Business valuation post–Tax Cuts and Jobs Act

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Introduction

On Dec. 22, 2017, President Donald Trump signed into law the Tax Cuts and Jobs Act (TCJA) that is effective for tax years beginning after Dec. 31, 2017, with a few exceptions.

This paper introduces the direct and indirect valuation impacts resulting from the provisions of the TCJA that affect businesses [1] and provides a framework for professional service providers, business owners and investors to understand how to incorporate the new provisions into valuations.

The following topics and corresponding valuation adjustments are addressed:

PRIMARY VALUATION IMPACTS

Provision	Impacts
Reduced corporate tax rates	▪ Valuation specialist must use new corporate tax rates ▪ Valuation specialist should consider adjustments to historical market data to match the current tax rates ▪ Valuation specialist should consider the impact to the discount rate and the capital asset pricing model, given the limitations on the deductibility of interest expense ▪ Valuation specialist should consider unique impact on pass-through entities
Limitations on the deductibility of interest expense	▪ Valuation specialist has options: – No change for profitable, low-leverage companies – Three-component capital structure for medium- to high-leverage companies – Cash flows to equity for high-leverage companies ▪ Generally does not apply to companies with less than $25 million in revenue

1 Quantification of the valuation impacts on businesses and the provisions of the TCJA related to individuals are outside of the scope of this paper.

PRIMARY VALUATION IMPACTS (continued from p. 1)

Provision	Impacts
Limitations on net operating losses (NOLs)	▪ Valuation specialist must incorporate changes into valuation modeling
Accelerated capital expensing	▪ Valuation specialist must incorporate changes into valuation modeling

OTHER VALUATION IMPACTS

Provision	Impacts
Market multiples and calibration	▪ Valuation specialist must be able to explain the change in value from pre-TCJA valuation dates to post-TCJA valuation dates
Impact on domestic companies with foreign operations	▪ Valuation specialist must consider the change to a territorial tax system in calculating the effective tax rate for companies with foreign operations
Impact from sunset provisions	▪ Based on history with tax reform, it is prudent to consider the taxation changes permanent until legislation is passed to amend taxation laws or the provisions are allowed to elapse

These valuation impacts are expected to have significant effects on how business owners and investors assess their ownership interests and set strategic plans in light of the additional cash flow that might be available to them.

Initial reactions to the TCJA are generally positive within the business community. Over the six months leading up to Dec. 22, 2017, the S&P 500 index grew 10.2 percent[2] with many attributing a meaningful portion of that growth to the anticipation of tax reform. Much of the optimism is based on the reduction in the top corporate tax rate from 35 percent to 21 percent, which makes U.S. corporations more attractive and competitive globally. However, along with the reduction in tax rates, there are also unfavorable changes like limitations on the use of NOLs and the deductibility of interest expense.

Accordingly, the long-term valuation impact of the TCJA is uncertain, and it will take time for business owners and investors to fully process the complexity of the new provisions. While we certainly expect to see values continue to rise, no one can predict if the bump in market values will normalize or if increased values are here to stay.

This paper is limited to our opinions on the TCJA's impact on valuation and does not include any form of tax advice or tax opinion. We strongly urge you to consult your tax advisors with respect to any tax-related matters. As practitioners continue to address the new provisions and the resulting valuation impacts become clearer, our opinions may change from those presented in this paper.

Summary of impacts on valuation approaches

As mentioned in the introduction to this paper, market values increased in anticipation of tax reform. This paper focuses on the valuation impact of the new provisions specifically with regard to valuation methodologies under the market approach and the income approach.

Market approach

While the new provisions can be discretely captured in income approach methodologies, as detailed in the sections that follow, their impact is harder to isolate when applying the market approach. In fact, several questions arise:

- Transaction multiples:
  - How can one apply pre-reform multiples in post-reform valuations?
  - What types of adjustments, if any, should be made to the multiples?
  - If earnings reflect the new tax provisions, should any adjustments be made to the multiples?
- Public company multiples:
  - If multiples reflected the anticipation of tax reform as early as summer 2017, are companies overvalued using these multiples prior to official passage of tax reform?
  - When calculating multiples, should earnings be adjusted to reflect the new provisions if the market was already pricing tax reform into valuations?

