ENTERPRISE VALUATION AFTER THE TCJA

ROBERT J. GROSSMAN

The Tax Cuts and Jobs Act will have a major effect on the valuation of privately-held companies.

Few external events have directly affected the valuation of corporate stock in recent years more than the Tax Cuts and Jobs Act (TCJA; P.L. 115-97, 12/22/17). Touted as perhaps the most expansive federal income legislation enacted in more than three decades, the TCJA was signed into law by President Trump on 12/22/17. Because the TCJA embraces a massive number of income tax changes, both taxpayers and practitioners must prepare for an upcoming income tax filing season unlike any other in recent memory.

Complicating matters further, nearly all of the changes in the TCJA applicable to individual income taxation are temporary and, under the Act, are set to "sunset" at the end of 2025 without further legislative intervention or modification. At that point in time, the individual income tax provisions included in the TCJA will expire, and the income tax law for years beginning after 12/31/25 will revert to "pre-TCJA" law. The political waters being what they are at the present, practitioners and taxpayers alike can only guess at the future of many of the temporary TCJA provisions.

The effect of the TCJA on valuation of equity capital interests in business enterprises, including corporations, partnerships and limited liability companies, is material and, in a vacuum, will usually work to increase equity capital value. The exact impact of the many provisions in the TCJA will vary from enterprise to enterprise, depending on the facts and circumstances. However, it is clear that the broad impact of the legislation is to provide income tax relief to business enterprises by reducing cash outflows to the federal government and increasing after-tax free cash flows to those enterprises.

It should be briefly noted that a substantial portion of the value growth in the publicly-traded equity markets in 2017 and in the early part of 2018 is commonly explained as being attributable to the anticipated income tax legislation and, especially, to the lower marginal rates anticipated in that Act prior to its passage. There is no reason to believe that a similar impact could not occur in the privately-held business sector.

ROBERT J. GROSSMAN heads the Tax and Business Valuation Services Groups at Grossman Yanak & Ford LLP, a CPA and consulting firm in Pittsburgh, Pennsylvania. He has nearly 40 years of experience in tax and valuation matters that affect businesses, both public and private, as well as the stakeholders and owners of these businesses. The breadth of his involvement encompasses the development and implementation of innovative business and financial strategies designed to minimize taxation and maximize owner wealth. Bob is a frequent speaker, regionally and nationally, on tax and valuation matters and is a course developer and national instructor for the American Institute of Certified Public Accountants (AICPA) and the National Association of Certified Valuators and Analysts (NACVA).

Example

The following simple example of applying a capitalization of expected future cash flows model under the income approach in valuation illustrates the primary impact that many business valuation practitioners and equity capital owners are noting after the enactment of the TCJA. The logic of this example cannot be ignored in the context of assessing the impact of the TCJA on valuations of equity capital interests in privately-held enterprises.

- Assuming a valuation numerator (expected future after-tax cash flow) of $6,000, application of a 40% effective combined federal and "net" state income tax rate implies a "pre-tax" numerator of $10,000.
- If the effective combined federal and state income tax rate is reduced to 30%, the valuation numerator (expected future after-tax cash flow) would increase to $7,000.
- Assuming that the prescribed capitalization rate developed in consideration of the investment risk associated with the attendant equity capital interest is 20% in both cases, the conclusion of value resulting from the application of the higher effective income tax rate would be $30,000 ($6,000/20%), while the conclusion of value resulting from the application of the lower (reduced) effective rate would be $35,000 ($7,000/20%).
- The difference represents an increase in value of $5,000, or 16.7% over the value produced using the higher effective rate of $30,000.

Certainly, great care has to be taken in matching the appropriate risk rates (i.e., discount or capitalization rate) with the expected economic benefit stream considered in the numerator under either the discounted economic benefit method or the capitalization of future expected economic benefits method under the income approach. In other words, matching *pre-tax* expected future economic benefits with an *after-tax* risk rate would clearly be inappropriate and would produce an erroneous result. On the other hand, matching both elements of the valuation calculation on an after-tax basis easily and efficiently provides for the technically correct result.

