ESOPs: A Solid Ownership Foundation for Construction Companies

By Franco Silva

Many business owners in the construction industry have decided to pursue an Employee Stock Ownership Plan ("ESOP") as part of their exit strategy. Selling the business to a third party isn't always a welcome or viable option, especially for business owners in the construction industry. In many cases, considerations such as company legacy, employee welfare and local community may be key deciding factors in selecting an exit strategy. An ESOP is a great way to help construction business owners accomplish all these key factors. Also, there can be a number of attractive tax and investment benefits with an ESOP. Further, ESOPs can help construction business owners gradually begin the process of converting their closely-held ownership over to liquid, diversified capital.

What is an ESOP?

Similar to a profit-sharing plan, an ESOP is a trust set up by a corporation to allot some of its stock to its employees over time. It's a unique combination of a tax-efficient leveraged buyout and an employee benefit plan. Shares are allocated to individual employee accounts based on their compensation levels as well as how long they have worked for the company; as employees accumulate seniority, they become increasingly vested in the account.

Benefits of ESOPs

An ESOP can help ensure the continuation of the business and can be a mechanism to retain and recruit top talent. An ESOP is scalable over time and offers a great degree of flexibility and advantages, such as short implementation periods, flexibility in liquidity and benefits to employees (i.e. allowing them to contribute to the company's success).

Tax Benefits

ESOPs also offer several tax incentives for the company, owner and participants alike:

- The principal amount of an ESOP loan can be tax-deductible, so a loan used to finance the ESOP transaction can be repaid by the company with pre-tax dollars.

- A selling shareholder can elect IRC §1042 tax deferral treatment and may be able to defer the capital gains associated with the sale of his or her shares, upon the satisfaction of certain requirements.
- For companies that elect S corporation status, the ESOP's share of recognized earnings is usually exempt from income taxes.
- An ESOP retirement account is non-contributory and tax deferred, which benefits employees.

Challenges

Although ESOPs offer numerous benefits, they do require an understanding of business valuation, transaction dynamics, tax law, regulatory compliance under ERISA and more. Even the perceived complexity of an ESOP can prove to be a detractor when deciding whether or not to implement an ESOP. If selling 100% of the company, outside lenders may be unwilling to finance the full purchase price of the company stock, which may require seller financing to cover the balance. In addition, ESOPs require ongoing administrative costs, including annual valuation, plan administration, legal and possible trustee fees.

Laying a Good Foundation

A well-thought-out ESOP implementation process will enable the resulting transaction to create strong value for the employees, the company and the seller. The structure of the ESOP transaction should be tailored to meet the needs of the selling shareholder and stakeholders. Laying a good foundation for the ESOP begins at the onset of the transaction and should include the following:

- *Selecting a Strong Advisory Team* - Selecting a strong team of advisors that include fiduciary, financial, legal and administrative professionals is key for a successful ESOP transaction. A strong advisory team will also help create a structure that enables the ESOP to be sustainable in the long term.
- *Conducting a Feasibility Study* - During the ESOP exploration process, a feasibility analysis should be performed to test various assumptions regarding the value of the company, the size of the transaction, financing options, surety program impacts and the expected ESOP benefit delivered to employees over time. ESOP transaction financing is non-productive in that it does not enhance the value of the business or provide growth opportunities. It is important that the management team understands the capital requirements necessary to operate and grow the business going forward.
- *Educating Surety on ESOP Transaction* - Construction companies should fully understand the impact an ESOP transaction may have on their financial statements and surety program. Educating their surety beforehand is key to ensure that appropriate bonding levels are maintained post-transaction. With proper planning and education, an ESOP can actually enhance the Company's surety program.
- *Management Transition* - Developing the next generation of management is important to maximize value and perpetuate any business. Identifying, grooming, and transitioning senior management takes many years to accomplish. As such, it is a great practice to continually search for and identify future company leaders.

The Bottom Line

ESOPs can be a highly effective tool for ownership transition with a host of advantages for construction business owners. Ultimately, proactive planning is key to the successful implementation of any ESOP transaction.

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