2 S&P Capital IQ.

These are just a handful of the questions resulting from tax reform. As with anything in valuation, the valuation specialist must consider all facts and circumstances and avoid blind application of valuation assumptions, like pricing multiples, to derive value. Also, given the ability to discretely capture the new provisions in income approach methodologies, it is now more important than before to corroborate valuations with multiple methodologies. A significant divergence in value between a market approach methodology and an income approach methodology likely signals the need for a second look at assumptions and a deeper dive into how the TCJA might have affected both indications of value.

Income approach

At first glance, income approach methodologies seem best suited to capturing the valuation impact of the TCJA. The new tax rates, the NOL limitations, the interest deductibility limitations and the other provisions can easily be captured in the cash flows underlying the methodologies. However, the changes aren't as simple as they might seem. The valuation specialist must not only consider the cash flow impacts but also the risk impacts. Additionally, some of the new provisions are temporary and have income-phase-out provisions that limit their application.

This paper focuses on how the TCJA's provisions affect valuations and our general suggestions on how to adjust assumptions to capture their impacts.

Tax rates

Top corporate rate reduced for tax years beginning after Dec. 31, 2017

The impact generating the most buzz is the reduction of the federal income tax rate for corporations generating income in the United States from a rate of 35 percent to 21 percent, beginning in 2018. Additionally, for dividend income from certain foreign subsidiaries, U.S. corporations will no longer be required to pay the differential to the U.S. tax rate and can repatriate income tax-free when desired. The resulting reform is similar to what some other countries have and is known as a territorial system. Historically, in the United States, corporations were required to pay the difference between foreign rates compared to U.S. rates, upon repatriation of foreign income into the United States. More on this topic as well as its impact on the reduction of the amount of "trapped cash" sitting in U.S. companies' foreign subsidiaries in the future and other considerations involving the new foreign derived intangible income (FDII) deduction are discussed further below.

With state and local taxes, the all-in tax rate is likely to fall from 40 percent to a range of 23 to 28 percent, depending on a company's state and local tax rate.

Impact on pass-through entity benefits

Per RSM's Washington National Tax (WNT) practice, "the recent enactment of the TCJA has many pass-through clients asking whether converting to C corporation status might be beneficial. With corporate tax rates falling to 21 percent, and much less generous reductions for pass-through entities, clients are quickly sensing an opportunity to reduce their annual tax burden." We recommend that valuation specialists continue to quantify the S corporation premium for pass-through entities. That said, the S corporation benefit following the TCJA appears to be minimal from the sensitivities performed thus far, depending on the type of business (service or nonservice), as well as the impact from temporary and permanent differences. Given the reduction in benefit, as the C corporation status is more favorable than it was previously, the valuation specialist should scrutinize whether a premium still exists on a case-by-case basis. Additional information regarding corporation status and potential impacts can be found in the following article, Converting from S corporation to C corporation: Select issues for consideration.

Tax rate considerations in the weighted average cost of capital (WACC)

It is important to understand the TCJA's potential impact to the discount rate, specifically, the beta. Challenges arise due to the inability to deduct all interest expenses, ultimately affecting the tax rate a company pays on earnings before taxes (EBT) and the optimal leverage model. Traditionally, each comparable company beta is unlevered at the respective comparable company's tax rate and relevered at a market participant tax rate. As betas begin to incorporate post-TCJA returns, unlevering at old tax rates will not capture the tax incentives or leverage model going forward, but rather capture the historical levels. For valuation, as we aim to align the WACC with the risk and expected return of the cash flows in the future, that future return needs to consider the TCJA.

