NOLs)***
  - Changes applicable for NOLs *arising* in tax years beginning after December 31, 2017:
    - No longer allowed to be carried back (with limited exceptions)
    - Can be carried forward indefinitely (20-year limitation repealed)
    - Amount of future income that can be offset is reduced from 100% to 80% for losses occurring in tax years beginning after December 31, 2017

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## Business Valuation in the Wake of the TCJA

### RELEVANT TAX REFORM PROVISIONS FOR VALUATION

- ***Sunset Provisions***
  - All of the substantive provisions affecting individual taxpayers are currently applicable in tax years 2018 through 2025
    - At the end of this period, all of the provisions expire, and the tax law in 2026 will revert to the law in force in 2017
    - Presumes Congress will not see fit to extend the provisions beyond 2025
  - Main changes in the corporate tax rate provisions are, by and large, permanent

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# Business Valuation in the Wake of the Tax Cuts and Jobs Act

## INCOME APPROACH CONSIDERATIONS

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## *Business Valuation in the Wake of the TCJA*

### INCOME APPROACH CONSIDERATIONS

- ***Value is equal to all future economic benefits that will inure to a holder of an asset over an investment period, reduced to a present value at a particular date of valuation.***
  - Two Primary Methods Under the Income Approach
    - Discounted Cash Flow
    - Capitalization of Free Cash Flow

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## *Business Valuation in the Wake of the TCJA*

### INCOME APPROACH CONSIDERATIONS

- ***Model Selection and Application***
- ***Free Cash Flow Calculations***
- ***Risk (Discount) Rate Implications***

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## Business Valuation in the Wake of the TCJA

### INCOME APPROACH CONSIDERATIONS

- ***Model Selection and Application***
  - Discounted Cash Flow Model (DCF)
    - Forecasts cash flows over a discrete forecast period
    - Allows for significant modeling flexibility and varying growth rates
    - Typically involves a terminal value calculation at the end of the discrete period

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## Business Valuation in the Wake of the TCJA

### INCOME APPROACH CONSIDERATIONS

- ***Model Selection and Application***
  - Capitalization of Cash Flow Model (CCF)
    - Assumes that cash flows will grow at a constant growth rate into perpetuity
    - Less flexible than a DCF Model, but appropriate for companies with steady year over year growth in free cash flow

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## *Business Valuation in the Wake of the TCJA*

### INCOME APPROACH CONSIDERATIONS

- ***Model Selection and Application***
  - Critical determination under the Income Approach is the point in time at which growth in cash flows is expected to stabilize
    - Based on when all of the contributing factors to free cash flow are expected to grow at a constant and sustainable rate
      - Profitability, Capital Expenditures, Working Capital

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## *Business Valuation in the Wake of the TCJA*

### INCOME APPROACH CONSIDERATIONS

- ***Model Selection and Application***
  - Provisions of the TCJA could affect when it is reasonable to assume constant growth in free cash flows
    - Ex. Sunset provisions of the TCJA could create material changes in cash flow year over year even if overall financial performance (excluding tax considerations) remained identical to a prior year

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### INCOME APPROACH CONSIDERATIONS

- ***Free Cash Flow Calculations***

  Free Cash Flow to Invested Capital =

  Net Income + Depreciation + [Interest Expense * (1 – Tax Rate)] – Capital Expenditures – Working Capital Investment

  - Represents the amount of cash flow available to all holders of invested capital (debt and equity)

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## Business Valuation in the Wake of the TCJA

### INCOME APPROACH CONSIDERATIONS

- ***Free Cash Flow Calculations***
  - Key Considerations
    - Federal Income Tax Rates
    - Deductions
    - Net Operating Losses

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# Business Valuation in the Wake of the TCJA

## INCOME APPROACH CONSIDERATIONS

- ***Free Cash Flow Calculations – Federal Income Tax Rates***
  - Prior to the TCJA
    - C Corporations taxed under a graduated rate system with the highest marginal rate being 35.0%
  - Under the TCJA
    - C Corporations taxed at a flat 21.0% rate

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# Business Valuation in the Wake of the TCJA

## INCOME APPROACH CONSIDERATIONS

- ***Free Cash Flow Calculations – Federal Income Tax Rates***
  - Magnitude of tax benefit from reduced rates will vary from company to company
    - Benefit will not simply be the difference in cash flow associated with the tax rate reduction, but rather the difference in the effective tax rates paid by companies after taking advantage of all of the provisions of the new law compared to the old

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## Business Valuation in the Wake of the TCJA

