Does the Tax Cut & Jobs Act (TCJA) Trump Business Valuation?

Integra International
November 20, 2018

Donald DeGrazia, CPA/ABV/CFF

Gold Gerstein Group LLC

505 Pleasant Valley Avenue
Moorestown, NJ 08057

Doug White, CPA, MAFF, CVA, CGMA

Glass Jacobson Financial Group

800 King Farm Blvd. #500
Rockville, MD 20850

Views expressed in these written materials and in the related live presentation do not necessarily reflect the professional opinions or positions that the presenter would take in an actual business appraisal assignment, or in providing services in connection with an actual litigation matter. Rather these materials are intended for instructional purposes and as examples of hypothetical situations that may be encountered.

Nothing contained in these written materials, or as orally expressed in the related presentation, shall be construed to constitute the rendering of appraisal advice; the rendering of an opinion as to the propriety of taking a particular position; or the rendering of any other professional opinion or service.

Business appraisal and related litigation services are necessarily fact sensitive. Therefore, participants are urged to apply their expertise to particular fact patterns that they encounter, and to seek competent professional assistance as warranted in the circumstances.

Donald J. DeGrazia, CPA/ABV/CFF
Gold Gerstein Group LLC ▪ DDeGrazia@G3CPA.com

Education
- Graduate of LaSalle University, Philadelphia, PA, Bachelor of Science Degree in Business Administration

Experience
- Partner in the accounting and business valuation firm of Gold Gerstein Group LLC with two offices in NJ; Expert testimony in court and arbitration proceedings relating to matrimonial and minority stockholder litigation, fraud, economic damages, and bankruptcy proceedings; Qualified as an expert witness by Federal, NJ and PA courts; Preparation of valuation reports for businesses and professional practices; Preparation of damage study reports; Accounting, tax and succession planning services for closely-held and family businesses.

Professional Affiliations and Credentials
- Certified Public Accountant (CPA) in NJ and PA; Accreditation in Business Valuation (ABV) and Certified in Financial Forensics (CFF) by the AICPA; Member of Integra International, Inc., worldwide association of independent accounting and consulting firms; Member of Expert Resource Connection, LLC (ERC), national alliance of business valuation and forensic accounting professionals.

Professional Activities
- American Institute of CPAs: Past conference chairman – National Litigation Support Services Conference; Conference Steering Committee member – National Business Valuation Conference and Family Law Conference; Accredited in Business Valuation Examination Committee Virtual Subcommittee to formulate exam questions; Family Law Task Force; “Ask the Experts” panel member of the ABV E-Valuation Alert electronic newsletter.
- New Jersey Society of CPAs: Past Chairman – Valuation & Litigation Services Resource Group; Past Chairman – Business Valuation Interest Group and Matrimonial Accounting Interest Group; Conference Chair – Valuation and Litigation Services Conference.
- Integra International, Inc: Executive Board member and Past Chairman – Global Board; Past President – Americas, Asia & Australia Division.
- Liberty USO of Pennsylvania & Southern New Jersey: Vice-chairman & Treasurer.
- Family Law Services Handbook: John Wiley & Sons, Inc. Co-author/Editor.
- PPC Guide to Divorce Engagements: Editor

Douglas White, CPA, CVA, MAFF, CGMA

Glass Jacobson Financial Group ▪ doug.white@glassjacobson.com

Experience:

- Mr. White has over 30 years of experience in accounting and auditing, management consulting and taxation and litigation support. He has performed engagements for a variety of business, non-profit and governmental entities, and for individuals. Through his work he has gained extensive knowledge of real estate, professional service businesses, retailing, IT and Cyber, government contractors, real estate management & development firms, various non-profit entities, political organizations, and international tax. Mr. White has been designated as an expert witness in Montgomery County and Prince Georges County, Maryland, Fairfax County, Virginia, and in the District of Columbia for domestic relations and civil cases.
  Mr. White currently is a partner at Glass, Jacobson, P.A. He is also licensed as a Life and Health Insurance Agent, and has passed the Series 65 exam (Uniform Investment Advisor Law Exam).

Education:

- Graduate of University of Maryland, 1978, Bachelor of Science Degree in Accounting, graduate with honors

Professional Associations:

- American Institute of Certified Public Accountants, 1981 - Present
- Maryland Association of Certified Public Accountants, 1981 - Present
- National Association of Certified Valuation Analysts, 2004 - Present
- NAIOP Commercial Real Estate Development Association, 1982 - Present
- Integra International, 2000 - Present
- Health & Life Insurance Agent, 2001 – Present

Other:

- Immediate past Global Chairman of Integra International
- Member of Integra International Global Board
- Past President of Integra International – AAA Division
- Board Member on the Maryland Tech Council
- Past President of the Make-A-Wish Foundation of the Mid-Atlantic, Inc.
- Treasurer of NAIOP DC MD
- As well as serving on the Board of other Local Business and Civic Associations

Special thanks to
Michelle Gallagher,
Ron Seigneur, and
Dan Mellor
for their assistance in
preparing these materials.

Tax Cuts and Jobs Act

- It did cut taxes and create jobs, BUT
- Is it simplification or complication?
- Many provisions revert (sunset) to old law in 2025
- Many provisions change between 2018 and 2025
- QBID and other sections' Proposed Regs issued to date … more to come … and likely changes to the Proposed Regs before they become Final Regs

Global Observations

» From an economic standpoint TCJA will favor businesses:

- Currently paying high effective tax rates;
- Investing large amounts in tangible (depreciable) assets; and
- Have little or no debt

