ESOP’s for the Construction Industry

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Agenda

- ESOP Definition and Tax Incentives, Structures, Corporate Governance
- Case Study
- Lending Surety and Accounting Issues
- Other Practical Examples of ESOP Transactions
- Summary of Benefits – Sellers, Company, Employees
- Common Questions/Q&A
ESOP’s – Basic Definition

- Tax-qualified retirement plan similar to a traditional profit sharing plan.
- Governed by ERISA
  - Internal Revenue Service
  - Department of Labor
- Like a profit sharing plan but it can invest 100% of its assets in Employer Stock.
- Unlike a profit sharing plan it must invest primarily in Employer Stock and the ESOP can borrow money to buy employer stock.
- Employee/participants are **beneficial** owners of the Employer stock, the trust is the actual owner.
Typical Concerns of Different Constituencies

- **Direct owners nearing retirement**
  - Getting paid for their stock ownership
  - Current shareholders lack of cash for cross purchase
  - Leaving a solid legacy – continuing success of Company
  - Fluctuations in value during buyout period
  - Health of Company

- **Direct owners in mid career**
  - Building wealth
  - Autonomy
  - Continuity of the business
  - Growth of the business / value of the stock
  - Cash for college, toys, investments
  - Opportunity for leadership
  - Health of Company
Typical Concerns of Different Constituencies (Continued)

- New owners and employees expecting ownership opportunities
  - Current compensation
  - Career path
  - Skill development
  - Incentive plans
  - Buying out existing shareholders/how it impacts them. Exit timeframe under current plan does not appear feasible for the group of owners expected to exit (“Pig and the Python”)
  - Strategic direction of the Company
  - Health of Company
Typical Concerns of Different Constituencies (Continued)

- ESOP/Trustee/Participants
  - Cash flow to repurchase participant accounts
  - Company leadership
  - Value of stock and factors impacting the value drivers
  - Impact to all participants
  - Health of Company
Demands on Capital/Earnings

- Retained earnings for growth and working capital
- Retirement plan
- Retained earnings for acquisitions and development
- Income taxes
- Incentive compensation
- Return on investment
- Fund succession plan
Usual Structure

 Owners / Employees

 Company

 Retiring Owners

 Buyout

 Gov’t

 Compensation

 Taxes
Subchapter S Environment – 100% Example

- Employees
- Ex-Owners
- Key Management
- Company
- ESOP

Connections:
- Compensation
- Note Payments
- SAR Plan
- Contributions
- Repurchase Obligation
- No Taxes

Payments and Contributions flow through the company to the ESOP for key management.
Partial ESOP / Subchapter S

- Owners / Employees
  - Compensation
  - Tax Dividends
  - Company
  - ESOP
  - Tax Dividends
  - Contribution/ Benefits
  - Ex-Owners
    - Redemption Payments
- Direct Owners
  - Taxes
  - Gov’t
Tax Efficiency of Employees
Buying Redeemed Stock
$100,000 Payment Without ESOP

Company
Net Cost of Bonus
$54,000

$100,000 - Bonus For Stock Purchases

$54,000 Payment of Stock Price

Shareholder Purchasing Stock

Shareholder - Redeemed by Company Net $54,000

Taxes - 27.8% of Gain

Taxes - 46% $46,000

Company
Net Cost of Bonus $54,000
$100,000 Payment with ESOP Purchasing Stock

Company

$54,000
+$25,000
Contribution

ESOP

$79,000 Payment

Shareholder

$46,000 -
Bonus

Selling Shareholder

$25,000 Stock Purchase

Tax - Same 27.8%
of Gain

$21,000

$25,000 more cash to bonus or redeem stock

$25,000 +$25,000 Contribution

Shareholder Purchasing Stock

Taxes - 46%
$21,000

Company

$25,000 Stock Purchase
Tax Incentives

- Contributions to an ESOP are tax deductible, including contributions used to pay interest and principal.

- C corporation dividends on employer stock can (in certain circumstances) be deductible.

- For C corporations, in some situations the gain on the sale of the stock can be deferred by the seller (§1042 transaction).

- S corporations avoid income taxes on shares owned by an ESOP.