We recommend considering the new statutory tax rates when unlevering betas within the WACC analysis once historical betas capture a sufficient level of post-TCJA returns, which should be assessed on a case-by-case basis. Consideration must also be given to the comparable companies' optimal leverage levels. For highly leveraged companies, the effective tax rate on earnings before taxes (EBT) may be higher due to the inability to deduct all interest expense, as discussed in more detail in the section below. For those comparable companies that are leveraged above the optimal level, an effective tax rate above the statutory rate may need to be considered and evaluated. Regarding relevering, the type of valuation (control or minority) should be considered. This fact pattern has not changed. For controlling valuations, a market participant statutory tax rate that aligns with the TCJA should be utilized. The same nuances that need to be deliberated in the unlevering process also need to be considered in the relevering process. If some industries and their corresponding market participants operate with debt leverage above the optimal level, a higher statutory tax rate accounting for the industry's inability to deduct all interest expense may need to be applied for a controlling valuation (i.e., an additional component in the WACC and the resulting tax rate from the TCJA). For minority interest valuations, the actual capital structure is still applied, which may or may not be above the optimal leverage model. Similar to a controlling valuation, if leverage is above the optimal level, an additional component may be added to the WACC and the resulting tax rate needs to be applied.

Sample WACC calculation:

Control valuation/Market participant perspective		
GPC Average Interest Expense/EBITDA	50.0%	(a)
Less: TCJA Allowable Interest Deduction (as % of EBITDA)	30.0%	(b)
Implied Non-deductible Interest Expense	20.0%	(c) = (a-b)
% of Non-deductible Interest Expense (as % of GPC Avg Int.Expense/EBITDA)	40.0%	(d) = (c/a)
Industry Interest-Bearing Debt/Total Capital Structure	25.0%	(e)
Multiplied by: % of Non-deductible Interest Expense	40.0%	(d)
Non-Deductible Interest-Bearing Debt/Total Capital Structure	10.0%	(f) = (e*d)
Industry Interest-Bearing Debt/Total Capital Structure	25.0%	
Industry Equity/Total Capital Structure	75.0%	(g) = (1-e)
TCJA New Tax Rate	25.0%	
Prior Tax Rate (before TCJA)	40.0%	

Financing	Cost	Weighting	Weighted
Cost of Equity	15.0%	75.0%	11.3%
After-tax Cost of Debt	3.8%	15.0%	0.6%
Pre-tax Cost of Debt	5.0%	10.0%	0.5%
Weighted Average Cost of Capital - TCJA		100.0%	12.3%
Weighted Average Cost of Capital - before TCJA (@40%)			12.0%

A single weighted average cost of debt is assumed for the industry. For simplicity purposes, the debt is assumed to have weighted average similar interest payments.

Minority valuation		
Revenue	$100.0	
EBITDA	$10.0	(a)
Multiplied by: TCJA Allowable Interest Deduction (as % of EBITDA)	30.0%	(b)
Allowable Interest Deduction	$3.0	(c) = (a*b)
Divided by: Entity-specific Pre-tax Cost of Debt	8.0%	(d)
Implied Deductible Interest-Bearing Debt	$37.5	(e) = (c/d)
Implied Deductible Interest-Bearing Debt/ Total Capital Structure	46.9%	(f) = (e/i)
Implied Deductible Interest-Bearing Debt/ Total Interest-Bearing Debt	67.0%	(g) = (e/h)
Total Interest-Bearing Debt	$56.0	(h)
Total Capital Structure	$80.0	(i)
Total Company Interest-Bearing Debt/Total Capital Structure	70.0%	(j) = (h/i)
Total Company Equity/Total Capital Structure	30.0%	(k) = (1-j)
TCJA New Tax Rate	25.0%	
Prior Tax Rate (before TCJA)	40.0%	

Financing	Cost	Weighting	Weighted
Cost of Equity	15.0%	30.0%	4.5%
After-tax Cost of Debt	6.0%	46.9%	2.8%
Pre-tax Cost of Debt	8.0%	23.1%	1.9%
Weighted Average Cost of Capital - TCJA		100.0%	9.2%
Weighted Average Cost of Capital - before TCJA (@40%)			7.9%

As with any minority interest valuation, an interative capital structure should still be applied. The example above is just one example of the minority WACC.

