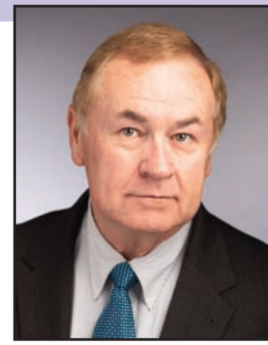
The Tax Cuts and Jobs Act and ESOP Valuations



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Few external events have affected the valuation of corporate stock held in an employee stock ownership plan (ESOP) more than the Tax Cuts and Jobs Act of 2017 (TCJA), signed into law by President Trump on December 22, 2017. Since its enactment, the tax law changes included in that legislation have led to a significant increase in stock values for most company stocks held in ESOP-owned companies. Higher values have led to further challenges for those companies in meeting their required repurchase obligation liabilities associated with the plans. Together, these two primary elements serve as a catalyst for a one-time dynamic change in the valuation of equities held by ESOPs.

While the TCJA is an expansive piece of legislation—coming in at more than 400 pages, with many sets of proposed regulations and Internal Revenue Service guidance being issued since its passage—the key provisions in that law relating to valuation of equity shares held by an ESOP can be reduced to a just a few. That is not to say that any number of the law's statutory business tax changes may not affect an ESOP-owned company. It simply means that those changes having the most profound effect on valuation can be sourced to these few critical provisions.

Note that as of the date of this article, the author is not aware of any Department of Labor guidance provided to business valuators and trustees on valuation matters to affirmatively address the many issues created by the enactment of the law. However, much discussion on these matters has been undertaken by many professionals involved in ESOPs, and this article reflects both the author's direct experience in ESOPs over many years and the seeming consensus of other professionals working in the ESOP arena.

CORPORATE INCOME TAX RATE REDUCTION

The most elemental of these provisions, and perhaps the one with the greatest effect on valuation, is the corporate tax rate reduction. The TCJA modified the corporate income tax rate regime from a graduated tax system with a maximum marginal rate of 35 percent to a flat tax system with a single marginal rate of just 21 percent.

The primary impact of the corporate income tax rate reduction on valuation is, obviously, lower future income tax liabilities resulting in additional "free" cash flow and, thus, higher value.

The impact on free cash flow is substantial and direct. Assuming pretax income of $1,000 and a maximum marginal income tax rate of 35 percent, the net after-tax income is $650. Alternatively, incorporating the lower maximum rate of 21 percent, the after-tax income is $790. If one assumes simply that the cash flow adjustments net to zero, the lower income tax rate accounts for 14 (35% - 21%) percent greater free cash flow.

Viewed another way, the numerator in the above-noted example changes from $650 to $790. The increase in the capitalizable future economic benefit stream is $140, an increase over the pre-TCJA future economic benefit stream of 21.5 percent.

Under the income approach and a simple capitalization model, this change (all other things remaining equal) would result in a direct increase in value equal to the 14 percent difference between the old maximum marginal income tax rate and the new. To look at this matter in any other way would be to challenge the validity of the income approach and capitalization model as they have generally been interpreted by the finance and business valuation community.

The idea of a value boost given the corporate marginal rate reduction under the TCJA is both logical and reasonable. Buyers—financial and strategic—are looking to expected future earnings, and implied cash flows derived therefrom, for purposes of determining offer prices and structuring acquisition transactions. In the "for profit" environment, the additional business acquisition cost associated with lower income tax liabilities and resultant higher cash flows will be "repaid" to the purchasers with greater future returns.

In looking at valuations of ESOP-owned companies, the matter is less clear. This is especially true when the ESOP owns 100 percent of the outstanding capital stock and the company has elected to be treated as an S corporation. In these cases, there are no greater future expected returns because the employee stock ownership

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trust is, in effect, a tax-exempt entity. Thus, though the valuation process generally requires that an ESOP-owned S corporation's free cash flows be "tax affected" at the C corporation rates, it will not actually realize that greater free cash flow as it is not currently a taxpaying enterprise. While the TCJA corporate income tax reduction will lead to a substantial single-year increase in the value of the S corporation's ESOP-owned shares, that same provision works to correspondingly increase the present value of the ESOP-owned S corporation's repurchase obligation liability. This increase in the repurchase obligation liability is both relevant and significant in that no additional cash flow is being generated by the change in the tax law to fund that higher future obligation.