### INCOME APPROACH CONSIDERATIONS

- ***Free Cash Flow Calculations – Federal Income Tax Rates***
  - Ex. ABC, Inc.
    - $20.0 million in taxable income
    - Prior to TCJA – State Taxes: 10.0% Federal Taxes: 35.0%
    - Under the TCJA – State Taxes: 10.0% Federal Taxes: 21.0%

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## Business Valuation in the Wake of the TCJA

### INCOME APPROACH CONSIDERATIONS

- ***Free Cash Flow Calculations – Federal Income Tax Rates***

| | Prior to TCJA | Under the TCJA |
|---|---|---|
| Pre-Tax Income | $ 20,000,000 | $ 20,000,000 |
| State Income Taxes @ 10.0% | (2,000,000) | (2,000,000) |
| Federal Taxable Income | 18,000,000 | 18,000,000 |
| Federal Income Taxes | (6,300,000) | (3,780,000) |
| After-Tax Income | 11,700,000 | 14,220,000 |
| Total Provision for Income Taxes | 8,300,000 | 5,780,000 |
| Effective Tax rate | 41.5% | 28.9% |

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## Business Valuation in the Wake of the TCJA

### INCOME APPROACH CONSIDERATIONS

- ***Free Cash Flow Calculations - Deductions***
  - Key Considerations
    - Interest Expense
    - Capital Expenditures (in the form of depreciation)
    - Research and Experimental Expenditures

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## Business Valuation in the Wake of the TCJA

### INCOME APPROACH CONSIDERATIONS

- ***Free Cash Flow Calculations – Interest Expense***
  - In calculating free cash flow to invested capital, the cash flow impact of interest expense and the corresponding income tax benefit is added back to net income
  - Limiting interest expense does not change the output of our previous free cash flow equation, but it does require an adjustment to the underlying equation

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### INCOME APPROACH CONSIDERATIONS

- ***Free Cash Flow Calculations – Interest Expense***

  Free Cash Flow to Invested Capital =
  Net Income
  \+ Depreciation
  \+ Deductible Interest Expense*(1 – Tax Rate)
  \+ Nondeductible Interest Expense
  – Capital Expenditures
  – Working Capital Investment

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### INCOME APPROACH CONSIDERATIONS

- ***Free Cash Flow Calculations – Interest Expense***

  - Implications of limiting the deduction of interest expense
    - Debt financing is more costly for companies than before
    - Interest expense deduction limit is not static year over year due to how it is calculated
      - This could create significant year over year valuation impacts, altering current income tax liabilities

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### INCOME APPROACH CONSIDERATIONS

- ***Free Cash Flow Calculations – Interest Expense***
  - Ex. A highly leveraged company might have a poor year in profitability, reducing its adjusted taxable income and therefore reducing the maximum allowable interest expense deduction
  - Company might be recognizing a loss after factoring total interest expense in, but may be required to recognize taxable income if not all of the interest expense is deductible

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## Business Valuation in the Wake of the TCJA

### INCOME APPROACH CONSIDERATIONS

- ***Free Cash Flow Calculations – Interest Expense***
  - Company could be faced with paying both taxes and interest expense in a year of low profitability
  - Note: Any disallowed interest will be permitted under the law to be carried forward indefinitely.
    - Modeling disallowed interest will require a determination of when the interest may be deductible

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## *Business Valuation in the Wake of the TCJA*

### INCOME APPROACH CONSIDERATIONS

- ***Free Cash Flow Calculations – Capital Expenditures***
  - TCJA accelerates the recognition of depreciation expense
  - Depreciation is a non-cash expense but it provides a cash flow benefit as a deduction in calculating taxable income
  - Assuming no changes in tax rates, the total depreciation benefit over an asset's useful life will be the same, but accelerating the recognition of the benefit increases its present value

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## *Business Valuation in the Wake of the TCJA*

### INCOME APPROACH CONSIDERATIONS

- ***Free Cash Flow Calculations – Capital Expenditures***
  - Lower federal income tax rates will reduce the income tax benefit of depreciation and decrease its present value
  - Accelerated recognition of depreciation expense will increase the present value of the depreciation tax benefit

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# Business Valuation in the Wake of the TCJA

## INCOME APPROACH CONSIDERATIONS

- ***Free Cash Flow Calculations – Capital Expenditures***
  - DEF, Inc. is planning to invest $2.0 million into a new piece of equipment with a useful life of 5 years
  - Assumptions
    - Prior to the TCJA – 41.5% Tax Rate, $500,000 Expensed Under Section 179, Additional 50% Bonus Depreciation, and Half Year MACRS Rates
    - Under the TCJA – 28.9% Tax Rate, Full $2.0 Million Expensed Immediately