Interest expense

Primary valuation impacts

- Companies which are profitable and have low leverage will see little or no valuation change if their interest expense does not reach the interest deduction limit.
- Medium- to high-leverage companies may add an additional component to the capital structure to include nondeductible interest expense.
- Alternatively, highly leveraged companies could discount cash flows to equity to reflect the interest deductibility limitation.
- This will not apply to some smaller companies and certain other businesses.[3]

The TCJA introduced a new limitation for interest deductibility. Other limitations on interest deduction remain. The new limitation is much broader in scope. Deductions for net interest expense will now be limited to 30 percent of adjusted taxable income (ATI). ATI is generally intended to represent earnings before interest, taxation, depreciation and amortization (EBITDA) through 2021 and 30 percent of earnings before interest and taxation (EBIT) thereafter. Interest deductions disallowed by this limitation generally will be carried forward to be retested in succeeding years. Our two *Tax Alerts* available here and here contain additional information about the new interest limitation.[4] This limitation will have the greatest impact on highly leveraged companies but will also substantially affect financially troubled companies.

Highly leveraged companies will now face this new strict limit on tax-deductible debt financing, which may cause a shift in optimal capital structures. Further, companies with depressed EBITDA margins but high interest expenses may pay taxes despite having losses in a given year.

From a valuation perspective, these changes must be captured in the WACC and the beta calculations. For the WACC, the company's optimal structure and expected earnings margin must be considered. Despite a company being currently highly leveraged, its optimal capital structure must be determined to assess interest deductibility on a go-forward basis. In addition to this, while a company may be financially troubled in a given year, the company's normalized earnings, with consideration given to projected and historical results, must be considered in order to determine the company's interest deductibility going forward based on the capital structure. This may result in an additional debt component in the capital structure: tax deductible interest-bearing debt and non-tax deductible interest-bearing debt.

While the above methodology takes the interest provisions of the TCJA into consideration, when valuing highly leveraged companies, valuation specialists may want to dive deeper into a review of interest deductibility by discounting cash flows to equity. When using equity cash flows, special consideration must be given to carry over interest deductibility. Per the TCJA, if interest is not deductible in a given year under the new limitation provision, the interest may be carried forward indefinitely and used to reduce taxable income if the limitation has not otherwise been reached. This may be the case if the company's capital structure is expected to change in the future or if earnings are expected to increase. In the event of a change of control, this carryover interest deduction will be subject to section 382 limitations, similar to NOLs.

Companies that have average gross receipts not exceeding $25 million for the three taxable years ending with the prior taxable year generally will be exempt from the new interest deductibility rules from the TCJA.[5] This threshold will be indexed to inflation after 2018.

After 2021, the ATI on which the interest deductibility is calculated will automatically change from an EBITDA analog to an EBIT analog. Congress has already seen opposition to this change. A collection of companies and trade groups wrote a letter to Senate leaders noting that this change would put "U.S. businesses at a competitive disadvantage around the world" given that interest deductibility limits are based on EBITDA in other countries around the world.[6] This change would have a significant impact on companies with high capital expenditures so it is not clear if this

3 There are a number of businesses that will be exempt from this limitation including, but not limited to, certain real property businesses, regulated sale of electricity, water or sewage services, etc. Review the TCJA and/or consult a tax professional for additional information regarding exempt businesses.

4 http://rsmus.com/what-we-do/services/tax/lead-tax/broad-new-limitation-on-business-interest-deductions.html and https://rsmus.com/what-we-do/services/tax/lead-tax/irs-notice-on-section-163j-business-interest-deduction-limitatio.html.

5 The gross receipts measurement takes into account rules aggregating gross receipts of various related entities and persons, and the exception is not available for tax shelters prohibited from using the cash method of accounting for federal income tax purposes. Review the TCJA and/or consult a tax professional for additional information.

6 BUILD Coalition Letter, Nov. 28, 2017.

change will come into effect. As noted above, however, it is prudent to consider the tax law changes permanent unless the law is further amended or allowed to lapse.

