

Business Transitions in a Post-TCJA World: Can an ESOP Help Mitigate Tax Uncertainty?



The Tax Cuts and Jobs Act (TCJA) was signed into law in December 2017. It introduced significant changes to the Internal Revenue Code (IRC), including reductions in individual and corporate tax rates, the introduction of the qualified business income deduction (IRC Section 199A), and changes to the estate tax exemption amount. Many of these provisions are set to expire or “sunset” at the end of 2025, leading to potential increases in tax liability for individuals and businesses.

Key provisions of the TCJA are scheduled to sunset on December 31, 2025, which would automatically reinstate prior law and may trigger substantial changes in tax liability for some. It is imperative for taxpayers to act now to address the potential loss of significant tax benefits by working with their advisors to identify which tax strategies may best mitigate risk and reduce overall tax obligations. Business owners especially must consider the challenges to both their individual and corporate tax strategies, as well as the impact on their estate and succession planning.

While tax legislative changes are always a possibility, it is difficult to predict an outcome with any certainty. However, certain tax-efficient business transition alternatives — such as employee stock ownership plans (ESOPs) — may help address challenges and identify opportunities. Read on to learn specifics about the possible impact of the scheduled TCJA sunset, and why now may be the time for business owners to consider an ESOP.

BUSINESS TRANSITION IN ESTATE PLANS AND BUSINESS SUCCESSION PLANS

Business-owning baby boomers planning to retire may begin exploring business succession opportunities such as third-party sales, ESOPs, or other internal transfers as part of their estate planning. Transitions like these are crucial for ensuring the continuity and longevity of their businesses and directly impact or are impacted by the owners' estate planning.

Tax laws are also a key consideration. For example, high-net-worth taxpayers who own businesses must consider the lifetime estate and gift tax exemption when transferring or gifting assets. For 2024, the lifetime giving exemption is \$13.61 million per individual and \$27.22 million for married couples (see this [BDO article](#) for more information on the lifetime giving exemption). However, under the TCJA, the exemption amount is scheduled to return to pre-2018 levels -- approximately \$7 million per individual, adjusted for inflation -- on January 1, 2026. This significant reduction may change how business owners transfer their business to their descendants.

Additionally, shareholders hoping to be able to leverage qualified Opportunity Zones (QOZs) to reduce capital gains tax exposure may have to pivot. QOZs were established under the TCJA to spur economic development and job creation in distressed communities by offering tax incentives to investors. These incentives included deferral of capital gains tax on investments in QOZs, potential reduction of the deferred tax if the investment is held for at least five years, and possible exclusion of gains from QOZ investments held for at least 10 years.

However, the program is set to sunset at the end of 2026, so that the last day to invest in a QOZ and receive the deferral benefit is December 31, 2026.

Succession planning can have substantial and far-reaching implications for [a business owner's estate planning](#). Considering the current tax landscape, a comprehensive review of current plans may require a shift in business and transition strategies. This should include thoughtful consideration of transition alternatives such as forming an ESOP, which can offer tax advantages and facilitate smoother transitions.

EFFECT OF TCJA EXPIRATION ON BUSINESS TRANSITION PLANNING

Business owners, sole proprietors, and pass-through entities may find that their business succession plans no longer suit the company's needs if the TCJA provisions expire as expected.

For example, the [Section 199A](#) deduction introduced by the TCJA allows eligible taxpayers to deduct up to 20% of their qualified business income, which can provide significant tax savings and boost cash flow needed for reinvestment and growth. However, this deduction is set to expire at the end of 2025, potentially leading to increased tax liability and reduced cash flow, which can impact a company's ability to facilitate a business transition. The sunset of this deduction may necessitate strategic tax planning to mitigate its impact, underscoring the importance of reevaluating business succession plans.

Likewise, the phase-out of the bonus depreciation rate will likely lead to adjustments in business capital expenditure strategies. The rate has been decreasing by 20% annually and will phase out completely for property placed in service after December 31, 2026. Bonus depreciation is a tax incentive that allows a business to immediately deduct a large percentage of the purchase price of eligible assets rather than write them off evenly over their useful life.

Finally, TCJA provisions currently limit the deduction for business interest expenses to 30% of adjusted taxable income. However, for tax years beginning after 2021, the calculation of adjusted taxable income changed in a way that effectively lowers the amount of interest expense businesses can deduct. This change has already had a significant impact on profitability and cash flow projections for some companies, which can have further effects on any business transitions that involve leverage.

CONSIDER AN ESOP FOR POTENTIAL TAX BENEFITS AND MORE

An ESOP is a broad-based, tax-qualified retirement plan that allows employees to become beneficial owners of the company they work for. ESOPs are often used as a corporate finance strategy, aligning the interests of employees with those of selling shareholders.

An ESOP — especially in the case of a 100% ESOP-owned S corporation — can help guard against tax uncertainty by providing a tax-advantaged alternative to business transitions.

Transitioning to an ESOP can be a win for owners, companies, employees, and communities. Owners benefit from possible tax deferrals and liquidity, companies benefit from increased cash flow and productivity enhancements, employees gain potential financial benefits, and communities benefit from the stability and growth of locally owned businesses. With some TCJA tax incentives set to expire, an ESOP can offer a tax-advantaged business transition option.

► **C Corporation Deferred Capital Gains Tax:** Internal Revenue Code Section 1042 allows owners of closely held C corporations to defer capital gains tax on the sale of stock to an ESOP. To qualify, the seller must sell at least 30% of their stock directly to the ESOP trust and reinvest the proceeds into qualified replacement property (QRP) within a specified time frame. The deferred capital gains tax can provide a significant financial benefit, making ESOPs an attractive exit strategy for business owners looking to retire or diversify their investments.

This provision incentivizes business owners to transition ownership to employees through an ESOP, which promotes employee ownership and can enhance company performance and employee morale.

► **Company Tax Benefits:** When an ESOP owns 100% of an S corporation, the company no longer pays federal and most state income tax. This is because the ESOP trust, as a pass-through shareholder, is a tax-exempt trust under IRC Section 501(a). As a result, the S corporation no longer needs to make tax distributions to cover federal (and most state) income tax on its earnings. Additionally, for C corporation ESOPs, ESOP contributions create tax deductions, enabling a tax-advantaged buyout of shareholders. Partnerships and LLCs taxed as partnerships would need to convert to a C or S corporation to have an ESOP.

The tax advantages available for ESOP transitions can help improve liquidity for the owners and provide significant tax savings for the company, making ESOPs a compelling option for business owners.


THE TIME TO ADDRESS THE SUNSETTING OF THE TCJA IS NOW

Being proactive in the face of the current tax landscape's uncertainty can be critical to a company's future and stakeholders, particularly when contemplating business transitions. For example, forming an ESOP requires thorough analysis of many factors, careful planning, and compliance with regulatory guidelines. Still, the benefits provided by forming an ESOP can be substantial.

For any business owner or company contemplating a sale to an ESOP, it is important to consult with an ESOP advisor who possesses the experience to adeptly navigate the complex regulatory and tax challenges associated with ESOP transactions.

BDO Capital Advisors is equipped to guide you through each phase of an ESOP transaction. Working in close collaboration with professionals from BDO USA, we can explain the common tax ramifications associated with various ESOP scenarios.

If you are considering an ESOP as part of your business transition strategy, now is the time to act. Contact BDO Capital Advisors to schedule a consultation and explore how an ESOP can benefit your business and align with your long-term goals.



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