- The tax exemption for S corporations significantly increases the ability of the company to meet debt obligations.
Simple Example – S Corporation Taxation Comparison

Earnings $1,000,000

**Private Company**

- **Owners**
  - 45% Tax: 450,000 Tax Dividend

- **S Corporation**
  - Tax: (450,000)
  - Equity: 550,000

**100% ESOP Company**

- **ESOP**
  - Tax: None
  - Equity: 1,000,000
Tax Incentives – Section 1042 Deferral Treatment

- Under a §1042 transaction, the gain on the sale of C Corporation employer securities to the ESOP is tax deferred provided it is reinvested in “qualified replacement property” within the “qualified replacement period”.

- Qualified Replacement Property - is generally defined as securities of domestic operating non-governmental companies. Special strategies can be used to assure the seller that taxes on the gain are never assessed while providing flexibility on use of sales proceeds.

- Qualified Replacement Period - is the 3 month period prior to the sale and the 12 months following.
Tax Incentives – Section 1042 Deferral Treatment (Continued)

- After the sale of the stock the ESOP must own at least 30% of the outstanding stock.
- The selling shareholder must have held the stock for at least 3 years.
- 25% shareholders, and some family members cannot participate in the future ESOP share allocations for this stock.
Qualified Replacement Property

**Eligible***

- Common Stock
- Convertible Bonds
- Corporate Fixed Rate Bonds
- Corporate Floating Rate Notes

**Not Eligible**

- Municipal Bonds
- US Government Bonds
- Mutual Funds
- Foreign Securities
- REITs
- Bank CDs

* Eligible issuer must have:
  - more than 50% of its assets used in the active conduct of a trade or business
  - no more than 25% of its gross income from passive sources – McDonalds does not qualify!
Leveraged ESOP – Typical Transaction

- The company borrows money from an outside lender (“External Loan”), or purchases from shareholders using a promissory note typically for a term of 5 years or less.

- Due to bonding requirements there will often be seller financing, (“External Loan”) which can be at subordinated debt interest rates. The loan terms can vary significantly.

- The company makes a loan to the ESOP (“Internal Loan”) for a term greater than the loan term from the lender(s) to the company (“External Loan”), usually 15-20 years.

- The company may also permit the participants in the 401(k) plan to transfer assets to the ESOP to purchase shares. Additional fiduciary concerns normally will need to be addressed.

- Contributions and income distributions/dividends in the amount of the loan payments are made to the ESOP (can include a match on employee 401(k) contributions).

- The ESOP makes the loan payment to Company (the Internal Loan is repaid) stock is then allocated to the participants.
Leveraged ESOPs - Initial Transaction

- **Lender(s)**
  - (1) $
  - (1) Note Payable

- **Company**
  - (2) Stock
  - (2) Note Payable

- **ESOP**
  - 401(k) Plan
  - Suspense Account
    - $ (?)

- **Shareholder(s)**
  - (3) Note
  - (3) Stock

Stock is held in the trust, but is not allocated to participants’ accounts.
Leveraged ESOPs: 1st Year Contributions

Stock is released from suspense and allocated to participants as the Internal Loan is repaid.
Issues and Concerns

- Implementation fees including valuation, lending, trustee and legal fees.

- Annual fees including valuation, administration recordkeeping, Audit of ESOP, and trustee fees.

- Impact to surety credit for contractors from leveraged ESOP transaction. May require step redemptions or Holding company.

- Repurchase obligation and monitoring it.

- Employee communication of sale and ongoing.
General Corporate Governance – Pre-Transaction

- Shareholders elect the Board of Directors.
- The Board of Directors will appoint a Trustee to represent the ESOP.
- Often an institutional trustee is appointed, but an individual can also act as trustee. Generally, the seller or another insider should not act as trustee for the transaction.
- The Trustee will hire advisors to the ESOP to assist with determining if the transaction is fair.
  - Attorney
  - Financial Advisor/Valuation firm
General Corporate Governance - Ongoing

- Once the transaction is completed the outside trustee can be retained or an insider may be appointed as trustee.

- If a new trustee is appointed after the transaction, it could be a board member(s) or member(s) of management. Generally, this is not recommended.

- The trustee can be a directed trustee, whereby an ESOP Committee appointed by the Board would direct the trustee how to vote the ESOP shares.