The valuation metric most often used in conjunction the determination of value is net cash flows, defined by a qualifier as "invested capital net cash flows" or "equity capital net cash flows." Both terms are defined in the *International Glossary of Business Valuation Terms*.[1] The former is defined as those cash flows that are available to pay out to equity holders (in the form of dividends) and debt investors (in the form of principal and interest) after funding operations of the business enterprise and making necessary capital adjustments. The latter is defined as those cash flows available to pay out to equity holders (in the form of dividends) after funding operations of the business enterprise, making necessary capital investments, and increasing or decreasing debt financing. An important element of both types of net cash flows is the funding of operations, assumed to include satisfaction of all income tax liabilities. As such, both terms are deemed to present *after tax* expected future net cash flows.

While the TCJA is an expansive piece of legislation, with many sets of proposed regulations and IRS guidance being issued since its passage, the key provisions in that law relating to valuation of equity capital shares can be reduced to just a few. That is not to say that any number of the law's statutory business tax changes may not affect the valuation of equity capital interests in a privately-held company. It simply means that those changes having the most profound effect on valuation can be sourced to these few critical provisions.

The effect of the TCJA on valuation of equity capital interests in business enterprises, including corporations, partnerships, and limited liability companies, is material and, in a vacuum, will usually work to increase equity capital value.

Income tax rate reduction for Subchapter C corporations

The most elemental of the key provisions—the provision that received the most media attention and, perhaps, the one with the greatest effect on valuation—is the corporate tax rate reduction. The TCJA modified the Code to convert from a corporate income tax rate regime with a gradu-

[1] International Glossary of Business Valuation Terms, 2001, a glossary developed jointly by the American Institute of Certified Public Accountants, the American Society of Appraisers, the Canadian Institute of Chartered Business Valuators, the National Association of Certified Valuation Analysts, and the Institute of Business Appraisers.

ated tax system and a maximum marginal rate of 35% to a flat tax system with a single marginal rate of just 21%.[2] The primary impact of the corporate income tax rate reduction on valuation is lower future income tax liabilities which result in additional "net" cash flow and, thus, higher equity capital value.

Because of the sheer magnitude of the top marginal income tax rate decrease, the impact on net cash flow is substantial and direct. Returning to the previous illustration, assuming pre-tax future net income of $1,000 and a maximum marginal income tax rate of 35% (federal only), the net after-tax income is $650. Alternatively, incorporating the lowered flat rate of 21%, the after-tax income is $790. If one assumes simply that the cash flow adjustments net to zero, the lower income tax rate accounts for 14% greater net cash flow.[3]

Under the income approach and a simple capitalization model, this change (all other things remaining equal) would result in a *direct* increase in value equal to the 14% difference between the old maximum marginal income tax rate and the new one. To look at this matter in any other way would be to challenge the validity of the broadly accepted and commonly used income approach and capitalization model as they have generally been interpreted by the finance and business valuation community over an extended period of time.

The idea of a value boost, given the corporate marginal rate reduction under the TCJA, is both logical and reasonable. Buyers, financial and strategic, are looking to expected future earnings, and implied cash flows derived therefrom, for purposes of determining offer prices and structuring acquisition transactions. In the "for profit" corporate business arena, that portion of the additional business acquisition cost associated with lower income tax liabilities (and demanded by the seller-market) will yield resultant higher cash flows to the purchasers with greater future returns (as demanded by the buyer-market).

It is also important to understand the impact of the TCJA's elimination of the graduated income tax system historically applied to C corporations in the United States. Prior law effective through 12/31/17 utilized a three-tier graduated income tax system, wherein the first $50,000 of taxable income was subject to a 15% income tax rate. The next $25,000 of taxable income was subject to a 25% rate, and taxable income in excess of $75,000 was subject to a marginal income tax rate of 34%. For larger corporations (those with taxable income in excess of $10 million), a top marginal rate of 35% was included in the law.

In addition, before passage of the TCJA, a corporation with taxable income in excess of $100,000 was required to pay an additional tax equal to 5% of the amount in excess of $100,000, up to a maximum additional tax of $11,750. In effect, this additional tax reclaimed the benefit of the lower marginal rates on the first $75,000 of taxable income.

