Anchin Alert

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Did the Tax Cuts and Jobs Act of 2017 Increase the Value of Equity Interests?

At first glance, a business or equity owner might conclude that the Tax Cuts and Jobs Act of 2017 (the "Act") increased the value of equity interests by 20% upon its signing by the President. By cutting corporate level taxes, the value of any business would, on the surface, immediately rise. However, the answer is not so straightforward.

Let's look at an example:

The mathematics of the cut are shown in the following simplified scenario, where a capitalization of income model is used to illustrate. Assuming a 3% growth rate ("g"), a 15% cost of equity (no debt), earnings before interest and taxes ("EBIT") grown at 3% of $2 million, and assuming net income equals cash flow (capital expenditures = depreciation, and no incremental working capital requirements), the model shows the same $2 million growing EBIT results in significantly higher after-tax income under the Act, and an implied increase in the value of equity of 20% for a C-corporation.

Capitalization of Income Model		Under Old Law		Under The Act
Sales Growth Rate (g)		3.0%		3.0%
Discount Rate (cost of equity)		15.0%		15.0%
EBIT x (1+g)		2,000,000		2,000,000
Taxes (Combined Rate)	**45%**	(900,000)	**34%**	(680,000)
Net Income to Equity		1,100,000		1,320,000
Net Cash Flow to Equity		**1,100,000**		**1,320,000**
Capitalization Rate = (Discount Rate - Growth Rate)		**12.0%**		**12.0%**
Value of Business (MVIC)		9,166,667		11,000,000
Less Debt		-		-
Value of Equity (Income Approach)		**$ 9,167,000**		**$ 11,000,000**
		Increase in value?		*20%*

However, in valuing a business a detailed examination of the impact of the Act on each industry and situation must be made. For example, restaurant and entertainment businesses may be negatively impacted by the immediate non-deductibility of entertainment expenses, and limitations on certain employee meal expenses that eventually eliminate the deduction in 2025. These limitations may also negatively impact client-oriented service businesses such as law firms, where entertainment is part of business development, and the firm may provide meals to employees working late.

The Act also ends the ability to carryback operating losses to prior years, which may have an unfavorable value impact on firms temporarily losing money, emerging from bankruptcy, or that are venture capital startups beginning to achieve profitability.

Another provision of the Act limits interest expense deductibility to 30% of operating earnings for companies with sales greater than $25 million. The private equity industry may be affected, and potentially lower prices from financial buyers may result. The biggest winners are capital intensive firm such as manufacturers, where new depreciation provisions should enhance cash flow.

The case of *Delaware Open MRI Radiology Associates v. Kessler* established the position that the tax implications of a business's legal structure affect the value of partial equity interests, resulting in potential valuation premiums for interests in pass-through entities. The Act muddies these waters, making it less clear which entity structure is preferable. While the corporate tax rate was significantly lowered, the rates for pass-through entities received smaller reductions, potentially shifting their attractiveness for businesses. To compensate, Section 199A of the Act allows pass-through entities to exclude the lesser of 20% of Qualified Business Income or Allocable Wages from income. Note that most professional service or consulting firms cannot avail themselves of this exclusion. Therefore the choice between a C-corporation, S-corporation or LLC requires a careful analysis of the business and its tax implications.
So did the Act increase equity values? The stock market is said to anticipate six months ahead, and it rose 10% in the 6 months before the Act's passage. However, the impact on any individual equity interest depends on its unique facts and circumstances.

Whatever your purpose in establishing the value of a business; acquisition, disposition, estate planning, buy-sell agreement or financial statement support, among others, the valuation professionals at Anchin are ready and able to provide the services you need. Our valuations are prepared by experienced, credentialed valuation professionals to avoid the inaccurate conclusions of applying generic industry "rules of thumb." An objective and credible valuation will always reduce questions and ambiguity and help minimize exposure to litigation and dispute resolution.

About the Author:
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