- On a few issues employees can direct the voting of the allocated ESOP shares, such as:
  - Recapitalization
  - Mergers
Repurchase Obligation/Lender Issues

- It is possible for a C corp. to gain a similar tax advantage by increasing contributions and paying greater deductible dividends, but this will result in accelerating the repurchase obligation.

- **Repurchase obligation** results from the company having to purchase the stock of terminated participants at FMV.
  - The faster the Internal Loan is repaid the faster shares are allocated to participants.
  - Until the Internal Loan is repaid the repurchase obligation can be deferred in most cases.
  - The outside lender is going to want to make sure that it’s External Loan is repaid before the Internal Loan is repaid.
  - If it is anticipated that there will be a series of stock purchases to eventually have a 100% ESOP owned company, paying off the Internal Loan over a longer period is important for purposes of securing financing for future transactions.
Lending Issues (Continued)

- Often the company will seek out a senior lender with expertise in construction and ESOPs.
- The senior lender will have significant influence over the terms of any seller financing as part of the transaction.
- The seller(s) may finance all or a part of the transaction. To the extent the seller proceeds could not be obtained from a senior lender, subordinated interest may be required.
- The senior lender is willing to finance more of the transaction if the company post-transaction has S status due to the ESOP shares being exempt from income taxes.
- The greater the transaction size (% of ESOP ownership) the greater the additional cash flow created from tax savings on the ESOP owned shares.
Surety Issues

Financial Aspects

- Impact on balance sheet-initial purchase hits equity in full
- Outflow of Capital/Inflow of Debt
- Repurchase Obligation
- Impact on Working Capital – Current portion of debt
- Acceptance of Home Office/Reinsurance Underwriter
- Transition of Leadership

Indemnification

- Lack of Personal Guarantees/Guarantors. Surety can no longer can get personal indemnification
- Protection of accounts in a qualified plan
- Collateral for the surety if all goes bad
Accounting Issues

- The initial transaction is a reduction/hit to equity. Equity is restored as the internal debt is paid down in a leveraged ESOP. Shareholder or bank debt is recorded, leveraging up the balance sheet.

- Loan between ESOP and Company is contra equity. Contra equity reduced as loan between Company and ESOP (internal loan) is repaid.

- Equity going forward is enhanced compared to non-ESOP companies. Non-ESOP companies pay income tax on taxable earnings whereas an ESOP “S” Corporation does not. This allows for an increase in equity going forward.

- Compensation Expense is recorded for the shares released to participants multiplied by the then FMV of the shares at time of release.
Leveraged ESOP Model - Detriments

● Significant decrease to equity
  ▪ Could likely cause issues with the bank and bonding company
  ▪ Further complicated by ongoing redemptions

● Balance sheet is leveraged up for shareholder debt
  ▪ Decreases working capital
  ▪ Increases debt to equity ratios
  ▪ Will likely need the debt to exiting owners to be subordinated to bank and bonding company
Summary of Benefits - Seller

- Complete control over timing of the transaction
- Receives fair value for stock (not as high as sale to strategic buyer)
- Lack of marketability and minority interest discounts under an ESOP are less than in traditional transactions
- Maintain confidentiality during the sale
- Preserve the company’s legacy
- Reward the management and employees
Summary of Benefits - Company

- Increased probability of management continuity.
- Company tax incentives:
  - Deductibility of principle payments (not important for a 100% ESOP owned S corporation.
  - Avoidance of all or a portion of its Federal, and state income taxes once S status is elected.
- Research shows that ESOP companies are more profitable than comparable non-ESOP companies.
- Significant tax savings are available to finance transaction particularly for S corporations.
Summary of Benefits - Employees

- An ESOP rewards employees who have promoted the employer’s success.
- Allows management to have effective control of the company, and possibly actual control over time.
  - Synthetic equity can be used to increase ownership stake.
- Research shows that employees of ESOP companies have better benefits and pay than employees of comparable non-ESOP companies.
- Tax savings significantly increase the value of the benefits through income distributions or increases in value of the stock.
ESOP Candidates