While the TCJA is an expansive piece of legislation, with many sets of proposed regulations and IRS guidance being issued since its passage, the key provisions in that law relating to valuation of equity capital shares can be reduced to just a few.

From a valuation perspective, the 21% flat rate set forth in the TCJA could work to diminish value in the smallest of C corporations. In other words, for those companies under valuation that have less than $50,000 of taxable income, the 21% flat tax works as a tax increase (realizing that there are other provisions within the legislation and the Code that might work to decrease taxable income from its previous level). An increased income tax liability equates to lower net cash flows and a resultant lower conclusion of value.

The TCJA corporate marginal rate reduction and modification is a permanent change to the Code. As of the date of this article, no events have occurred that would lead one to believe that the rate will be increased anytime soon. Therefore, those working in the financial markets, including business valuation specialists, have no alternative but to consider the lowered marginal rate in their decision making and analysis.

In many business valuations of enterprises organized and operated as pass-through businesses, and especially S corporations, this author has often observed some element of tax-affecting incorporated into the business valuation process. In light of these observations, it is nec-

2 Section 11(b).

3 Note, that the decrease in the federal marginal income tax rate results in a higher net state income tax rate for those C corporation companies/businesses conducting business in states subject to an income tax. The federal tax benefit associated with the deduction is reduced due to the lower associated federal tax savings.

essary to incorporate the marginal rate decrease (as well as other elements of the TCJA) into those calculations when considering valuation of pass-through entities and, if deemed appropriate, the application of a pass-through entity premium. Tax-affecting issues are addressed further in this article.

Income tax rate reduction for individuals

The TCJA modifies the individual income tax rates on a temporary basis. The modifications include a graduated set of seven tax brackets and a highest marginal tax rate of 37%, down from the pre-TCJA individual marginal income tax rate of 39.6%.[4]

The decrease in individual marginal tax rates is not likely to have a direct effect on the discipline of business valuation. It should, however, be considered in conjunction with expected distributions of cash to fund equity capital owner tax liabilities, and the expected returns on the alternative deployment of the resultant lower distributions.

The most elemental of the key provisions of the TCJA—the provision that received the most media attention and, perhaps, the one with the greatest effect on valuation—is the corporate tax rate reduction.

In addition, where it is determined to be appropriate to add a premium for the tax advantages associated with pass-through entity status, the reduced individual income tax rates clearly demand consideration in developing the premium.

Limitation on the deduction of business interest expense

The TCJA adds a very significant change to the traditional deduction for business interest. Under amended Code Section 163(j)(1), the deduction of interest paid or accrued on a debt incurred in a trade or business is limited, regardless of how the taxpayer's business is organized (i.e., C or S corporation, partnership, sole proprietorship, etc.), effective for tax years beginning after 12/31/17. The law does provide an exception for small businesses with average gross receipts of $25 million or less.

The deduction for business interest for any taxpayer is limited in any tax year to the sum of:

1. Business interest income of the taxpayer for the tax year;
2. 30% of the taxpayer's adjusted taxable income for the year, including any increases in adjusted taxable income as a result of a distributive share in a partnership or S corporation, but not below zero; and
3. Floor plan financing interest of the taxpayer for the tax year.

The effect of the new limitation, generally, is to limit the deduction for business interest to 30% of the taxpayer's adjusted taxable income after offsetting the business interest expense fully against business interest income.

Any business interest not allowed as a deduction for the tax year under these rules may be carried forward and treated as business interest paid or accrued in the succeeding tax year.[5] The interest may be carried forward indefinitely, subject to certain restrictions for partnerships and S corporations.

From a business valuation perspective, consideration must first be given to the resulting increase in net cash flows under a direct equity measurement of value included in any particular measurement period or year considered in the discounted future net cash flows method. Applicable limitations on the deduction for business interest expense, in combination with the indefinite carryforward period, will require that valuators consider the "year of deductibility," to ensure the most accuracy possible when developing future financial forecasts.