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# Business Valuation in the Wake of the TCJA

## INCOME APPROACH CONSIDERATIONS

- ***Free Cash Flow Calculations – Capital Expenditures***

| Prior to the TCJA | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | Year 6 |
|---|---|---|---|---|---|---|
| Depreciation Expense | 1,404,000 | 238,400 | 143,040 | 85,824 | 85,824 | 42,912 |
| Tax Rate | 41.5% | 41.5% | 41.5% | 41.5% | 41.5% | 41.5% |
| Tax Savings | 582,660 | 98,936 | 59,362 | 35,617 | 35,617 | 17,808 |
| Present Value Factors at 12.0% | 0.8929 | 0.7972 | 0.7118 | 0.6355 | 0.5674 | 0.5066 |
| Present Value of Tax Savings | 520,232 | 78,871 | 42,252 | 22,635 | 20,210 | 9,022 |
| Total Present Value of Tax Savings | 693,223 | | | | | |

| Under the TCJA | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | Year 6 |
|---|---|---|---|---|---|---|
| Depreciation Expense | 2,000,000 | - | - | - | - | - |
| Tax Rate | 28.9% | 28.9% | 28.9% | 28.9% | 28.9% | 28.9% |
| Tax Savings | 578,000 | - | - | - | - | - |
| Present Value Factors at 12.0% | 0.8929 | 0.7972 | 0.7118 | 0.6355 | 0.5674 | 0.5066 |
| Present Value of Tax Savings | 516,071 | - | - | - | - | - |
| Total Present Value of Tax Savings | 516,071 | | | | | |
| | | | | | | |
| Difference Between New Law and Old Law | (177,152) | | | | | |

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## Business Valuation in the Wake of the TCJA

### INCOME APPROACH CONSIDERATIONS

- ***Free Cash Flow Calculations – Capital Expenditures***
  - Change in present value driven by:
    - Change in expensing provisions (increase in present value under TCJA)
    - Change in tax rates (decrease in present value under TCJA)
  - Net Change = change due to expensing + change due to tax rates
    - $47,848 + (225,000) = (177,152)

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## Business Valuation in the Wake of the TCJA

### INCOME APPROACH CONSIDERATIONS

- ***Free Cash Flow Calculations – Capital Expenditures***
  - Takeaways
    - Present value of tax benefit will be lower under the new law than the old law due to lower tax rates (acting to decrease a company's value)
    - For a profitable company, the overall decrease in total taxes paid in each period more than offsets the lower present value of the depreciation tax benefit, resulting in an overall net increase in value

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## *Business Valuation in the Wake of the TCJA*

### INCOME APPROACH CONSIDERATIONS

- ***Free Cash Flow Calculations – Research & Experimentation Expenditures***
  - After 2021, existing methods for expensing R&E expenditures will be eliminated
  - The eliminated methods are the methods that allow accelerated recognition of these expenses
  - Lower tax rates, coupled with a more delayed recognition of these expenses will decrease their present value

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### INCOME APPROACH CONSIDERATIONS

- ***Free Cash Flow Calculations – Net Operating Losses (NOLs)***
  - Key Considerations
    - NOLs no longer allowed to be carried back to pre-loss years (previously up to two years)
    - NOLs can be carried forward indefinitely (previously only 20 years)
    - NOLs arising in a tax year after December 31, 2017 can only reduce 80% of taxable income in any remaining carryback or carryforward year (previously 100%)

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## Business Valuation in the Wake of the TCJA

### INCOME APPROACH CONSIDERATIONS

- ***Free Cash Flow Calculations – Net Operating Losses (NOLs)***
  - In aggregate, the TCJA provisions will negatively impact the present value of NOLs going forward as they primarily work to defer their use further into the future
  - Note that, like the depreciation tax benefit, the dollar amount associated with a NOL will also be lower going forward due to lower tax rates

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## Business Valuation in the Wake of the TCJA

### INCOME APPROACH CONSIDERATIONS

- ***Free Cash Flow Calculations – Net Operating Losses (NOLs)***
  - Companies with existing deferred tax assets reflective of future use of NOL carryforwards may see significant decreases in their total assets on their balance sheets as the value of these benefits is adjusted downward

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## *Business Valuation in the Wake of the TCJA*

