VIEWPOINT ON VALUE

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Do you have a **Question?** or want to speak to

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3 questions to ask about tax reform when valuing a business

In every business valuation assignment, the expert must consider the current regulatory environment. The recent tax reform legislation is the biggest change to the tax law in over 30 years. It will lower taxes for many businesses and is expected to provide various growth opportunities. When valuing a business under the new tax law, it's important to ask these questions.

1. How much tax will the company save?

The new tax law is known as the Tax Cuts and Jobs Act (TCJA) for a reason: It *cuts* the corporate tax rate to a flat 21% and eliminates the 20% corporate-level alternative minimum tax. Under prior law, C corporations and personal service corporations were taxed based on a graduated rate scale that topped out at 35%.

To help level the playing field, the new law also allows pass-through businesses — such as S corporations, limited liability companies, partnerships and sole proprietorships — to deduct 20% of qualified business income starting in 2018. This deduction is subject to various restrictions based on income levels and the entity's W-2 wages. In addition, this break isn't available for certain types of service businesses at higher income levels.

Experts must consider the full effects of reduced federal tax rates and other business-related tax law changes when valuing a business interest. (See "Beyond tax cuts" on page 3.) State taxes may also be affected by changes in the federal tax laws.

Most business owners have already discussed with their tax advisors how the new law will affect the company's cash flow and the value of any deferred tax items. A business valuation expert probably will ask about these tax planning meetings and request any notes that were taken. This information is essential during the valuation process.

2. How does management plan to use the savings?

Some businesses could be adversely affected by the tax law changes, such as those with substantial offshore assets and income. But most will pay less in federal taxes. Some companies will use their tax savings to repurchase shares, pay off debt, pay dividends or put money into savings. These options generally won't add value over the long run. Others will pursue growth strategies by buying new equipment, investing in R&D or hiring new workers. These alternatives could potentially add value.

Management's *intentions* about spending any tax savings are critical when valuing a *minority* interest. Shareholders who lack control of strategic decisions are at the mercy of controlling

shareholders who may not pursue growth options.

Conversely, when valuing a controlling interest, an expert might assume that management has a fiduciary duty to pursue options that maximize shareholder value. However, it's important to note that strategies that might expose stakeholders to excessive risks could adversely affect a company's cost of capital.

Management's spending plans could, in turn, affect other valuation assumptions. For example, if management plans to use tax savings to pay off debt, it could affect the company's capital structure and the cost of capital your valuation expert uses in the income approach.

3. Are management's cash flow projections reasonable?

Experts often rely on cash flow projections prepared by management to value a business. Before using these estimates, an expert must consider whether the effects of tax reform have been factored in and whether management's expectations appear reasonable.

For an added level of assurance, management can ask the company's accountant to review in-house projections. Or, better yet, management can have an outside financial expert prepare them independently.

Valuation is a moving target

The new tax law brings massive changes to businesses. Experienced valuation experts stay atop the latest legislative developments, consider how the changes will affect a subject company's earnings and adjust their methods accordingly. ■

Beyond tax cuts

When incorporating the effects of the Tax Cuts and Jobs Act (TCJA) into a business valuation, it's critical to identify provisions that could potentially affect a subject company's tax base (the amount to which new, lower tax rates will be applied). For example, the new law:

- Reduces the deduction for corporate dividends that C corporations receive from other corporations,
- Limits interest expense deductions for businesses with more than $25 million in annual revenue,
- Reduces or eliminates deductions for certain employee fringe benefits and business-related meals and entertainment,
- Imposes a new one-time repatriation tax on offshore earnings and profits for U.S. multinationals,
- Accelerates depreciation deductions for new and used asset purchases (though the expanded bonus depreciation breaks are only temporary),
- Eliminates the domestic production activities deduction or "manufacturers' deduction" under Section 199,
- Limits deductions for "excess business losses" incurred by noncorporate taxpayers and net operating losses (NOLs),
- Liberalizes the eligibility rules for the cash method of accounting,
- Restricts like-kind exchanges for personal property assets,
- Limits compensation deductions for amounts paid to principal executive officers, and
- Requires certain R&D expenses incurred after 2022 to be capitalized and amortized over five years (15 years if conducted outside the United States) instead of being deducted currently.

All these changes could potentially affect a company's cash flow and long-term growth. But the effects will vary from company to company, so it's important to have an in-depth understanding of the new tax law.

Classifying shareholder "loans"

Are loans to and from shareholders bona fide debt obligations, a form of equity capital or a hybrid of the two? The distinction is relevant when valuing a business, as well as in divorce cases. Often, experts turn to the IRS rules for objective guidance on this matter.

IRS stance

Owners occasionally borrow funds from their businesses, say, to pay a child's college costs or provide a down payment on a vacation home. These loans to shareholders appear on a company's balance sheet as a *receivable.*

For loans of more than $10,000, the IRS requires taxpayers to treat the transaction as a bona fide debt. Then the company must charge the shareholder an "adequate" rate of interest. Each month the IRS publishes its applicable federal rates (AFRs), which vary depending on the term of the loan.