While the valuation increase attributable to taxpaying entities (including certain corporations partially owned by ESOPs) is logical as greater future free cash flows are expected, the plight of the ESOP-owned S corporation shares presents a unique challenge for both valuators and ESOP trustees.

Based on random surveys by this author of many professionals involved in ESOPs, it appears that the mechanics of the effect on the repurchase obligation liability are most often being addressed through an increase in the discount for lack of marketability. The difficult nature of applying this protocol to any given ESOP-owned company stock valuation is the lack of empirical evidence, as well as the lack of accepted precedent, procedures, or reconciliation processes to calculate the increased discount, if deemed applicable by the valuator.

The simple and overriding assumption, however, is that the value increase attributable to the corporate income tax rate reduction will be realized in higher present values of near-term current dollars (as of the date of valuation), and the payment of the repurchase obligation liability will be payable in the future, and very often, significantly far into the future. Thus, the present value of those repurchase obligation liabilities are generally presumed to be materially less than the rise in current value due to the rate change, leading to a conclusion of value that nets to the substantial one-time value increase.[1]

As one would presume, the impact of this change is less impactful for ESOP-owned corporations taxed under Subchapter C of the Internal Revenue Code. These entities remain taxpaying entities after the passage of the TCJA. This being the case, the increased implied free cash flows arising out of the corporate income tax rate reduction is realized in these instances. Given the benefits of eliminating all federal income tax liabilities, as well as many state income tax liabilities, the author has observed a growing number of ESOP-owned corporations moving to 100 percent ownership and making the S election.

QUALIFIED BUSINESS INCOME DEDUCTION

For S corporations that are partially owned by an ESOP, it is not uncommon to distribute cash to fund non-ESOP shareholder tax liabilities on corporate income "passed through" to them and included on their personal income tax returns. In fact, very often, S corporation shareholder agreements include a provision to require management to distribute sufficient funds to meet these liabilities. Usually, this occurs by means of distributing cash to all shareholders proportionate to their ownership in the S corporation at that rate of tax paid by the shareholder with the highest marginal tax rate.

The TCJA includes a new and very significant provision whereby those shareholders may be entitled to a deduction equal to 20 percent of any "qualified business income" passed through to them by the corporation. The economic effect of this provision is to reduce the individual's effective federal income tax rate on this income from the highest marginal rate of 37 percent to 29.6 percent. As such, the "taxable" shareholders of the corporation will require less cash in the future to meet their income tax obligations if they qualify for the deduction. It is widely expected that such a change will lead to lower cash distributions in the future from S corporations with qualified business income.

The need for fewer cash flow distributions to fund shareholder income tax liabilities in these entities may or may not affect the annual ESOP valuation. Historically, much controversy and commentary has surrounded the "tax affecting" of S corporations. It stands to reason that those S corporate shares owned by an ESOP on a non-controlling basis would require similar consideration.

Moreover, the job of the valuator will be expanded to include a determination as to the deployment of any additional "after-tax" cash that is realized and retained by the corporation. Assuming reinvestment of these amounts in capital equipment, working capital, other assets, or debt reduction of the business, valuators will be tasked with following the additional economic gains attributable to such investment or repayment and determining their influence on overall equity value.

BUSINESS INTEREST DEDUCTION LIMITATION

A very non-traditional change set forth in the tax legislation is a provision that limits business interest deductions, regardless of the form of that business. Under that statute, and for tax years beginning after 2017, the allowable net interest deductions for businesses are limited to 30 percent of adjusted taxable income. Disallowed business interest expense is carried forward indefinitely.

In the case of a partnership or S corporation, the deduction limitation applies at the entity level, except that disallowed interest of the entity is allocated to each partner or shareholder as excess business interest.

Note that while this provision stands out as one influencing the disci-

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pline of valuation, it does NOT apply to smaller enterprises, defined in the legislation as those businesses with average gross receipts of $25 million or less.

With respect to recently financed and leveraged ESOPs, in which the company borrows an amount of funding that is large relative to its adjusted taxable income, valuators may find that their deductible expenses (interest) will be lower and, therefore, their taxable income may be higher under this change.

With respect to valuation of companies with ESOPs, the limitation will affect the determination of cash flows both to equity and to invested capital. The overriding effect is that a limitation on deductions, even if permitted to be carried forward indefinitely, works to increase tax liabilities and diminish cash flow in the years of limitation. As such, if this limitation applies to any subject company under valuation, care must be taken to ensure that the tax detriments/benefits are carefully inserted to the proper years. If the carryforwards are beyond the discrete project period, valuators will need to adjust normalized future cash flows beyond that point or, alternatively, determine the remaining economic benefit net of taxes and add that amount to the operating/enterprise value to develop a sound conclusion of value.

