BCC Advisers Litigation & Valuation Report

NOVEMBER/DECEMBER 2018

Consider tax reform when valuing pass-through entities

5 steps to calculate lost future earnings

Tax law change draws attention to owners' compensation

Mifflinburg Telegraph, Inc. v. Criswell
Which is appropriate: Lost profits or lost business value?

BCC ADVISERS

LITIGATION SUPPORT
BUSINESS VALUATION
MERGERS & ACQUISITIONS

866-787-8019
www.bccadvisers.com

Serving Middle-Market Clients Since 1988

Consider tax reform when valuing pass-through entities

The Tax Cuts and Jobs Act (TCJA) brings numerous changes that will affect businesses' operating cash flows and values. One change in particular — referred to as the qualified business income (QBI) or the Section 199A deduction — is critical to understand when valuing pass-through entities (PTEs). For purposes of this article, PTEs include sole proprietorships, S corporations, limited liability companies (LLCs) and partnerships.

History of the tax-affecting debate

PTEs generally pay no entity-level income tax. Instead, income is passed through to their owners, who are taxed at their individual income tax rates.

Historically, this has given PTEs a tax advantage over C corporations, which are potentially subject to double taxation. That is, income is taxed once at the entity level and again when it's distributed to shareholders as taxable dividends. As a result, the U.S. Tax Court generally has found that PTEs should be valued at a premium over comparable C corporations, to reflect the economic benefits of pass-through taxation.

Some valuation experts disagree with the Tax Court's stance, arguing that earnings from PTEs should be "tax affected" based on an assumed corporate income tax rate. The theory is that tax-affecting reflects certain risks assumed by a hypothetical buyer, such as the risk that a PTE will lose its tax-favored status or that minority owners will owe tax on the PTE's earnings — even when controlling owners fail to make distributions.

As a compromise between these two points of view, valuation experts may use sophisticated models that take into account personal taxes while reflecting a hypothetical buyer's risk of entity-level taxes.

Unequal tax cuts for businesses

C corporations received several major tax breaks under the TCJA. Notably, their federal income tax rate has been permanently reduced to 21% and the corporate alternative minimum tax (AMT) has been eliminated.

But the top marginal federal income tax rate for individuals only decreased slightly under the TCJA, from 39.6% to 37%. And the individual AMT remains, although the exemption deductions and phaseout thresholds are now higher.

The deduction for QBI is intended to level the playing field between C corporations and PTEs. But it's available only for tax years beginning in 2018 through 2025, and the deduction is subject to various restrictions and limitations.

The mechanics

To understand how the deduction for QBI affects the value of PTEs, it's important to learn how it works. The deduction, which

applies at the individual owner level, is generally equal to 20% of an owner's QBI from the entity. (The deduction also can't exceed 20% of an owner's taxable income calculated before any QBI deduction, less net capital gains.)

In addition, QBI doesn't include reasonable compensation received by S corporation shareholders or guaranteed payments for services received by partners. (See "Tax law change draws attention to owners' compensation" on page 5.)

The deduction is subject to two significant limitations:

1. Wage limitation. Above the applicable taxable income threshold, the deduction is limited to either 1) 50% of an owner's share of the entity's W-2 wages, or 2) 25% of W-2 wages, plus 2.5% of the acquisition cost of certain depreciable property (including real estate) that's used by the PTE during the tax year to produce QBI.

2. Service business disallowance rule. Income from specified service businesses and businesses "whose principal asset is the reputation or skill of one or more of its employees or owners" is ineligible for the QBI deduction at higher income levels. (See "Which service firm owners may be ineligible for the QBI deduction?" at right.)

These limitations apply only if an owner's taxable income (calculated before any QBI deduction) is above $157,500, or $315,000 for married joint-filers. Above these thresholds, the limitations are phased in over a $50,000 taxable income range, or a $100,000 range for married joint-filers. The limitations are fully phased in when taxable income reaches $207,500, or $415,000 for married joint-filers.

