Building an Effective Succession Plan and Exit Strategy for Construction Industry Owners and Executives

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An Employee Stock Ownership Plan (ESOP) can provide significant benefits to shareholders, management and employees of a privately-owned construction business.

An ESOP can

- Be an excellent financial alternative for business owners rather than selling their business to a third-party, such as a private equity group or a strategic buyer,
- Offer certain tax benefits while providing business owners liquidity, diversification and enhanced retirement benefits,
- Facilitate the financing of corporate transactions and provide employees with an ownership interest in their employer and a valuable retirement benefit,
- Minimize the impact and risk of multiemployer union pension plans, and
- Maximize economic and estate planning benefits compared to alternative options.

Sale Scenarios

An ESOP can be utilized as a creative solution for a construction company business owner's dilemma of, on the one hand, wanting to retire from direct involvement in the company and, on the other hand, wanting the company to continue in the hands of family members or employees who have a similar personal and emotional investment in the company. An owner who has spent years building a successful company may not be interested in selling the company to an unrelated third party, even though, as a practical matter, the owner must actually sell his/her stock in order to get value out of the company and move on to the next phase of life.

In many cases, it may also be difficult to sell the business because the business owner's relationships are the main source of new business and potential buyers may want significant earn outs, claw backs or other egregious purchase covenants. Also, many construction companies participate in multiemployer union pension plans that may be significantly underfunded whereby potential buyers may require significant discounts because of such multiemployer union pension liabilities. In some cases, it may be difficult to increase the debt load of the business because of business growth or surety bonding requirements.

In these types of situations, instead of selling to an outsider, such as private equity or a strategic buyer, the owner may sell to an ESOP. This strategy would enhance their own personal security with the proceeds from the sale while at the same time maintaining significant ownership of the business. Further, through the ESOP strategy the owner will share his/her ownership interest with others who have been managing or working in the company over the years and, therefore, share a similar emotional investment in the company.

With an ESOP, if a succession management team is not in place, the ESOP can be used as a tool to trigger a tax-advantageous monetization event while simultaneously grooming family members or a new management team to succeed the owner over a given time horizon such as a three-, five- or ten-year time period. If the family members or succession management team prove that they can handle the management of the business, the owner can retire and get paid again from the payment of his/her ESOP interest, which can be significant. If the family members or succession management team prove that they cannot handle the management of the business, the company can then be sold to a third party. In both scenarios, the owner, family members, management and employees will all receive incremental value because of the ESOP ownership interest, and if structured properly can result in a tax-free sale.

The government provides significant tax incentives for businesses to create ESOPs, and most studies show that these plans outpace 401(k)s as a source of retirement income for participants and can outperform the S&P 500 in year-over- year investment returns.

Combining an ESOP with a 401(k) plan can offer significant benefits to the owner and employees. Surprisingly, the total number of ESOPs and the employees they cover have not grown substantially in recent years. There are a number of reasons for the slow growth of ESOPs but most industry pundits point to a reputation hangover from misuse of the plans by bad companies and a lack of understanding of the complex workings of ESOPs as the most likely barriers to adoption. Some have argued that there has been significant growth in ESOPs but point out that many successful ESOPs are sold to third parties by successor management teams to monetize the business and de-risk the ESOP participants, thereby keeping the number of

ESOPs at a level number in the United States at around 6,000.

Tax Benefits of an ESOP

An ESOP is a tax-qualified retirement plan that invests primarily in stock of the sponsoring employer and meets several other conditions.

An ESOP can potentially eliminate U.S. taxation on a business going forward. The tradeoff for this tax planning approach is that the employer must share ownership with some or all non-shareholder employees. The ability to eliminate federal tax is the result of changes made in 1998 to the Internal Revenue Code that exclude the earnings of a Subchapter S Corporation allocable to an ESOP from taxation. These provisions were added by Congress to incentivize employee ownership. Under current law, an S corporation that is owned 100% by an ESOP will not incur any federal taxes (or unrelated business income tax). Since an S corporation can have retained earnings, the ability to have such retained earnings grow tax-free represents a powerful vehicle.

Most states follow the federal statue and don't tax ESOP S corporation earnings. In many instances, such significant tax benefits allow for a quicker monetization of the business with better economics than a third party sale to either a private equity or a strategic buyer.

Many ESOPs are structured to defer the gain on a sale of a company to an ESOP. This is called a 1042 exchange transaction. A shareholder who sells employer stock to an ESOP may defer recognition of capital gain if the ESOP owns at least 30 percent of the corporation after the transaction and the sales proceeds are reinvested in securities or bonds of domestic operating companies. The seller must have held the stock being sold to the ESOP for at least three years prior to the sale.

The mechanism for deferring gain on the sale is a reduction in the seller's basis in the replacement property purchased with the proceeds of sale of stock to the ESOP. If all the proceeds are reinvested, the basis reduction equals the gain on the sale and is allocated among the items of replacement property in proportion to their cost. If some proceeds are not reinvested, gain is recognized only to the extent that the proceeds exceed the reinvested amount, and the deferred gain reduces basis. The seller will then recognize the deferred gain when he disposes of the replacement property in any transaction other than a tax-free reorganization (with some exceptions), a transfer by reason of death, a gift, or the sale of the property in another Section 1042 transaction.