### INCOME APPROACH CONSIDERATIONS

- ***Discount Rates***
  - The most appropriate discount rate for free cash flows to invested capital holders is the weighted average cost of capital (WACC)

  WACC = (Weight Equity * Cost of Equity) + [Weight Debt * Cost of Debt * (1 – Tax Rate)]

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## *Business Valuation in the Wake of the TCJA*

### INCOME APPROACH CONSIDERATIONS

- ***Discount Rate***
  - Considerations
    - Capital Structure
    - Cost of Debt
    - Cost of Equity

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## Business Valuation in the Wake of the TCJA

### INCOME APPROACH CONSIDERATIONS

- ***Discount Rate – Capital Structure***
  - Optimal capital structures will vary from company to company based on differences in the stage of their life cycles, industry risks, competitive pressures, and company specific risks
  - Debt generally creates more strain on a company's financial position due to contractual repayments, loan covenants, and default risk

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## Business Valuation in the Wake of the TCJA

### INCOME APPROACH CONSIDERATIONS

- ***Discount Rate – Capital Structure***
  - Debt financing is generally significantly less expensive than equity financing and interest expense is often tax deductible, thereby creating tax savings
  - All else equal, limiting the deduction of interest expense makes debt financing less attractive
  - It remains to be seen whether or not the provisions of the TCJA will create any material shifts in capital structures on a market-wide basis

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## *Business Valuation in the Wake of the TCJA*

### INCOME APPROACH CONSIDERATIONS

- ***Discount Rates – Cost of Debt***
  - The pre-tax cost of debt is the interest rate at which debt financing is available to a company
  - Due to the deductibility of interest expense, the true cost of debt is lower by a factor of (1 – Tax Rate)
    - Lower corporate tax rates under the TCJA will therefore increase the after-tax cost of debt
    - Higher discount rates decrease present value calculations

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## *Business Valuation in the Wake of the TCJA*

### INCOME APPROACH CONSIDERATIONS

- ***Discount Rates – Cost of Debt***
  - It is unclear as to whether or not the TCJA will impact rates charged by lenders (pre-tax cost of debt)
  - Ex. 6.0% Pre-Tax Cost of Debt

| | Prior to TCJA | Under the TCJA |
|---|---|---|
| Pre-Tax Cost of Debt | 6.0% | 6.0% |
| Tax Rate | 41.5% | 28.9% |
| After-Tax Cost of Debt* | 3.5% | 4.3% |

**After-Tax Cost of Debt = Pre-Tax Cost of Debt * (1 - tax rate)*

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## Business Valuation in the Wake of the TCJA

### INCOME APPROACH CONSIDERATIONS

- ***Discount Rates - Cost of Equity***
  - Build-Up Method

Cost of Equity = Risk-Free Rate + Equity Risk Premium + Size Risk Premium + Company Specific Risk Premium

*At the current time, there is not sufficient information to quantify any expected changes in the cost of equity due to the passage of the TCJA*

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## Business Valuation in the Wake of the TCJA

### INCOME APPROACH CONSIDERATIONS

- ***Discount Rates – Cost of Equity***
  - Build-Up Method Example

| | Prior to TCJA | Under the TCJA |
|---|---|---|
| Risk-Free Rate | 2.6% | 2.6% |
| Equity Risk Premium | 6.0% | 6.0% |
| Small Company Market Premium | 5.6% | 5.6% |
| Company Specific Risk Premium | 3.0% | 3.0% |
| **Cost of Equity** | **17.2%** | **17.2%** |

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## Business Valuation in the Wake of the TCJA

### INCOME APPROACH CONSIDERATIONS

- ***Discount Rates – Weighted Average Cost of Capital***
  - Assumptions
    - 17.2% Cost of Equity
    - 6.0% Pre-Tax Cost of Debt (3.5% After-Tax Prior to the TCJA and 4.3% After-Tax Under the TCJA)
    - Capital Structure 70% Equity 30% Debt

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## Business Valuation in the Wake of the TCJA

### INCOME APPROACH CONSIDERATIONS

- ***Discount Rates – Weighted Average Cost of Capital***

WACC PRIOR TO THE TCJA

| | Weight | Cost | Weighted Cost |
|---|---|---|---|
| Equity | 70.0% | 17.2% | 12.0% |
| Debt | 30.0% | 3.5% | 1.1% |
| | | WACC | 13.1% |

WACC UNDER THE TCJA

| | Weight | Cost | Weighted Cost |
|---|---|---|---|
| Equity | 70.0% | 17.2% | 12.0% |
| Debt | 30.0% | 4.3% | 1.3% |
| | | WACC | 13.3% |