Net operating losses

Primary valuation impacts

- NOLs generated in 2018 and beyond need to be assessed separately from other NOLs as:
  - Their use is limited to 80 percent of taxable income in each year
  - They can be carried forward to offset future income indefinitely, but not carried back to offset past income
  - There are some exceptions to these NOL rules: they do not apply to property and casualty insurance companies, and certain farming losses may be carried back to offset prior income

Pre-reform	Post-reform	Applicable time period
NOLs can generally be carried back two years and carried forward 20 years to offset taxable income	▪ Carrybacks generally are disallowed ▪ NOLs generally can be carried forward indefinitely	Applicable to NOLs generated in taxable years ending after Dec. 31, 2017
NOL carryforwards and carrybacks can be used to fully offset taxable income (except for alternative minimum tax purposes)	NOLs can only be used to offset 80 percent of taxable income each year	Applicable to NOLs generated in taxable years beginning after Dec. 31, 2017

Example:

- Background:
  - A company with tax years ending Dec. 31 generated $100 million of NOLs through Dec. 31, 2017.
  - The company then generates $80 million of NOLs in the tax year ending Dec. 31, 2018.
  - No limitations on the use of NOLs (such as the section 382 limitation) apply to the company at any time.
- Scenario 1: The company achieves $100 million of taxable income in 2019 and $90 million of taxable income in 2020.
  - The company can use the $100 million of NOLs generated through 2017 to fully offset 2019 income.
  - The company can only use $72 million of the $80 million NOL generated in 2018 to offset income in 2020 based on the 80 percent limitation.
- Scenario 2: The company achieves $130 million of taxable income in 2019 and $90 million of taxable income in 2020.
  - The company can use the $100 million of NOLs generated through 2017 to offset $100 million of 2019 income.
  - The company can use the $24 million of NOLs generated in 2018 to offset $24 million of the remaining $30 million of 2019 income ($30 million x 80 percent = $24 million).
  - The company can use the remaining NOL balance of $56 million ($80 million – $24 million = $56 million) to offset 2020 income as it is under the 80 percent limitation of $72 million ($90 million x 80 percent = $72 million) allowed to be used to offset 2020 income.

The disallowance of NOL carrybacks could be detrimental to companies experiencing financial distress, as they would not receive the immediate cash flow from a tax refund resulting from the carryback of NOLs to offset income earned in prior years. Further, the ability to carry forward NOLs indefinitely may not be as beneficial as initially apparent. Companies need to assess their abilities to realize future NOL tax benefits as financially distressed companies may not ever realize the NOL tax benefits despite indefinite carryforwards.

Internal Revenue Code (IRC) section 382, which is applicable to tax years after a change in control, remains unchanged by the TCJA. Both section 382 and the 80 percent limitation may apply. Given the additional complexities introduced by the TCJA surrounding NOL usage, we recommending consulting a tax advisor, especially if a company has NOLs generated pre- and post-TJCA in addition to having NOLs subject to section 382 limitations.

Capital expensing

Primary valuation impacts

- Valuation specialists need to understand the subject company's historical and projected capital expensing policy since there are multiple recovery options; however, most companies would choose to take advantage of bonus depreciation to reduce taxable income.
- Full expensing of qualified property vs. capitalizing and depreciating over the useful life generally creates a timing impact related to cash flow. Ultimately, these new rules affect the timing of when companies may take deductions for capital expenditures.
- Companies in certain industries or in early stages of development with a high volume of capital expenditures (e.g., plant and equipment) may experience a significant tax benefit from 100 percent bonus depreciation. On the other hand, companies that invest in research and experimentation (R&E) expenditures or intangible assets may benefit less.
- Certain classes of property are subject to specific provisions that must be understood when applying the capital expensing provisions of the TCJA. This paper does not introduce all new provisions; readers must consult a tax advisor to fully understand the provisions applicable to their industry.

Other valuation impacts

- The capital expensing provision of the TCJA will likely result in larger disparity between book depreciation and tax depreciation so it will be important to understand the differences when analyzing cash flow.
- This also adds more importance to purchase price allocations/ASC 805. Immediate expensing was expanded to certain used property, so the acquirer could have significant write-offs of purchase price in the year of the acquisition. However, full expensing is limited and does not extend to most intangible property, goodwill or to assets such as land or most real estate.
- This provision increases the benefit of asset transactions over stock transactions, but the lowering of the corporate rate to 21 percent does somewhat reduce the benefit of an asset transaction under the previous rules.

