The Valuation Implications from the New Tax Law

The new tax law introduced as the Tax Cuts and Jobs Act (TCJA) overhauls the current tax system and brings with it changes that will have both short-term and long-term implications for company valuations, acquisitions, and financial and tax reporting.

Most corporate and individual taxpayers will see lower tax rates. Corporate taxpayers will see top statutory rates drop from 35 to 21 percent. Individual business owners will see top rates drop to 37 percent with a 20 percent "pass-through deduction" that can be taken for qualified business income through 2025.

The impact of the legislation goes beyond tax cuts, however, affecting after-tax cash flows and the cost of capital. Taking a comprehensive approach to evaluating the new law's valuation ramifications will be essential. It will also take time; many provisions of the new tax law will require more complex modeling than in the past to incorporate the various effects. The following presents an overview of the major provisions of the new law and the related valuation implications.

Impact of Tax Reform on Cash Flow

There are three main ways to value a business, the income approach, the market approach and the cost approach. Under an income approach, company value is generally derived from the ability to generate after-tax earnings and cash flows. A lower tax burden should increase after-tax cash flows, but there are many other factors to consider. For example, the change in the effective corporate tax rate may be much less dramatic than the 35 to 21 percent drop indicates, because effective tax rates paid by U.S. companies across all industries were less than 30 percent under the previous tax law. Therefore, the increase in after-tax cash flows will likely be less than the 40 percent reduction in corporate statutory rates would seem to imply.

Another provision in the new law that benefits businesses is the expanded bonus depreciation. Businesses can take 100 percent bonus depreciation for new and used qualified property placed in service after Sept. 27, 2017, and before Jan. 1, 2023 (with some exceptions). After 2022, bonus depreciation is reduced by 20 percent each year until it is fully phased out in 2026. Valuation models should incorporate the temporarily expanded bonus depreciation provision, and project capital expenditures and depreciation until 2026 to properly account for the impact. The acceleration of depreciation will increase the present value of the associated tax benefit, which will have a positive effect on cash flow.

Terminal value cash flows will require additional consideration as many of the tax reform provisions are short term and will expire. Since the terminal value is based on the expected cash flows into perpetuity, careful consideration of the various implications of the new law will be required when making assumptions to calculate the terminal value component of the valuation.

Impact of Tax Reform on Discount Rates

Expected cash flows are discounted by the weighted average cost of capital (WACC), which reflects an entity's perceived risk. The lower tax rate will increase the complexity of the WACC calculation as both the cost of equity and the cost of debt will be impacted. Challenges may arise in the cost of equity calculation as the historical data used to estimate the market risk premium does not incorporate the impact of the tax rate changes. The tax reform changes will also impact the beta (systematic risk) calculation when determining the cost of equity. Estimating the beta for private companies under the capital asset pricing model (CAPM) involves unlevering and relevering the betas of comparable guideline public companies. The process of unlevering and relevering the beta is based in part on the actual or potential capital structure of the subject entity. CAPM calculations are also affected by the reduced tax rate and will now need to factor in the limitations on interest deductibility. As a result, it will be important to carefully model and support the assumptions for the cost of equity in valuation models.

Overall, changes in the tax rates will have a greater impact on the cost of debt than the cost of equity. A reduced tax rate will increase the after-tax cost of debt. However, company valuations should consider the ability of a business to deduct its interest expense. The new law limits business interest expense deductions to interest income plus 30 percent of adjusted taxable income (based on EBITDA through 2021 and EBIT thereafter). Interest in excess of the limitation may be carried forward indefinitely. The limitation is not applicable to businesses with annual gross receipts of less than $25 million over the prior three years. Additional testing will be required to determine the materiality of the interest expense limitation based on a company's leverage and the timing of future deductions related to any excess expense above the 30 percent threshold.

Impact of Tax Reform on Pass-Through Entities

Historically, pass-through entities provided significant tax benefits due to the single layer of taxation at the individual taxpayer level. The combination of a reduced C corporation tax rate and the deduction for pass-through qualified business income will change the valuation debate for pass-through entities, particularly given the relatively higher individual income tax rates.

The 20 percent deduction for pass-through entities expires after 2025 and is subject to a host of limitations. It is limited to 20 percent of qualified business income from domestic companies, which means the net amount of qualified items of income, gain, deduction, and loss. Qualified items of income, gain, deduction and loss do not include investment income such as any item taken into account in determining net long-term capital gain or net long-term capital loss, dividends, income equivalent to a dividend, or payments in lieu of dividends, or interest income other than that which is properly allocable to a trade or business.

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The pass-through deduction is also subject to a limitation based on W-2 wages and qualified property and may also be impacted by a number of other special rules and limitations. Certain specified service businesses—including health care, accounting, law and consulting—only qualify for the deduction if their taxable income falls below certain thresholds. Additional modeling will be required along with consideration of the specific facts and circumstances of the subject entity to determine the extent of any pass-through entity premium.

Other Considerations

- **Net Operating Losses (NOLs)** – Under the new legislation, businesses can deduct NOLs arising after Dec. 31, 2017, but only up to 80 percent of taxable income. The NOLs may be carried forward indefinitely but can no longer be carried back. This change may reduce the tax value of transaction expenses because the taxable benefit would not be recoverable until there is sufficient taxable income.

- **International Taxes** – The U.S. will shift to a territorial tax system where 100 percent of foreign profits for shareholders with at least 10 percent ownership will be exempt from U.S. taxation. With the transition, the new legislation requires a deemed repatriation of accumulated and deferred foreign earnings. The tax on repatriated earnings is 15.5 percent for cash and cash equivalents and 8 percent for remaining earnings and profits. The repatriation tax may be paid in annual installments over a period of up to eight years. S Corporation shareholders can defer payment until the occurrence of a triggering event as defined in the new law. It remains to be seen how companies will utilize the repatriated cash, whether it will take the form of increased investment or higher levels of dividends or stock redemptions.

The provisions of the new law are complex and will impact entity structures, acquisition deal terms, and valuations. Significant analysis will be required in valuation models to fully capture the impact of the new legislation. The fact that many of the provisions will change over time adds to the complexity. It will be critical to understand each entity's specific facts and circumstances and properly document assumptions made when assessing the effect on value.

For more information on the tax reform bill and the implications for valuation, please contact:

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