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# FAIR VALUE™

Reprinted from Volume XXIII, Number 1 Spring/Summer 2018

# Divorce Valuation Tax Trap!

*by: George Hawkins, ASA, CFA*

**Divorce mediation fails.** After a day of arguing about the value of Buckhead Corporation (a C corporation) at the date of separation (6/30/17), the parties are at an impasse and decide to proceed to trial. The ex-wife and her attorney have argued confidently all day that the value will increase at the date of trial valuation date and that 100% of the post separation increase is passive (not the result of the husband's active efforts) and therefore divisible property in the divorce. However, they have not divulged why they believe this to be true.

George Hawkins

**The ex-wife throws a Hail Mary pass.** Buck Doaks, the sole shareholder, is sure that the $4.8 million value at separation is rock solid and that he has nothing to lose by going to trial, convinced that nothing has changed in the business from separation to the trial valuation date (4/1/18). Buck and his attorney believe this is nothing more than a desperation move by his ex-wife and her attorney that will fail.

**April Fools!** The trial date valuation report arrives and upon opening the conclusions page Buck Doaks clutches his chest at what he sees. As shown in **Table 1**, Buckhead Corporation has increased in value from separation to trial by almost $1 million, a 20% increase, all of which his own appraiser has opined is due to "passive forces," making the increase divisible property in the divorce.

**Our Fool wants to know why.** How can this be, Buck asks, because nothing in the business has changed? It is too bad our resident Fool believes all news is fake because he missed one "little technicality" that really did change- the late 2017 passage of the *Tax Cuts and Jobs Act ("Act")* by Congress and its signature into law. Flipping through the report, Buck's attorney finds the page with the capitalization method (an income valuation approach) that the valuator used to arrive at the fair market value of Buckhead Corporation, shown in **Table 2.** The reason for the change in value is immediately apparent- a change in tax rates.

Table 1
**Buckhead Corporation**
**Opinion of Fair Market Value of a 100% Controlling Interest in the Common Shares Held by Buck Doaks**

| | **(6/30/17) Separation** | **(04/01/18) Trial** |
|---|---|---|
| Opinion of Fair Market Value | $4,800,000 | $5,745,000 |
| Dollar Change (All Passive, i.e., Divisible) | $945,000 | |
| % Change (rounded) | 20% | |

Table 2
**Buckhead Corporation (a C Corporation)**
**Calculation of Fair Market Value by the Capitalization of Earnings (Income) Method**

| | **(6/30/17) Separation** | **(04/01/18) Trial** |
|---|---|---|
| Revenues | $10,000,000 | $10,000,000 |
| -Expenses | ($8,500,000) | ($8,500,000) |
| Pre-Tax Income | $1,500,000 | $1,500,000 |
| C Corporation Tax Rate (Federal, NC) | 36.0% | 23.4% |
| -Corporate Level Income Taxes | ($540,000) | ($351,000) |
| **Net Income** | **$960,000** | **$1,149,000** |
| Divided by Capitalization Rate | 20% | 20% |
| **Value of Company** | **$4,800,000** | **$5,745,000** |

**Impact of Above**

| | | |
|---|---|---|
| Dollar Change in Value | $945,000 | |
| *% Change in Value* | *19.7%* | |



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**Get out your checkbook Buckaroo- it is all divisible.** Nothing fundamental to the business or its valuation actually did change- except for tax rates. The business earned the same pre-tax income and the appraiser used the same capitalization rate to arrive at a value. However, as a C corporation, Buckhead Corporation's income taxes decreased materially, increasing the after tax net income (earnings) to be capitalized.

At separation, Buckhead Corporation paid taxes at a 34% federal rate and a 3% NC state rate, with state taxes deductible for federal taxes, or a net rate of 36%. Thanks to the tax bill, however, C corporation rates were now reduced to a flat 21% federal rate, which, after the same state rate, gives a total net rate of 23.4%, a **35%** reduction. Since Buck had nothing whatsoever to do with the change in tax rates, the increase in value is all passive and therefore divisible! Unfortunately for Buck and his attorney, the ex-wife and her attorney had known what was coming due to tax reform- no wonder they were mum during mediation, just biding their time and letting the value magically rise.