Full expensing of qualified property

The TCJA provides for immediate expensing (i.e., 100 percent bonus depreciation) for certain qualified assets acquired and placed in service on or after Sept. 27, 2017, and before Jan. 1, 2023. However, taxpayers must be cognizant of the fact that the placed-in-service date is not the only date that determines eligibility for the 100 percent bonus. The acquisition date is also relevant. Section 168(k)(8) contains a special rule phasing down the bonus percentage for assets acquired before Sept. 28, 2017.

For such property, the applicable bonus percentage is as follows:

- Placed in service during 2017 — 50 percent
- Placed in service during 2018 — 40 percent
- Placed in service during 2019 — 30 percent
- Placed in service after 2019 — 0 percent

Thus, in order to qualify for the 100 percent bonus, both the acquisition date and the placed-in-service date of the qualified property must fall after Sept. 27, 2017. In determining the acquisition date, companies should note two special rules under the existing Reg. section 1.168(k)-1 regulations. First, an asset will be deemed to be acquired when the company entered into a binding purchase contract for that asset. Second, for self-constructed assets, the taxpayer is deemed to have "acquired" the asset once it begins its manufacture, construction or production, which is further defined as when "physical work of a significant nature" begins. Under the available safe harbor, "physical work of a significant nature" begins when 10 percent of the property's total cost is incurred. Taxpayers contracting for the manufacture, construction or production of an asset are treated as self-constructing the asset. While the IRS has not updated Reg. section 1.168(k)-1 since tax reform passed, there is no reason to expect divergent guidance on either of these issues.

Step down and phase out

The TCJA increased the expensing allowance under IRC section 179 to $1 million, but still subject to limitations and phaseouts. This had previously been in place, but was capped at $500,000. There is also a limitation at the individual level so consideration should be made for pass-through entities.

The 100 percent bonus depreciation benefit will begin to phase out in 2023 and be completely phased out by 2027 for all assets other than aircraft and other longer production assets, which will phase out in 2028. The applicable expense percentage is reduced to 80 percent, 60 percent, 40 percent and 20 percent for qualified property placed in service in calendar years 2023, 2024, 2025 and 2026, respectively. In the case of qualified property acquired before Sept. 28, 2017, but placed in service after Sept. 27, 2017, the applicable expensing percentage (50 percent) under current law would apply. An opt-out election will still be available for taxpayers who do not wish to accelerate depreciation.

Valuation specialists should consult with tax advisors to ensure that all limitations and phaseouts are appropriately considered in the projected financial information.

Qualified property

The definition of qualified property subject to bonus depreciation was expanded to include acquired used property. This does not apply to goodwill and most intangible assets. Be aware that more than half of the states currently do not conform to bonus depreciation. The definition of qualified property includes, but is not limited to:

- Equipment (machines, etc.) purchased for business use
- Tangible personal property used in business
- Business vehicles with a gross vehicle weight in excess of 6,000 lbs. (IRC section179, vehicle deductions)
- Computers, computer off-the-shelf software
- Office furniture, office equipment
- Property attached to your building that is not a structural component of the building (i.e., a printing press, large manufacturing tools and equipment)
- Partial business use (equipment that is purchased for business use and personal use: generally, your deduction will be based on the percentage of time you use the equipment for business purposes)

The TCJA will expand the definition of qualified property to include qualified film, television and live theatrical productions. The term qualified property will not include any property used in the trade or business of certain regulated public utilities and any property used in a trade or business that has had floor plan financing indebtedness.

Any eligible trades or businesses that elect out of the interest expense limitations must depreciate real property under the alternative depreciation system (ADS). When making an election with respect to real property depreciation rules, business interest limitations should generally be considered.

Research and experimentation expenditures

The TCJA resulted in significant changes to the treatment of R&E expenditures. Before tax years beginning after Dec. 31, 2021, companies still have an option of how to treat R&E expenditures under IRC section 174 on their tax returns. Currently, two options are available: direct expensing of R&E expenditures when paid or incurred, or capitalization and amortization over no less than 60 months from when the company first begins to derive benefit from the R&E. However, under the TCJA, companies will have less flexibility in treating these expenditures.

