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The Road Ahead: Considerations for Tax Reform's Impact on Your ESOP

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The Tax Cuts and Jobs Act of 2017, or TCJA, provides ESOP plan sponsors with opportunities and challenges. Now is the time to plan for changes to any repurchase obligation, plan design, and corporate strategies to take full advantage of the opportunities and mitigate the effects of the challenges. Some changes may require a more immediate response depending on the company's specific circumstances.

21 percent flat corporate tax rate

The change from a bracketed tax system to a flat corporate tax has broad implications. A C corporation (C corp) or partially owned S corporation (S corp) ESOP plan sponsor should immediately consider the benefits of maximizing its 2017 contribution to the ESOP. Regardless of the contribution method (loan prepayment, cash contribution, or share contribution) the likely answer is to accrue a cash contribution for the 2017 plan year, taking advantage of the greater value of the deduction in 2017.

- Prepayment of an ESOP note will have varied impacts depending on plan and company variables. Before deploying this option, conduct a repurchase obligation analysis.
- A cash contribution can help fund future repurchase obligations or outside share purchases. If the contribution is large and cash in the plan is low, this method could be especially useful when used with rebalancing.
- Share contributions may be helpful from a cultural perspective but carry additional fiduciary, share valuation, and corporate considerations.

The lower tax rate beginning in 2018 should increase available cash for a C corp sponsoring an ESOP and likely increase the company's share value. The lower tax rate's impact on company valuation for an S corp may be more complex (partial and 100 percent ESOP-owned to varying degrees). In general, S corps pass through earnings to shareholders making changes to corporate tax rates irrelevant. However, S corp stock is typically valued as a C corp under the "FMV Standard," which will lead to an increased share value with no offsetting corporate tax savings. Of course, greater share values may materially increase the ESOP repurchase obligation, making planning for the additional repurchase obligation essential.

S corp 20 percent pass-through income deduction

This section of the TCJA only affects partially owned S corp ESOPs. S corps typically distribute enough cash to shareholders for them to pay their taxes. A potential 20 percent reduction in tax liability for the outside shareholders of certain S corps means there may be less S corp distributions flowing to the shareholders, including the ESOP. With the expected reduction in S corp distributions, ESOP companies may be required to make greater company contributions to satisfy their debt payments and repurchase obligation.

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Provided the plan does not have any contribution limitations, a larger company contribution will generally have the effect of spreading more of the annual ESOP share allocation over a broader participant base. Also, the additional cash retained by the company may also have an impact on share value. Companies with these circumstances should consider analyzing their expected ESOP share allocations in 2018 to anticipate plan compliance issues and ensure the expected allocations align with company objectives.

Ongoing considerations

C corp and partial S corp ESOPs may want to consider increased annual contributions to the ESOP for years after TCJA becomes effective.

For a C corp, the significant reduction in tax should mean greater retained cash in the corporation. Increasing the annual cash contribution to the plan will help mitigate the ESOP repurchase obligation in two ways: (1) the additional cash can be used to fund future share repurchases, and (2) the reduction in retained cash will reduce share value. In addition, cash in the plan may be used to purchase shares from outside shareholders. The potential downside is that the increased benefit level for participants may be greater than desired by the employer.

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For a partially owned S Corp, the potential 20 percent pass-through deduction will likely result in reduced S corp distributions to the ESOP, with greater retained cash in the company. An additional contribution in the amount of the reduction in S corp distributions to the ESOP will get the plan, in total, back to its pre-TCJA position; contributions in excess of this amount will have implications similar to a C corp.

In either scenario, care must be taken so that contributions do not exceed legal limitations.

Interest deductibility

The TCJA has specific provisions changing the maximum allowable interest deduction. From 2018 to 2021, the deduction is limited to 30 percent of EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) then 30 percent of EBIT (Earnings Before Interest and Taxes) for 2022 and beyond. This change only affects C corps and partial S corps. In the case of an ESOP with recent transaction debt the limitation may be problematic. While this interest limitation is relatively high, some companies may need to restructure corporate loans to avoid limitations on the amount of deductible interest.

Transaction and corporate structure considerations

Another impact of the lower corporate tax rate is a decrease in the tax-effectiveness of the S corp structure. Depending on the income level of the shareholder(s), it is likely an income pass-through will be subjected to a higher tax rate. Going forward, there may be reasons for a partially owned S corp ESOP plan sponsor to convert to a C corp and an increased likelihood of new ESOPs being formed by C corps. With the changes to the C corp tax rate, the barrier to a conversion to C corp is reduced, while allowing the selling shareholder(s) to take advantage of a 1042 exchange (see below).

In addition to the changes noted above, the new maximum itemized deduction for state and local taxes of $10,000 on an individual's federal return may present new opportunities for selling shareholders to take advantage of 1042 exchanges. A 1042 exchange, in short, is a mechanism that allows a shareholder of a closely held C corp to sell shares to an ESOP and "exchange" the proceeds from the sale for qualified replacement property (QRP). The tax on the sale of shares is deferred until the sale of the QRP. Depending on the filing state of the selling shareholder, the savings may be worth an in-depth look. When considered with other changes from the TCJA, selling shareholders may have renewed interest in 1042 exchange tax treatment for their sale to the ESOP.

Conclusion

The structure of an ESOP relative to other defined contribution plans is unique, tying the success of the company to the success of the plan. There are many TCJA provisions that affect the company and thereby, the ESOP trust and the plan participants. ESOP plan sponsors should work with internal and external advisors to analyze their situation and plan a path forward consistent with their objectives.

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