Business Valuation Implications of the Tax Cuts and Jobs Act of 2017

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The end of 2017 ushered in some amazing regulatory and federal tax code changes that will fundamentally change how business ownership interests are valued and how business owners will plan for their retirement and estate objectives. Some of these behavioral aspects will be favorable, while others may be detrimental to the creation of wealth and business continuity.

In April 2017 the President signed Executive Order 13789 directing the U.S. Treasury to examine recent tax regulations to determine whether any of the regulatory projects imposed an undue financial burden on taxpayers, added undue complexity, or exceeded the statutory authority of the IRS. On July 7, 2017 the Treasury released Notice 2017-38 providing an interim list of eight projects identified as subject to the Executive Order. Included in this list were the proposed regulations (REG-163113-02) concerning estate and gift tax under section 2704, and specifically concerning the restrictions on the ability to dispose of or liquidate family controlled entities, by creating an additional category of restrictions that also would be disregarded in assessing the fair market value of an interest.[1] On October 4, 2017 the U.S. Treasury Department released a final report with recommendations for specific actions to mitigate the burden imposed by the proposed regulation. A related Treasury release states that the proposed regulations under section 2704 would be withdrawn because they "…would have hurt family-owned businesses by limiting valuation discounts. The regulations would have made it difficult and costly for families to transfer their businesses to the next generation."

On December 20, 2017, the House and the Senate passed the Tax Cuts and Jobs Act (the "Act"). It was signed into law by the President on December 22nd. The significant overhaul will have immediate and long-term implications on valuations of businesses, equity, and related assets and liabilities, as entities continue to assess the impact on corporate strategy, acquisitions, and financial and tax reporting.[2] Though it will take buyers time to fully assess the impact of the act, investors in public equities appear to view the changes positively with major stock exchanges reaching record high valuations in anticipation of its passage. Some analysts have estimated the replacement of the graduated C-corporation tax rates with a single flat rate of 21% will increase valuations by a minimum of 16%. This is an overly simplistic assessment given the complexity of the Act and its provisions relating to the deductibility of interest, expensing of assets, the phase out of specific provisions, and the associated implications to the cost of both debt and equity components of a specific enterprises capital structure. The above analysis assumes a C-corporation tax structure. The effective tax analysis for pass-through tax entities, including S-corporations, Partnerships, and LLCs, is much more complex.

The longer-term impact on individual entities will evolve with time given the likelihood of future changes to the Act, the risk that assumptions taking its provisions into perpetuity may not be reasonable, and the continuing response by market participants in adjusting their valuation models and methodologies.

[1] Proposed Regulations Under Section 2704 Withdrawn, KPMG LLP

[2] Considering the Impact of the Tax Cuts and Jobs Act on Valuations, Ernst & Young LLP, December 22, 2017

The valuation of an asset under the income approach is based upon the future cash flows generated by the asset and a risk-adjusted discount rate to calculate their present value. Under a discounted future cash flow method ("DCF") as much as 80% of the enterprise value is captured in the terminal period in year five of the forecast. The growth rates and tax attributes are assumed to continue into perpetuity in the final year of the forecast. A major flaw of the Act was in how it was passed causing most of its provisions to sunset on or before January 1, 2026. It would not be appropriate to use a simplified approach by only changing the tax rate used and assuming that other inputs remain constant. Care should be taken when making assumptions to estimate the business value in perpetuity when using an income capitalization model or exit multiple. It is likely market participants will regard the expected profits given the new tax rates as riskier and less certain, which may increase their required rate of return.[3]

The Act changes not only the tax rate, but also the calculation of taxable income[4] regardless of corporate form. Factors to consider include the treatment of capital expenses, limitations on the deductibility of interest expense, and how these limitations will impact the discount rate and amount of debt in the entity's capital structure. It is reasonable to anticipate that more equity, with its comparatively greater costs over debt in an acquirer's capital structure, will be utilized to fund acquisitions. The deductibility of interest expense is limited to 30% of the enterprise EBITDA for the years 2018 through January 1, 2021. For tax years 2021 through 2025, the deduction is limited to 30% of EBIT. Any unused business interest expense may be carried forward indefinitely, though the tax asset value will be a function of effective federal tax rates. Even though the Act lowers tax rates, its limitations on interest deductions may result in increased tax liability to corporations and investors in flow-through businesses that finance acquisitions with debt. This may likely put downward pressure on valuation multiples offsetting part of the increase from reduced tax rates.

The Act provisions for greater immediate expensing of acquired assets should lead to a preference for asset deals over stock purchases by acquirers. Though the immediate deductibility of qualifying acquired business assets placed in service after September 27, 2017 and before January 1, 2023 should support higher valuations, it will also trigger the recognition of built-in capital gains taxes by the sellers. Absent the ability of the parties to take advantage of code section 338(h)10 or 754 elections, it is possible that seller net after-tax proceeds could be unfavorably reduced. Business owners will need to work closely with their legal, tax, and financial advisors to ensure that the enterprise is properly positioned to minimize the effects of transactional form.

The Act establishes a 20% deduction of qualified business income from certain pass-through businesses. Specific services, such as health, law, and professional services, are generally excluded. Single filers with taxable income below $157,000 (deduction phased-out fully at $207,500) can claim the deduction on income from service industries. From a valuation standpoint, this deduction should not have any

[3] Ibid.
[4] Ibid.

meaningful implication under the standard of fair market value which assumes hypothetical parties, not specific investors.
Of importance to all estate and gift advisory service providers is the increase of the exemption to $11.2 million ($22.4 million for married couples). This exemption remains in effect until December 31, 2025, at which time the exemption will revert to the $5 million level indexed for inflation. This is both good and bad for the creation of wealth and orderly ownership succession of closely-held business.

As owners set their business exit goals, they struggle with innumerable emotional issues. These issues range from quality of life issues, to job security of their children and business legacy, to funding their retirement. Often an asset gap, the difference between the financial resources they have versus what they will need, exists. Overestimation of the business' value occurs when owners take a biased view of their companies and assume their companies are worth much more than similar companies, possibly based on an assumed rule of thumb that doesn't really exist.[5]

The existence of a lower life time exemption compelled business owners and their advisors to seek tax efficient strategies to transfer their business ownership interest. An added benefit of these strategies is that they often required the conduct of a complete business valuation. An appraisal is a process of discovery. Elements of this discovery process include the legal audit of corporate organizational form, by-laws, operating agreements, and contracts by legal counsel to the analysis of tax attributes, contingent tax liabilities, debt obligations covenants and guarantees, and operational data by the business' tax and accounting advisors. Another benefit to the owner was the analysis of the strengths, weaknesses, opportunities, and threats (SWOT analysis) to the enterprise, its competitive position, capital investment and product development needs, and discrete forecasting of operational and financial performance. Many owners came away with a new awareness of how to manage the risk and complexities of having children and relatives in key management positions and the resultant value implications. Advisors will need to develop persuasive arguments to avoid complacency and apathy by business owners and convince them to invest in long term value creation and effective estate planning.

In conclusion, how the Tax Cuts and Jobs Act of 2017 will affect the value of a business is not as simple as imputing a 16% increase attributable to the decline in effective C-corporation tax rates. As is frequently the case, the facts and circumstances of a particular asset or ownership interest in an entity is very important in arriving at the ultimate conclusion of value.

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[5] Knowing What You Have to Get What You Need, An Exit Planning Case Study, Family Business Legacies, January 16, 2018