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## 10 Ways the 2017 Tax Cuts and Jobs Act Will Impact Business Values

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Chapter Quarterbacks

High School Teachers  
Increase the Reach

# 10

## Ways the 2017 Tax Cuts and Jobs Act Will Impact Business Values

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On December 22, 2017, the Tax Cuts and Jobs Act of 2017 ("TCJA") was signed into law. The TCJA was the biggest tax overhaul since 1986. It was the result of a decades-long process over numerous presidential administrations to achieve business tax reform. It resulted in reducing the corporate tax rate to its lowest point since 1939. The TCJA included changes for individuals and businesses from small to multinational corporations and across all industries.

The new law may have a substantial impact on individuals and businesses, leaving many companies wondering how it might impact the value of their business.

The value of a business is essentially based on two factors: (1) future cash flows and (2) the company's rate of return (cost of capital). The two inputs have an inverse relationship. An increase in cash flows has a positive impact on the value of a business, while an increase in the cost of capital has a negative impact on value.

The TCJA includes new provisions that impact business values in the United States by affecting a company's cash flow and cost of capital through changes to tax rates, and deductions, including deductions for depreciation/capital expenditures, net operating losses, interest, pass through income and more, which are discussed in greater detail in this article.

### 1 TAX RATES: REDUCTION OF FEDERAL CORPORATE INCOME TAX TO 21%

The TCJA eliminated the four corporate rates (15%, 25%, 34% and 35%) and replaced it with a flat corporate rate of 21%. Lower corporate tax rates will increase the after-tax cash flows of the firm. The goal of the lower tax rate is to increase the competitiveness of doing business in the United States and to encourage the development of corporate investment domestically.

The new tax law also repealed the corporate alternative minimum tax.

- + Business value will increase due to the reduction of the federal corporate income tax rate and elimination of the Alternative Minimum Tax ("AMT"), which raises cash flow.

### 2 CAPITAL EXPENDITURES & DEPRECIATION: 100% EXPENSING ON CERTAIN ITEMS BEFORE BEING PHASED OUT

TCJA implemented favorable treatment for recovering costs associated with capital expenditures for businesses. The new law allows for the immediate expensing of the cost of certain new and used assets. "Qualified Property" includes machinery and equipment, but it excludes buildings, land, certain improvements, and intangible property.

Bonus depreciation changed from 50% of the cost during the year placed in service to 100%. This bonus depreciation will phase out over time: 2018-2022 (100%), 2023 (80%), 2024 (60%), 2025 (40%), and 2026 (20%).

In addition, the Section 179 expense limit increased, and eligible items were expanded to include some nonresidential building improvements, including roofs, HVAC, fire protection, and alarm systems.

The annual limit for Section 179 expense increased from \$500,000 to \$1 million and the phase-out for taxpayers increased from \$2 million to \$2.5 million. Both of these amounts are indexed to inflation.

- + Business value will increase due to the accelerated depreciation, which reduces the company's cost of capital.

Accelerated depreciation creates a greater tax shield today because of the time value of money. (A dollar today is worth more than a dollar tomorrow.)

### 3 NET OPERATING LOSSES (NOLs): DEDUCTION LIMITED TO 80% OF INCOME

NOLs are a valuable tax asset. The TCJA limits NOLs carryforwards to 80% of taxable income, and carrybacks of NOLs have been eliminated. Acquirers can no longer utilize the acquisition of an NOL for carryback purposes. Exceptions to the carryback rules are select farming and insurance company losses. NOLs now can be carried forward indefinitely instead of 20 years.

- Business value will decrease due to the limits on the net operating loss deduction, increasing income tax expense, which reduces cash flow.

## 4 INTEREST: NEW LIMITS ON ANNUAL DEDUCTIBILITY

Interest expense deductions are limited for companies with a three-year average of annual revenues over \$25 million. Deduction is limited to 30% of adjusted taxable income ("ATI") plus business interest income plus motor vehicle floor plan financing interest. Before 2022, ATI approximates earnings before interest, tax, depreciation, and amortization ("EBITDA"). For 2022 and after, ATI approximates earnings before interest and taxes ("EBIT"). Disallowed interest deductions are carried forward indefinitely.

The gross receipts of related businesses must be combined for the \$25 million average annual revenues test, which is to prevent businesses from breaking up into several legal entities to avoid the limitation.

The after-tax cost of debt increases. The Cost of Debt formula is Interest Rate x (1 minus the tax rate) Prior to the TCJA:  $(5\% \times (1 - 40\%)) = 3\%$  Now:  $(5\% \times (1 - 21\%)) = 4\%$

- Business value will decrease due to the interest expense deduction cap, increasing income tax expense, which reduces cash flow. This especially hurts large highly leveraged companies.
- Business value will decrease due to the lower tax shield provided by interest expense, which raises the company's cost of debt and cost of capital.

## 6 BASIS EROSION AND ANTI ABUSE TAX ("BEAT"): PROTECTS EROSION OF U.S. TAX BASE

BEAT is a minimum tax imposed on corporations that have average gross receipts over the past three years over \$500 million and incur certain types of expenses including royalties, charges for services, and interest payments to foreign related parties that exceed three percent or more for the tax year (two percent where a bank or securities dealer is part of the affiliated group). Registered Investment Companies, Real Estate Investment Trusts, and S Corporations are excluded from the BEAT. The rate for BEAT is 5% (2018), 10% (2019-2025) and 12.5% for each year thereafter.