ENTITY STRUCTURE CONSIDERATIONS

Much has been made of the lower tax rate structure and the effective use of S corporation structures in future tax planning. This challenge to S corporation status rides solely on the income tax rate differential between the corporate tax rate of 21 percent and the top marginal rate of individual shareholders of 37 percent.

There is no question that the rate differential issue is an important consideration in contemplation of potential reorganizations. Moving forward, there may be reasons for a partially ESOP-owned S corporation to convert to a C corporation, and there may be an increased likelihood of new ESOPs being formed by C corporations.

However, the multiple layers of income tax attributable to C corporations involved in a later sale of its underlying assets can quickly erode any incremental tax arbitrage realized by the current rate differentials. This is, of course, principally due to the double layer of tax regime for C corporations, which remains a foundational element of C corporation taxation.

A second item of consideration in making such an assessment is the impact of the state and local income tax deduction limitation imposed by the TCJA. For tax years beginning after December 31, 2017, taxpayers itemizing income tax deductions will no longer be able to deduct the state and local income and property taxes in excess of $10,000. This limitation will likely be consumed by most individual taxpayers' personal state and local income tax and property tax deductions, thereby, effectively limiting the state and local income tax deduction on their pass-through income to zero.

A corporation does not have such a limitation, and there may be advantages for a partially ESOP-owned S corporation to convert to a C corporation to realize these tax savings. It should not be forgotten that the rate reduction to 21 percent works to make the value of the deduction less beneficial than before the TCJA.

Finally, it is important that planners for companies considering the use of an ESOP keep in mind that the tax deferral treatment afforded by virtue of Internal Revenue Code § 1042 is available only for sales of C corporation stock. A § 1042 exchange, briefly, provides a mechanism that allows a shareholder of a privately held C corporation 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 later sale of the QRP.

The deferral of the federal capital gain taxes on the sale of the stock of a C corporation has always been an important consideration in reviewing tax structures in coordinating the adoption of an ESOP. After the TCJA, and the state and local income tax deduction limitation (depending on the filing state of the selling shareholder), the savings resulting from the deferral may be worth a careful analysis.

The author has not observed a rush to convert from S status to C corporation status and does not expect that such is likely, even with the rate arbitrage that might be available. State and local income taxes, financial, operational, employment, and other business matters must all be carefully considered prior to making such a change.

CONCLUSION

The final impact of the TCJA on the valuation of ESOP-owned companies remains a matter of debate and may not be fully understood for some time. There can be no question, however, that anticipation of the tax legislation, as well as its enactment, has led to significant overall growth in value on the public markets, at least on a "near-term" basis. There is no reason to believe that the law did not have an impact on all valuations generally. Thus, a failure to carefully assess the impact of the TCJA on any subject enterprise under valuation would be to run askew of governing professional standards.

Returning to where we started in this article, expected future tax savings equate directly to free cash flow and, all other things being equal, should result in increased equity value. This outcome is confirmed in the ESOP-owned company arena as well, where the author has observed significant, but reconcilable, current-year value increments.

The propriety of this treatment seems to follow Department of Labor protocols and emphasis on consistency. If, ultimately, prior-year values were assumed to be properly deflated due to cash flow reductions for income taxes levied at 35 percent, it is appro-

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There have been 20 appraisal decisions since 2011 in cases where fairness opinions are publicly available. In 19 of them, the opinions used comparable companies as one of the methodologies. Experts for one side or the other (but not both) used comparable companies in 11 of the cases. However, in only one (*DFC Global*[9]) did the Court consider comparable companies in arriving at its decision. Nonetheless, the Court sometimes uses comparable companies as a basis for beta in cases where it rejects a comparable company analysis, most recently in July 2018.[10]

The comparable company approach is a valuable arrow in the valuator's quiver. The declining use of the method in Delaware appraisals appears to reflect, to some degree, the limited use of this method by expert witnesses. Expert witnesses have been stressing DCF because of the Court's demonstrated preference for it and have limited their use of comparable companies. Nonetheless, the continuing use of comparable companies in investment bankers' fairness opinions illustrates the widespread acceptance of (and reliance on) this approach in the investment community.