**Cases in the hopper and what to do?** For matters that are presently pending that have separation dates before the approval of the Act's tax cuts, it is easy to see why it might be advantageous for the non-owner spouse and his or her attorney to want to stall and let the value increase. Similarly, the owner spouse and his or her counsel might want to push to settle based on the separation value before the other parties fully ponder the implications! The above example only involved the impact on a C corporation, but as this article will show, complications can also be present for S corporations, LLCs, and partnerships, only much more complex.

The new tax rates are now a reality, potentially resulting in significant business valuation implications for all kinds of purposes (estates, gifts, shareholder disputes, etc.), not just for a divorce like Buck's. The result is that the valuations of all businesses, including C corporations, "pass through entities" (S corporations, partnerships, LLCs), and sole proprietorships have been fundamentally altered in ways that may result in very substantial changes in value.

This article is not a detailed discussion of the tax bill and tax rates or a complete foray into how they are applied. There are numerous analyses (some hundreds of pages or longer) delving into the intricacies of the Act and how commentators think it will or might be applied when the Treasury Department issues its regulations. What this article does is to provide an awareness of business valuation issues that are likely to emerge that are broadly important to attorneys and their clients. Most of the changes for C corporations come down to a simple change in the tax rate, which is in contrast to a more complicated picture for the "pass through entities" such as S corporations, partnerships and LLCs. The focus of this article will be on S corporations, the form most used by operating private businesses. Before doing so, this article will give a brief refresher on the differences between C and S corporations (a type of pass-through entity) and then delve back into an actual valuation example. The article will return to Buck's brother Bubba, an S corporation shareholder, facing a similar, challenging dilemma.

**Pass through entities- a brief refresher.** Summarized below is a high level overview of the basic fundamental tax differences between C and S corporations (corporations who elect Subchapter S income tax treatment under the Internal Revenue Code):

**C corporation:**

- **Corporate earnings-** The corporation pays federal and state income taxes on its pre-tax earnings.
- **Dividends-** The individual pays personal income taxes on any dividends received from the corporation.
- **Earnings retained in the corporation (i.e., not paid out as distributions)-** This has no effect on the shareholder's cost basis in the shares.
- **Sale of shares-** The shareholder is taxed personally on any taxable gain upon the sale of the shares. The amount of any gain (if present) is based on the selling price as compared to the shareholder's cost basis (typically purchase cost).

**S corporation:**

- **Corporate earnings-** The earnings of the S corporation are taxed like a partnership, being "passed through" (do not confuse with paid out) to the individual shareholders for taxation personally at their individual income tax rates (note that some states tax S corporation income at the entity level, but not North Carolina).

- **Distributions (same thing as dividends)-** Distributions received are not subject to personal income taxes (to the extent the distributions paid by the corporation do not exceed its accumulated earnings and profit and to the extent they do not exceed the shareholder's cost basis in the stock).

- **Earnings retained in the corporation (i.e., not paid out as distributions)-** This increases the shareholder's cost basis in the shares.

- **Sale of shares-** The shareholder is taxed personally on any taxable gain upon the sale of the shares. The amount of any gain (if present) is based on the selling price as compared to the shareholder's cost basis. Cost basis is increased (decreased) based on various items. To the extent that earnings are retained in the corporation and not distributed to shareholders this increase's the shareholder's cost basis, thus reducing any gain that is taxable.

Because C corporations pay taxes corporately on their earnings and then again by the shareholders personally on any dividends received, they are frequently referred to as "double taxed." By contrast, S corporations (and LLCs and partnerships) are often referred to as "tax favored," with earnings only being taxed once (at the personal level), and with distributions generally not taxable. In addition, any earnings retained by the S corporation increase the shareholder's cost basis in the shares in the event of a later sale of the shares, reducing individual income taxes due on any gain on sale that might be realized. By contrast, the shareholder in a C corporation does not benefit from this increase in basis, paying tax on the gain based on his or her original purchase cost (or basis) for the shares.

As a result of the foregoing differences in tax treatment of ownership in C and S corporations and the different individual and corporate tax rates involved, even before the Act this had given rise to controversy over if and how these differences should be incorporated for valuation purposes when valuing an S corporation.

