The Tax Cuts & Jobs Act of 2017 – Tax and Valuation Implications of a Sunset vs an Extension of the Act

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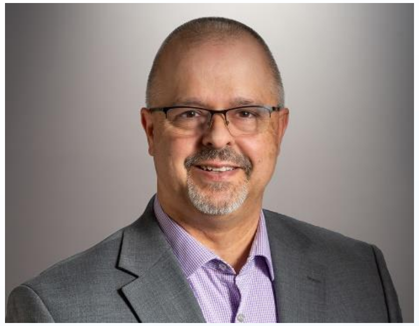
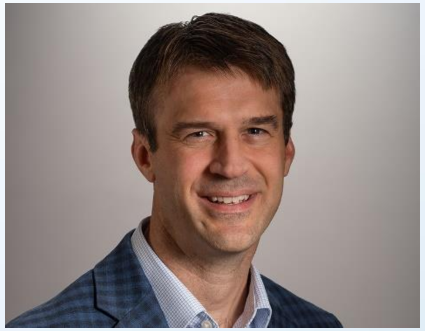
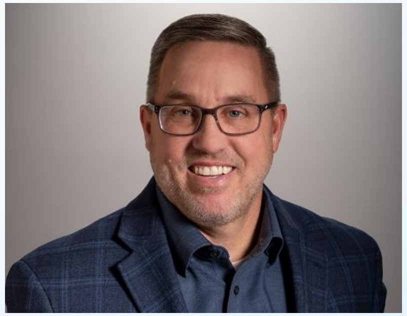
Introductions



Eric Blocher, CPA, ASA, CVA
Partner & Director of Business Valuation Services



Jeremy Peachey, CPA, MBA
Partner & Tax Team Member



David Blain, CPA, CVA
Partner & Director of Entrepreneurial Accounting Solutions (EAS)

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Objectives for Today

- Obtain an understanding of the tax implications of the sunset or extension of TCJA Provisions.
- Obtain an understanding of the impact that the sunset or extension of TCJA Provisions will have on the value of your business.
- Obtain a better understanding of valuation theory and how it and the tax assumptions impact the value of your business.
- Questions and comments are welcome!

Tax Cuts & Jobs Act of 2017 (TCJA)

Key TCJA Provisions – Personal

- Personal income tax rates
  - Graduated rates changed from 10% - 39.6% to 10% - 37% with the dollar limits changing and are adjusted for inflation annually.
  - These will sunset back to 2017 rates (higher marginal rates) in 2026.
- Standard deductions
  - Were nearly doubled and are adjusted for inflation annually.
  - These will sunset back to 2017 levels in 2026.
- Personal Exemptions were reduced to $0 and are scheduled to sunset back to 2017 levels and adjusted for inflation

Key TCJA Provisions – Personal

- Child tax credit
  - Was increased to $2,000 per qualifying child with phaseouts based on income levels
  - These will sunset back to 2017 levels in 2026.
- State and Local Tax (SALT) deductions.
  - Was limited to $10,000 in total state and local income and property taxes as an itemized deduction.
  - This will sunset back to 2017 levels in 2026 and no longer have a cap.
- Mortgage interest deduction
  - The itemized deduction is limited based on the loan amount and HELOC interest was not deductible unless it was used for the property securing the loan.
  - This will sunset back to 2017 limits in 2026.

Key TCJA Provisions – Business

- **Reduced C Corp tax rate from 35% to 21%. The all-in tax rates fell from approximately 40% to 23% - 28% depending on state tax rates. This was a <u>permanent</u> change.**
- **Qualified Business Income (QBI) - 20% deduction of pass-through QBI. Known as the Section 199A deduction**

  - Limited to the greater of 50% of W-2 wages, or sum of 25% of W-2 wages, plus 2.5% of qualified property

  - Does not apply to some service businesses (law, accounting, financial services, and others)

  - Was done to even the playing field between C Corps and pass-through entities.

Key TCJA Provisions – Business

- Pass-through income tax rates (on business income)
  - Graduated rates changed from 10% - 39.6% to 10% - 37% with the dollar limits changing and are adjusted for inflation annually.
  - These will sunset back to 2017 rates (higher marginal rates) in 2026.
- Bonus depreciation
  - Allowed accelerated capital expensing for certain business assets
  - Began at 100% expensing and has worked its way down to 40% in 2025 , 20% in 2026, and 0% in 2027.
  - This directly reduces the income tax liability in the year expensed and increases cash flow.

