Tax Reform Impact on ESOPs

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The Tax Cuts and Jobs Act, signed on December 22, 2017, included a handful of provisions affecting retirement plans. There were none specifically targeted at ESOPs but there are several that will indirectly impact them.

A big focus of tax reform was the reduction of corporate income taxes from 35% to 21% of earnings. One of the side effects of the tax reduction is the impact on ESOP valuations and future repurchase obligations under the plan. Because companies will have additional after-tax profits (due to the tax reduction), the appraised value of ESOP stock should increase, which will in turn lead to higher expected future cash needs to repurchase shares as employees leave. C Corporations should see the smallest impact from this change because theoretically they should have extra cash on hand to cover their increased obligation. However, 100% S Corporation ESOPs (as tax exempt trusts) will not see any difference to their after-tax cash flow post tax reform, which could lead to challenges in managing the increased repurchase obligation for them. We recommend that majority S Corporation ESOPs consider performing a repurchase study to look at strategies to manage cash flow going forward.

The tax bill also makes some changes to the net interest deductions for businesses. For 2018-2021, the bill limits net interest deductions for businesses to 30% of earnings before interest, taxes, depreciation and amortization (known as EBITDA). This is reduced further in 2022 to 30% of earnings before interest and taxes (EBIT). So new ESOPs will need to consider how their loan payments compare to EBITDA or EBIT to make sure that they are able to deduct payments. 100% S Corporation ESOPs will not be affected since they don't pay tax. There are still questions outstanding on how the tax law changes will impact existing loans as they do not address whether the changes apply only to loans made after the bill goes into effect or if there is retroactive applicability.

State and Local taxes are expected to increase for sellers to ESOPs due to the new limits on federal deductions and the cap of $10,000 on the amount of state and local income taxes that can be deducted from gross income. This change applies whether the business owner is selling to an ESOP or selling to anyone else. I don't anticipate this tax change will discourage the creation of new ESOPs but it may lead to an increased interest in the use of Section 1042, which allows for the deferral of federal taxation on the gains from the sale of stock to an ESOP (subject to meeting all of the special requirements).

Finally, the tax bill created a 20% deduction on pass-through income for S Corporations, subject to certain requirements. As a result, less than 100% S Corporation ESOPs will need to distribute less cash each year so that non-ESOP shareholders can pay their share of taxes on corporate profits.

If you have any questions on the specific tax impacts to your ESOP, we encourage you to contact your CPA or tax attorney. If you have any other general questions or would like to discuss a possible repurchase study for your ESOP, please contact your RMS Account Executive.

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