**Tax reform- rates for S corporations and other pass-through entities come down- or do they?** Before 2018 it was really simple. The taxable pre-tax income of a company was straightforward to understand and simply "passed through" to the owner's personal return for inclusion and taxation at his or her applicable personal rates. Enter the 2018 Act's goals of tax cuts, "tax simplification," and the new winners and losers. Virtually all big, publicly traded corporations are C corporations and send truckloads of donations to the campaigns of our leaders in Washington, along with dispensing hordes of lobbyists to troll the halls of Congress. This clearly paid off, as evidenced by the large reduction in stated tax rates for C corporations, declining from a maximum of 35% to 21%, a massive reduction their lobbyists said was needed to remain competitive in a global world. Never mind that, after write-offs and loopholes, the average C corporation was already only paying effective average tax rates of about 21% to 23% ***before*** the passage of the Act!

**Enter the small business lobby.** Congress couldn't tell the voters that small business was left out, so the Act provided that the private, pass-through business could reduce its "Qualified Business Income" ("QBI,") that was subject to taxation by taking a deduction. For an S corporation, QBI is profit that is after reasonable compensation paid to owners, but does not include interest income (other than that which is properly allocable to a trade or business), dividend income, long or short-term capital gain income, does not include income unassociated with a U.S. trade or business, and certain other less common exclusions. Pass-through entity owners are entitled to take a deduction against QBI of 20%, limited to a calculation (slated for the inclusion in the next math section of the SAT test) as follows:

**The New Pass-Through Entity Math: The 20% Deduction's Wages Limitation**

- Compute the sum of 25% of the total Company W2 wages (including with reasonable compensation paid owners), plus 2.5% of the unadjusted basis of qualified property. Multiply this by the specific shareholder's ownership percentage to get his or her share. Note that qualified property only includes depreciable property, the value of which is immediately after acquisition, the cost of which will be included until the later of 10 years or the last year of the depreciation recovery period, does not include non-depreciable assets like land, and is owned at the end of the year.

- Compute 50% of the total Company W2 wages (including with reasonable compensation paid owners). Multiply this by the specific shareholder's ownership percentage to get his or her share.

- Take the greater of the two above calculations to give the wage limitation.
- Compute 20% of the shareholder's share of QBI.
- Take the lesser of 20% of QBI or the wage limitation to the give the amount the pass-through entity's specific shareholder can deduct against his or her share of QBI income to arrive at the net profit that is subject to taxation on the shareholder's personal return.

Before readers think this is a clear path to a son or daughter's perfect SAT math score, how this is applied to different types of pass-through entities (e.g., sole proprietorships and LLCs) varies and the devil is in a large amount of details being left out. For example, in a sole proprietorship where the owner is the only employee there are no W2 wages, hence no 20% deduction. Also, in a partnership or LLC the guaranteed payments to partners are not W2 wages and do not count towards the W2 wages limit, although QBI is after taking those guaranteed payment expenses into account. As further confusion (and good news for really small businesses), the above rules (and later service limitations to be discussed) do not apply in certain situations where the ***individual's*** taxable income (on their personal tax return) is less than $315,000 if married filing jointly or $157,500 for other taxpayers. In short, these individuals do not have to meet the above tests to benefit from the 20% deduction.

**So much for tax simplification!** This is a very high level overview as the actual law is far more complicated, with many caveats, exclusions, fine print and uncertainties as to the Act's application. There are many unknowns, for example, about how the ultimate regulations issued by the Treasury Department will implement specific items in the bill. As just one example, total company wages in the above tests is assumed by most commentators to include reasonable compensation to the owners. This is inferred, but is not yet certain. Also, does this include compensation to other related parties inside or outside the business?

Another complication is the use of the term "reasonable" compensation to owners. Salaries paid to S corporation shareholders are subject to unlimited Medicare surtax, including personally at 1.45% of total pay, as well as the matching 1.45% portion paid by the company. One of the areas of tax avoidance in recent years has been for some S corporation shareholders to pay themselves as small a salary as was reasonably possible to reduce the Medicare surtax paid. By taking renumeration out as distributions, which are not taxable, instead of as wages, the shareholders realized more after-tax cash flow. If you're thinking ahead, you can probably already guess where this might be going for the new "have nots" of the new tax bill- the accountants, attorneys, physicians and consultant businesses of the world- this article will get to them later. But first, let us examine the possible effects of the bill on the non-service oriented S corporation.

