New Tax Bill Makes ESOPs More Attractive

By Ronald J. Gilbert, President ESOP Services, Inc.

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The "Tax Cuts and Jobs Act" (TCJA") of 2017 will make Employee Stock Ownership Plans ("ESOPS") much more attractive in 2018 for many companies and selling shareholder(s). It will also raise issues for consideration for existing ESOP companies.

While the TCJA made no direct changes to any specific ESOP tax-related benefit, the lowering of the C corporation tax rate to 21% will benefit many companies considering an ESOP transaction in 2018. This change will also benefit C corporations with ESOP ownership, and may benefit S corporations with partial ESOP ownership. (**Click here** a brief review of existing ESOP tax benefits.)

## Forming an ESOP in 2018?

Prior to 2018, the Internal Revenue Code 1042 ("IRC 1042") was not a viable option for many S corporation tax entities because it required conversion to a C corporation prior to the sale of stock to the ESOP. However, the lower C corporation tax rate is causing many S corporations, or LLC's that have elected to be taxed as S corporations, ("S corporation tax entity"), to take a close look at the benefits of selling stock to an ESOP after converting to a C corporation.

IRC 1042 is often referred to as the "tax-free" rollover because it allows qualified individuals selling stock to an ESOP to defer capital gains taxes under certain circumstances. In order for stockholders of a privately-held corporation to be eligible to elect to defer capital gains under the "tax-free" rollover, the sponsoring corporation must be a C corporation. This requires an S corporation tax entity to convert to a C corporation, which often creates significant C corporation income tax liability due to the "Five-year C corporation" requirement. Under IRS rules, a corporation that converts from S to C corporation tax status cannot convert back to an S corporation for five years.

## Five Year Requirement Usually Too Costly

Over the past 25 years, we have conducted a number of "S to C" feasibility studies. Most have shown that converting to a C corporation is too costly, despite significant potential tax savings to the selling shareholders. After making the maximum annual tax deductible contribution to the ESOP, the costs to the corporation were usually too high to justify conversion. By remaining an S corporation, companies enjoy the tremendous benefit of tax-free income because the percentage of stock owned by an S corporation sponsored ESOP is not subject to federal income tax, and most states mirror this treatment.

With the new lower C corporation tax rate of 21%, many more S corporation tax entities will be able to justify converting to a C corporation by paying C corporation taxes at the lower rates for five years, and thus providing the selling shareholders the benefit of the "tax-free" rollover.

## Tax Savings Up to 35%

The IRC 1042 "tax-free" rollover allows sellers to defer capital gains tax. Because long-term capital gains rates are unchanged with the tax law, tax savings for individuals electing the "tax-free" rollover can go as high as 25-35%, depending on the state of residence. The example below measures the "tax-free" rollover savings realized by the selling shareholders versus the capital gains tax that would be paid. The selling shareholder savings must then be measured against the corporate taxes that the C Corporation will pay under the 21% federal, plus state, tax rate.

Example:

| | | C Corporation | S Corporation | C vs S |
|---|---|---|---|---|
| **Seller Tax and Proceeds** | | **1042** | **No 1042** | |
| **Assumed Value of Sale to ESOP** | | **$20,000,000** | **$20,000,000** | **$0** |
| Less Basis | | $0 | $0 | $0 |
| **Taxable Gain** | | **$20,000,000** | **$20,000,000** | **$0** |
| Subject to Capital Gains ($0 Basis) | | $0 | $20,000,000 | |
| Cost to Carry - *85% for 1042 on Margin (Est 5 years) Approx.* | 1% | $1,000,000 | $0.00 | $1,000,000 |
| Capital Gains Tax Rate Assumption | | 0.0% | 35.0% | |
| Capital Gains Tax | | $0 | $7,000,000 | -$7,000,000 |
| Est ESOP Account Balance in 2022 | | $0 | TBD | TBD |
| **Net Proceeds** | | **$19,000,000** | **$13,000,000** | **$6,000,000** |

Every situation must be carefully analyzed based on corporate and shareholder information and objectives. In some cases, remaining an S corporation will offer the best option.

**ESOPs Are A More Competitive Buyer**

Electing the "tax-free" rollover can also lead to higher net proceeds during a sale to an outside buyer – approximately 35% higher if the proceeds of the outside sale are subject to long-term capital gains taxes. Or, the outside buyer would need to pay approximately one-third more for the company to give the selling shareholders the same net proceeds. (Keep in mind that under the "tax-free" rollover rules, Qualified Replacement Property (QRP) that is acquired after the ESOP transaction receives a "stepped-up" basis if held till death and the capital gains tax is **extinguished** at death. It is never paid and becomes truly tax-free.)

**Existing ESOPs**

Some S corporation ESOP companies are considering converting to C corporation status to take advantage of the new lower C corporation tax rates. While this can make sense in some scenarios where the ESOP is a partial owner, there are many factors to be analyzed, including the timing of a future ESOP transaction, the impact of other tax changes (including new TCJA provisions placing limitations on interest deductions to 30% of EBITDA), and the structure of current ESOP and non-ESOP debt amortization.

**C to S**

C corporations that completed a partial ESOP transaction have frequently converted to S corporation status effective the beginning of the following fiscal year. For corporations with a calendar fiscal year, if the conversion takes place prior to March 15th, the effective date of the conversion is January 1. With the 21% C corporation tax rate, the tax savings realized by the conversion of a partially ESOP-owned C corporation will be substantially less and, as a result, fewer C to S conversions may occur. If, however, a C corporation has become a 100% ESOP owned conversion to an S corporation, converting on January 1 of the following year will almost always will be the recommended course of action.

**Greater Shareholder Value for ESOP Participants**

With a lower C corporation tax rate there will be greater net profit. Obviously, this will increase the value of the shares owned by the C corporation ESOP, and thus increase the value of individual ESOP participants' accounts.

Less obviously, we also expect to see an increase in the value of shares owned by the ESOP in most S corporations. Most ESOP valuations rely, at least in part, on projected after-tax net income (public company comparables are frequently used as well), and independent ESOP valuation firms "tax affect" the S corporation earnings. This means that even in a 100% ESOP-owned S corporation that pays no federal or state income tax, the assumption is that C corporation taxes are paid. A lower C corporation tax rate means greater shareholder value for most S corporations, although they will not have any greater actual increase in S corporation income.

**The Two-Edged Sword**

An increase in projected stock value will have a direct impact on the corporation's repurchase obligation due to the ESOP. This means that ESOP repurchase obligation studies and projections will need to be updated.

**What Next?**

Whether you are contemplating a first-time ESOP transaction for your company in 2018, or you are an existing ESOP company considering converting from S to C or C to S,  consult with **all** your professional advisors to make certain that your board of directors has all the facts necessary to make an informed decision.