Key TCJA Provisions – Business

- **Federal Estate Tax Exemption changes**

  - The TCJA nearly doubled the estate and gift tax exemption limits and in 2025 are ~$14 million per individual and ~ $28 million per married couple.

  - This would be reduced to approximately $7.25 million per individual and $14.5 million per married couple if the TCJA sunsets

- **Changed the treatment of Research & Experimentation (R&E) expenditures**

  - Years beginning after 12/31/2021 R&E are capitalized and amortized over 5 years.

  - Cash flow is impacted by the reduction in tax deductible expenses.

  - This is a <u>permanent</u> change.

Key TCJA Provisions

- Net Operating Losses
  - Limited to offsetting 80% of taxable income
  - Can no longer carry back 2 years
  - Can carry forward indefinitely
- Limitations on the deductibility of interest expense.
  - In 2025 the interest expense deduction is limited to 30% of Earnings Before Interest & Taxes (EBIT)
  - Generally, does not apply to companies with < $25 Million in revenue.

Business Valuation (BV) Basics

A Few Important Business Valuation Basics

- **Essential to Business Valuation is that is a <u>Forward-Looking</u> exercise (expectation of future Cash Flow).**
- **It is based upon what you know at the Date of the Valuation.**
  - **- The TCJA has provisions that are scheduled to sunset and will impact future cash flow.**
  - **- Valuators need to model out the changes in cash flow based upon the expected sunset provisions.**
  - **- A Discounted Future Earnings approach was adopted as the best way to address the changes.**

A Few Important Business Valuation Basics

- The Time Value of Money is always considered (present value).

  - A dollar today is worth more than a dollar next year.

- Transaction multiples

  - Multiples derived from Guideline Transactions are unreliable when they were based upon tax regulations which are no longer current, so this method was difficult to apply after the TCJA was passed.

  - If the TCJA provisions sunset or they are extended, this method will again be difficult to apply because we won’t know if the purchase price was based on the TCJA sunsetting or being extended

A Few Important Business Valuation Basics

Gordon Growth Model

$$PV = \frac{E_1}{K - G}$$

Where:

- PV = Present Value (time value of $)
- E1 = Expected Cash Flow in period 1
- K = Risk Adjusted Discount Rate, "Cost of Capital" or the Required Return (tax rates impact K)
- G = Expected L/T Growth in Cash Flow
- **To keep it simple – remember the 2 parts: the Numerator (cash flow) and the Denominator (required return and risk).**
- **These 2 parts will help determine the impact that the TCJA can have one value.**

TCJA Valuation Implications

TCJA Implications – C Corp

- The reduction in C Corp tax rates to 21% is permanent.
  - If the TCJA Sunsets and tax law is reset to 2017 then there is a tax advantage to being a C Corp. Even considering the tax on dividends.
  - In July 2022, Pennsylvania enacted H.B. 1342 which reduced the corporate net come tax from 9.99% to 4.99% by 2031. The reduction began in 2023.
  - A different effective tax rate, and a potentially different weighted average cost of capital should be calculated and modeled out each year.
  - The primary way to handle this is through a Discounted Future Earnings Analysis.

TCJA Implications – QBI & Tax Rates

- The 20% QBI deduction was done to even the playing field between C Corps and pass-through entities.
  - If the QBI Deduction Sunsets and disappears, the tax law is reset to 2017. There could be a tax disadvantage to being a pass-through entity. Even considering the avoidance of a dividend tax.
  - The increase in the pass-through tax rates and loss of the 20% QBI deduction results in higher taxes and less cash flow available to the owner and will be a reduction in value compared to an Equivalent C Corp. The increase in taxes could be significant.
  - Valuators have generally been accounting for the anticipated sunset of TCJA provisions, so it would not necessarily be a decrease in the value of a pass-through entity where it has already been factored in.
  - If the TCJA is extended and pass-through tax rates remain lowered and the QBI deduction remains… the value would INCREASE because an increase in tax rates in years beyond 2026 was being shown.

TCJA Implications – Estate Tax Exemptions

- The possible reduction in the estate tax exemption amounts are a driving force behind a tremendous amount of valuation activity in 2025.
  - The potential reduction of the exemption from ~$28 million to $14.5 million is a difference of $13.5 million in potential lost “estate tax savings”.
  - With a possible estate tax rate of 40% that is approximately $5.4 million in estate tax to be paid if the exemptions are reduced and have not been flied utilized when they were available.

TCJ Implications – Interest Expense

- The TCJA imposed a limit on the deductibility of interest expense at 30% of EBIT.