**Back to valuation: brother Bubba Doaks and his S corporation.** You guessed it- divorce runs in the family and Buck's brother Bubba has a sister business, Bubblehead Corporation, with the same financial characteristics, but which has instead elected taxation as a Subchapter S corporation- that is, the company's income is taxed to Bubba personally. Bubba and his ex-wife also split at the same time as brother Buck. Before the Act, Bubba's maximum personal federal tax bracket rate was 39.6% (separation), but under tax reform it is now 37% (trial). After taking into account the impacts of personal North Carolina state rates, Bubba's combined tax rate has declined modestly from 45.1% to 42.5%. However, this is not the end of the picture, since Bubba's situation qualifies him to take advantage of the Act's new 20% deduction against qualified business income (QBI) for certain pass-through tax entities like his S corporation.

**Table 3** (next page) shows the effects of the pre-and-post-separation tax rates on Bubba's income taxes and the ultimate after-tax net income he realizes from his company.

**Bubba Takes the Fight to Washington.** A **$166,500** increase (20.2%) in annual net after-tax profit is nothing to scoff at and a valuation is usually at a multiple (inverse of a cap rate, i.e., a cap rate of 20%, or 0.2 applied to earnings, is the same as 5 times earnings) of that increase. However, Bubba would probably drive his monster truck to Washington, D.C. and up the steps of the Capitol building in protest, angry that his new average, effective tax rate of 34% (federal and state) is so much higher than the new 21% flat rate (before the effect of state rates) for those C corporation fat cats (like his brother Buck).

**Watch out Bubba- better settle that divorce.** Like brother Buck, Bubba isn't much on reading so he fails to

**Table 3**
**Calculation of Bubblehead Corporation Profits to Owner**
**Using Personal Income Tax Rates**
**(an S Corporation)**

| | **(6/30/17) Separation** | **(04/01/18) Trial** |
|---|---|---|
| Revenues | $10,000,000 | $10,000,000 |
| -Expenses | ($8,500,000) | ($8,500,000) |
| Pre-Tax Income (Assumed to be QBI) (B) | $1,500,000 | $1,500,000 |
| -S Corp. Deduction Against QBI (20%) | N/A | ($300,000) |
| Taxable Income | $1,500,000 | $1,200,000 |
| **Personal Tax Rate (Federal, NC)** | **45.1%** | **42.5%** |
| Personal Income Taxes (A) | $676,500 | $510,000 |
| Pre-Tax Income | $1,500,000 | $1,500,000 |
| -Income Taxes Personally | ($676,500) | ($510,000) |
| **Net Income After Tax to Shareholder** | **$823,500** | **$990,000** |
| **Summary of Impacts** | | |
| Dollar Change in Net Income | $166,500 | |
| % Change in Net Income | 20.2% | |
| Average Effective Tax Rate (B/A) | 45.1% | 34.0% |

understand that even before the new Act and continuing afterward, there are some key added benefits to Bubblehead Corporation as an S corporation versus a C corporation that the above analysis does not consider- the effects of which he will later regret at trial. These include the following:

- Bubba personally pays no personal income taxes on any distributions made from the S corporation to him, whereas his brother Buck (in the C corporation) gets taxed on dividends, generally at a 20% rate federally and in North Carolina at a 5.49% personal rate.

- To the extent that Bubba personally retains earnings in the Company rather than distributing them, this increases his cost basis in his shares that is used for computing his taxable gain should he later sell his company. By contrast, if brother Buck's C corporation retains earnings instead of paying them out as dividends, he gets no such increase in cost basis, with the original purchase cost for the shares dictating the computation of a later taxable gain should he sell his shares. This can be a really big deal for Bubba's S corporation since it retains some of its earnings to support growth. If both Buck and Bubba's respective C and S corporation otherwise operate identically and later sell for the same amount, Bubba will pay far less tax on the gain than his brother.