In addition to influencing the numerator under the income approach to business valuation, the interest cost may also have an effect on determining the invested capital net cash flow where the conversion from income to net cash flow requires an adjustment for interest expense. The limitation will work similarly to the determination of deductible interest noted above but, mechanically, works through the conversion to net cash flow in the invested capital model.

Finally, consideration must be given to a higher "weighted average cost of capital" where interest expense is limited. In such instances, the net cost of debt is increased in two ways. The first is through a lower federal income tax benefit associated with the lower marginal tax rate discussed earlier in this article. The second element is where the deduction, itself, is limited, and the federal income tax benefit associ-

[4] Sections 1(i)(1), (2), and (3), as added by the TCJA.

[5] Section 163(j)(2), as added by the TCJA.

EXHIBIT 1 Depreciation Expense

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Prior to TCJA	1,404,000	238,400	143,040	85,824	85,824	42,912
Under TCJA	2,000,000					

ated with that deduction is deferred until the deduction is allowed in a later measurement period or year. Together, these two provisions will work to increase the cost of debt, thereby lowering the net cash flow available for payment of dividends to equity capital holders and, correspondingly, value.

Qualified business income deduction

A major change in the taxation of companies structured as pass-through business enterprises is likely to have a profound effect on the amount of business funds required to fund the pass-through owners' personal income tax liabilities on their shares of entity-level income.

It is common practice to distribute that amount of cash each tax year necessary to fund shareholder tax liabilities on corporate (or partnership) income "passed through" to them and included on their personal income tax returns. In fact, very often, S corporation shareholder, partnership, and limited liability company agreements include provisions requiring management to distribute sufficient monies to meet these liabilities. Usually, the protocol includes distributing cash to all pass-through equity owners proportionate to their ownership in the pass-through enterprise at the top marginal rate of tax paid by the equity owner with the highest tax rate.

The TCJA includes a new and unique provision, whereby many owners of an equity interest in certain businesses may be entitled to a deduction equal to 20% of any "qualified business income" passed through to them by the enterprise.[6] The economic effect of this provision is to reduce the individual effective federal income tax rate on this income from the highest marginal rate of 37% to 29.6%. As such, the "taxable" equity capital owners of the corporation will require less cash in the future to meet their income tax obligations if they qualify for the deduction. It is widely expected that such a change will lead to lower future cash distributions from the affected businesses, allowing those funds to add to equity owner returns, and/or reinvestment within the businesses' operations.

The need for fewer cash flow distributions to fund shareholder income tax liabilities in these entities may or may not affect the valuation. Historically, much controversy and commentary has surrounded the "tax-affecting" of S corporations. As discussed later in this article, it is impossible to address the tax-affecting issue in any valuation without consideration of this particular provision.

Moreover, the job of the valuator will be expanded to include a determination as to the deployment of any additional "after-tax" cash that is realized and retained by the corporation. Assuming reinvestment of these amounts in capital equipment, working capital, other assets, or debt reduction of the business, valuators will be tasked with following the additional economic gains attributable to such investment or repayment and determining their influence on overall equity value.

Cost recovery/bonus depreciation modifications

Special depreciation rules have traditionally played an important role in motivating taxpayers to invest in new machinery and equipment and have often been perceived by Congress to bolster the economy and create new employment opportunities.

Effective for assets placed in service after 9/27/17, and before 1/1/23, the TCJA increased the amount of bonus depreciation that can be taken on qualifying property to 100%. Thus, during that period of time, the entire cost of qualifying capital expenditures can be fully written off in the year of acquisition. After

[6] Section 199A.