- Factors that would indicate that the company WOULD be a good ESOP candidate:
  - A history of sustainable profits
    - Belief in the value of employees having a stake in the business
    - Currently making contributions to a qualified retirement plan
    - Desire for or currently have good internal controls and strong corporate governance
    - Lack of strategic buyers
    - Current ownership wants to maintain the company’s legacy
    - Need to buyout large minority shareholder(s)
    - Want to reduce cost of capital
    - External ownership of stock is difficult to manage
    - Owner wants control but wants to take some “chips off the table”
    - Owner always dreamt of the day his company would pay no tax
ESOP Candidates

- Factors that would indicate the company should NOT consider an ESOP:
  - Consistently weak earnings
  - Company has poor internal controls
  - Company’s management philosophy does not promote strong corporate governance (i.e., company is personal checkbook)
  - Poor employee/management relations
  - Poor relationship with surety and lenders
  - Weak management succession plan
  - Lack of adequate employee compensation base
  - Owners feel ESOP is only way out regardless of other negative issues noted above
Why Consider Change to 100% ESOP Owned S Corporation? Win-Win-Win

- Seller gets possible deferral of tax on a sale to the ESOP
- Company gets a tax deduction and creates vehicle for managing and funding future redemptions of stock
- Opportunity to get employees better tax treatment at retirement using the ESOP as the vehicle for the employees to purchase stock
Why Consider Change to 100% ESOP Owned S Corporation? Win-Win-Win (Continued)

- Compare to true cost of current model
- Lower the credit risk of ability to fund obligations
- Enhanced long term sustainability of ESOP model
- Retention of capital for growth of company
- Retention of talent – growth of ESOP accounts greater with tax savings
- Throw year end tax planning out the window on 100% ESOP!
Practical Examples of ESOP Transactions

Large design and build GC used an ESOP to convert from C to S

- Goals:
  - Reduce number of shareholders from several hundred to less than hundred in order to elect S status.
  - Unlock the true value of the company to its selling shareholders.
  - Increase beneficial ownership to as many employees as possible while easing the administrative burden of having widespread employee ownership.
  - Maximize free cash flow to finance the purchase of the shares.
Practical Examples of ESOP Transactions

- **Outcome:**
  - Company used the ESOP stock valuation to entice existing employee owners to have their shares redeemed at a value significantly greater than under the buy-sell (book value). The transaction was financed with an External Loan from a bank.
  - The ESOP then bought the redeemed shares from treasury using an “internal note”.
  - Significantly, reduced the number of shareholder and was able to make an S election.
  - Employer contributions previously made to the 401(k) plan, (including the employer match) were converted to ESOP contributions to be used to make payments on the “internal loan”.
  - S corporation dividend on the ESOP shares will also be used to make “internal note” payments.
  - The combined free cash flow from the employer contributions and the dividends almost covered the entire external loan, so there was almost no impact on its cash flow to purchase the shares at the higher ESOP value.
Practical Examples of ESOP Transactions

GC used an ESOP to buyout inactive family shareholders

- Goals:
  - Purchase shares from inactive family members at an attractive price.
  - Through the ESOP cash-flow advantages, increase the amount of shares that could be purchased.
  - Provide an enhanced retirement benefit to existing employees.
Practical Examples of ESOP Transactions

- **Outcome:**
  - Inactive family shareholders agreed to sell stock partially due to being able to sell sooner with an understanding of the cashflow advantages of using an ESOP versus taking their chances and selling stock later without the ESOP.

  - The combined free cash flow from the employer contributions (redirected from the 401(k) to the ESOP) and the dividends on ESOP shares covered the entire cost of the purchase of the shares from the inactive shareholders. There was no impact on cash flow to purchase the shares.

  - The 5 year projected account balances under the new ESOP were over twice as much as the projected accumulation from contributions that would have been made by the employer to the 401(k) plan.
XYZ– ESOP Case Study

Background:

- 50 year old CM/GC that has averaged approximately $275 million in revenues over the past 5 years.

- The two original owners sold their ownership to three of the current (larger) shareholders in the mid 1980’s, who in turn brought in other shareholders over time.

- At the time of the ownership change in the 1980’s, revenue was approx. $55 million.

- Company is a subchapter S and prior to implementing an ESOP, had 15 shareholders with the majority of the shares being held by 3 individuals.
XYZ Company – ESOP Case Study

Background (cont.):

- In addition to making distributions to shareholders to pay taxes, Company had a number of incentive plans for employees including:
  1. Shareholder bonus plan
  2. Employee bonus plan at 15% of earnings, and
  3. Deferred bonus plan for senior managers ranging between 0 and 21% of earnings

- The company had an ownership transition plan in place that essentially required the company to purchase shares over a period of time at a multiple of book value. This requirement was triggered when shareholders reached a certain age.