Tax reform creates valuation challenges

It's unclear whether PTEs are still advantageous from a tax perspective under the new law, especially after the deduction for QBI expires at the end of 2025. Generally speaking, it's important for valuation experts to understand how the TCJA (and any future tax law changes) affect different types of businesses and factor company-specific effects of the changes into their valuation analyses. ■

Which service firm owners may be ineligible for the QBI deduction?

Owners of "specified service businesses" are ineligible for the qualified business income (QBI) deduction if their taxable income (calculated before any QBI deduction) exceeds $207,500, or $415,000 for married joint-filers. This disallowance rule potentially affects owners of pass-through businesses that perform services in these fields:

- Health,
- Law,
- Accounting,
- Actuarial science,
- Performing arts,
- Consulting,
- Athletics,
- Financial services,
- Brokerage services, and
- Investing and investment management, trading, or dealing in securities, partnership interests or commodities.

The tax law specifically excludes architecture and engineering firms from the service business limitation, however. To determine whether this provision applies to a particular service business, contact a financial expert who's familiar with the latest IRS guidance.

5 steps to calculate lost future earnings

From personal injury to wrongful termination, there are many reasons an individual might seek to recover lost earnings. However, this is no simple matter — in fact, the level of analysis can be just as complicated as estimating lost profits for a business.

The calculations require an estimate of the earnings the plaintiff would likely have enjoyed but for the defendant's wrongful act, along with the plaintiff's actual expected earnings. The difference between those two amounts is then discounted to present value. While this sounds relatively straightforward, multiple steps are required.

1. Hire a financial expert

Courts are likely to reject lost earnings estimates that are purely speculative. So, first and foremost, an independent, experienced financial expert is needed. He or she will sift through the data and apply objective market data to arrive at a reliable damages amount. The expert's task is to estimate the individual's future earnings, based on facts and circumstances.

2. Analyze earnings history

The calculations start with "base" earnings, including salary, benefits, bonuses and commissions. If the plaintiff has worked for the same employer for several years with a consistent pattern of annual increases, determining base earnings is simple. If the earnings history is erratic, however, the expert takes into account the reasons (such as health problems) in arriving at base earnings.

The expert also might adjust base earnings for unusual, nonrecurring payments, such as a "signing bonus" or the settlement of a major lawsuit. He or she further considers variable compensation, such as commissions and performance bonuses.

3. Adjust past earnings as needed

Past earnings trends can be a good predictor of future earnings, but they may need to be adjusted. In analyzing historical earnings trends and projecting future earnings, an expert considers the impact of seasonal variations and economic trends that may distort past earnings patterns.

The expert also analyzes the plaintiff's promotion history and evaluates the likelihood that promotions will continue at the same rate in the future. The plaintiff's level of education and future job potential should also be considered.

If the case involves employment discrimination, the plaintiff's earnings history may not be a reliable indicator of his or her earnings potential. Under those circumstances, it may be necessary to rely on the earnings of other employees in comparable positions.

4. Evaluate benefits

Placing a monetary value on benefits is another challenge. Benefits can cover a lot of ground, from health insurance and retirement plans to company cars and meals. So, they can be a significant component of earnings. The plaintiff may not remember — or even be aware of — all of the benefits he or she receives, so it's important to use the discovery process to make sure all benefits are accounted for.

In some cases, using statistical evidence, such as average employee benefits as a percentage of salary, may be appropriate. But if benefits are substantial, it may be worthwhile to determine the

value of each benefit separately. Other evidence that's commonly used includes worklife tables and historical and projected inflation rates.

5. Determine the loss period

The appropriate loss period can have a significant impact on the overall damages award. Typically, it extends from the date the plaintiff was discharged or otherwise prevented from working until he or she secures comparable employment. If the plaintiff can't work or is no longer able to achieve the previous level of earnings, the loss period may extend over his or her entire worklife expectancy.

Need help?