EXHIBIT 2 Depreciation Expense--Present Value of Tax Savings

Prior to the TCJA	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Depreciation Expense	1,404,000	238,400	143,040	85,824	85,824	42,912
Tax Rate	41.5%	41.5%	41.5%	41.5%	41.5%	41.5%
Tax Savings	582,660	98,936	59,362	35,617	35,617	17,808
Present Value Factors at 12.0%	0.8929	0.7972	0.7118	0.6355	0.5674	0.5066
Present Value of Tax Savings	520,232	78,871	42,252	22,635	20,210	9,022
Total Present Value of Tax Savings	**693,223**					

Under the TCJA	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Depreciation Expense	2,000,000	–	–	–	–	–
Tax Rate	28.9%	28.9%	28.9%	28.9%	28.9%	28.9%
Tax Savings	578,000	–	–	–	–	–
Present Value Factors at 12.0%	0.8929	0.7972	0.7118	0.6355	0.5674	0.5066
Present Value of Tax Savings	516,071	–	–	–	–	–
Total Present Value of Tax Savings	**516,071**					
Difference Between TCJA & Old Law	(177,152)					

2023, the bonus percentage is phased down by 20% per year. In addition, while bonus depreciation under the old rules was limited to "original use" or new property, the expanded bonus depreciation under the TCJA applies equally to "non-original use" or used property.

In addition to the broadening of the bonus depreciation rules, the TCJA also increases the applicable thresholds in the Section 179 capital asset expensing allowance. Under the TCJA, the Section 179 dollar limitation is increased to $1 million. The total amount of capital asset investment that a taxpayer can undertake in any year is $2.5 million, after which the $1 million cap begins to phase out.

Like the limited interest deduction, it is important to understand that the tax depreciation rules are, essentially, timing matters in the determination of income tax due each year. Thus, the impact of these deductions will be considered in the determination of net cash flows each year.

From the perspective of deducting the costs of capital asset expenditures more quickly, an immediate reaction might be to expect substantial higher net cash flows in the future forecasts due to acceleration of the depreciation deductions. However, the additional net cash flows may not be as significant as one might initially expect, given the decrease in the top marginal income tax rate. It is noteworthy that the present value of the overall federal income tax benefit associated with pre-TCJA bonus depreciation is very often greater than the pres-

EXHIBIT 3 Change in Present Value of Tax Savings Due to Expensing

Prior to the TCJA	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Depreciation Expense	1,404,000	238,400	143,040	85,824	85,824	42,912
Tax Rate	41.5%	41.5%	41.5%	41.5%	41.5%	41.5%
Tax Savings	582,660	98,936	59,362	35,617	35,617	17,808
Present Value Factors at 12.0%	0.8929	0.7972	0.7118	0.6355	0.5674	0.5066
Present Value of Tax Savings	520,232	78,871	42,252	22,635	20,210	9,022
Total Present Value of Tax Savings	**693,223**					

Under the TCJA (Assuming No Change in Tax Rates)	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Depreciation Expense	2,000,000	–	–	–	–	–
Tax Rate	41.5%	41.5%	41.5%	41.5%	41.5%	41.5%
Tax Savings	830,000	–	–	–	–	–
Present Value Factors at 12.0%	0.8929	0.7972	0.7118	0.6355	0.5674	0.5066
Present Value of Tax Savings	741,071	–	–	–	–	–
Total Present Value of Tax Savings	**741,071**					
Net Change in Present Value of Tax Shield	47,848					

ent value of the post-TCJA federal income tax benefit. The principal reason for this anomaly is the extreme difference in pre- and post-TCJA marginal income tax rates associated with regular Subchapter C corporations.

To illustrate, assume a company is planning to invest $2 million into a new piece of equipment. Prior to the TCJA, the company would be able to accelerate the recognition of depreciation through Section 179 as well as the 50% bonus depreciation. Any remaining undepreciated cost would have been expensed over the cost recovery period assigned that class of property under the Modified Accelerated Cost Recovery System (MACRS) for tax purposes. Under the TCJA, the entire amount of the planned capital expenditures can be expensed as depreciation in the first year, if the property is placed in service in that year.

The depreciation expense in each year for the planned capital expenditures under prior law, as well as that allowed under the TCJA, is illustrated in Exhibit 1. Note that for purposes of this example it is assumed that the asset has a five-year useful life. Moreover, it is assumed that prior to the TCJA, $500,000 of the $2 million expenditure is expensed under Section 179, and an additional 50% of the remaining depreciable basis is eligible for depreciation in the first year. Half-year MACRS rates would have then been applied to the remaining depreciable basis to determine the total depreciation that would be recognized in each year.

