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US Tax Reform and Valuation: The Impact on Cash Flows, Cost of Capital, Interest Expense and Multinational Corporations

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The 2017 Tax Cuts and Jobs Act became effective on December 22, 2017, and it has a sweeping impact on both US companies with foreign operations and non-US companies conducting business and investing in the US through legal entities.

The reform changed the valuation process for both types of businesses in several key ways. Here are some of the most important changes to be aware of:

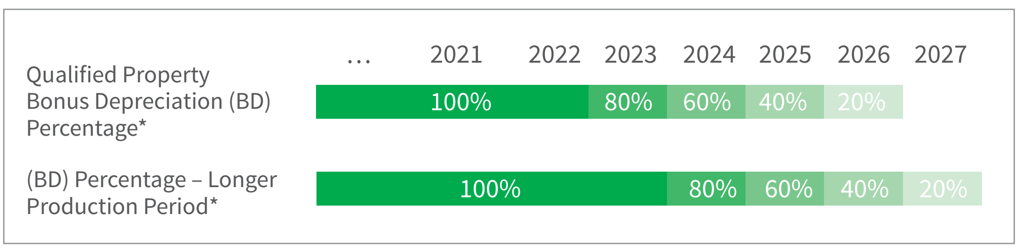
Impacts on Cash Flows (Numerator)

Corporate tax reduction. The most important impact on cash flows is the permanent reduction, as of January 1, 2018, in corporate tax from 35% to a flat 21%. This needs to be considered in DCF, as it affects both discrete period cash flows and terminal value calculation. For these purposes, it's probably safe to assume a 25% tax rate including state and local taxes.

Asset depreciation. The change to asset depreciation is temporary, and enables businesses to apply 100% (bonus depreciation) expensing for certain business assets:

- For most fixed assets (except real estate), the tax payers or corporation can deduct 100% of the CapEx that they make between September 22, 2017, and December 31, 2022.
- After 2022, there is a gradual phase-out of the percentage that you can expense.
- For production assets that depreciate over a longer period (a power plant, for example), 100% deductibility is extended for up to an additional year.

See the table below for examples of phase-out schedules for regular and longer-production business assets:



A few things to keep in mind:

- To take advantage of this change, you may wish to consider extending DCF projections to 10 years instead of 5 years.
- Keep in mind that state income tax regulation may or may not allow you to take advantage of bonus depreciation.
- Buyers may favor deals structured as asset transactions, because if you buy assets for US tax purposes, you would no longer depreciate those assets over 5-10 years.
- In the case of an asset deal in PPA, there is no change in amortization of intangibles: they would still get 15 years of straight-line treatment.

R&D expenditure. The Act will also change the way R&D can be expensed. R&D expenditures made in the US can still be expensed 100% in some cases, but only through 2021. Beyond this period, the company will have to begin amortizing and capitalizing over a 5-year period. R&D expenditures made outside the US will need to be capitalized and amortized over a 15-year period.

NOLs. If you are performing a valuation that uses both historical and expected NOLs, the treatment for both will need to be done separately, because the calculations for each are now different.

The table below lays out the differences in each case:

NOLs arising pre 12/31/2017	NOLs arising post 12/31/2017
20-year carry-forward treatment	Indefinitely carry-forwarded, with carry-backs prohibited
Not subject to an income limitation	Limited to 80% of taxable income in any particular year

Impact on Cost of Capital (Denominator)

The Act also impacts the way the cost of capital is calculated, because the subsidy that the cost of debt created has now changed due to the lowering of the tax rate from 35% to 21%.

Analysts also forecast that the risk-free rate will increase in response to the increase in US government borrowing over short periods. The risk-free rate may increase further as the Federal Reserve Bank moves towards reducing the balance sheet on items such as the investments in various asset categories that have been accumulating since the 2008 financial crisis.

If the risk-free rate increases, the after-tax cost of debt can also be expected to go up, and the cost of most corporate borrowing will also increase.

It's also worth looking at the potential impact on the equity risk premium (ERP): historically lowering US corporate tax rates has increased private equity multiples, thereby lowering ERP.

Betas are currently being estimated using historical data. However, the change in the tax rate may impact the financing risk component depending on the formula chosen to estimate the beta and the amount of debt in capital structure. Estimating the beta for private companies under the capital asset pricing model (CAPM) involves levering and unlevering the betas of comparable guideline public companies. CAPM calculations are also affected by the reduced tax rate and will now need to factor in the limitations on interest deductibility. As a result, it will be important to carefully model and support the assumptions for the cost of equity in valuation models.

Overall, changes in the tax rates will have a greater impact on the cost of debt than the cost of equity. A reduced tax rate will increase the after-tax cost of debt. However, company valuations should consider the ability of a business to deduct its interest expense.

Impact on Interest Expense

Business interest expense deductions. In addition to an increase in the cost of debt, a new section of the tax code (Section 163(j)) changes the way US business interest expense deductions are calculated.

For tax years occurring after December 31, 2017, deductions for interest expense is limited to the sum of:

- Business interest income (excluding investment interest)
- 30% of adjusted taxable income
- Floor plan financing interest

Adjusted taxable income. For tax years beginning in 2018 through 2021, the computation of adjusted taxable income should approximately reflect a business's earnings before interest, taxes, depreciation, and amortization (EBITDA).

For tax years beginning after 2021, the adjusted taxable income would be the approximate earnings before interest and taxes (EBIT). As a result, adjusted taxable income should generally decrease, ultimately reducing the maximum amount of deductible business interest expense.

For tax years 2018 – 2021, we recommend calculating adjusted taxable adjusted taxable income as follows:

Taxable income before NOL deduction
+/- Any item not allocable to a trade or business
+/- Business interest expense or business interest income
+/- §199A deduction (new qualified business income deduction; N/A for corporations)
+/- Depreciation, amortization and depletion
+/- Any other adjustments as prescribed by the secretary

For tax years 2022 and after, the calculation is the same as the above, but there is no adjustment for depreciation, amortization and depletion.

Using this calculation, the impact on valuation will be greater for highly levered companies, as well as for cyclical or unprofitable business.

International Provisions

The Act will impact the way the US government taxes global operations of US multinational corporations.

Several key provisions will now come into effect:

- The US will shift to a territorial tax system where 100% of foreign profits for shareholders with at least 10% ownership will be exempt from US taxation.
- The new legislation requires a deemed repatriation of accumulated and deferred foreign earnings. The tax on repatriated earnings is 15.5% for cash and cash equivalents and 8% for remaining earnings and profits. The repatriation tax can be paid in annual installments over a period of up to 8 years.
- Income classified as global intangible low-taxed income (GILTI) will be subject to immediate US corporate tax.
- S Corporation shareholders can defer payment until the occurrence of a triggering event as defined by the new law.

Key Takeaways

For US companies with foreign operations and non-US companies with legal ties to the US, the 2017 Tax Cuts and Jobs Act will impact the valuation process. Overall, both the numerator and the denominator in a DCF calculation will increase, with the change in the denominator (WACC) depending on the capital structure of the company. While many companies will see a tax benefit from the Act, companies that are highly leveraged will not enjoy as much of a lift.

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