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## Business Valuation in the Wake of the TCJA

### INCOME APPROACH CONSIDERATIONS

- ***Basic Valuation Example***
  - $2.0 million in cash flow expected over the next year expected to grow by 3% thereafter
  - WACC = 13.3%

$$Present\ Value = \frac{\$2{,}000{,}000}{(13.3\% - 3\%)} \approx \$19.4 \text{ million}$$

PRESENT VALUE SENSITIVITY TO WACC

| | Weighted Average Cost of Capital | | | | | | |
|---|---|---|---|---|---|---|---|
| | 13.3% | 11.0% | 12.0% | 13.0% | 14.0% | 15.0% | 16.0% |
| Present Value | $ 19.4M | $ 25.0M | $ 22.2M | $ 20.0M | $ 18.2M | $ 16.7M | $ 15.4M |

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## Business Valuation in the Wake of the TCJA

### INCOME APPROACH CONSIDERATIONS

- ***Growth Expectations***
  - Lower tax rates may not be a dollar-for-dollar tradeoff
    - Ex. Price-Competitive Industries
  - Much of the intent of the TCJA is to spur economic growth

## Business Valuation in the Wake of the TCJA

### INCOME APPROACH CONSIDERATIONS

- ***Summary***
  - TCJA will impact the Income Approach:
    - Model selection
    - Cash flow calculations
    - Discount rates
    - The most impactful element will be the change in the federal corporate income tax rate

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## Business Valuation in the Wake of the Tax Cuts and Jobs Act

### MARKET APPROACH CONSIDERATIONS

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## *Business Valuation in the Wake of the TCJA*

### MARKET APPROACH

- ***Definition of Market Approach (International Glossary)***
  - "...a general way of determining a value indication of a business, business ownership interest, security, or intangible asset by using one or more methods that compare the subject to similar businesses, business ownership interests, securities, or intangible assets that have been sold."
- ***Practical Application***
  - Apply market-based multiples to subject company metrics

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## *Business Valuation in the Wake of the TCJA*

### MARKET APPROACH

- ***Methods***
  - Guideline transaction (merged and acquired) method
  - Guideline public company method
  - Past completed transactions method, and
  - Rules of thumb

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## *Business Valuation in the Wake of the TCJA*

### MARKET APPROACH

- ***Impact on Guideline Transaction Method***
  - Increase in free cash flow will increase business values
  - Impact on transaction multiples
    - After-Tax Multiples
    - Pre-Tax Multiples
  - Sufficient level of data may be unattainable under the Guideline Transaction Method in the short-term

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## *Business Valuation in the Wake of the TCJA*

### MARKET APPROACH

- ***Impact on Guideline Transaction Method***

| | Old Law | New Law | Change |
|---|---|---|---|
| Cash Flow | $ 3,340 | $ 3,844 | $ 504 |
| Cash Clow Capitalization Rate | 14.0% | 14.0% | - |
| **Business Value/Purchase Price** | **$ 23,857** | **$ 27,457** | **$ 3,600** |

| | Old Law | New Law | Change |
|---|---|---|---|
| **Business Value/Purchase Price** | **$ 23,857** | **$ 27,457** | **$ 3,600** |
| *Revenue Multiple* | *0.80* | *0.92* | *0.12* |
| *EBITDA Multiple* | *4.77* | *5.49* | *0.72* |
| *EBIT Multiple* | *5.96* | *6.86* | *0.90* |
| *Cash Flow Multiple* | *7.14* | *7.14* | - |

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## Business Valuation in the Wake of the TCJA

### MARKET APPROACH

- ***Impact on Guideline Transaction Method***

| | Tax Rate | Actual | Tax Rate | Adjusted | Change | % Change |
|---|---|---|---|---|---|---|
| Revenue | | $ 12,500 | | $ 12,500 | | |
| EBITDA | | $ 2,500 | | $ 2,500 | $ - | 0.0% |
| Less: D&A | | (500) | | (500) | - | 0.0% |
| EBIT | | 2,000 | | 2,000 | - | 0.0% |
| Less: Taxes | 41.5% | (830) | 28.9% | (578) | 252 | -30.4% |
| Earnings | | 1,170 | | 1,422 | 252 | 21.5% |
| Plus: D&A | | 500 | | 500 | - | 0.0% |
| Cash Flow | | 1,670 | | 1,922 | 252 | 15.1% |
| **Actual Business Value/Purchase Price** | | **$ 10,000** | | | | |
| Cash Flow Multiple | | 6.0 | | 6.0 | | |
| **Adjusted Business Value/Purchase Price** | | | | **$ 11,510** | | |

| **Implied Multiples** | **Actual** | **Adjusted** | **Change** | **% Change** |
|---|---|---|---|---|
| *Multiple of Revenue* | *0.8* | *0.9* | *0.12* | *15.1%* |
| *Multiple of EBITDA* | *4.0* | *4.6* | *0.60* | *15.1%* |
| *Multiple of EBIT* | *5.0* | *5.8* | *0.76* | *15.1%* |
| *Multiple of Cash Flow* | *6.0* | *6.0* | *0.00* | *0.0%* |