Experts who apply a systematic approach to calculating lost future earnings can provide the court with objective, reliable information to use when awarding damages. Contact a financial expert for more information. ■

Tax law change draws attention to owners' compensation

The Tax Cuts and Jobs Act (TCJA) introduces a deduction for up to 20% of qualified business income (QBI) for owners of pass-through entities, for tax years beginning in 2018 through 2025. When calculating an owner's QBI, one doesn't count reasonable salary compensation paid to an S corporation shareholder employee and guaranteed payments paid to partners as compensation for services to partnerships.

How does the deduction affect owners' compensation?

When a pass-through entity's income qualifies for the 20% QBI deduction, every $1,000 of incremental owners' compensation paid to an owner by an S corporation or partnership can effectively reduce the QBI deductions allowed to owners by $200. That's because the compensation is subtracted in calculating the entity's QBI.

In addition, compensation paid to owners increases their taxable income, which can cause QBI deduction limitations to apply at the owner level. So, pass-through entities may have a tax incentive to *underpay* owners under the TCJA.

Why does it matter?

Owners' compensation issues can arise in various valuation contexts. For example, a business valuation expert may need to adjust owners' compensation to market value. Above- or below-market compensation can provide a distorted picture of what business earnings would be in the hands of a hypothetical willing buyer.

For federal income tax purposes, the IRS may question the reasonableness of owners' compensation when a business is suspected of engaging in tax

avoidance strategies. For example, a C corporation might overpay its owners to disguise nondeductible dividends as deductible compensation. Or an S corporation might disguise a portion of its owners' wages as distributions, which aren't subject to federal payroll taxes.

What's reasonable?

The following techniques are often used to estimate reasonable compensation:

Cost approach. An owner's duties may be broken down into components — such as administration, finance, marketing, purchasing and engineering — and then a "cost" is assigned to each duty based on salary survey data.

Market approach. An owner's salary may be compared to amounts paid by similar companies for similar services.

Income approach. An "independent investor" test is applied to determine whether a hypothetical independent investor would be satisfied with his or her return on investment (ROI) after the company pays owners' compensation.

The suitability of these approaches depends on the availability of salary and company-specific data. For instance, measuring ROI requires access to the company's fair market value for each year analyzed.

Get it right

When paying owners' compensation, there's a new consideration for pass-through entities: how it'll affect the deduction for QBI. Those that pay below-market compensation risk IRS scrutiny, because underpaying owners can artificially inflate their QBI deductions. A financial expert can help quantify reasonable compensation, based on objective market data and the characteristics of the business. ■

Mifflinburg Telegraph, Inc. v. Criswell

Which is appropriate: Lost profits or lost business value?

The U.S. District Court for the Middle District of Pennsylvania recently awarded damages for various business torts committed against a print shop by two former employees and the competing business they started. A key question was whether lost profits or lost business value was the appropriate measure of damages.

Alleged wrongdoing

The defendants, a married couple, were two of Mifflinburg Telegraph's five employees. The wife's title was "primary designer and printer," but she essentially ran the business after the owner's death in 2013. She entered into negotiations with the owner's estate to purchase the business for $225,000, but the negotiations failed.

In late 2013, the wife started a competing business, Wildcat Publications. Before her departure from Mifflinburg Telegraph in February 2014, she allegedly provided customers with reorder forms that listed Wildcat's contact information, misappropriated Mifflinburg Telegraph's proprietary customer list, and deleted the customer list and order histories from Mifflinburg Telegraph's computers.

Much of Mifflinburg Telegraph's business came from repeat customers. So, without order histories and customer logos, the company had to start from scratch.

A "formidable" task

The court had difficulty determining damages because the plaintiff failed to justify the amount claimed, and there was no opposing counsel. (The case was decided on a motion for default judgment against Wildcat.) In addition, the company's damages consisted mainly of "intangible damage to its goodwill," and any decrease in value could be attributed to the recent death of its owner, the loss of key employees or negative market forces in the printing industry.