Even before the Act, business appraisers would not simply value Bubblehead Corporation's S corporation shares by reducing the pre-tax profit by income taxes at the personal level (at personal tax rates) and then capitalizing the after-tax income. This is because the rate of return data used by all business appraisers to develop capitalization rates comes from publicly traded C corporations. Since that data relates to returns that are ***after*** corporate level taxes, but before personal taxes, this presents a problem. Many (and perhaps most) business appraisers would take the following steps to value an S corporation:

**Steps to calculate the S corporation value:**

- **Step 1-** Tax affect the S corporation's earnings as if were a C corporation- Tax affect the earnings (i.e., reduce the earnings by income taxes) of the S corporation as it were a C corporation, paying C corporation corporate level tax rates because of that pesky earlier problem- the rate of return data for cap rates comes from C corporations.

- **Step 2-** Capitalize net income or net cash flow to get an "as if C corporation" value- Divide the earnings (or net cash flow) being capitalized by the capitalization rate. The result is an "as if C corporation value" using C corporation income tax rates. Had a discounted cash flow approach been used it would also be employed as in Step 1, also resulting in an as if C corporation value.

- **Step 3-** Determine and incorporate the value of additional S corporation after-tax benefits, if present, to get to the S corporation value- As noted earlier, there were various additional benefits of Bubba's S corporation versus his brother's C corporation that were not captured in Table 2. Various models have been developed to estimate the additional after tax incremental benefits received by the S corporation shareholder versus the same shareholder in an otherwise equivalent C corporation. This differential can then be incorporated in a valuation as an adjustment to the as if C corporation value to arrive at the final S corporation value.

For purposes of **Step 3**, this article will use the *S Corporation Economic Adjustment Model* (or "*SEAM"*) method developed by Dan Van Vleet, one of the most commonly used models in business valuation. For a detailed overview (before the Act) of the entire S corporation versus C corporation valuation debate and the underlying details of the SEAM model, visit our website

(businessvalue.com/business-valuation-tools/) and look for the *Seminars on Business Valuation Issues* tab. This contains the manuscript and PowerPoint (*Tax Issues in Business Valuations: S Corporations and LLCs*) which this author gave to the Family Law section of the North Carolina Bar Association in September 2017.

**Bubblehead's S corporation value- the tax trap ensnares poor Bubba.** Using the findings from the SEAM model (too complex for inclusion in this article), **Table 4** calculates the value of the company using the previous steps, first tax affecting its results as if it were a C corporation (since the rate of return data is from C corporations), next capitalizing the value to get as a C corporation value, then finally adjusting the value to take into account the additional impact of its S corporation benefits (**15.1%** at separation and **15.6%** at trial). Several takeaways from **Table 4** are important:

**Table 4**
**Calculation of Fair Market Value by the Capitalization of Earnings (Income) Method of Bubblehead Corporation (an S Corporation) With Full S Corporation Benefits Incorporated**

| | | (6/30/17) Separation | | (04/01/18) Trial |
|---|---|---|---|---|
| Revenues | | $10,000,000 | | $10,000,000 |
| -Expenses | | ($8,500,000) | | ($8,500,000) |
| Pre-Tax Income | | $1,500,000 | | $1,500,000 |
| **C Corporation Tax Rate (Federal, NC)** | | **36.0%** | | **23.4%** |
| -Corporate Level Income Taxes (Step 1) | | ($540,000) | | ($351,000) |
| **Net Income** | | **$960,000** | | **$1,149,000** |
| Divided by Capitalization Rate | | 20% | | 20% |
| **Value of Company as if C Corp. (Step 2)** | | **$4,800,000** | | **$5,745,000** |
| x Added S Corp. Benefits (from SEAM) | 15.1% | 1.151 | 15.6% | 1.156 |
| **Value of Company as S Corp. (Step 3)** | | **$5,524,800** | | **$6,641,220** |
| **Summary of Impacts** | | | | |
| Dollar Change in Value (Separation to Trial) | | | $1,116,420 | |
| % Change in Value | | | 20.2% | |
| S Corp. Greater Value Than C Corp. | | $724,800 | | $896,220 |
| % Greater S Corp. Value | | 15.1% | | 15.6% |

- **Values have increased due to the Act's lower tax rates-** Other factors being equal in a company, the after-tax cash flows and benefits have increased with both C and S corporations that can avail themselves of the lower rates. The present value of cash flows is greater, leading to increased company values, even before taking into account the other benefits of the S corporation. Treating Bubblehead as if it were a C corporation, its value increased from $4,800,000 to $5,745,000, a $945,000 increase in value due solely to the reduction in C corporation tax rates. Next, after taking into account the incremental S corporation added benefits (versus the C corporation) of Bubblehead's tax status as captured by the SEAM model, the total value increased from separation to current by **$1,116,420**, a major **20.2%** increase in value, again due solely to changes in tax rates!