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## Business Valuation in the Wake of the TCJA

### MARKET APPROACH

- ***Impact on Guideline Public Company Method***
  - Efficient market hypothesis
  - Impact on public stock performance (page 46)
  - Considerations for valuators
    - Date of valuation considerations
    - Matching multiples and benefit streams
    - Application to subject company

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# Business Valuation in the Wake of the Tax Cuts and Jobs Act

## COST/ASSET APPROACH CONSIDERATIONS

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## Business Valuation in the Wake of the TCJA

### COST/ASSET APPROACH CONSIDERATIONS

- ***Required to be considered in every valuation prepared in accordance with professional standards***
  - Approach is relatively easy to understand
    - Based on the economic principle of substitution
    - Breaks down a company into a set of assets and liabilities that will act as the elementary units in developing its value
    - Determination of value is predicated upon an assessment of the current value of the subject company's assets and liabilities

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## Business Valuation in the Wake of the TCJA

### COST/ASSET APPROACH CONSIDERATIONS

- ***Methods under the Cost/Asset Approach:***
  - Asset Accumulation Method;
  - Excess Earnings Method;
  - Rules of Thumb (Asset-Based); and
  - Sellers Discretionary Cash Flow

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## Business Valuation in the Wake of the TCJA

### COST/ASSET APPROACH CONSIDERATIONS

- ***Asset Accumulation Method/Net Asset Method***
  - Most Common Method
    - The valuator restates all of the assets and liabilities of the subject company from their historical cost basis to the appropriate standard of value
    - After the revaluation of the assets and liabilities from their respective historical cost basis to their fair market value, netting the two adjusted totals is deemed to be the market value of the subject company's equity

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## Business Valuation in the Wake of the TCJA

### COST/ASSET APPROACH CONSIDERATIONS

- ***Built-In Gains Tax – Corporation***
  - If the required asset and liability adjustments generate market asset values that exceed the tax basis of those assets, it is necessary to make an adjustment to reflect the deferred income tax effect of the unrealized gain or loss
  - The amount of the gain is equal to the fair market value of the asset less the tax basis of that asset

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## Business Valuation in the Wake of the TCJA

### COST/ASSET APPROACH CONSIDERATIONS

- ***Impact of the TCJA:***
  - Reduction in the corporate tax rate from 35% to 21%
  - There is no lower preferential rate for capital gain income under subchapter C of the Code
  - Since the change to the tax rate is permanent, the tax liability decreased with the enactment of the TCJA, resulting in an increase in value
  - *See example on page 52*

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## *Business Valuation in the Wake of the TCJA*

### COST/ASSET APPROACH CONSIDERATIONS

- ***Built-in Gain Tax on C Corporation Conversion***
  - The conversion of a C corp into an S corp generally does not trigger an immediate tax liability, but there may be some trailing tax consequences:
    - At the time of the S election, the electing C corp is required to calculate the amount of built-in gain that it has in each of its assets
    - If any of these assets are sold during the five-year period following the date of the conversion, this built-in gain will be subjected to income tax at the corporate level as if the corporation remained a C corp

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## *Business Valuation in the Wake of the Tax Cuts and Jobs Act*

C CORPORATION VS. S CORPORATION

VALUATION ISSUES

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## Business Valuation in the Wake of the TCJA

### C CORP VS. S CORP VALUATION ISSUES

- ***Support for Tax Affecting S Corporations***
  - Standard of Value
  - Proper Application of Risk Rate
  - Control/Minority Interests
  - Lack of Market Confirmation

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## Business Valuation in the Wake of the TCJA

### C CORP VS. S CORP VALUATION ISSUES

- ***Valuing S Corporations After the TCJA***
  - Calculate the value as if it were a C corporation
  - Account for differences between corporate and individual income tax rates
  - Calculate the benefit of the avoidance of dividends tax
  - Quantify the ability to build-up basis in S corporation stock

