Valuation & Litigation Briefing

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What does the new tax law mean for business valuation?

The Tax Cuts and Jobs Act (TCJA) is the most significant overhaul of the tax code in more than 30 years. In addition to cutting tax rates, the law adds, modifies and eliminates many other business-related tax breaks, along with transitioning to a territorial tax system for corporations with foreign earnings.

Business owners welcome many of the changes to the tax law, but not all the changes are favorable for business — or simple to understand. While it may be tempting to address the new law by simply adjusting the subject company's tax rate, the law is far more complicated.

Valuation experts will need to develop complex models to reflect the changes under the TCJA. Here's an overview of how the changes will affect the income and market approaches.

Projecting earnings

Under the income approach, an expert projects future earnings (typically equity or invested capital cash flows) and converts them to present value using a discount rate that's based on the company's risk. The TCJA can affect a subject company's future earnings, its risk profile — or both.

Many companies will enjoy lower tax rates, which enhance after-tax cash flows. Specifically, corporate income tax rates have been reduced from a top rate of 35% to a flat rate of 21%. Pass-through entities — such as sole proprietorships, partnerships, S corporations and limited liability companies — will also be taxed at lower rates, because the TCJA 1) lowers individual income tax rates, and 2) provides a 20% deduction for qualified business income (QBI).

However, the tax breaks for pass-throughs expire at the end of 2025. In addition, the QBI deduction is subject to several limitations, based on income levels and spending on W-2 wages and depreciable property. And certain service businesses may be ineligible for the deduction over certain income levels.

The new law contains several other changes that affect taxable income. For example, 100% bonus depreciation will temporarily boost after-tax cash flow for many businesses. This provision allows businesses to fully deduct the cost of qualifying assets placed in service after September 27, 2017, and before January 1, 2023. After 2022, bonus depreciation will be reduced by 20% each year and eliminated after 2026. (These dates are extended by one year for certain property, such as aircraft, with "longer production periods.") The new law also expands the Sec. 179 depreciation deduction limits.

When projecting future earnings, experts should use caution when

No deduction for sexual harassment and abuse settlements

The Tax Cuts and Jobs Act (TCJA) eliminates tax deductions for settlements or payments (including attorneys' fees) "related to sexual harassment or sexual abuse," if they're subject to a nondisclosure agreement. So, defendants will have to decide between deductibility and confidentiality.

This provision will require careful planning (including reasonable apportionment of payments) in cases involving both sexual harassment or abuse and other claims. It also leaves unanswered questions about the deductibility of whistleblower settlements and severance payments related to sexual harassment or abuse claims.

relying on depreciation expense to approximate the need for tax expenditures. Accelerated depreciation deductions could make those assumptions flawed. Likewise, when calculating terminal value in a discounted cash flow model, it's important to evaluate whether projected cash flows can continue into perpetuity, given the temporary nature of many of the TCJA provisions.

Calculating the discount rate

The TCJA also makes it harder to quantify discount rates. In general, lower tax rates increase the cost of debt. That's because interest expense deductions have a reduced tax advantage when tax rates are lower.

Moreover, the new law generally limits interest expense deductions for larger businesses (those with average annual gross receipts of $25 million or more) to interest income plus 30% of adjusted taxable income. (Disallowed interest expense can be carried forward indefinitely.) There are some exceptions to the interest expense limitation. For example, auto dealerships can generally deduct all interest paid on vehicle "floor plan" financing.

Under these changes, some companies may decide to spend some tax savings on repaying debt. This could, in turn, alter a company's capital structure to include more equity. When valuing a minority interest, it's important to remember that minority shareholders may lack control over financing decisions.

The bottom line? Valuation experts must consider each company's facts and circumstances in calculating the discount rate.

Selecting comparables

Under the market approach, valuation experts compute pricing multiples from "comparable" transactions involving similar public or private companies. Those pricing multiples are then applied to the subject company's financial results.

Timing may be critical when selecting and evaluating comparables. Multiples derived from transactions that were completed before the TCJA passed need to be analyzed carefully, because they may not fully reflect the tax law changes. Conversely, some publicly traded comparables may have been priced in anticipation of tax reform, long before the new law was passed.

Going forward, changes to the tax law could stimulate or stall M&A activity in a particular industry, driving prices up or down. Because the effects will vary from company to company, experts must carefully analyze a company's facts and circumstances when comparing it to guideline public companies.