- **Valuation increases due to lower tax rates are passive- the divorce valuation tax trap ensnares Bubba-** The final value has increased by **$1.16 million** from separation to trial, all of which is passive (and therefore divisible) in our simplified example, due solely to changes from the Act. Bubba must be feeling the pain- too bad his mediation also failed based on the separation value.

- **Determining the taxable income and the associated impacts on company value are much more complicated, particularly for S corporations and other pass-through entities-** What is not apparent is just how complex the calculation of the S corporation adjustment factor used above is, particularly after the Act. Not shown above, the SEAM model (used to calculate the added S corporation added benefits adjustment factors of 15.1% and 15.6% in **Table 4**) is now infinitely more complex than before the Act in the required inputs and calculations. Inclusion of the SEAM calculation in this article would have crowded out all of the other content. This raises the importance of engaging a skilled valuator who is fully cognizant of these changes and can properly capture them in a quantitative analysis.

- **Impact on value may vary depending on whether a shareholder is "active" or "passive"-** In the above example, Bubba is actively involved in the management of Bubblehead Corporation, enabling him to avoid paying the 3.8% Affordable Care Act (ACA) surtax on certain portions of his income. However, a shareholder (e.g., a minority shareholder who merely holds shares as an investment) who is not actively involved would be subject to the ACA tax, so the valuation impact would differ from **Table 4** and would need to be incorporated by the valuator.

"Active" and "passive" are subject to specific IRS definitions and have nothing to do with the family law concepts of active versus passive factors that lead to appreciation in value during the marriage or post separation.

- **S corporation shares may be worth materially more than equivalent C corporation shares (or not)-** Even before the Act, there was an increasingly predominant view that S corporation shares were worth more than equivalent C corporation shares due to differences in after-tax benefits. This has become widely recognized in the U.S. Tax Court and has filtered into courts in a variety of other venues. After the Act this same issue may still exist depending upon the facts; attorneys need to be on the lookout to ensure that the valuator correctly deals with this issue. What is new, however, is that the Act carved out certain "have nots" that will receive only partial or no 20% S corporation deduction benefits (discussed below) and will face an entirely different situation than Bubba, of which the valuator must also be cognizant.

**Second class pass-through citizens and the 20% solution.** Congress must not like higher earning doctors, lawyers and most other professionals in pass-through entities. Under the *Act*, only those earning no more than $415,000 (married couple filing jointly) or $207,500 (single filer) will benefit from the 20% deduction, although its full benefit is phased down once going above $315,000 in earnings (married, filing jointly, above $157,500 for single filers). In deciding these have nots with respect to those benefiting from the 20% deduction, the Act created second class citizens who fall into a "specified service trade or business" defined as follows:

> A "specified service trade or business" means any trade or business involving the performance of services in the fields of health, law, accounting, consulting, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees, or which involves the performance of services that consist of investing and investment management, or trading or dealing in securities. However, a trade or business that involves the performance of engineering or architectural services is not a "specified service."

As is obvious, many service businesses operate in gray areas where it is as of yet unclear where they will fall under the above definition. Also, armies of tax lawyers are already dreaming up elaborate business structures to attempt to engineer around these rules so as to still benefit from the full 20% pass-through entity tax deduction.

**Lack of interest?** The Act also introduces limitations on the ability of all types of company entities to deduct interest expense, further complicating the valuation challenge of arriving at the after tax earnings or net cash flow to capitalize. Interest expense of companies that is deductible will be limited to 30% of adjusted taxable income. Adjusted taxable income is computed as shown in **Table 5**.