The Winning Trifecta (High effective tax rate, high cap ex and low debt to capital ratios)								
Industry Name	*Number of firms*	*Market Capitalization*	*Effective Tax Rate*	*Effective Tax Rate - Market Aggregate*	*Cap Ex/Market Cap*	*Versus Market*	*Debt to Capital*	*Versus Market*
Precious Metals	111	$ 32,455.72	35.62%	10.43%	5.94%	2.80%	15.15%	-8.37%
Transportation (Railroads)	8	$ 212,040.22	37.53%	12.34%	3.92%	0.78%	18.48%	-5.04%
Transportation	18	$ 211,707.26	33.62%	8.43%	5.45%	2.31%	23.09%	-0.42%
Metals & Mining	102	$ 82,571.77	46.08%	20.89%	3.89%	0.76%	23.39%	-0.12%
Oilfield Svcs/Equip.	130	$ 370,355.71	47.00%	21.81%	4.29%	1.16%	23.65%	0.14%
Retail (General)	18	$ 496,744.73	33.84%	8.65%	3.90%	0.76%	23.75%	0.24%
The Losing Trifecta (Low effective tax rate, low cap ex and high debt to capital ratios)								
Industry Name	*Number of firms*	*Market Capitalization*	*Effective Tax Rate*	*Effective Tax Rate - Market Aggregate*	*Cap Ex/Market Cap*	*Versus Market*	*Debt to Capital*	*Versus Market*
Hotel/Gaming	70	$ 330,397.87	19.58%	-5.61%	2.77%	-0.36%	28.52%	5.01%
Diversified	24	$ 946,925.03	21.93%	-3.26%	2.31%	-0.82%	24.52%	1.01%
Computer Services	111	$ 319,191.63	14.82%	-10.37%	1.82%	-1.31%	23.57%	0.05%

Source: Aswath Damodaran, January 2018 Data Update 3: Taxing Questions on Value
http://aswathdamodaran.blogspot.com/2018/01/january-2018-data-update-3-taxing.html

Global BVFLS Considerations under TCJA

- Standard of value and methodology issues
  - Who is the hypothetical willing buyer?
- Cash flow method considerations
- Cost of capital/weighted average cost of capital
- Tax affecting pass-through entities and the QBID
- Reasonable compensation/double dip considerations relating to QBI
- Use of historical data
  - Market based comparable transaction method multiples
  - Equity Risk Premium (historical/supply side)
- **How much tax knowledge will BV professionals be expected to know?**
- Impact on Gift/Estate and M&A BV Practices

Noteworthy – Example of Intended Consequences

- Apple Inc. (AAPL) announced it would **pay a one-time tax of $38 billion on its overseas cash holdings** and ramp up spending in the U.S., as it seeks to emphasize its contributions to the American economy after years of taking criticism for outsourcing manufacturing to China.
- Apple said it would **invest $30 billion in capital spending in the U.S. over five years that would create more than 20,000 jobs**. The total includes a new campus, which initially will house technical support for customers, and **$10 billion toward data centers across the country. It also will expand from $1 billion to $5 billion** a fund it established last year for investing in advanced manufacturing in the U.S.
- All told, Apple said it would directly contribute **$350 billion to the U.S. economy over the next five years, with the bulk—about $55 billion this year**, for example—coming from ongoing spending on parts and services from U.S. suppliers. That number also includes the federal tax payment and capital spending.

Source; WSJ - January 17, 2018

How Will Companies Use Their Tax Savings?

- ATT
  - Invest $1 billion in the U.S. to transition to 5G mobile network.
  - $1,000 bonus to 200,000 employees.
- Lockheed Martin
  - $5 billion cash contribution to fund retirement obligations through 2021.
  - $200 million in Lockheed Ventures fund for employee training and education contributions for STEM.
- McDonalds
  - Invest $150 million toward trade schools and college training for employees.
- Cisco
  - Repatriate $67 billion and using $25 billion for stock buyback.
- Alphabet (Google)
  - $8.6 billion in stock buy backs.
- Detroit Edison
  - Requested cost cuts from vendors and suppliers based on their expected tax savings to be passed through to DTE's customers.

Key Business Changes

» **Lower corporate rate - 21% (flat rate) on all corporations, including PCs**

» **New 20% Qualified Business Income Deduction (QBID) = Lower tax liability for eligible pass-through businesses**

» **Increased expensing of capital items**

» **Business interest deduction limited**

» Domestic Production Activities Deduction (DPAD) repealed

Key Business Changes (con't)

- **Business entertainment expenses no longer deductible**
- Cash basis of accounting now available to businesses with revenue up to $25M
- Active business losses limited
- NOL deduction modified
- Corporate AMT repealed
- Like-kind exchanges limited to real property

Corporate Tax Rate Comparison

Income Range	Old	New	Change
$1 to $50,000	15%	21%	6.0%
$50,001 to $75,000	25%	21%	-4.0%
$75,001 to $10,000,000	34%	21%	-13.0%
Over $10,000,000	35%	21%	-14.0%

§179 Depreciation – Increased & Expanded

- Expense allowed up to $1M of tangible personal property
- Expense phased-out $ for $ if over $2.5M of elected property placed in service
- Expands the definition of qualified tangible personal property and qualified real property eligible to include:
  - tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging
  - improvements to non-residential real property placed in service after the date such property was first placed in service:
    - roofs;
    - heating, ventilation, and air-conditioning;
    - fire protection and alarm systems;
    - and security systems.

Bonus Depreciation Changes

» Immediate deduction at the following declining percentages for eligible property placed in service:

- 100% 09/27/17 – 12/31/2022
- 80% in 2023
- 60% in 2024
- 40% in 2025
- 20% in 2026
- 0% after 2026

» Eligible property expanded to include "used" property

» Reference to qualified improvement property removed

» Bonus depreciation not permitted if using ADS depreciation (see business interest limitation rules)

New Limitation on Business Interest Deduction

- Applies only to businesses with >$25M average gross receipts
- Business interest deduction is limited to 30% of "adjusted taxable income" (basically EBITDA for 2018-2022 and EBIT thereafter)
- Disallowed interest deduction carries forward indefinitely
- Determined at the tax-filer level (e.g. the partnership not the partners would be subject to testing), but it is determined at the consolidated return level for affiliated corporations
- May elect to maintain full deductibility of interest
  - Election requires longer depreciation period for buildings (ADS required)
    - Commercial - 40 years vs 39
    - Residential - 30 years vs. 27.5
  - ADS deprecation election disqualifies use of bonus deprecation

Excess Business Losses

- Applies to noncorporate taxpayers
- Business losses over a threshold amount will be considered Excess Business Losses
- Threshold amount for a tax year is $500,000 for married individuals filing jointly, and $250,000 for other individuals, with both amounts indexed for inflation
- Threshold is applied at the partner or shareholder level
- Excess business losses are not allowed for the tax year, but are instead carried forward and treated as part of the taxpayer's net operating loss (NOL) carryforward in subsequent tax years

Net Operating Loss (NOL) Deduction

Old Law: NOLs generally carried back 2 years and then forward 20

New Law:

» NOL carryover deduction can offset 80% of taxable income (90% deduction for AMT for individuals)

» No NOL carrybacks (generally)

» NOLs to be carried forward indefinitely

Business Meals & Entertainment

» Business Meals – Lots of controversy here!!