For tax years beginning after Dec. 31, 2021, companies must capitalize and amortize all R&E expenditures paid or incurred in connection with their trade or business. The straight-line recovery periods are five years and 15 years for domestic and foreign incurred R&E, respectively, and the midpoint of the tax year is utilized as the convention for the first year of amortization. Capitalized R&E must continue to be amortized over the remaining five- or 15-year life even if a research project is abandoned, disposed of or retired. Historically companies have taken the position that the remaining basis could be written off upon abandonment or disposition. Ultimately, these new rules do not prevent a taxpayer from taking a deduction for R&E; however, they very much affect the timing of when companies are allowed to take that deduction.

Other considerations

Private equity portfolio company mark-to-market valuations

The effects of the TCJA on private equity funds, partners and their portfolio companies are numerous and beyond the scope of this paper. For additional information, refer to our insight article on the topic.

For valuation specialists involved with assessing the fair value of private equity investments in portfolio companies, the TCJA presents its own set of challenges. These challenges primarily manifest as we try to reconcile a value as of Dec. 31, 2017, less than two weeks after the reform passed, with the previous quarter or year.

First it is critical to understand that public company trading multiples will generally best reflect the impacts of the TCJA that were known or knowable by market participants as of the valuation, or measurement, date. Exceptions may occur when the publicly traded companies are not very comparable to the subject mark (e.g., the comparable companies all have significant foreign operations whereas the subject company does not).

However, this understanding does not allow a valuation specialist to simply apply public company-derived multiples to a post-reform measurement date without attempting to reconcile to past measurement dates. If the subject mark appreciated in value by a significant or surprising amount from the prior, pre-reform measurement date to the current, post-reform measurement date, then the valuation specialist must investigate more closely.

For example, assume the private equity fund's position in the subject company increased by 15 percent from Sept. 30, 2017 to Dec. 31, 2017. Historically, the position had remained flat or increased 3 to 5 percent each period, unless there was a financing round in which case the position usually increased 10 percent or more. Further, assume the subject company raised no additional capital nor achieved any milestones during the final quarter of calendar year 2017. How might a valuation specialist go about quantifying or at least evaluating the effects of the TCJA on this increase in value?

Presented below is a simple framework for evaluating the effects of the TCJA. This is not meant to be exhaustive or prescriptive. Each subject company is unique and must be analyzed as such. Still, the framework will prove useful when confronted with a situation like the one discussed above.

- Compare the movement in comparable companies' multiples between the post-reform measurement date and a contemporaneous pre-reform date such as Dec. 1 or Dec. 15, 2017, rather than the prior measurement date.
- Consider the general appeal of the TCJA to the comparable and subject companies. Typically, those companies that benefit the most from the TCJA:
    1. Are not highly-levered
    2. Devote significant resources to capital expenditures
    3. Were subject to a high effective tax rate prior to the TCJA
- Evaluate the comparable and subject companies' foreign operations, specifically if any of the companies had significant trapped cash (see next subsection). A significant balance of trapped cash may produce a one-time valuation increase, as might the prospect of a territorial tax system (also discussed in the next subsection).
- Determine whether the comparable subject companies suffered any significant one-time charges due to revised estimates of deferred tax assets (DTA) or liabilities (DTL). While outside the scope of this paper, the TCJA required companies to revise their estimates of the fair value of such assets and liabilities and take a charge through the income statement, if necessary. Such a one-time charge, whether positive or negative, could affect the valuation multiples as of the measurement date. With respect to the subject company, the effects of any DTA or DTL revision should be adjusted out of the historical or projected financial performance before applying multiples.

Returning to our previous example, let's assume the valuation specialist recalculated the comparable companies' multiples as of Dec. 1, 2017 as a first step in assessing the cause of the 15 percent increase in value. The valuation specialist determined that from Dec. 1 to Dec. 31 the mean multiples only increased approximately 3 percent, which seemed reasonable because these companies do not fit the typical profile of beneficiaries of the TCJA. However, the valuation specialist noticed that two of the comparable companies were dragging down the mean multiples because both companies announced significant one-time charges to earnings due to revised deferred tax asset estimates. Once removed from the group of comparable companies, the mean increase in EBITDA multiples between Dec. 1 and Dec. 31 increased from approximately 3 percent to over 10 percent. After discussing with the private equity group, audit firm and other professionals, the team was able to get comfortable with a 15 percent increase over the prior measurement date since so much of that increase seemed to be generated by once-in-a-generation tax reform.