- Little financial analysis had been performed to determine the feasibility of this plan in connection with the current incentive plans in place and the cash that would be required for these redemptions.
XYZ Company – ESOP Case Study

The Process:

- An analysis of the ownership transition plan was presented to the Board of Directors in May of 2010.

- The analysis demonstrated problems with the current ownership transition plan.

- Alternatives to enhancing the ownership transition plan were discussed, including a possible ESOP.

- The Board approved the formation of a committee to further address the issues and engage advisors to assist in the problem.

- The company had a strong culture of employee engagement and a philosophy of wanting to create a company that could be perpetuated.
XYZ Company – ESOP Case Study

The Process (cont.)

- They interviewed law firms to determine who would help us navigate through the process. The law firm selected was very helpful in creating a formal process that started with the formation of an ESOP committee (essentially the committee created by the board).

- Their law firm helped them outline the steps to be taken and how to make sure the process was appropriately documented.

- The following timeline illustrates how their process unfolded:
XYZ Company – ESOP Case Study

Board meeting May, 2010, formed ESOP committee reporting to BOD

Effective Date January 1, 2012

August – Sept. valuation of company and preparation of initial feasibility study

Dec. – May Analysis of other ownership transition strategies

Sept. – Oct. Interviewed and selected trustee

June – July interviewed and hired advisors, including legal, financial and valuation

Oct.- Nov., study presented and discussed by BOD. BOD requested other ownership transition options to be reviewed

June – August Engaged Crowe for phase II with two options for a 30% ESOP

Nov. – Dec. S/H vote and finalize legal documents
XYZ Company – ESOP Case Study

Issues and Challenges:

- They needed to be cognizant of the effect that an ESOP would have on our balance sheet.
  1. They kept both their surety carrier and primary bank updated on their plans.
  2. Equity levels and leverage drove them to a strategy whereby they issued new shares to the ESOP trust, resulting in no reduction to equity and creating a new 30% owner of our company.

- Their incentive compensation plans needed to be adjusted so they could afford an ESOP.
  1. The deferred bonus plan was frozen.
  2. The shareholder bonus plan was eliminated.
  3. Shareholders became part of the employee bonus plan. The employee bonus plan was restructured and heavily weighted to performance of the company.
  4. A stock appreciation rights plan (SARS) was added for key employees of the company.
  5. No changes were made to their 401(k) plan.
XYZ Company – ESOP Case Study

Issues and Challenges (cont.)

- They had shareholders ranging in age from the 30’s to the 60’s. Everybody was not on the same page.

1. They examined and analyzed different ownership structures.
2. They listened to and addressed concerns of shareholders.
3. They educated them on the financial ramifications that they faced if they did not do something.
4. Strong leadership helped drive the company to a new ownership transition plan that they believe best meet the needs of their employees and shareholders.
XYZ Company – ESOP Case Study

Implementation:

- The closing of the transaction was followed by a letter from the president of the company announcing the ESOP and in general, what it meant to their employees. This letter emphasized the desire to perpetuate the company by creating a culture of ownership that had led to their success to date.

- An ESOP communication committee was formed with employees from different areas of the company. They were responsible for:
  - Communication with workforce, usually done through a quarterly newsletter.
  - Arranging company functions to emphasize and answer questions about the ESOP.
  - Opening lines of communication with the workforce for engagement in areas where they could improve the results of the company.
  - Educated the workforce on how value is created for the ESOP.

- The first allocation of shares occurred at their annual state of the company meeting in January of 2013 and was generally well received.
Conclusion:

- The process took 1 ½ years, but they felt that they needed to move slowly and examine all the issues and alternatives.

- Different shareholders had different agendas, so every concern needed to be brought forward and vetted, even if it was in a one-off meeting.

- It was important to the company that the advisors hired were not only competent in their areas of expertise, but were creative and had construction industry experience.

- They wanted to make sure that during the process they had good corporate governance, good ideas and solutions to problems. That all started with hiring good advisors.
Questions?