In a 1042 transaction, the business owner and family members cannot participate in an ESOP. This strategy generally makes sense for a very old or sick business owner. However, given the low capital gains rate environment some argue that paying capital gains today makes more sense if tax rates increase in the future thereby allowing more flexibility of the owner to re-invest sales proceeds without the restrictions of Section 1042. Of course, each situation should be reviewed carefully.

Another design approach for a construction company ESOP would be to add the ESOP to an existing 401(k) plan or create a new 401(k) plan with an ESOP component. This approach allows the owner to monetize their business interest while also permitting the owner to participate in the ESOP which can allow for a material tax deferral or tax eliminated retirement benefit of the ESOP ownership interest.

401(k) plans integrated with ESOPs have been around for many years and are commonly used by public companies but there has been an increased trend in such use for private companies. 401(k) plans can be structured utilizing a pre-tax approach or a ROTH account approach whereby the investment in ESOP equity is taxable today but the retirement benefit that

is paid out after the later of 5 years or age 59-1/2 is totally tax free. If the ESOP equity interest is included in a 401(k) plan such an approach may produce superior economic benefits as compared with a 1042 transaction, offer more investment flexibility and better align all stakeholders (the owner, family members, management team and workers).

Multiemployer Union Pension Challenge

A major challenge for a business in the construction industry is that many participate in multiemployer union pension plans. For many construction companies, such participation can have a negative impact on the equity value a potential buyer may be willing to pay to purchase the company due to off balance sheet liabilities that may become on balance sheet liabilities when and if these plans become insolvent. In many cases, business owners are not aware of the magnitude or negative impact these withdrawal liabilities can have with regard to the business valuation in a sale transaction or in the future solvency of their business.

Construction companies that may be forced into bankruptcy because of the pandemic or other business reasons could cause an “avalanche” impact on other well-managed construction companies that participate in these union plans. If a participating construction company fails to make its required contributions, the unfunded obligations of the plan may be borne by the remaining participating employers. This is commonly referred to as the “last man standing” rule. The government agency (the PBGC) that insures a portion of the retirement benefits for workers is expecting many of these plans to become insolvent. Financial accounting rules require that companies that participate in these plans disclose information with regard to these multiemployer plans, but such disclosures do not include the withdrawal liability.

Many unknowing companies could be at risk of bankruptcy, and business valuations may not properly reflect fair value. It may also be impossible or more challenging to sell a business connected to these plans without a significant purchase price adjustment. Consequently, the tax benefits of an ESOP may offer a better monetization strategy to the business owner and to the employees in the long term.

Estate Planning – Creating Liquidity and Diversifying

It is likely that a business owner's biggest asset is their company, which is not generally a relatively liquid asset. When the time comes for estate taxes to be paid on the owner's estate, unless other provisions have been made, the business may have to be sold in order to pay estate taxes. Rather than waiting for the eventuality of a possible forced sale in such a situation, a business owner can create current liquidity while at the same time retaining management control of their company by selling their interest in the company to an ESOP.

By selling the company stock to an ESOP, a business owner can create immediate liquidity and retain management control of the company through participation in the ESOP. When the owner is ready to retire, he/she can get paid from the ESOP or initiate a sale of the company to a third party. Thus, a sale to an ESOP is an ideal planning mechanism for an owner's gradual secession from a company in a way that allows him or her to diversify their own portfolio and prepare for retirement in a tax-favorable manner while at the same time providing a benefit to employees which may, in turn, positively affect the health of the company.

The ability of a business owner to sell company stock to an ESOP and use the proceeds to diversify his or her portfolio enables the owner to treat their heirs equally even if they will not all inherit company stock equally. For example, if an owner believes that an heir is not interested in being involved with the business, is not well-suited for the business, or would disagree with another, more competent heir as to how the business should be run, he/she may wish to leave such heir assets that are equal in value to the company stock left to another heir. Thus, in order to avoid family feuds between heirs over a family business, an owner who has diversified his/her assets by selling to an ESOP can treat heirs fairly by leaving them property of equal value, whether it is shares in the family business, the ESOP or shares in another investment.

Characteristics of a Good Company for an ESOP

The characteristics of a good construction company for an ESOP include:

- A desire for ownership diversification and wealth creation,
- A growing, profitable business with strong cash flow – a financially healthy business is best-suited to implement an ESOP, and
- An ownership group that is not reluctant to allow additional shareholders – their employees – to share in the company's equity.

An ESOP cannot save a highly indebted business or one with a poor business model, but it can be a powerful succession planning tool for a welll-managed construction company.

Building Retirement

An ESOP may be just the right tax/legal vehicle for those who own a construction business, want financial security, and want to leave behind a legacy. So, plan now and explore an ESOP that can achieve both goals.

Contact Us

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