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Final Regulations issued on pass-throughs' 20% of QBI deduction

The Treasury has issued final regulations explaining whether pass-through entities qualify for the new tax law ["TCJA"] deduction of 20% of qualified business income. An article by a published accounting author has been placed at http://NYNJCT-BV.COM/IRC Section 199 Regs.html

Excluded from claiming the deduction are certain service businesses above an income threshold. Specific industries excluded include healthcare, law, accounting and consulting. Others, such as real estate, architects and engineers, do qualify.

Regular corporations have now received permanent tax relief when their tax rate was decreased from 35% to 21% and an end to taxation on their foreign profits. Pass-through owners, on the other hand, only obtained temporary relief under TCJA as such provisions expire in 2025.

There is no generally accepted effect of the new law on business value, except that as a general rule values should be higher if the tax burden is less. The interest-shield effect, however, is reduced by TCJA because it increases the cost of debt. In general, taxpayers may deduct interest paid only up to the sum of their business interest income, plus 30% of adjusted taxable income, plus floor plan financing interest. Accordingly, this reduces the value of highly leveraged companies, but firms with less than $25 million in revenues will not see any value reduction.

Empirical ERP calculated by Prof. Damodaran of NYU

It is nice to know that some of the BV data, which we use daily because published experts told us to, actually ties up with reality. Professor Aswath Damodaran has recently published his most recent calculation of the Equity Risk Premium [ERP.[1]] Professor Damodaran teaches valuation at NYU's Stern School

[1] ERP is the constant which is added to the risk-free cost of capital along with [occasionally] a size or industry premium and other adjustments in order to calculate the cost of equity in any add-on method. For the largest firms, the cost of capital is equal to risk-free cost of capital plus ERP.

of Business and over the years has published on the general topic of business valuation, including a lot of data. He is not in any way associated with any BV professional association; accordingly, his thoughts, experience and recommendations are those of an academic and thus worth considering. While he tends to reflect on his experience with the larger of the closely-held and many of the publicly-held firms, his opinion is accepted as unbiased. For many of his lectures and data, see http://damodaran.com.

Prof. Damodaran does not use historical ERP estimates such as Duff & Phelps[2] or CRSP[3]. Instead, he uses a theoretically correct, forward-looking approach estimating the price which investors demand for the risk of investing in equities. The number is backed out from current market prices and expected future cash flows. In a fashion, the calculation is akin to the yield to maturity on a bond. His estimate of the ERP as of the beginning of 2019 is 5.96%, up from 5.08% one year earlier. We note that Duff & Phelps' recommended ERP is currently 5.5%

NJ Case Shows What Can Happen When a Buy-Sell Agreement is Un-Clear

Namerow v. PediatriCare Associates, LLC, a 2018 New Jersey Superior Court unpublished opinion has the following facts. The company's buyout agreement prescribed that the price at which a shareholder can sell his interest to the other investors is based on the most recent appraisal. Annual appraisals were required by the Agreement, but this was not done for some 17 years. This gave the Court no choice but to use the 2000 appraisal as a basis for the price for the outgoing shareholder in 2017. The wording of the Agreement is also based on the term "net worth" which the parties disagreed about. Under most accounting systems net worth is defined as total assets less liabilities, and typically include intangible assets only if the company is the result of a business combination; otherwise the intangible assets are not recorded on the books.

While the case is likely to take time to go through the courts, the results thus far are unsatisfactory and somewhat illogical. Perhaps business owners should make sure their Buy-Sell agreement is clear and well understood by all parties. If intangible assets are recognized by all parties even if the accounting system does not reflect them, then such should be covered by the agreement. Of course, appraisals should actually be ordered as per agreement.

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[2] Duff & Phelps publishes the Cost of Capital Navigator which this practice uses extensively.

[3] The Center for Research in Security Prices at the University of Chicago's Booth Graduate School of Business has provided the basis for the Ibbotson *Stocks, Bonds, Bills and Inflation* series which are now available through the D&P Cost of Capital Navigator.

New Jersey Adopt Key *Daubert* Factors but Not Completely

The New Jersey Supreme Court, in an important ruling, took a big step towards *Daubert* but did not embrace it entirely. The matter arose out of a civil mass tort action against the pharmaceutical company that makes a prescription drug for acne. The plaintiffs, who commenced their action in 2005, alledged that the drug is responsible for another disease. Since then a number of studies found no causal connection between the drug and the new disease. The plaintiffs persevered but the trial court found the experts's methodology flawed. The appellate division reversed and the plaintiffs asked for review by the Supreme Court asking for clarification of expert witness standards, which meant deciding... "whether the *Daubert* standard's factors would further elucidate the New Jersey standard for admissibility of expert testimony." The Court's short answer was affirmative.

The state Supreme Court's ruling, in effect, reconciled the state and the federal standards. The Court even stated that "we are persuaded that the Daubert standards should be incorporated for use by our Courts." At the same time, the state Supreme Court stopped short of declaring New Jersey a Daubert jurisdiction. The plaintiffs' experts in this case were excluded and the trial court's conclusion was well supported.

Thinking of Selling? Line Up Valuation[s] Well Ahead of Deadline

Typically, business owners order a business valuation perhaps 3-5 years before their targeted exit date. This has several benefits, in addition to obtaining a valuation not colored by the "free" assessment of the business broker. A typical business broker has a conflict because, at the margin, a low price could result in a transaction, unless the owner knows better.

Additionally, a third party appraiser will alert the owner of the work that needs to be done before the business is sellable: reliable and complete accounting, agreement-based relationships with customers, fully-documented procedures and productive employees.

A study by a large accounting firm relates that an increasing number of closely-held business owners intend to sell rather than pass the business to family members. Yet only a quarter of those businesses have a succession or exit plan of any type.

NY high court Approves Minority Discount in Wrongful Dissolution

The defendant had a minority interest in a general partnership that owned and operated a shopping mall. He withdrew from the partnership, and the remaining partners continued the business without him in accordance with NY partnership law. Litigation ensued, as the remaining partners calculated the defendant's interest by applying discounts for goodwill, lack-of-marketability and lack-of-control. The appellate division concluded that the dissolution was wrongful and acquiesced to the rather large discounts calculated by the remaining owners. On the other hand, it also approved a $1.6 million award for attorneys and experts fees.

This is, according to the appellate court's finding, not a dissenting shareholder action. The Court of Appeals essentially agreed, except that one of its judges stated that the minority discount, combined with the other discounts as per the partnership statutes, would constitute double jeopardy. All discounts thus stood. See *Congel v. Malfitano* 2018 NY Lexis 496 [March 27, 2018.]

J.L. Pierson, ASA, ARM-BV is an experienced business appraiser who supports the NY, NJ and CT business communities from his base in Darien, CT. His clients are closely-held businesses with revenues of up to $300 million in all industries, as well as owners of family limited partnerships/LLCs, professional corporations and their advisors. He specializes in business valuation for estate/gift tax, succession planning, sale/purchase and litigation such as shareholder and corporate disputes and divorce, corporate development and transaction support purposes. This newsletter is generated internally to reflect key development in BV which may affect clients and prospects.

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