Challenges ahead

These are just a few of the provisions that create business valuation challenges. Your expert can help you evaluate the TCJA's potential effects in specific valuation contexts. ■

Identity crisis

How experts identify alter ego companies

Don't give up on defendants that appear to have limited financial resources. In some cases, plaintiffs may be able to successfully assert that the defendant is nothing more than an "alter ego" for a more solvent company. How do you know when an alter ego exists? Here are a few questions to investigate.

Is the defendant inseparable from a parent or subsidiary?

Alter ego litigation generally is sought to "pierce the veil" of a corporation or limited liability company (LLC) or take away the owners' limited liability protection. Doing so provides access to the financial resources of a defendant's subsidiaries — or even individual shareholders. But to be successful, plaintiffs need to show that a company and its shareholders lack separate identities. (The alter ego doctrine may apply to corporations, LLCs and other entities. For simplicity, we use the terms "corporate" and "corporation" in this article.)

Courts are more likely to disregard a corporate form if the shareholders themselves disregarded the corporation's separate existence.

Courts are more likely to disregard a corporate form if the shareholders themselves disregarded the corporation's separate existence. For example, if the shareholders neglected corporate formalities — such as electing officers and directors and keeping meeting minutes — the corporation might be an alter ego. In addition, commingling of funds and assets can blur the distinctions between a corporation and its shareholders.

Lack of separateness also can be an issue when a parent corporation has one or more subsidiaries. Plaintiffs who dealt with a subsidiary may have believed they were dealing with the parent. The businesses may have been so similar that it was difficult to tell them apart. Or the parent's actions or representations may have led the plaintiff to believe that the parent would stand behind the subsidiary's obligations.

Similarities between a parent and subsidiary can create confusion and support application of the alter ego doctrine. Entities may not be separate, for example, when they share the same (or similar) product line, name, branding or management team.

The existence of transactions between a corporation and its shareholders or parent that aren't conducted at arm's length also merits attention. A financial expert can provide insight into whether such situations are ordinary and appropriate or whether they indicate abuse.

Is the defendant dependent on related parties?

One common sign that a company is an alter ego is financial dependence on its shareholders or parent. This relationship often is demonstrated when the corporation is undercapitalized, the shareholders or parent owns most of the assets used in the business and leases them or sells them to the corporation at bargain rates, or the shareholders or parent makes undocumented or below-market loans to the corporation or relieves the corporation of its payment obligations.

Typically, experts analyze a corporation's capital structure and compare key financial ratios and indicators to those of similar companies to determine whether the defendant is undercapitalized. They also may review the company's operating history and analyze intercompany transactions and relationships to determine whether the corporation became undercapitalized due to operating losses or irregularities in its financing. Experts further analyze transactions to determine whether they were conducted on an arm's-length basis.

Does another entity control the defendant?

Although operational similarities and financial dependence provide experts with solid leads, nothing says "alter ego" like a parent that exercises undue influence or dominates a corporation. In this case, the shareholders or parent may cause the corporation to favor it over third parties, by, for example, giving it preferred status over other creditors.

In such cases, a financial expert can review the corporation's operations and transactions, examine accounting records and apply valuation techniques. These tools help the expert determine whether the corporation's dealings with related parties are legitimate and unbiased — or involve undue control or domination by its owners.

Consult with a financial pro

Alter ego companies aren't always easy to identify, because dishonest companies know how to structure related-party entities to hide financial assets and evade responsibility. A financial expert can be a valuable tool for unraveling covert relationships and proving that a defendant has abused the corporate structure. ■

Patent apportionment: Don't double count damages!

When calculating reasonable royalty damages in patent infringement cases, experts are often called upon to "apportion" the royalty base among multiple patents or between infringing and noninfringing products or product features. In *Finjan, Inc. v. Sophos, Inc.*, the U.S. District Court for the Northern District of California excluded an expert's testimony on *Daubert* grounds because her apportionment methodology improperly inflated the royalty base.

Multiple infringement claims

In this case, Sophos' unified threat management (UTM) suite of antivirus software products allegedly infringed six of Finjan's patents. (Ultimately, Sophos was found to have infringed five of the patents.)

