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# Insights

## How May The New Tax Act Affect Your ESOP?

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The Tax Cuts and Jobs Act of 2018 (the "Act") was signed into law by President Trump on December 22, 2017. It is heralded as making the most significant changes in corporate taxation in the US in more than 30 years. The Act makes changes to C corporations, S corporations and other pass-through entities. Some changes are permanent while others are temporary. With regard to employee stock ownership plans ("ESOP"s), the Act impacts both how valuations are performed and what the outcome of the valuation will be.

Although many changes in the Act affect ESOPs in minor ways, the most significant impact is the permanent reduction in the corporate tax rate to 21%, effective in 2018. Many ESOP valuations are based either partially or fully on an income approach, and often the discounted cash flow ("DCF") method is used. Under the DCF method, the appraiser normally starts with the EBIT (earnings before income tax) value and then subtracts estimated federal and state income taxes. Those estimated taxes will now be much less than in prior years, resulting in an increase in discount rates and, in the end, stock value. Many expert ESOP appraisers predict the change in the corporate tax rate could result in a stock value increase of 10% to 15%, or more.

Another way to value ESOPs is a market approach, which values an ESOP company by comparison to other similar companies using one of two methods. The guideline public company ("GPC") method uses public companies as a comparison to the private company the ESOP owns. The Act should not have much of an effect on the GPC method because the decreased taxation should already be reflected in December 31, 2017 pricing multiples of public companies.

The second market approach is the merged and acquired company ("M&A") method. Under this method, the appraiser attempts to find data on recent M&A transactions that could provide a comparison for the ESOP company value. Unlike the GPC method, the M&A transactions from 2017 will not reflect the Act's change to the tax law. If the appraiser can find transactions from 2017 and 2018, it may be able to identify possible pricing differences between the two years, and make adjustments to the 2017 multiples.

For S corporation ESOPs, it is general practice in the industry to value S corporations as if they were taxable C corporations, even though the S corporation does not pay taxes. The outcome is that the lower federal tax rate may increase equity value for S corporation ESOPs, thereby increasing repurchase obligation ("RO"). But there is no increase in cash flows to help manage the RO. Sponsors of S corporation ESOPs must be aware of this inconsistency and may determine to change the ESOP's distribution policy to help with cash flow.

The impact of the Act may not be fully understood for some time as the various provisions permeate operational decisions, including capital investment, human resource management, expense configuration, capital structure, dividend and distribution policies and M&A activity. ESOP valuations and the valuation process will likely differ from previous years, although the magnitude of the differences is not yet known.

Higher cash flows will not likely be completely offset by higher required rates of return, leading to increased equity values, all things being equal.  But all things are not equal, and with all the Act's provisions, permanent or subject to amendment or phase-out, it is important for the appraiser, trustee, and management to talk through the Act and its present and prospective impact on the ESOP plan sponsor and on the ESOP.