How ESOPs Can Be Beneficial for Construction Companies

Construction Practices Newsletter

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What Is an ESOP?

First and foremost, an ESOP is an employee benefit plan that is qualified for tax-favored treatment under the Internal Revenue Code of 1986, as amended (IRC). However, an ESOP can also be a tool of corporate finance, and provide a market for closely held stock. For ESOPs sponsored by S corporations under IRC Section 1361, the ESOP may also offer significant tax savings.

Unlike other retirement plans, an ESOP is mandated by law to invest its assets primarily in stock of the sponsoring company. It is also the only ERISA-qualified plan that is permitted to borrow funds on company credit in order to acquire company stock. In addition, shareholders who sell company stock to an ESOP are permitted, in certain circumstances, to defer taxation on the gains realized from the sale. For all of these reasons and more, an ESOP can be a powerful tool in business planning.

Under the right circumstances, an ESOP can assist a construction company to obtain surety bonds because the ESOP can help to demonstrate continuity of management and ownership, and to enhance cash flow and net worth.

Reasons to Adopt an ESOP

Benefits to Selling Shareholders

An ESOP provides an internal market for stock of a closely held corporation. Therefore, an ESOP offers a selling shareholder liquidity and the opportunity to diversify his or her holdings. It also offers an alternative to a sale of the company to a third party. If the sale is made to the ESOP (and

therefore is for the benefit of employees), the company can maintain its culture and employees can retain their jobs.

The IRC also provides a special tax incentive for certain sales of stock to an ESOP, subject to compliance with a number of specific rules. A shareholder of a closely held company may be able to sell stock to an ESOP, reinvest the proceeds in other securities, and defer taxation of the long-term capital gain resulting from the sale (so long as a number of special requirements are met).

If an ESOP obtains an acquisition loan, the fair market value of shares of company stock immediately following the loan will reflect the debt incurred by the ESOP. The post-transaction value of the ESOP will usually be lower than its pre-transaction value. In estate planning, some shareholders take this opportunity to contribute or gift shares of company stock at this lower value.

Technique of Corporate Finance

As a technique of corporate finance, an ESOP can be used to raise new equity capital, to refinance outstanding debt, or to acquire productive assets through leveraging with third-party lenders. Because contributions (and certain dividends) paid to an ESOP are tax-deductible, a company can fund both principal and interest payments on an ESOP's debt service obligations with pre-tax dollars.

EXAMPLE: Assume that Company X wishes to raise $1 million to purchase a building. Company X could borrow $1 million from a third-party bank. As the company makes payments on the bank loan, the interest paid on the loan would be tax-deductible as a business expense, but there would be no tax deduction available for principal payments. Assume instead that Company X obtains the bank loan and then sells newly issued shares of its stock to the ESOP having a value of $1 million. The ESOP finances the purchase by obtaining an acquisition loan from Company X with the same terms as the bank loan. Each year, Company X makes a tax-deductible contribution to the ESOP in the amount necessary for the ESOP to make its payment on the acquisition loan to the company. The ESOP uses the contribution to pay Company X on the acquisition loan, and Company X uses the same funds to make payments on the bank loan. Because the funds originally were a tax-deductible contribution to the ESOP, both principal and interest payments are generally now tax-deductible.

A company may also acquire another company using an ESOP in order to permit the owners of the target company to qualify for tax-deferred sale treatment. This practice would allow the company to pay a reduced price for the target company.

S Corporation Tax Benefit

Stock of an S corporation may be held by certain tax-exempt organizations and qualified employee trusts (including an ESOP). However, the IRC subjects such tax-exempt organizations and employee trusts to the tax on "unrelated business income" with respect to S corporation income. Then again, ESOPs are exempt from the "unrelated business income" tax to the extent that income is from "employer securities." The result is that an ESOP will not be subject to tax on its share of the S corporation's taxable income.

Employee Ownership Culture

Studies have shown that companies with employee equity ownership perform better than companies who do not. An ESOP permits a company to provide beneficial ownership of its stock to company employees. The ESOP structure gives employees a meaningful stake in the company, and therefore provides a motivation for employees to act more responsibly and to increase productivity. This "ownership mentality" should foster a positive and success-oriented work environment.

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