- Business value will decrease for companies that are impacted by BEAT due to increased taxes, which reduce cash flow.

## PASS THROUGH INCOME: NEW 20% DEDUCTION

IRC Code Section 199a allows a 20% deduction for qualified business income ("QBI") for sole proprietors, owners of S corporations, and members of LLCs/partnerships. The QBI deduction is NOT allowed for health-care, law, accounting, and consulting also referred to as personal service firms. Architects, engineers, and the real estate industry do receive the benefit.

QBI includes the net amount of qualified items of income, gain, deduction, and loss of a qualified trade or business. Specific investment-related income, deductions or losses, and an S Corporation shareholder's reasonable compensation (or guaranteed payments) are excluded from the definition of QBI.

- a. There is a wage/property limitation on the QBI Deduction. The deduction is limited by the greater of:
    - i. 50% of wages paid by the business to its employees that are allocable to the taxpayer;
    - ii. Or 25% of W-2 wages paid by the business to employees that are allocable to the taxpayer PLUS 2.5% of the unadjusted basis of the business' qualified property.
  - b. If an individual taxpayer's income threshold is \$157,000 (married couples is \$315,000) the full 20% deduction is allowed regardless of the limitations listed above, and it does not matter if their business is a personal service firm.
    - i. However, if a taxpayer's overall income is \$207,500 (\$415,000 married filing jointly), the limitations will apply in full. They are allowed no deduction if their pass-through income is from a personal service firm.
    - ii. For taxpayers between the two thresholds, they would receive a partial tax benefit. The income eligible for the deduction phases out for personal service firms.
- + Business value of pass through entities ("PTEs") will increase for these entities eligible for the 20% deduction and will increase or be neutral for entities that are not eligible.

## PATENT SALES: ELIMINATION OF CAPITAL GAIN TREATMENT

Historically, when a patent was sold, the profit from the sale was treated as a capital gain. Under the new tax law, patents are no longer treated as capital assets, which means that profits from the sale of a patent will now be taxed as ordinary income. This does not impact C corporations because income and capital gains are still taxed at the same rate.

- Business value of PTEs will decrease due to the increased tax rate, which reduces cash flow.

The decline in the corporate tax rate to 21% will help cushion the increased tax expense.

## 8 LIKE KIND EXCHANGES: REPEALS APPLICATION TO CERTAIN BUSINESSES OR INVESTMENT PROPERTIES

TCJA reduced the types of property eligible for a Section 1031 “like kind” exchange. Starting in 2018, the TCJA eliminated like kind exchange treatment for certain personal property. Personal property that can no longer be exchanged includes intangibles (e.g., licenses and patents), aircraft, vehicles, machinery and equipment, railcars, boats, and livestock.

- Business value will decrease due to the elimination of the deferral of certain taxes for transactions, which reduces cash flow.

## 9 RESEARCH & DEVELOPMENT EXPENSE: CAPITALIZED AND AMORTIZED OVER 5 YEARS

Under the old tax law, taxpayers could elect to expense research and development (“R&D”) in the year occurred or alternatively, the company could capitalize the R&D expense over the useful life of the research (but no less than 60 months).

The TCJA amended that “Specified R&D Expenses” incurred after December 31, 2021, are now capitalized and amortized over five years (15 years if outside the United States).

“Specified R&D Expenses” includes expenses for software development but excludes expenses for land and property used in the course of R&D.

- Business value will decrease due to the reduction of the amortization tax deduction, increasing income tax expense, which reduces cash flows.

## 10 BUYERS’ COST OF CAPITAL: IMPACTS ON THE COST OF EQUITY AND COST OF DEBT

The overall impact on a potential buyer’s cost of capital has yet to be seen. The cost of capital is comprised of the cost of equity and the cost of debt.

- a) The potential impact on the cost of equity boils down to how participants react in the market.
  - How will companies utilize their tax savings?
  - Will debt-heavy companies try to lower their leverage ratios?
  - How will companies respond to new rules surrounding interest, depreciation, capital expenditures, and R&D?
  - Will a future legislature session lead to changes of the TCJA?
- b) The cost of debt component of the cost of capital will increase due to lower interest tax shields and new limits on the deduction of interest expense, which will have a greater impact on heavily leveraged firms and private equity firms that use debt to finance transactions. Even though the after-tax cost of debt is higher, lower income taxes will increase the ability of borrowers to service the debt.

- Business value will decrease due to an increased cost of debt, which raises the cost of capital.

Businesses will have a higher required rate of return, which negatively impacts the value.



Chaffe & Associates, Inc. is led by President and CEO, Vanessa Brown Claiborne, who also manages the Valuation group. With over 75 years of combined accounting and business valuation expertise, Chaffe’s certified public accounting team also includes Marc Katsanis who serves as the Senior Vice President, and Vice Presidents Riley Busenlener and Nene Glenn Gianfala. Chaffe’s Valuation Group has extensive experience in the valuation of businesses across a wide range of industries for mergers and acquisitions, private equity investment, estate and gift tax purposes, Employee Stock Ownership Plans (ESOPs), expert witness/litigation support, exit planning, shareholder transactions and restructuring, as well as intangible asset valuations for purchase price allocations specifically for business combinations and intellectual property valuation including patents and goodwill impairment.

*Pictured clockwise: Riley Busenlener, Vanessa Brown Claiborne, Nene Glenn Gianfala, and Marc Katsanis*