Applying the applicable tax rates under the prior law (41.5%) to the pre-TCJA law expensing schedule in Exhibit 1 and applying present value concepts, the tax benefit in each year using an assumed discount rate of 12.0% results in a present value of $693,223. In contrast, applying the lower effective income tax rate (28.9%) under the TCJA under the new expensing rules and discounting the tax benefit cash flow to present value at an assumed discount rate of 12.0% results in a present value of $516,071, or approximately $177,152 less under the TCJA than prior to it. These differences are illustrated in Exhibit 2.

The change in the present value of the depreciation tax benefit is a result of both the significant reduction in the corporate income tax rates as well as the change in expensing provisions under the TCJA. These effects can be isolated by varying one factor at a time. Exhibit 3 illustrates the change in the present value of the tax benefit attributable to the additional bonus depreciation.

The TCJA adds a very significant change to the traditional deduction for business interest.

As can be seen in Exhibit 3, keeping tax rates under the old law constant while adjusting for the additional bonus depreciation allotted for under the TCJA results in a $47,848 increase in the present value of the depreciation tax benefit. This increase is attributable to the more immediate recognition of tax savings afforded to a company through the bonus depreciation provisions of the TCJA.

Exhibit 4 shows the change in the present value of the depreciation tax benefit attributable to changes in the tax rate. As can be seen in Exhibit 4, the lower tax rate decreases the present value of the depreciation tax benefit as it creates a smaller dollar amount of tax savings in any given year. The net change in the present value of the depreciation tax benefit is, therefore, equal to the sum of the change resulting from changes in expensing and the change resulting from changes in the tax rate, or $47,848 + (225,000) = (177,152).

It is important to note that, while the present value of the tax benefit attributable to depreciation is expected to be lower under the TCJA than under the old law, the decrease is attributable to lower tax rates, which as previously demonstrated, serve to increase free cash flow. The overall decrease in total taxes paid more than offsets the lower present value of the depreciation tax benefit for a profitable enterprise. Thus, for a profitable enterprise, although the total present value attributable to depreciation tax savings will decrease, the overall increase in after-tax cash flow is expected to more than offset the decrease, resulting in a net increase in present value.

Net operating losses

The TCJA includes provisions that modify traditional carryover and carryback periods related to net operating losses (NOLs).[7] Under prior law, NOLs were permitted to be carried back two years and forward for 20 years to offset the taxable income generated in those tax years. Under the TCJA, in most instances, NOLs are no longer permitted to be carried back to pre-loss years and will be carried forward indefinitely. Moreover, prior to the TCJA, NOLs were allowed to be offset against 100% of taxable income in any year to which the loss could be carried. Post-TCJA, those losses incurred through 12/31/17, will remain 100% offsets against any future income. However, NOLs generated in years beginning after 12/31/17, will only be permitted to offset 80% of the income of the future year(s) to which the NOL is carried.

Two general valuation considerations are relevant in light of these changes. First, the changes are likely to negatively impact the present value of NOLs incurred after 12/31/17, as the new rules will work to defer their utilization further into the future, and thus later realization of the corresponding federal income tax benefits. Secondly, like the business interest limitation and bonus depreciation rules discussed earlier, the federal income tax benefit realized as a result of carrying the NOLs forward will be substantially lower than pre-TCJA, again due to the lower marginal income tax rates.

Pass-through entity tax-affecting

A natural outgrowth of the many provisions affecting businesses under the TCJA is how the new law's provisions will impact the valuation for pass-through business entities. While most practitioners appear to value controlling equity capital interests in these entities by applying regular C corporation marginal income tax rates to forecasted taxable income, there has long been con-

7 Section 172 (as amended by TCJA).

EXHIBIT 4 Change in Present Value of Tax Savings Due to Tax Rates

Prior to the TCJA (Assuming TCJA Expensing)	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Depreciation Expense Tax Rate	2,000,000 41.5%					
Tax Savings	830,000					
Present Value Factors at 12.0%	0.8929					
Present Value of Tax Savings	741,071					
Total Present Value of Tax Savings	**741,071**					