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## *Business Valuation in the Wake of the TCJA*

### C CORP VS. S CORP VALUATION ISSUES

- ***Valuing S Corporations After the TCJA - Calculate the value as if it were a C Corporation***

| | Prior to TCJA | Under the TCJA |
|---|---|---|
| **Pre-Tax Income** | **$ 20,000,000** | **$ 20,000,000** |
| State Income Taxes @ 10.0% | (2,000,000) | (2,000,000) |
| Federal Taxable Income | 18,000,000 | 18,000,000 |
| Federal Income Taxes | (6,300,000) | (3,780,000) |
| **After-Tax Income** | **11,700,000** | **14,220,000** |
| **Total Provision for Income Taxes** | **8,300,000** | **5,780,000** |
| **Effective Tax rate** | **41.5%** | **28.9%** |

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## *Business Valuation in the Wake of the TCJA*

### C CORP VS. S CORP VALUATION ISSUES

- ***Valuing S Corporations After the TCJA – Tax Rate Differential***
  - Historically the rate differential between the highest corporate and individual income tax rates was minimal
  - PA C corporations have a 28.9% effective tax rate
  - Owners of pass-through interests who actively participate have 40.1% effective rate if the business does not qualify for the QBI deduction and 32.7% if it does qualify

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## Business Valuation in the Wake of the TCJA

### C CORP VS. S CORP VALUATION ISSUES

- ***Valuing S Corporations After the TCJA – Tax Rate Differential***

**PENNSYLVANIA S CORPORATION**

| | | | | | |
|---|---|---|---|---|---|
| Pre-tax Income | | 10,000 | 10,000 | 10,000 | 10,000 |
| 20% QBI Deduction | | - | - | (2,000) | (2,000) |
| Federal Taxable Income | | 10,000 | 10,000 | 8,000 | 8,000 |
| Federal Income Tax | 37.0% | (3,700) | (3,700) | (2,960) | (2,960) |
| Federal Net Inv. Income Tax | 3.80% | - | (380) | - | (304) |
| PA Tax | 3.07% | (307) | (307) | (307) | (307) |
| Net After Taxes | | 5,993 | 5,613 | 4,733 | 4,429 |
| Total Taxes Paid | | 4,007 | 4,387 | 3,267 | 3,571 |
| Effective Tax Rate | | **40.1%** | **43.9%** | **32.7%** | **35.7%** |

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*Figures are in thousands (000)*

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## Business Valuation in the Wake of the TCJA

### C CORP VS. S CORP VALUATION ISSUES

- ***Valuing S Corporations After the TCJA – Tax Rate Differential***
  - In the circumstance that a C corporation has a history of distributing all of its earnings the effective tax rate is 52%
  - If distributions approximated 40% of income, the effective tax rate is 38.1%
    - The remaining 60% will build-up the shareholders basis in the S corp.

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# *Business Valuation in the Wake of the TCJA*

## C CORP VS. S CORP VALUATION ISSUES

- ***Valuing S Corporations After the TCJA – Tax Rate Differential***

| PENNSYLVANIA C CORPORATION 100% DISTRIBUTION | | | PENNSYLVANIA C CORPORATION DISTRIBUTE 40% | | |
|---|---|---|---|---|---|
| Pre-tax Income | | 10,000 | Pre-tax Income | | 10,000 |
| PA Corporate Tax | 9.99% | (999) | PA Corporate Tax | 9.99% | (999) |
| Federal Taxable Income | | 9,001 | Federal Taxable Income | | 9,001 |
| Federal Corporate Tax | 21.0% | (1,890) | Federal Corporate Tax | 21.0% | (1,890) |
| Net Available to Distribute | | 7,111 | Net Available to Distribute | | 7,111 |
| Federal Tax on Distribution | 20.0% | (2,000) | Federal Tax on Distribution | 20.0% | (800) |
| PA Tax on Distribution | 3.07% | (307) | PA Tax on Distribution | 3.07% | (123) |
| Net After Taxes | | 4,804 | Net After Taxes | | 6,188 |
| Total Taxes Paid | | 5,196 | Total Taxes Paid | | 3,812 |
| Effective Tax Rate | | **52.0%** | Effective Tax Rate | | **38.1%** |

*Figures are in thousands (000)*

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# *Business Valuation in the Wake of the TCJA*

## C CORP VS. S CORP VALUATION ISSUES

- ***Valuing S Corporations After the TCJA – Avoidance of Dividends Tax***
  - The benefit for dividend tax avoided considers the benefit attributed to the single level of taxation that an S corporation is subjected to as compared to double taxation of C corporation distributions
  - The double taxation regime of C corporations is no longer the steep penalty it once was