If the company doesn't charge interest or follow a complicated set of below-market interest rules to impute interest on the loan, the IRS may claim the shareholder received a taxable dividend or compensation payment rather than a loan. The company may deduct the latter, but it will also be subject to payroll taxes. However, both dividends and additional compensation would be taxable income to the shareholder personally.

Loans may also be made from the shareholder to the business. These transactions appear as a *liability* on the company's balance sheet. Interest should also be charged or imputed on these amounts. Interest expense is claimed as income by the shareholder and deducted as an expense by the business.

Valuation connection

Classifying debt vs. equity transactions may also be relevant when estimating the value of an equity interest in a business. In some

cases, a business valuation professional may decide it's appropriate to reclassify a note to or from a shareholder to the equity section of the balance sheet, because management has treated the transaction as a capital contribution, a distribution or a draw on the shareholder's equity account.

In turn, such reclassification may reduce the amount of debt in the company's capital structure, thereby possibly increasing its cost of capital. (That's because the cost of debt is typically less than the cost of equity.) The cost of capital is a key input when applying the income approach.

Likewise, when using invested capital methods — which derive preliminary values that include both interest-bearing debt and equity — experts must subtract interest-bearing debt to arrive at the value of equity. So, to the extent that shareholder loans have been reclassified from debt to equity, the expert will have less debt to subtract from the value of invested capital.

In divorce cases, the distinction may be particularly important, depending on when an asset was acquired or a debt was incurred. For example, a marital estate might specifically exclude a business interest that was acquired before the couple was married, but it might include a loan made during the marriage to keep the company afloat during a market trough. Or the marital estate might include loans from the company to pay for a shareholder's personal expenses incurred during the marriage. Matters are more complicated for businesses with multiple owners.

6 factors

When deciding whether payments made to shareholders qualify as bona fide loans, the IRS considers these six factors:

1. Loan size,
2. Earnings and dividend-paying history,
3. Provisions in the shareholders' agreement about limits on amounts that can be advanced to owners,
4. Loan repayment history,
5. The shareholder's ability to repay the loan, based on his or her annual compensation, and
6. The shareholder's level of control over the company's decision making.

The IRS also asks whether the shareholder executed a formal, written note that specifies the repayment terms, such as the interest rate, a maturity date, any collateral pledged and a repayment schedule.

Debt or equity?

The classification as equity or debt can potentially have a material impact on the overall value of the firm. Deciding whether transactions between a company and its shareholders qualify as debt or equity can be somewhat subjective. But the IRS guidance outlines some objective considerations that can be used to support an expert's decision. ■

How will new accounting rules affect the valuation process?

Under U.S. Generally Accepted Accounting Principles (GAAP), two new accounting rules on revenue recognition and leases will soon go into effect. In turn, the new rules could affect parts of the business valuation process.

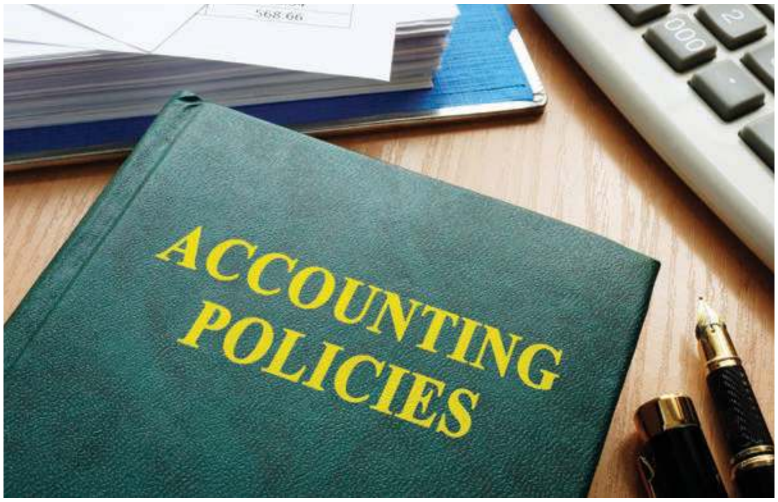
Overview of changes

First, it's important to understand the changes the standards will bring to companies that follow GAAP.

Revenue recognition. ASU No. 2014-09, *Revenue from Contracts with Customers*, primarily affects the timing of revenue recognition. It replaces about 80 industry-specific revenue recognition rules with a basic principle: Companies should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the payment that it expects to be entitled to in exchange for the goods or services.

Public companies must implement the new revenue recognition standard in 2018. It will have a major impact on entities that enter into long-term contracts with customers, such as software, wireless and media companies and asset managers.

Leases. Under the current accounting rules, companies report many obligations for leasing real estate, vehicles and equipment as operating leases on their income statement under rent expense. Starting in 2019, ASU No. 2016-02, *Leases*, is expected to add more than $1.2 trillion in off-balance-sheet leases to public companies' balance sheets.



For all leases with terms of more than 12 months, the revised standard requires right-to-use assets and lease obligations to be added to the balance sheet. A lease obligation must be discounted to its present value by the rate implicit in the lease or the lessee's incremental borrowing rate.