- deduction remains at 50% for food and beverage expenses associated with operating a trade or business.
- For tax years 2018 through 2025, the 50% deduction expands to include expenses incurred for meals furnished to employees for the convenience of the employer.
- Amounts after 2025 are not deductible.
- Employee meals while on business travel also remain deductible at 50%.

» **Business Entertainment: No longer deductible**

- **Examples include sports tickets, golf outings, and related venues!**

Qualified Business Income Deduction (QBID)

» Eligible deduction equal to 20% of domestic "qualified business income" from a pass-through entity (LLC/partnership, S-Corp, Sch C, Sch E, Sch F) (IRC Sec. 1202(e)(3)(A))

» MFJ taxable income **< $315,000 = Full QBID eligible**, regardless of whether a service business, or not

» MFS, HoH and Single – divide the limitation in half at $157,500

Qualified Business Income Deduction (QBID)

» MFJ taxable income **$315,000 - $415,000 = QBID phase out**, regardless of whether a service business, or not

» MFJ taxable income **> $415,000**

- Service business = **No QBID**
- Non-service business = **QBID limited** to the lesser of
  - 20% QBI
  - Greater of
    - 50% of W-2 Business Wages
    - 25% of W-2 Business Wages plus 2.5% of unadjusted basis

Qualified Business Income Deduction (QBID)

» Service Businesses

» A specified service business means any business activity involving the performance of services by employees or owners in the fields of **health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services**, or any business where the principal asset of such business is the **reputation or skill of one or more of its employees**.

- Architecture and engineering were specifically omitted
- Included are the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.

Qualified Business Income Deduction (QBID)

» **Overall Limitation:** after determining eligible QBID, the deduction is then equal to the LESSER OF:

- the combined "qualified business income" of the taxpayer, or
- 20% of the excess of taxable income minus the sum of any net capital gain

» Qualified business losses carry over for purposes of computing future QBID

» Applies to trusts & estates

Qualified Business Income Deduction (QBID)

MFJ Taxable Income:	Business Type: Service	Business Type: Non-Service
< $315,000	20% QBI	20% QBI
$315,000 - $415,000	Phase Out	Phase Out
> $415,000	No QBID	QBID is the lesser of (a) 20% QBI (b) greater of - W-2 Wages x 50% - W-2 Wages x 25% + 2.5% of unadjusted basis

Note: after determining eligible QBI deduction above, an overall limitation applies, where the deduction is equal to the LESSER OF:

- the combined "qualified business income" of the taxpayer, or
- 20% of the excess of taxable income minus the sum of any net capital gain

Qualified Business Income Deduction (QBID)

- » Combined Qualified Business Income
- » THE SUM OF:
  - The LESSER OF:
    - 20% of the taxpayer's "qualified business income" or
    - THE GREATER OF:
      - 50% of allocable share of W-2 wages paid by the business, or
      - 25% of allocable share of W-2 wages paid by the business plus 2.5% of allocable share of the unadjusted basis of all qualified property.
  - PLUS:
    - 20% of qualified REIT dividends
    - qualified publicly traded partnership income.

Qualified Business Income Deduction

- <u>Combined Qualified Business Income</u>
- THE SUM OF:
  1. The LESSER OF:
     a. 20% of the taxpayer's "qualified business income" or
     b. THE GREATER OF:
        i. 50% of allocable share of W-2 wages paid by the business, or
        ii. 25% of allocable share of W-2 wages paid by the business plus 2.5% of allocable share of the unadjusted basis of all qualified property.
  2. ~~PLUS:~~
     ~~a. 20% of qualified REIT dividends~~
     ~~b. qualified publicly traded partnership income.~~

Qualified Business Income Deduction

» Combined Qualified Business Income

» THE SUM OF:

1. The LESSER OF:
   a. 20% of the taxpayer's "qualified business income" or
   b. THE GREATER OF:
      i. 50% of allocable share of W-2 wages paid by the business, or
      ii. 25% of allocable share of W-2 wages paid by the business plus 2.5% of allocable share of the unadjusted basis of all qualified property.

~~2. PLUS:~~
   ~~a. 20% of qualified REIT dividends~~
   ~~b. qualified publicly traded partnership income.~~

Qualified Business Income Deduction

» W-2 Wage Limitation

- "W-2 wages" means the total wages subject to wage withholding, elective deferrals, and deferred compensation paid with respect to employment of its employees
- "Wages" is defined by reference to IRC 3401(a), which includes remuneration for services performed by an employee. W-2 wages of PEO employees are eligible.
- Self-employment income excludes wages
- W-2 wages computed on a **per-business basis**
  - Unless aggregated under Proposed Reg §1.199-A-4

Qualified Business Income Deduction

» Combined Qualified Business Income

» THE SUM OF:

1. The LESSER OF:
   a. 20% of the taxpayer's "qualified business income" or
   b. THE GREATER OF:
      i. 50% of allocable share of W-2 wages paid by the business, or
      ii. 25% of allocable share of W-2 wages paid by the business plus 2.5% of allocable share of the unadjusted basis of all qualified property.
2. ~~PLUS:~~
   a. ~~20% of qualified REIT dividends~~
   b. ~~qualified publicly traded partnership income.~~

Qualified Business Income Deduction

» <u>Qualified Property</u>

- Defined in Section 199A(b)(6)(A) as:

  (1) any tangible property,
  (2) subject to depreciation (i.e. inventory does not count),
  (3) which is <u>held</u> at the <u>end of the year</u> by the business, and
  (4) is <u>used</u> at <u>any point in the year</u> in the production of QBI,
  (5) during its “depreciable period”

- “Depreciable Period”
  - Starts on the date the property is placed in service, and
  - Ends on the LATER of:
    - Ten years, or
    - The last day of the last full year in the asset's "regular" (not ADS) depreciation period

Qualified Business Income Deduction

» <u>Qualified Property</u>

- "Depreciable Period"
- <u>Example</u>
  - In 2010 Lugeco purchased a piece of machinery for $25,000 and a non-residential rental building for $250,000. Both assets are used in Lugeco's business and held at the end of 2018.
  - Even though the depreciable life of the machinery is only 5 years, the owners of Lugeco will be able to use the unadjusted basis of $25,000 for purposes of the Wage plus Basis Limitation for ten full years (from 2010-2019) because the depreciable period runs for the LONGER of the useful life (5 years) OR 10 years