Under the TCJA	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Depreciation Expense **Tax Rate**	**2,000,000** **28.9%**					
Tax Savings	**578,000**					
Present Value Factors at 12.0%	**0.8929**					
Present Value of Tax Savings	**516,071**					
Total Present Value of Tax Savings **Net Change in Present Value of Tax Shield**	**516,071** (225,000)					

troversy (especially with respect to the IRS) on how best to value non-controlling equity capital interest in these entities. Over time, the issue has proven particularly troublesome for non-controlling equity capital interests in S corporations where there is little question of acceding the S corporation income tax benefits associated with S corporation status. The issue was addressed in detail by the IRS with the release of a technical job aid on the topic in 2014.[8]

The impact of pass-through entity tax status has been repeatedly segregated into three separate and distinct taxpayer-friendly or beneficial economic characteristics. The first of these is the arbitrage created by the differences between individual income tax rates paid on the income "passed-through" to equity owners and the alternative corporate income tax rate that would be applied to that same income if it had been subjected to income tax at the corporation level. The second of these characteristics is the ability of the pass-through business entity to distribute cash equal to the amount of income previously taxed to its equity owners. In effect, this ability is equated to avoiding the second layer or "dividends" tax imposed on distributions of cash to equity holders in a regular Subchapter C corporation. Finally, the

[8] "Valuation of Non-Controlling Interests in Business Entities Electing to be Treated as S Corporations for Federal Tax Purposes—A Job Aid for IRS Valuation Analysts," 10/29/14; www.irs.gov/pub/irs-utl/S%20Corporation%20Valuation%20Job%20Aid%20for%20IRS%20Valuation%20Professionals.pdf.

third favorable characteristic allows holders of equity interests in pass-through entities to increase the tax basis of their ownership interest for previously-taxed income that is not distributed. Thus, this benefit allows for a lower gain on the disposition of their ownership interest.

Numerous models and techniques have been offered throughout the business valuation community, including experts within the IRS and courts. A detailed review of these models and techniques is beyond the scope of this article. Suffice to say, the models have been carefully scrutinized and peer reviewed among business valuators over an extended period of time spanning the last two decades. While no model or technique has been widely confirmed as being the most appropriate, it is noteworthy that some increase in value has been ascribed to the valuation of privately-held equity capital interests using these models and techniques or other similar models.

Prior to the enactment of the TCJA, the highest individual marginal income tax rate was 39.6%, while the highest corporate marginal income tax rate was 35%. If the Qualified Business Income Deduction discussed earlier applies, the highest individual marginal income tax rate on the qualified business income will be 29.6%. The highest individual marginal income tax rate is now 37%, while the highest corporate marginal income tax rate is 21%. This change is the most profound in evaluating the economic benefit of maintaining pass-through entity status versus regular subchapter C status.

Affecting the first taxpayer-friendly characteristic of arbitrage to a pass-through entity owner no longer exists and, in fact, offers this benefit to the corporate entity structure. While discussions continue on the TCJA and its effect on the valuation of pass-through entities, it seems logical that the traditional assignment of a pass-through entity premium to the otherwise determined value will decrease as a result of the rate change dynamics in the two alternative structures.

Conclusion

The final impact of the TCJA on the valuation of privately-held companies continues to be a matter of debate and commentary as valuation practitioners and financial analysts study the law's many provisions and the IRS releases more guidance. Therefore, the law's full effect on valuation may not be fully understood for some time.

However, as noted earlier, there is no question that anticipation of the tax legislation, as well as its enactment, has led to significant overall growth in value on the public markets at least on a "near-term" basis. There is no reason to believe that the law did not have a similar impact on all valuations generally. Thus, a failure to carefully assess the effect of the TCJA on any subject privately-held enterprise under valuation would be to run askew of governing professional standards.

Care should be taken by the business valuation community to ensure that the TCJA, as well as the seemingly constant release of proposed Treasury regulations and other interpretive guidance, is incorporated into their determinations of value. ■