Taxation of foreign income and trapped cash

The TCJA fundamentally changes how U.S.-domiciled corporations' foreign income is taxed. Previously, U.S. companies had to first pay foreign taxes on income earned abroad, and then pay U.S. tax on any income generated by those foreign activities once it was repatriated, or brought back to the United States.

Now U.S. companies' foreign income generally is only subject to tax abroad, based on the rates of the country in which that income was earned. This is known as a "territorial" system, a type of system that has been in use by most other developed countries for some time.

As valuation specialists, it is obvious that we must incorporate the different tax rates and rules of each territory in which a subject company operates. It is important to assess taxable income in each country separately. We caution against the use of a single blended, world-wide effective tax rate throughout the valuation because it cannot account for changes to the subject company's worldwide operations.

For example, assume taxable income earned in Germany currently accounts for 10 percent of the subject company's current total taxable income, which has a worldwide effective tax rate of 30 percent. If taxable income in Germany is projected to grow three times faster than the subject company's taxable income in other countries, the 30 percent worldwide effective tax rate quickly becomes erroneous. Furthermore, perhaps the subject company is taking advantage of certain generous German tax incentives in order to grow. Such a blended rate would not incorporate the nuances of such benefits. Clearly, the best practice is to project income in each tax territory to more accurately reflect the likely tax outcome for the subject company.

One important nuance ensconced within the TCJA is the FDII deduction. This deduction allows U.S. C corporations that generate revenue through the sale of goods or services to foreign customers for foreign use to take certain deductions. These deductions, which are outside the scope of this document, can reduce taxes on FDII from 21 percent to as low as 13.125 percent.

The conversion to a territorial system will also reduce the amount of trapped cash sitting in U.S. companies' foreign subsidiaries in the future. Trapped cash is so named because the penalties for repatriating the cash (i.e., paying U.S. corporate income taxes on it) are significant and often keep companies from investing the cash in domestic operations, or returning the cash to domestic shareholders.

The TCJA allows for repatriation of foreign cash earned prior to the implementation of the territorial tax system at much lower tax rates ranging from 8 to 15.5 percent.[7] The exact calculation of this tax is beyond the scope of this paper, but the valuation implications are not. While this repatriation tax is a nonrecurring event, valuation specialists must discuss management's plans to repatriate any previously trapped cash, and whether any such repatriation may affect future development plans and growth, or company or industry leverage. These considerations are important even if the appraisal subject excludes the subject company's foreign operations.

Sunset provisions

The TCJA also includes several provisions that are set to sunset, or expire, at various future dates. One notable example is the automatic change to the interest expense deduction threshold previously discussed, but there are others. Investors, executives and advisors are asking for direction on how to incorporate these sunset provisions into their decision-making, particularly when expected liquidity events or exits extend far into the future.

A full academic review of sunset provisions in U.S. law is beyond the scope of this paper, however there exists evidence to suggest that laws with such provisions rarely expire and these provisions are used as a tool to pass otherwise challenging laws.[8] The Washington Post also reported, "[a]ctual expirations [of laws with sunset provisions] remain rare. There are some examples, like a federal assault weapons ban that expired in 2004, or the independent counsel statute in 1999. But it's difficult to find others: inquiries with the Office of Management and Budget, the speaker of the House and the Senate librarian recently failed to turn up any other major recent examples."[9]

7 Private equity fund and portfolio companies the impact of tax reform, Jan. 23, 2018.

8 Sunset provisions in the tax code: A critical evaluation and prescriptions for the future, New York University Law Review, April 7, 2018.

9 In Congress, sunset clauses are commonly passed but rarely followed through, The Washington Post, Dec. 15, 2012.

Given that laws with sunset provisions rarely expire, it seems prudent to assume these provisions will not expire. However, investors, executives and advisors should always incorporate the facts and circumstances specific to their situation into any analysis. If, for example, the expiration of certain provisions would produce a poor return on investment or indicate impairment then it is incumbent on those involved with the decision to reevaluate key assumptions, including whether or not they expect the provisions to expire.

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