Despite its limited acceptance of comparable companies, the Court of Chancery has pointed out that it is helpful to use more than one methodology in valuations. The Court of Chancery has expressed its desire to consider multiple valuation methods, saying in 2010:

> Although there is no single preferred or accepted valuation methodology under Delaware law that establishes beyond question a company's value, there are commonly accepted methodologies that a prudent expert should use in coordination with one another to demonstrate the reliability of its valuation. If a discounted cash flow analysis reveals a valuation similar to a comparable companies or comparable transactions analysis, I have more confidence that both analyses are accurately valuing a company.[11]

In 2013, it wrote:

> Generally speaking, "it is preferable to take a more robust approach involving multiple techniques— such as a DCF analysis, a comparable transactions analysis (looking at precedent transaction comparables), and a comparable companies analysis (looking at trading comparables/multiples)— to triangulate a value range, as all three methodologies individually have their own limitations."[12]

Experts should expressly consider comparable companies in their valuations and be prepared to explain to the Court why their selected companies are valid comparables. Otherwise, they should explain why they are unable to use the method (especially if the relevant fairness opinion used it). When they are able to demonstrate that their analysis has employed "a good sample of actual comparables," perhaps the Court of Chancery will be more likely to utilize this useful and widely accepted valuation method.

1 Delaware decisions customarily use "comparable" rather than "guideline."
2 *Grimes v. Vitalink Communications Corp.,* 1997 Del. Ch. LEXIS 124 (Aug. 26, 1997) at *3.
3 *In re Appraisal of SWS Group, Inc.,* 2017 Del. Ch. LEXIS 90 (May 30, 2017) at *31.
4 *Dell Inc. v. Magnetar Global Event Driven Master Fund Ltd,* 177 A.3d 1 (Del. 2017).
5 *Merlin Partners LP v. AutoInfo,* 2015 Del. Ch. LEXIS 128 (Del. Ch. Apr. 30, 2015) at *26-*27.
6 *In re Orchard Enters., Inc.,* 2012 Del. Ch. LEXIS 165 (Del. Ch. July 18, 2012) at *31
7 *Id.* at *32, quoting *In re Radiology Assocs., Inc. Litig.,* 611 A.2d 485, 490 (Del. Ch. 1991).
8 *SWS Group, Inc.,* 2017 Del. Ch. LEXIS 90 at *30, quoting *In re: Appraisal of The Orchard Enterprises, Inc.,* 2012 Del. Ch. LEXIS 165 (July 18, 2012) at *36.
9 *In re Appraisal of DFC Global Corp.,* 2016 Del. Ch. LEXIS 103 (Del. Ch. July 8, 2016); *rev'd on other grounds, DFC Global Corp. v. Muirfield Value Partners, L.P.,* 172 A.3d 346 (Del. 2017).
10 *Blueblade Capital Opportunities LLC v. Norcroft Cos., Inc.,* 2018 WL 3602940 (Del. Ch. July 27, 2018) at *34.
11 *In re Hanover Direct, Inc. Sh'holders Litig.,* 2010 Del. Ch. LEXIS 201 (Sept. 24, 2010) at *5-*6.
12 *Merion Capital, L.P. v. 3M Cogent, Inc.,* 2013 Del. Ch. LEXIS 172 (July 8, 2013) at *17-18, quoting *Muoio & Co. v. Hallmark Entertainment Investments Co.,* 2011 Del. Ch. LEXIS 43 (Mar. 9, 2011) at *83-*84.

priate that a substantial swing in rates would serve to move value in the reverse direction.

Finally, as noted earlier, the Internal Revenue Service has issued to date many sets of proposed Treasury regulations and other guidance. More changes are scheduled to come later this year. As such, care should be taken by the business valuation community to ensure that the additional interpretive guidance is incorporated into their determinations of value.

1 Future obligations to fund the repurchase of the ESOP shares allocated to plan participants is always reduced to present value based on census data and expected dates of exercise for the "put" rights held by those participants. As a result, ESOP-owned companies with a younger work force likely have a greater period of time between the date of any valuation and the date when the shares must be "repurchased" than an identical company with a more senior work force. Such a circumstance would equate to lower present values at any date of valuation due to that longer time frame.

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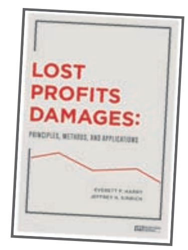

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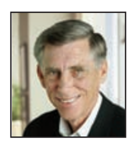

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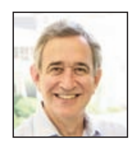

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