Qualified Business Income Deduction

» Qualified Property

- "Depreciable Period"
- Example
  - In 2010 Lugeco purchased a piece of machinery for $25,000 and a non-residential rental building for $250,000. Both assets are used in Lugeco's business and held at the end of 2018.
  - As to the building, the owners of Lugeco will be able to use the unadjusted basis of $250,000 for purposes of the Wage plus Basis Limitation for 39 full years (from 2010-2048) because the depreciable period runs for the LONGER of the useful life (39 years) OR 10 years

QBID Example #1 - Non-Service Business

Taxpayer is married and has $200,000 net business income, $50,000 in other income and takes the standard deduction

QBI Deduction:

Business income	$	200,000
Other Income		50,000
AGI		250,000
Less: Standard deduction		(24,000)
Taxable income	$	226,000
		< $315K
QBI Deduction:		
20% x 200,000 QBI	$	40,000
Overall limitation:		
20% x 226,000 taxable income	$	45,200

QBID Example #2 - Non-Service Business

Taxpayer is married and has $300,000 net business income, $150,000 in other income and takes the standard deduction. The business paid no wages and has qualified fixed assets with an unadjusted basis of $50,000

QBI Deduction:

Business income	$	300,000
Other Income		150,000
AGI		450,000
Less: Standard deduction		(24,000)
Taxable income	$	426,000
		> $415K
QBI Deduction = lesser of:		
(a) 20% x 300,000 QBI	$	60,000
(b) Greater of:		
50% x -0- W-2 wages	$	-
25% x -0- W-2 wages + 2.5% x 50,000	$	1,250
Overall limitation		
20% x 426,000 taxable income	$	85,200

QBID Example #3 - Non-Service Business

Taxpayer is married and has $750,000 net business income, $100,000 in other income and $50,000 in itemized deductions. The business paid $120,000 in wages and has qualified fixed assets with an unadjusted basis of $4,000,000

QBI Deduction:

Business income	$	750,000
Other Income		100,000
AGI		850,000
Less: Itemized deductions		(50,000)
Taxable income	$	800,000
		> $415K
QBI Deduction = lesser of:		
(a) 20% x 750,000 QBI	$	150,000
(b) Greater of:		
50% x 120,000 W-2 wages	$	60,000
25% x 120,000 W-2 wages + 2.5% x $4M	$	130,000
Overall limitation		
20% x 800,000 taxable income	$	160,000

What is my QBI Deduction?

Is it a Specified Service Business?

- No → Is taxable income over threshold?
  - No → Deduction = **QBI x 20%**
  - Yes → Is taxable inc. over full phase-out?
    - No → Deduction phased-out
    - Yes → Deduction = LESSER of
      a. QBI x 20%, OR
      b. GREATER of
         i. 50% of W-2 wages, or
         ii. 25% of W-2 wages plus 2.5% of unadjusted basis
- Yes → Is taxable income over threshold ($315k/$157.5k)?
  - No → Deduction = **QBI x 20%**
  - Yes → Is taxable income over full phase-out?
    - No → Deduction phased-out
    - Yes → NO DEDUCTION

Business Valuation Considerations

TCJA Impact on Valuation Process

» Engagement considerations
- Additional information
- Increased costs
- Additional time

» Application to the three approaches to value
- When was TCJA “known or knowable”?
- Should you rely on history in determining future economic benefit?
- Are single period capitalization models still appropriate?
- How should future cash flow be determined?
- Have all potential scenarios been considered?
- How long should the discrete projection period be?
- How should the “long-term “ growth rate be determined?
- How will the cost of capital change?
- Should multiple discount rates be used?

Known or Knowable

What did we know and when could we have known it?
…And when should we use it?

November 2, 2017	Congressman Brady introduces TCJA in the U.S. House
November 6, 2017	House Ways & Means Committee markup
November 9, 2017	House Ways & Means Committee moves TCJA
November 9, 2017	TCJA goes to the U.S. Senate
November 13, 2017	Senate Finance Committee markup
November 16, 2017	U.S. House passes TCJA
November 28, 2017	Senate Budget Committee passes TCJA
December 2, 2017	U.S. Senate passes TCJA
December 15, 2017	House & Senate Conference Committee approves final version of TCJA
December 22, 2017	President Trump signs

Business Cash Flow under TCJA

- What will management do with their tax saving dollars?
- Growth rates
- Capital expenditures and depreciation
- Tax rates
- QBID
- Interest deduction limitations ... WACC
- Loss limitations
  - Net operating losses
  - New $500K (MFJ) / $250K (Unmarried) threshold

TCJA's Impact on Cash Flow Dependent Methods of Valuation Will be Substantial

» After-tax GAAP income will likely increase for many businesses…but what will be management's intentions for the increased income?
What will be the impact on cash flow?

» Tax motivated Cap-Ex decisions?
- 100 % Bonus Depreciation §168(k)
- Enhanced §179 Expensing impact on productivity, growth in revenue and earnings

» Retain it to pay down debt or enhance liquidity?

» Will high-volume customers demand better prices?

» Will enhanced earnings be distributed:
- Dividends to Stockholders/Partners?
- Bonuses to Employees?

What about Bonus Depreciation Changes?

» Generally speaking – if impact after 2023 not considered, company may be overvalued

» Immediate deduction at the following declining percentages:

- 100% 09/27/17 – 12/31/2022
- 80% in 2023
- 60% in 2024
- 40% in 2025
- 20% in 2026
- 0% after 2026

» Will it matter if Sec. 179 expensing makes up the difference in declining percentage years

What about Bonus Depreciation Changes?