  - Highly levered companies can exceed the limit, resulting in higher income taxes, less cash flow, and a lower value.

  - The deductibility of interest expense should be modeled out using projections from the Discounted Future Earnings method and known and anticipated debt amortization.

  - A sunset of the TCJA could result in an increase in value to highly levered companies from a reduction in income tax expense.

TCJA Implications – Bonus Depreciation

- The sunset of the TCJA's Bonus Depreciation would have little impact going forward because it is set to allow only a Bonus depreciation percentage of 20% in 2026.
  - However, if Bonus depreciation were extended (for a similar timeframe as in the TCJA) or extended permanently, the resulting reduction in income taxes could be material, resulting in greater cash flow and an increase in value.
  - The time value of money, which is a factor in all valuations, makes it so that from a cash flow and value perspective is can make sense to take all Bonus depreciation available.

TCJ Implications – Example

TCJA Sunset vs Extended

WACC - Under the Tax cuts and Jobs Act - Extended							
	% of Total		Rate		Tax impact		
Interest bearing debt	25.00%	X	8.00%	X	(1 - tax rate)	=	1.42%
Stockholders' Equity	75.00%	X	20.00%		-	=	15.00%
		Weighted Average Cost of Capital (WACC)					16.42%
		Less: long-term growth					3.50%
		WACC Capitalization Rate					12.92%
		Tax Rate			29.00%		

TCJ Implications – Example

TCJA Sunset vs Extended

WACC - Under the Sunset Provisions - Old Law

	% of Total		Rate		Tax impact		
Interest bearing debt	25.00%	X	8.00%	X	(1 - tax rate)	=	1.20%
Stockholders' Equity	75.00%	X	20.00%		-	=	15.00%
		Weighted Average Cost of Capital (WACC)					16.20%
		Less: long-term growth					3.50%
		WACC Capitalization Rate					12.70%
		Tax Rate			40.00%		
			Percentage WACC change				1.36%

TCJ Implications – Example

TCJA Sunset vs Extended

Inputs		
	Scenario 1 - Sunsets	**Scenario 2 - Extend**
Normalized Net Income Before Taxes	$ 4,200,000	$ 4,200,000
Normalized Depreciation	$ 2,500,000	$ 2,500,000
Estimated personal income tax rate - Federal, State, and Local	40.00%	29.00%
Normalized annual Capital Expenditures	$ 2,500,000	$ 2,500,000
Normalized Annual Interest Expense - 8%	$ 1,800,000	$ 1,800,000
Earnings Before Interest and Taxes (EBIT)	$ 6,000,000	$ 6,000,000
Long-term Debt	$ 22,500,000	$ 22,500,000
Weighted Average Cost of Capital (at Market levels)	16.20%	16.42%
Long-term Growth	3.50%	3.50%

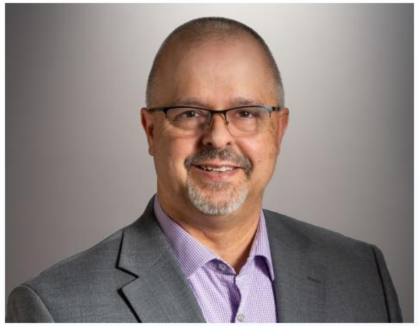
TCJ Implications – Example

TCJA Sunset vs Extended

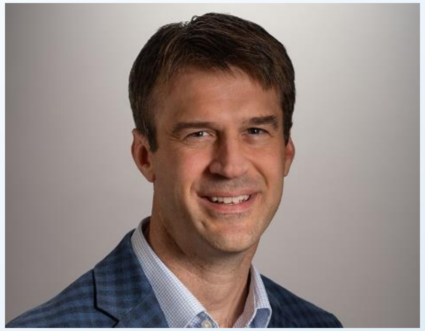
	Scenario 1 - TCJA Sunsets		Scenario 2 - TCJA Extended	
Normalized Income Before Taxes	$	4,200,000	$	4,200,000
Less Taxes of		(1,680,000)		(1,218,000)
Earnings After Taxes	$	2,520,000	$	2,982,000
Add: Interest Expense (net of taxes)		1,080,000		1,278,000
Add: Normalized Depreciation		2,500,000		2,500,000
Less: Normalized Capital Expenditures		(2,500,000)		(2,500,000)
Net Cash Flow to Invested Capital	$	3,600,000	$	4,260,000
Divide by WACC Cap Rate		12.70%		12.92%
Marketable Value of Invested Capital	**$**	**28,346,457**	**$**	**32,972,136**
Percentage Increase In Value				**16.32%**

Questions?