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## Business Valuation in the Wake of the TCJA

### C CORP VS. S CORP VALUATION ISSUES

- ***Valuing S Corporations After the TCJA – Avoidance of Dividends Tax***

**PENNSYLVANIA C CORPORATION**
**VARIOUS DISTRIBUTION LEVELS**

| | | 50% | 60% | 70% | 80% | 90% | 100% |
|---|---|---|---|---|---|---|---|
| Pre-tax Income | | 10,000 | 10,000 | 10,000 | 10,000 | 10,000 | 10,000 |
| PA Corporate Tax | 9.99% | (999) | (999) | (999) | (999) | (999) | (999) |
| Federal Taxable Income | | 9,001 | 9,001 | 9,001 | 9,001 | 9,001 | 9,001 |
| Federal Corporate Tax | 21.0% | (1,890) | (1,890) | (1,890) | (1,890) | (1,890) | (1,890) |
| Net Available to Distribute | | 7,111 | 7,111 | 7,111 | 7,111 | 7,111 | 7,111 |
| Federal Tax on Distribution | 20.0% | (1,000) | (1,200) | (1,400) | (1,600) | (1,800) | (2,000) |
| PA Tax on Distribution | 3.07% | (154) | (184) | (215) | (246) | (276) | (307) |
| Net After Taxes | | 5,957 | 5,727 | 5,496 | 5,265 | 5,034 | 4,804 |
| Total Taxes Paid | | 4,043 | 4,273 | 4,504 | 4,735 | 4,966 | 5,196 |
| Effective Tax Rate | | **40.4%** | **42.7%** | **45.0%** | **47.3%** | **49.7%** | **52.0%** |

*Figures are in thousands (000)* *Assumes active participation in the business*

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## Business Valuation in the Wake of the TCJA

### C CORP VS. S CORP VALUATION ISSUES

- ***Valuing S Corporations After the TCJA – Basis Build-Up***
  - The benefit of the build-up in basis is determined by quantifying the capital gains tax savings upon the eventual sale of the S corporation stock
  - The tax savings on a $5 million basis build up is 22.5% [20% + 3.07%*(1-20%)] or $1,125,000

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## *Business Valuation in the Wake of the TCJA*

### C CORP VS. S CORP VALUATION ISSUES

- ***Valuing S Corporations After the TCJA***
  - S corporations have historically had a tax advantage over C corporations creating some value, which members of the valuation community have used various methods to quantify
  - Valuations of S corporations will continue to be a major topic of discussion

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# *Business Valuation in the Wake of the Tax Cuts and Jobs Act*

## CONCLUDING THOUGHTS AND PRACTICAL CONSIDERATIONS

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## *Business Valuation in the Wake of the TCJA*

### CONCLUDING THOUGHTS

- Pro-business changes in the tax law directly alter future financial projections of a business
  - Reducing income tax should increase cash flow and present an increase in valuation of the subject business
- The effects of the TCJA reach beyond computations of income tax – extending far into economics, financial markets and asset valuations

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## *Business Valuation in the Wake of the TCJA*

### CONCLUDING THOUGHTS

- The impact of the changes that affect valuation are as far reaching as the purpose for which the valuation is used:
  - Transactions
  - Marital dissolutions
  - ESOPs
  - Equity owner buy-outs
  - Gifting and estate planning

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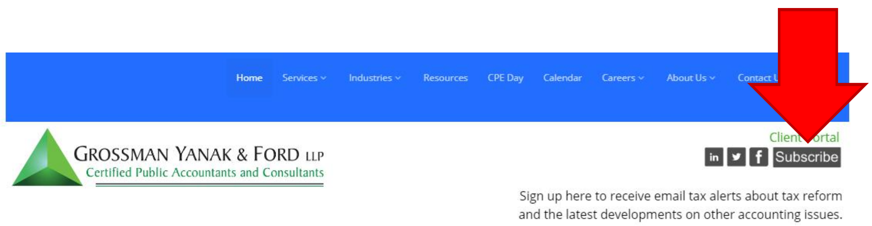
## *Business Valuation in the Wake of the TCJA*

### CONCLUSION AND PRACTICAL CONSIDERATIONS

- ***Please go to our website to subscribe to receive timely updates about tax reform legislation and other issues***

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## *Business Valuation in the Wake of the TCJA*

# FINAL QUESTIONS?

# THANK YOU!