**Table 5**
**Interest Expense- How Much Qualifies for A Deduction?**

| | |
|---|---|
| | Company's pre-tax income |
| + | Exclude interest expense |
| - | Exclude interest income |
| - or + | Gains, losses, on assets held for investment |
| - | Other non-business income |
| + | Exclude depreciation, amortization and depletion expenses |
| + | Exclude net operating loss deductions |
| | **Adjusted Taxable Income** |
| | x 0.3 |
| | **Preliminary Deductible Interest Expense** |
| + | Floor plan interest (e.g., to finance auto dealer vehicles) |
| | **Total Deductible Interest Expense** |

Adjusted taxable income in **Table 5** is approximated by using earnings before interest expense, taxes, depreciation and amortization expense (EBITDA) for the years 2018 through 2021. This is before the 20% reduction for pass-through entities, any net operating loss deduction, or any items of income, gain or deduction not properly allocable to the trade or business. After 2021, a more restrictive test of interest deductibility comes into play, based on 30% of a company's 12 month earnings before interest expense and taxes (EBIT).

**Practical impact on company value.** The effect of this from a valuation standpoint is that the highly leveraged (dependent on debt), low profit margin business may have a harder time deducting all of its interest expense. The result is that the business will generate less after-tax earnings or cash flow for its owners, making it worth less. Consequently, if your client's business falls into

this camp, make sure the valuator correctly takes this into account in the valuation calculation. Plus, this is only scratching the service of the valuation impact of the interest expense issue.

**WACC a business valuation mole.** Readers familiar with the use of the so-called "net of debt" or "invested capital" income valuation approach know this involves the use of a company's weighted average cost of capital (WACC). This takes into account the cost of a company's debt (the interest rate it pays), its cost of equity (the annual rate of return investors in the common equity require for the risk of ownership), and the proportional use of debt and equity in the capital structure to come up with the WACC. This WACC represents a percentage annual rate of return that is used to discount the forecasted future cash flows of the business back to present value, i.e., the value of the enterprise. The cost of debt portion of the WACC calculation takes into account its tax deductible nature (at least until the Act) to come up with its true after-tax cost. What does all of this mean?

**Impact on valuation- leveraged buyout artists get their comeuppance.** Up until the Act, the financial masters of the universe (our investment banker and private equity friends) who acquire companies using lots of borrowed money were able to deduct their entire interest cost for financing the purchase. This essentially made all taxpayers collectively subsidize this, giving acquirors a cheap after-tax cost of debt and helping fuel the number of highly leveraged acquisitions. For example, suppose the cost of the debt (pre-tax) was 7% and the interest expense was tax deductible at a 40% tax rate (assumed to make it simple). Therefore, the true after-tax cost before the Act was 4.2% (1-0.4, or 60% of 7%). Going forward, businesses that have a lot of debt and cannot meet the interest deduction test will face a much higher after-tax cost of debt. In the preceding example, the non-compliant company would now face an after-tax cost of debt of 7%, much higher than 4.2% were the interest to have been deductible as it was before the Act. This raises the WACC, in turn lowering the present value of a company's future cash flows (plus the after-tax cash flows are now lower). That's a sophisticated way of saying that leveraged companies may not be worth as much as those that can deduct the interest, other things being equal.

Some businesses will be exempted from the interest deduction issue entirely, such as the following:

**Exemptions from Interest Deduction Limitations**

- A corporation or partnership with average annual gross receipts (revenues) for the three-year period immediately preceding the taxable year that do not exceed $25 million.
- A trade or business of performing services as an employee.
- Any electing real property trade or business as defined in the Act (the occupant of our White House might have something to do with this one).
- Any electing farm business as defined in the Act.
- Electrical energy, water, or sewer disposal service.
- Gas or steam through a local distribution system.
- Transportation of gas or steam by pipeline.

**Implications for attorneys and their clients.** By now, you are probably brain dead from reading this article and the good news is you were spared from the thousands of other small details of the Act. However uninteresting tax rules may be, properly advising clients has now become far more complex after tax simplification. Astute attorneys who want to win cases involving valuation issues must be careful to engage professional business appraisers who can properly navigate these issues and understand their potentially significant implications for value. ♦

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**This article is an abbreviated discussion of a complex topic and does not constitute advice to be applied to any specific situation. No valuation, tax or legal advice is provided herein. Readers of this article should seek the services of a skilled and trained professional.**