- Example Assumptions
- Company began in 2014
- Cap Ex of $100,000 each year historically and forecasted
- 50% Bonus utilized in prior years
- 5 year SL depreciation for remainder (for ease in calculations, most likely an accelerated MACRS method would have been used)

Bonus Depreciation Example: Results

Results of not considering Bonus Depreciation:

» If single period capitalization method used for BV with CapEx=Depr – value conclusion would be ***understated*** by the total present value of the bonus depreciation impact of $14,156

» If DCF method with 5-yr forecast used (2018-2022) – value conclusion would be ***overstated*** by the 2023-2032 negative present value of the bonus depreciation impact of ($46,420)

Bonus Depreciation Example: 2014-2022

		2014	2015	2016	2017	2018	2019	2020	2021	2022
CapEx		100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000
Bonus %		50%	50%	50%	50%	100%	100%	100%	100%	100%
Depreciation										
Before TCJA		(60,000)	(70,000)	(80,000)	(90,000)	(100,000)	(100,000)	(100,000)	(100,000)	(100,000)
After TCJA		(60,000)	(70,000)	(80,000)	(90,000)	(140,000)	(130,000)	(120,000)	(110,000)	(100,000)
Difference		-	-	-	-	40,000	30,000	20,000	10,000	-
Taxes	26%					(10,400)	(7,800)	(5,200)	(2,600)	-
After-tax difference						29,600	22,200	14,800	7,400	-
Discount period						0.5	1.5	2.5	3.5	4.5
WACC discount rate						15%	15%	15%	15%	15%
Present value factor						0.9325	0.8109	0.7051	0.6131	0.5332
Present value						27,602	18,001	10,436	4,537	-
									PV Total 2018-2022	60,576

Bonus Depreciation Example: 2023-2032

		2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
CapEx		100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000
Bonus %		80%	60%	40%	20%	0%	0%	0%	0%	0%	0%
Depreciation											
Before TCJA		(100,000)	(100,000)	(100,000)	(100,000)	(100,000)	(100,000)	(100,000)	(100,000)	(100,000)	(100,000)
After TCJA		(84,000)	(72,000)	(64,000)	(60,000)	(60,000)	(76,000)	(88,000)	(96,000)	(100,000)	(100,000)
Difference		(16,000)	(28,000)	(36,000)	(40,000)	(40,000)	(24,000)	(12,000)	(4,000)	-	-
Taxes	26%	4,200	7,300	9,400	10,400	10,400	6,200	3,100	1,000		
After-tax difference		(11,800)	(20,700)	(26,600)	(29,600)	(29,600)	(17,800)	(8,900)	(3,000)		
Discount period		5.5	6.5	7.5	8.5	9.5	10.5	11.5	12.5		
WACC discount rate		15%	15%	15%	15%	15%	15%	15%	15%		
Present value factor		0.4636	0.4031	0.3506	0.3048	0.2651	0.2305	0.2004	0.1743		
Present value		(5,471)	(8,345)	(9,325)	(9,023)	(7,846)	(4,103)	(1,784)	(523)		

PV Total 2023-2030	(46,420)
PV Grand Total 2018-2030	14,156

Miscellaneous TCJA Issues Impacting Valuation

- NOL Carryforwards for C-Corps
- 80% of income limitation on use of NOLs will decrease after-tax income and cash flow in intervening years
- Loss of NOL carrybacks can have a significant effect on early years of a DCF projection

TCJA's Impact on Capital Structures and WACC

- Deductibility of Interest Expense
- Limitation on deductibility of interest expense may change capital structures across industries
- Stronger balance sheets from enhanced equity may increase the WACC since equity is generally more expensive than debt. But does that reduce SCRF?
- Loss of deductions for part of interest costs raise the net cost of debt and therefore the WACC
- Resulting changes to WACC will likely be modest in most scenarios

Cost of Capital/WACC under TCJA

- » Tax rates
- » Growth rates
- » Company specific risk
- » Debt/Equity weighting
- » Pass-through entities & QBID
- » Historical vs supply-side ERP
- » Interest deduction limitations
- » Loss limitations
  - Net operating losses
  - New $500K / $250K threshold

Cost of Capital post TCJA

» Explore the possible impact of TJCA on the following:

- Risk Free Rate
- Beta (tax rates and leverage ratios a factor)
- Industry Risk Premium (*proxy for Beta*)
- Equity Risk Premium
- Size Premium
- Company Specific Premium

- **Invested Capital**
- ***After-tax Cost of Debt***
- Cost of Equity (above)
- ***Capital Structure***

Cost of Capital post TCJA

» Many cost of capital inputs are based on HISTORICAL data to estimate an *expected* rate of return *going forward*:

- Equity Risk Premium (includes historical risk free returns)
- Small stock risk premium
- Beta based historical volatility

» A typical time period is from 1926 to the relevant date for any valuation.

- This time period included many changes in the U.S. tax landscape, many economic cycles, stock market booms and crashes, etc.

Cost of Capital post TCJA- WACC

» After-tax Cost of Debt should increase

- Lower tax shield do to reduced income tax rate, &
- Limitations on ability to deduct interest rate at all
  - Exception: <$25,000,000 in sales

Cost of Capital post TCJA- WACC

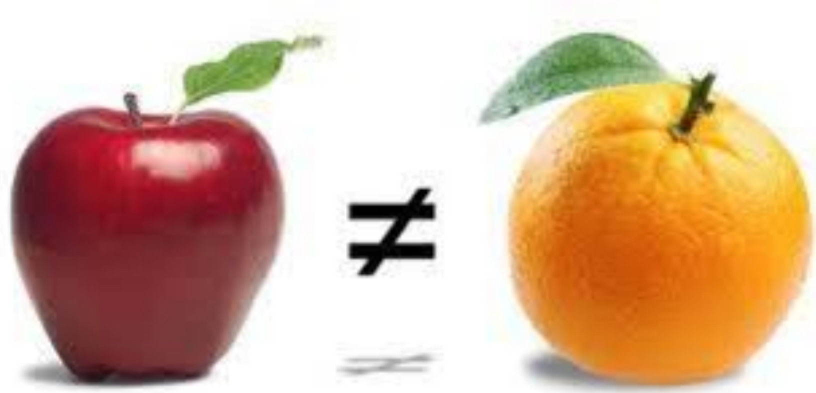
		Pre-TCJA		TCJA
Gross Sales		30,000,000		30,000,000
Operating expenses		(28,500,000)		(28,500,000)
Adjusted Taxable income		*1,500,000*		*1,500,000*
Interest expense	*700,000*		*700,000*	
Allowed interest deduction		(700,000)		(450,000)
Depreciation		(200,000)		(200,000)
Taxable income		600,000		850,000
State taxes	6.0%	(36,000)	6.0%	(51,000)
Federal taxes	34.0%	(191,760)	21.0%	(167,790)
Net Income		**372,240**		**631,210**
Effective tax rate		38.0%		25.7%
% of interest expense deducted		100.0%		64.3%
Tax savings from interest expense		265,720		115,830
After-tax cost of debt		*4.34%*		*5.84%*
Debt capital		10,000,000		10,000,000
Pre-tax cost of debt		7.0%		7.0%
Interest expense		700,000		700,000
After-tax cost of debt based on effective		*4.34%*		*5.20%*
% increase in cost of debt		***0.0%***		***12.4%***