The plaintiff's damages expert opined that five of UTM's seven modules infringed Finjan's patents. She determined that a reasonable royalty rate was 16%. But, in applying that rate, she double or triple counted revenue attributable to certain product features, resulting in a royalty base that was greater than 100% of the products' total value.

The court offered an example: The "'844 patent" covers two modules: the threat engine and live protection modules. So, Finjan's expert opined that it was appropriate to apportion 28.6% (2/7) of the royalty base to that patent. In addition, the expert claimed, the "'494 patent" also covered those modules, making it appropriate to apportion 28.6% of the royalty base to that patent as well. The court concluded that the expert's methodology was unreasonable, because it used an inflated royalty base.

No overlapping patents

Finjan argued that its expert's methodology was reliable because she'd calculated damages on a per-patent basis, allowing the jury to calculate damages specific to each patent even if some of the patents were found to be invalid. It characterized Sophos' challenge as a claim that Finjan is "only entitled to recover damages as if it was one patent in suit because we have overlapping technologies at issue."

The federal district court agreed with Sophos. The opinion states, "If Finjan's patented technologies are truly overlapping then it can in fact only recover damages as if one patent is in suit as 'no patent can issue for an invention actually covered by a former patent.'"

The court acknowledged that Finjan's patents could cover related or intermingled technologies, but not identical ones. Viewed that way, multiple patents that cover the same feature "must cover different technologies that together contribute to the total value of the [feature]."

If at first you don't succeed …

Finjan's expert amended her report, applying a more complex methodology that involved declining royalty rates. Although the revised approach resulted in lower damages, it suffered from the same flaw as the first report. Assuming that each module had equal value, the court explained, Finjan's patents accounted for, at most, 5/7 of UTM's total revenue.

The total revenue was approximately $21.5 million, so the total possible apportioned revenue base was approximately $15.4 million ($21.5 million × 5/7). Applying a 16% royalty rate to this royalty base, the court arrived at a maximum reasonable royalty damages award of $2.5 million, but the expert's methodology produced a $5.6 million royalty — more than double the court's estimate.

Applying a "sanity check"

Finjan illustrates the importance of stepping back and asking whether a damages calculation makes sense. In general, a royalty base that substantially exceeds the total revenue generated by an infringing product clearly doesn't seem reasonable. ■

Valuing divestitures and spinoffs

It's not uncommon for companies to sell or "spin off" part of the business. However, valuation adjustments may be needed to reflect changes in the newly independent company's relationship with its former parent.

A question of dependency

If the new company is essentially a standalone company, before and after the transaction, the valuation issues will be minimal. But if the company was dependent on its former parent, a valuator must determine:

- Whether the divested business unit will continue to receive support from the parent or whether it will eventually transition to a standalone company,
- The impact of the transaction on the divested business unit's earnings and risk profile for valuation purposes, and
- How to project future earnings and cash flow if no historical records are available.

Examples of control-related issues that may require valuation adjustments to report transactions on an arm's-length basis include:

Management. If the former parent provided the divested business unit with management services, it's important to evaluate the terms of the parties' relationship, including how much the parent charged and how long the management services will continue. Often the details are spelled out in the sales agreement or a separate written contract. If the new arrangement calls for additional charges for management services, the valuation expert should adjust the company's earnings accordingly.

If the divested business unit plans to transition to a standalone business, the valuator should evaluate the capabilities of its management team. Any shortcomings should be reflected in the valuation, either by adjusting projected earnings or treating it as a risk factor.

Intellectual property. If the divested unit relies on patents, trademarks, copyrights or other intellectual property (IP) owned by the parent, the valuation expert must determine whether the company will be able to license the IP going forward and review the terms of any license agreements. If the scope of the license is narrow, it may create additional risk or inhibit the company's growth potential. If the divested business unit will pay the parent a license fee, the expert needs to assess whether the fee is reasonable based on comparable royalty rates and adjust earnings to reflect these fees.

Transfer pricing. Market prices don't necessarily apply to intercompany sales. But if the divested business unit and its parent continue to do business after the deal closes, the parties will need to negotiate a market pricing structure. And the valuation expert may need to adjust earnings accordingly.

Custom approach

Divestitures and spinoffs give rise to many challenges — these examples are just the tip of the iceberg. A valuation professional can help deal with control-related issues and provide a clear picture of the value of what's being transferred. ■