Financial analysis

Early adoption of the updated standards is permitted under GAAP. Plus, private companies receive a one-year delay for implementing the changes. As companies adopt the changes using different timelines, it may be difficult to compare early-adopters vs. on-time adopters, public vs. private companies, and the subject company before vs. after implementation. Beyond that time frame, the changes could result in apples-to-oranges comparisons between companies that follow GAAP and those that report results using another basis of accounting (such as tax-basis financials).

Valuation experts benchmark financial performance to get a handle on a company's risk profile and capital structure. This analysis may be used to adjust pricing multiples or to estimate future cash flow and discount rates.

When analyzing the subject company's financial results, business valuation experts consider whether the company and the companies that it's benchmarked against have implemented the new standards. In some cases, an expert may need to adjust the financial statements to achieve meaningful comparisons.

Methods

Likewise, when using comparable pricing data under the market approach, business valuation experts must consider whether the subject company and the comparable companies have implemented the changes.

For example, when valuing a software company as of December 31, 2018, it might not be accurate to apply 1) a price-to-revenue multiple based on transactions involving comparable public software companies that have implemented the new revenue recognition standard to 2) a private software company that hasn't implemented the new standard.

In some cases, an expert may need to adjust the financial statements to achieve meaningful comparisons.

Experts also need to consider whether the company has implemented the accounting rule changes when applying the income approach. For example, changes to the lease accounting rules could make lessees appear significantly more leveraged than they were under the old rules. If an expert uses the industry average capital structure to quantify the weighted average cost of capital for a small business, it's important to consider the extent to which these companies have implemented the new lease standard.

Dig deeper

Major changes are coming to U.S. GAAP. Before relying on financial statements to value a business, experienced experts evaluate the company's underlying accounting methods and consider the extent to which they will affect the value of the business. ■

Garbage in, garbage out

Court rejects DCF model based on flawed projections

The Delaware Court of Chancery deferred to the deal price, not a discounted cash flow (DCF) analysis, in a recent going-private merger of pet specialty retailer PetSmart. Although DCF is often seen as the "gold standard" in valuation tools, this method is only as reliable as its underlying assumptions.

Experts offer divergent conclusions

In *In re Appraisal of PetSmart, Inc.*, both sides hired experts to estimate the fair value per share on the merger date (March 11, 2015). The petitioner's expert concluded that fair value was $128.78 using a DCF model. He discounted the company's free cash flows to present value using the weighted average cost of capital and then subtracted debt to determine the value of equity. Management prepared the projections of future cash flows *exclusively* for the merger.

PetSmart's expert concluded that the most reliable indicator of fair value on the transaction date was the merger price ($83). He said it resulted from a "well-run active auction" where 1) the sale was well publicized, 2) there were many interested parties and multiple bids, and 3) the incentives of the board and management aligned with those of the shareholders. PetSmart's expert also said that management's projections "were prepared specifically for the sale process (not in the ordinary course of business) by inexperienced management who were pushed [by the board of directors] to be overly optimistic."

Court sides with PetSmart

After hearing testimony from 17 witnesses (including four experts) and reviewing over 2,300 exhibits, the Delaware Court of Chancery deemed management's projections unreliable for the following reasons:

- PetSmart's use of long-term projections was "unprecedented."
- The projections were created for the purpose of obtaining benefits outside PetSmart's ordinary course of business.
- The projections were inconsistent with the company's recent performance.
- The company had a poor history of meeting its projections.

Instead, the court concluded that the merger price was the result of a "robust pre-signing auction in which adequately informed bidders were given every incentive to make their best offer in the midst of a well-functioning market."

Expertise is essential

"Every company is different; every merger is different," said the court in *PetSmart*. Merger price may not always be the most reliable indicator of fair value. Business valuation expertise is an essential part of any appraisal rights claim. When reliable long-term cash flow projections are available, the DCF model may be a useful valuation tool. ■

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Michael has more than 30 years of experience with a focus on valuation, litigation support, and taxation issues. He has additional expertise in auditing, financial statement analysis and consulting. His traditional accounting experience, includes taxation and financial statement reporting for closely held businesses, with a concentration on professional practitioners, real estate developers, construction contractors, retailers, manufacturers, and computer hardware and software providers.

Michael earned his Bachelor of Science Degree from the University of Delaware. He holds accounting certifications in both New Jersey and New York. Michael is a member of the American Institute of Certified Public Accountants (AICPA), a recipient of the AICPA's Accredited in Business Valuation (ABV), and Certified in Financial Forensics (CFF) designations. Michael is a member of the New Jersey Society of Certified Public Accountants (NJSCPA), where he was the Group Leader of the Business Valuation, Forensic & Litigation Services Interest Group, and is currently on the Steering Work Group. He is certified by the National Association of Certified Valuation Analysts (NACVA), and holds that organization's highest designation as a Certified Valuation Analyst (CVA). He is accredited as a Certified Fraud Examiner (CFE). In addition, Michael is an Accredited Senior Appraiser of the American Society of Appraisers (ASA).

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