Cost of Capital post TCJA- Application

Single Period Capitalization	Pre-TCJA	TCJA	Δ
EBIT	$1,900,000	$1,900,000	
Less: taxes	(509,000)	(345,000)	
Debt-free Net Income	1,391,000	1,555,000	*11.8%*
Capital expenditures	(200,000)	(200,000)	
Depreciation	200,000	200,000	
Working Capital	(45,000)	(45,000)	
Debt-free Net Cash Flow	**$1,346,000**	**$1,510,000**	*12.2%*
Divide by WACC Cap. Rate	8.5%	8.8%	*3.5%*
Enterprise Value	**$15,835,000**	**$17,159,000**	*8.4%*
Less: Debt capital	(7,000,000)	(7,000,000)	
Equity Value	**$8,835,000**	**$10,159,000**	*15.0%*

WACC	Pre-TCJA	TCJA	Δ
Pre-tax debt	8.0%	8.0%	
Tax rate	38.0%	25.7%	
After-tax debt	***4.96%***	***5.94%***	***19.8%***
Weight	44.4%	41.0%	
Cost of Equity	***15.0%***	***15.0%***	*??*
Weight	55.6%	59.0%	
Discount Rate	**10.5%**	**11.3%**	*7.6%*
Less: Growth	-2.0%	-2.5%	*25.0%*
Capitalization Rate	**8.5%**	**8.8%**	*3.5%*

Does everything match?



Cost of Capital post TCJA- Application

» Does updated tax rate in valuation match:

- Derivation of AFTER-TAX net cash flow
- Does this AFTER-TAX net cash flow comprehend:
  - Proper QBI benefit
  - New deprecation rules
  - Interest rate limitations
  - Sunset provisions

» Do expectations of profit vary greatly from past?

» Do these change in expectations warrant an adjustment to the Company Specific Risk Premium?

C Corp BV Example

- Income approach using single period capitalization
- Reduced tax rate utilized
- Capital Expenditures = Depreciation
- No interest or loss limitations
- WACC adjusted for tax rate and capital structure changes

C Corp BV Example – Tax Rate

Tax Rate Change - BV Example	Before TCJA		After TCJA	
Federal Corporate Rate		35.0%		21.0%
State Corporate Tax Rate (Avg)	6.0%		6.0%	
Federal Tax Deduction (35% & 21%)	-2.1%		-1.3%	
Adjusted State Corporate Tax Rate	3.9%	3.9%	4.7%	4.7%
Combined Federal & State Corporate Rate		38.9%		25.7%
Tax Rates used for BV Example		**39.0%**		**26.0%**

C Corp BV Example – WACC

WACC Change - BV Example	Before TCJA		After TCJA	
Equity Rate *		20.0%		20.0%
Debt Rate	5.0%		5.0%	
Tax Deduction (39% & 26%)	-2.0%		-1.3%	
After-tax Debt Rate	3.1%	3.1%	3.7%	3.7%
Equity Weighting		65.0%		70.0%
Debt Weighting		35.0%		30.0%
WACC		14.1%		15.1%
Long-term Growth *		-3.0%		-3.0%
WACC Capitalization Rate		11.1%		12.1%
WACC Cap Rate used for BV Example		**11.0%**		**12.0%**
* did not change for ease in demonstrating example				

C Corp BV Example – Equity Value

Single Period Capitalization Method	Before TCJA	After TCJA	
EBIT	$ 100,000	$ 100,000	
Tax Deduction (39% & 26%)	(39,000)	(26,000)	
Debt Free Net Income	61,000	74,000	
Capital Expenditures	(25,000)	(25,000)	
Depreciation	25,000	25,000	
Working Capital	(5,000)	(5,000)	
Debt Free Cash Flow	56,000	69,000	
WACC Capitalization Rate	11.0%	12.0%	Increase
Enterprise Value	**$ 509,000**	**$ 575,000**	13.0%
Debt	(250,000)	(250,000)	
Equity Value	**$ 259,000**	**$ 325,000**	25.5%

Pass-through Entities & QBID

Tax Affecting Pass-Through Entities & QBID

Does the PTE Premium Still Exist?

- TCJA calls into question the issue of a PTE premium… but not necessarily the controversy over whether or not to tax-affect PTE earnings for valuation purposes.

- Some tax-affecting methods are based on harmonizing effective tax rate differentials between entities (Delaware Open Radiology vs. Kessler)

- Does the QBID put most business entities on the same playing field?

Tax Affecting Pass-Through Entities & QBID

What are authors of various S-Corp Models saying…

» PTE premium analysis based on long term empirical data (Fannon & Sellers) will only be minimally impacted in the early years of TCJA.

» Dan VanVleet on his SEAM model under TCJA:

- PTE Service business: Value benefit of PTE service business vs. C corp largely gone and will decline more over next 8 years.
- Non-Service business: Value benefit of non-service business vs. C corp likely still positive, but less than before TCJA and declining over the next 8 years.
- 8 to 10 %

Tax Affecting Pass-Through Entities & QBID

- TCJA immediately reduces tax , increasing income and cash flow…but it sunsets.
- Are single-period capitalized cash flow methods still appropriate?
- Long-term cash flow projections will eventually bump up against the sunset date: Should DCF models be taken out to 2025?
- Should a second discount rate be used to calculate the terminal value?
- How should we deal with these added complexities in an already controversial area of valuation? Who will understand (who will care)?

QBID's Impact on Valuation Theory

- How should appraisers deal with the applicability and calculation of the QBID in valuation?
  - Remember the 9% DPAD deduction (now repealed)…how was that historically treated in BV, if at all? Is the QBID the same?
- FMV assumes a "hypothetical willing buyer & seller"…How do we reconcile QBID's impact, if any across the spectrum of hypothetical buyers?
- Does the temporary nature of the QBID have any impact?
  - Immediately reduces tax and increases cash flow
  - But it sunsets

To QBID or Not to QBID…that is the REAL Question

- How will you deal with the applicability and calculation of the QBID as it relates to the subject company?
- Will you assume C-Corp status and ignore QBID?
- Apply QBID across the board in all cases.
- Compute QBI on the basis of the facts and circumstances of the case?
- Assume income threshold is ***<u>not</u>*** exceeded?
- Assume income threshold ***<u>is</u>*** exceeded?
- Fully calculating the QBID may require information not available in the normal course of the valuation engagement.