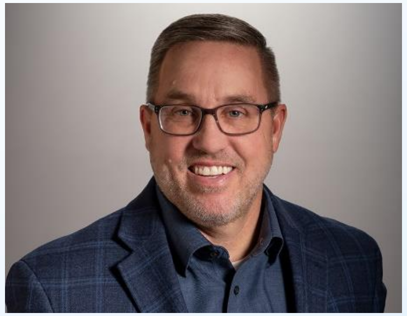
Contact Information



Eric Blocher, CPA, ASA, CVA
Partner
eblocher@macpas.com
717-972-5730



Jeremy Peachey, CPA, MBA
Partner
jpeachey@macpas.com
717-972-5737



David Blain, CPA, CVA
Partner
dblain@macpas.com
717-972-5722

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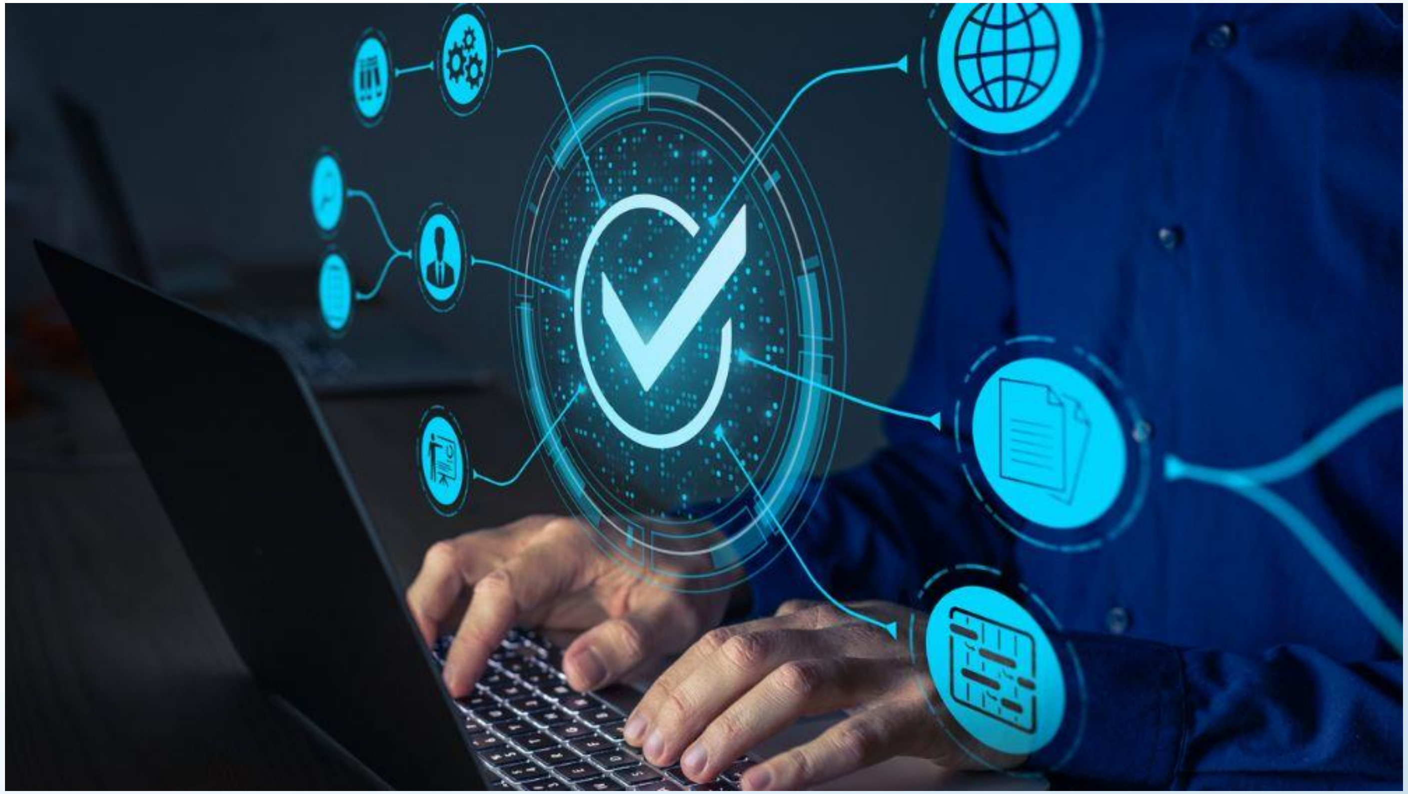

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