The plaintiff sought approximately $265,000 in damages, based in part on testimony from the executor of the owner's estate. The executor valued the company prior to the defendants' actions at approximately $300,000. The value was based on an industry rule of thumb of four times the average adjusted annual earnings before depreciation, interest and taxes (EBDIT) for the previous five years. The executor also opined that the company had no value at the time of the hearing.

The court opinion references a sworn affidavit from a business valuation professional. He estimated that the value of Mifflinburg Telegraph's equity in 2013 was between $25,000 and $226,000, using various methods. He estimated that it was worthless by 2015, however.

The court valued the company at $225,000 in 2013, based on "what a ready, willing, and able buyer was prepared to pay for it." But the court couldn't "in good conscience" award Mifflinburg Telegraph an amount equal to the proposed purchase price.

Although the "duplicitous" actions of the defendants clearly damaged Mifflinburg Telegraph's goodwill, the business continued to operate. The company retained its assets and accounts receivable, so some value remained. Absent a contract to purchase the company or covenants not to compete, awarding Mifflinburg Telegraph the entire price would make it "more than whole."

Rather, the court concluded, the award should represent the damage the defendants caused to Mifflinburg Telegraph in the form of lost profits. The court found Mifflinburg's tax returns for 2008 to 2014 to be "instructive" when qualifying lost profits.

Notably, from 2013 to 2014, just after the defendants began competing with the company, its gross profits plummeted by nearly 70%. So, the court awarded Mifflinburg Telegraph $157,500 — 70% of its $225,000 value.

The court assumed that a 70% drop in gross profits equates with a 70% loss of value. Many financial experts would dispute this assumption, arguing that the court based its damages calculation not on lost profits but on the decrease in the company's value. While the court admits that the 70% loss in value is an "imperfect calculation," the judge found that amount "to more closely represent the harm done here" than awarding the plaintiff for the entire value of the business.

Bottom line

The court's *reasoning* in this case seems consistent with the prevailing view: Lost business value is an appropriate damages measure when a business is substantially destroyed, but the lost profits measure makes more sense when a business survives. However, the court ultimately based its damages award on lost business value, even though Mifflinburg Telegraph survived. ■

This publication is distributed with the understanding that the author, publisher and distributor are not rendering legal, accounting or other professional advice or opinions on specific facts or matters, and, accordingly, assume no liability whatsoever in connection with its use. ©2018 VLBnd18

Valuations

At some point, your business-owner clients will need to have a valuation of their company stock – whether for gifting, estate settlement, settling a legal dispute, securing financing, or succession planning purposes. Our accredited analysts are experienced in providing a comprehensive approach that is recognized and accepted by regulatory institutions including the Internal Revenue Service and the Department of Labor.

Litigation Support

Called upon as experts by both plaintiffs and defendants, BCC's valuation professionals can serve as witnesses or consultants for your case. We assist through all phases of litigation, arbitration, mediation and trial, often reviewing the work of analysts retained by clients or the opposing party, checking suitability of methodology and testing assumptions. We handle multiple aspects of case preparation, leaving the attorney free to focus on the intricacies of the law.

Mergers & Acquisitions

Whether representing a buyer or seller in a business ownership transfer, BCC's professionals are experienced in utilizing a variety of M&A processes tailored to the objective of your client's transaction. Senior-level consulting is provided throughout our engagement. For clients that would benefit from international exposure, we work with colleagues in the Alliance of International Corporate Advisors to access qualified buyers and sellers worldwide.

Our reputation has been built upon a dedication to the highest standards of quality and service. BCC Advisers is committed to meeting our clients' needs by providing a high level of expertise, creative problem solving and personalized assistance.

Our team of experienced investment bankers, accredited analysts and expert witnesses is happy to assist you and your clients when you require valuation, litigation support, or merger & acquisition services.

BCC ADVISERS

866-787-8019
www.bccadvisers.com