Reasonable Compensation Considerations

- » Increased emphasis on compensation planning for entities where the QBID limitations are in play
  - "greater of (50% of W-2 wages) or (25% of W-2 wages, plus 2.5% of depreciable assets)"
- » Potential for planning opportunities with closely held C corporations where the goal is to expose more income to the new 21% rate
- » Methods and precedents to determine and support reasonable compensation for owner-employees has not changed
  - Complex trade offs between optimizing TCJA impact, employment taxes, pension plan thresholds, and expense reimbursements

Where is the sweet spot?

~28.57% compensation allocation, assuming 2.5% fixed asset test is irrelevant

Reasonable Comp/Max QBID Analysis	
20% x (Y-X) = 50% x (X)	
20% / 70% =	0.2857
1,000,000.00	Y = Biz Inc before wage
(285,714.29)	X = Reasonable Wage
714,285.71	QBI
20%	
142,857.14	Tentative QBID
285,714.29	X = Reasonable Wage
50%	
142,857.14	Tentative QBID

Market Transaction Based Methods of Valuation Won't Escape Impact from TCJA:

» Tax rate changes won't directly affect EBITDA or EBIT earnings streams since they are pre-tax.

» However, some of the management decisions identified above may change those earnings streams.

» EBITDA multiples will likely rise as a result of increased values caused by enhanced after-tax cash flows.

» Multiples derived from comparable company transactions occurring ***before*** TCJA may understate value.

Market Transaction Based Methods of Valuation Won't Escape Impact from TCJA:

Some notable observations and adjustments:

» "The guideline transactions method, however, will likely also be of little use going forward, at least for a few years…The transaction multiples reflected in these historical databases do not reflect expectations of substantially higher after-tax cash flows following the 2017 tax act (except for perhaps a few during the latter part of 2017)."

» "The point of this qualitative discussion is that the old "Rules of Thumb" were thrown out the door when President Trump signed the Tax Cuts & Jobs Act of 2017."

Source: Chris Mercer, "Business Valuation: Things Just Aren't the Same Anymore After the Tax Cut and Jobs Act of 2017", Mar. 5, 2018 (pg. 5).

Van Vleet

Enterprise Value Adjustment Multiple Model (EVAM)

Enterprise Value Adjustment Multiple (EVAM)

$$\frac{(1 - \text{2018 Tax Rate})}{(1 - \text{2016 Tax Rate})} \times \frac{\text{2016 WACC}}{\text{2018 WACC}} = 1.1180$$

Where

2018 Tax Rate = 26.0%
2016 Tax Rat = 39.1%
2016 WACC = 9.16%
2018 WACC = 9.96

Source: Daniel R. Van Vleet and William P. McInerney, "Valuing C Corps and Pass-Through Entities Under the New Tax Law", Business Valuation Review, Volume 37, Spring 2018, American Society of Appraisers, Business Valuation Committee (pg. 7).

Van Vleet

Enterprise Value Adjustment Multiple (EVAM)

Enterprise Value Adjustment Multiple		2018 Valuation
(1)	2018 EBITDA	$ 300,000
(2)	2016 EBITDA Multiple	4.43
(3)	2016-Based Enterprise Value	1,329,084
(4)	Enterprise Value Adjustment Multiple	1.1180
(5)	2018 Act-Adjusted Enterprise Value	1,485,915
(6)	Debt	(600,000)
(7)	2018 Act-Adjusted Equity Value	$ 885,915

Source: Daniel R. Van Vleet and William P. McInerney, Valuing C Corps and Pass-Through Entities Under the New Tax Law", Business Valuation Review, Volume 37, Spring 2018, American Society of Appraisers, Business Valuation Committee (pg. 8).

Impact of TCJA on Gift & Estate BV Practice

» Estate exemption doubles and portability rules continue
  - Fewer taxable estates = less need for business valuations?

» Basis Step Up continues
  - Gifting Impact: Family business owners more apt to hold on to interests vs gifting interests to received basis step up at death
  - Estate Impact: Even if under the exemption amount, estates should establish date of death value to determine basis step

» For large estates with closely-held stock, IDGTs remain attractive
  - IDGT Refresher: Selling discounted interests to IDGT's using exemption as down payment and promissory note for the remainder.
  - Higher exemption allows higher amounts available for down payment or ability to sell more interests

Choice of Entity Example

- Passthrough Entity vs. C Corporation

		Old Law	TCJA
Passthrough Entity	Before tax earnings –	$1000	$1000
	Earnings distributed –	$1000	$1000
	Individual level tax –	$396 (39.6%)	$296 (37% of $800)
	Net after-tax earnings to Owner –	$604	$704
	Effective tax rate	**39.6%**	**29.6%**
C Corporation	Before tax earnings –	$1000	$1000
	Corporate level tax –	$350 (35%)	$210 (21%)
	After tax earnings distributed –	$650	$790
	Individual level tax–	$154.70 (23.8%)	$188.02 (23.8%)
	Net after-tax earnings to Shareholder -	$495.30	$601.98
	Effective tax rate	**50.47%**	**39.8%**

What is the Best Form of Passthrough Entity?

			Net revenue before compensation							
	$75,000	$100,000	$150,000	$200,000	$250,000	$300,000	$400,000	$500,000	$750,000	$1,000,000
Entity (comp amt)										
C Corp	21.0%	32.9%	32.9%	32.9%	32.9%	32.9%	32.9%	32.9%	39.8%	39.8%
LLC	23.7%	23.8%	24.5%	23.4%	23.0%	23.0%	22.9%	24.0%	26.4%	28.0%
S Corp (SS wage cap)	25.9%	27.5%	26.4%	24.2%	23.2%	22.5%	22.0%	22.7%	24.5%	25.8%
S Corp (75% net rev)	21.1%	22.0%	24.7%	25.0%	24.9%	24.9%	25.7%	27.4%	30.3%	32.1%
S Corp (50% net rev)	17.1%	17.8%	20.5%	21.9%	23.0%	23.1%	23.5%	25.0%	27.8%	29.5%
S Corp (25% net rev)	13.1%	13.6%	16.4%	17.7%	18.8%	19.6%	20.8%	22.6%	25.3%	26.9%
			Effective Tax Rate (including payroll/SE tax)							

Choice of Entity Considerations

- Although taxes do matter, the entity choice decision is **NOT** all about tax rate differences!
- Long-term decision
  - Partnership converting to C-Corp is essentially a permanent decision – no tax efficient option to switch back.
  - S-Corp converting to C-Corp is essentially a 10-year decision – S Corporations cannot revert back to C for 5-years. After that, there is another 5-year period they are subject to additional taxes for built-in gains on re-conversion.
- What are the chances future legislation could change rates again?

Should I Convert to a C Corp?

» PROBABLY NOT

- Effective tax rate (where income > $77k)

  32.9% or 39.8%

- Any other form of entity yields lower tax rate when C-Corp is distributing all or substantially all of earnings.
- Very small entities wanting to reinvest all or substantially all earnings to finance growth may benefit as a C-Corp, at least initially.

  (But this could be a costly decision down the road)

Effective Tax Rate Differences

Depends on business distributions and ownership holding period

Entity rate comparison

FEDERAL top rate comparison by entity

Type of business income	2018 Top rate
Pass-through: Active	29.6%*/**
Pass-through: Passive	33.4%*/**
C corporation: Distribute all earnings	39.8%*
C corporation: Distribute ½ of earnings	30.4%*
C corporation: Retain all earnings	21%

*Includes 3.8% Medicare tax on investment income, but not FICA or SE tax on earned income. Also assumes AAA has been used after conversion to C.

**Assumes 20% deduction not otherwise limited

https://www.grantthornton.com/library/articles/tax/2018/switch-C-corp-status.aspx

Other Considerations

» Will business qualify for the pass-through deduction (QBID)?

» What are the owner's plans for exiting the business

- PTE offer certain advantages
- C-Corp double taxation on sale and distribution of proceeds to owners

» State tax considerations

- Entity level State business tax calculations often differ between C-Corps and PTEs
- No deduction limitation for C-Corp
- Deduction now limited for individual owner of PTE

PTE: Pass-through Entity (S-Corp/Pship)

Other Considerations (cont)

- Income and distributions to owners
  - C-Corp/S-Corp wages & Partnership guaranteed payments – flexible (QBID considerations)
  - C-Corp dividends – based on pro-rata ownership (double taxation considerations)
  - S-Corp allocated income & distributions - based on pro-rata ownership
  - Partnership allocated income & distributions – specific allocations allowed
- Does business have foreign earnings - new tax law denies PTE's many special deductions and exclusions on foreign tax rules that C-Corp enjoy
- Does the business have current NOL's or expect losses in the future

History of U.S. Tax Rates

Year	First Bracket	Top Bracket	Year	First Bracket	Top Bracket	Year	First Bracket	Top Bracket
1913-1915	1.00%	7.00%	**1936-1939**	4.00%	79.00%	**1968**	14.00%	75.25%
1916	2.00%	15.00%	**1940**	4.40%	81.10%	**1969**	14.00%	77.00%
1917	2.00%	67.00%	**1941**	10.00%	81.00%	**1970**	14.00%	71.75%
1918	6.00%	73.00%	**1942-1943**	19.00%	88.00%	**1971-1981**	14.00%	70.00%
1919-1920	4.00%	73.00%	**1944-1945**	23.00%	94.00%	**1982-1986**	12.00%	50.00%
1921	4.00%	73.00%	**1946-1947**	19.00%	86.45%	**1987**	11.00%	38.50%
1922	4.00%	56.00%	**1948-1949**	16.60%	82.13%	**1988-1990**	15.00%	33.00%
1923	3.00%	56.00%	**1950**	17.40%	84.36%	**1991**	15.00%	31.00%
1924	1.50%	46.00%	**1951**	20.40%	91.00%	**1992-2000**	15.00%	39.60%
1925-1928	1.50%	25.00%	**1952-1953**	22.20%	92.00%	**2001**	15.00%	39.10%
1929	38.00%	24.00%	**1954-1963**	20.00%	91.00%	**2002**	10.00%	38.60%
1930-1931	1.13%	25.00%	**1964**	16.00%	77.00%	**2003-2012**	10.00%	35.00%
1932-1933	4.00%	63.00%	**1965**	14.00%	70.00%	**2013-2017**	10.00%	39.60%
1934-1935	4.00%	63.00%	**1966-1967**	14.00%	70.00%	**2018**	10.00%	37.00%

Diminishing Support from the IRS

Number of Locations, Employees, or Visitors	2011	2012	2013	2014	2015	2016	2017
IRS Offices (Cities)	541	523	510	499	479	470	454
Appeals Officers (AOs)	1,129	1,058	958	881	795	739	737
Revenue Officers (ROs)	4,402	4,035	3,703	3,441	3,191	3,072	2,962
Revenue Agents (RAs)	8,652	8,638	8,520	8,418	8,329	8,557	8,502
Stakeholder Liaison Outreach Employees (Communication Liaison Outreach Employees in FY 2017)	137	123	119	110	105	98	105
Stakeholder Partnerships, Education and Communication Outreach Employees (SPEC)	522	475	444	405	386	365	311
Taxpayer Assistance Centers (TACs)	401	401	398	382	378	376	371
TAC Service Reps	1,639	1,515	1,484	1,520	1,423	1,267	1,121
Taxpayer Advocate Service, Case Advocates	996	945	919	862	784	726	683

Integra Business Valuation Committee

1. Intended to address valuation issues worldwide, through knowledge exchange such as:

   a) International Business Valuation Standards
   Delegates of The European Group of Valuers Association (TEGoVA) WILL DEVELOP European Business Valuation Standards (EBVS).

   b) Prof. Pablo Fernandez – IESE Business School in Madrid & Barcelona, Spain
   Market Risk Premium (MRP) Survey for developing cost of capital estimates.

c) Cost of Capital Professional
New Cost of Capital Resource.
Authors include our Denver, Colorado member Ron Seigneur.

d) Webinars on specific topics, such as "TCJA & Business Valuation" and other issues to be developed.

2. Develop an Integra Business Valuation List Serv
   - Post & respond to valuation questions from members in group format in real time.
   - Participation by all committee members.
   - Distribute information on cutting edge issues as they occur.

3. Establish Quarterly conference calls of committee members to discuss valuation & committee issues.

4. Eventually establish committee meetings at global & regional conferences.