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Tax Policy, Market Timing and Readiness to Sell Are Leading Construction Company Shareholders to ESOPs

By Patrice Radogna | Tuesday, September 28, 2021
Construction Careers , HR , Succession Planning

The ESOP group at Marcum is seeing a marked increase in the number of inquiries from construction company shareholders, regarding employee stock ownership plans as an exit strategy. A trifecta of conditions is driving such interest in the construction community, including:

1. 2021 U.S. Tax Policy Outlook;
2. Market conditions; and
3. Readiness to sell.

2021 U.S. TAX POLICY OUTLOOK

The Biden-Harris administration has publicized its goal to raise $3 trillion in tax revenue over the next decade. This revenue is expected to fund, among other initiatives, the INVEST in America Act, which includes new spending on highways, bridges, waterways, transit, airports, the electric grid and broadband. To pay for these investments in America's infrastructure, President Joe Biden is proposing a tax overhaul (with significant increases in corporate tax for domestic and multi-national businesses), dubbed the "Made in America Tax Plan."

MAJOR BUSINESS TAX CHANGES

- Increase the corporate income tax rate from 21% to 28% (which is now part of the recently released Made In America Tax Plan, addressed above);
- Create a corporate minimum tax on book income for corporations with profits of $100 million or more;
- Increase the tax rate on global intangible low-tax income (GILTI) from 10.5% to 21%; and
- Offer tax credits to small business for adopting workplace retirement savings plans.

MAJOR INDIVIDUAL AND PAYROLL TAX CHANGES

- Restore the pre-Tax Cuts and Jobs Act top individual income tax rate of 39.6% for those with income over $400,000;
- Increase the tax rate on long-term capital gains and qualified dividends from 20.0% to 39.6% for individuals earning over $1 million;
- Eliminate the step-up in basis for unrealized capital gains at death (beyond an exemption amount of $1,000,000 in capital gains) for heirs;
- Phase out the qualified business income deduction under IRC Section 199A for filers with taxable income over $400,000; and
- Impose a new 12.4% social security tax on wages above $400,000 shared equally between the employee and employer.

HOW DOES THE TAX PROPOSAL IMPACT ESOPS AS AN ALTERNATIVE TO TRADITIONAL M&A?

1. **Deferral/elimination of the capital gains tax**
   This has always been a strong influencer in the decision by a selling shareholder to sell their company to an ESOP. In a C-corporation, a selling shareholder can elect to defer or potentially eliminate the capital gains tax in a qualified ESOP transaction. This is accomplished by making a Section1042 election for the sale of their equity to the ESOP. With capital gains tax rates possibly reaching 39.6%, the avoidance (or deferral) of the capital gains tax is a substantial tax benefit and warrants careful consideration by any shareholder looking to monetize and sell all or even a portion of their stake in their company.

   Note that the avoidance of the capital gains tax under Section 1042 assumes that the Biden tax plan is not successful in legislating the elimination of the step-up in cost basis at death (for property transferred to heirs), as the step-up in basis is key in eliminating capital gains.

2. **Minimization or avoidance of corporate income taxes**
   If a company remains a C-corporation, there are significant deductions available to the corporation that will mitigate taxes for the ESOP. If the company is organized as or elects S-corporation status, the company can minimize taxes, or in many cases, altogether eliminate corporate income taxes. (The elimination of all federal and most state income taxes is possible for an S-corporation, as the ESOP Trust is a tax-exempt entity. Thus, income passes through to the shareholder and there are no taxes for a 100% S-corporation. Though there would still be taxes for any other shareholder, if the ESOP is not the 100% shareholder of the company.) With a proposal to increase the corporate income tax rate from 21% to 28% (thus reversing the increased economic wealth experienced by business owners since the income tax rate was lowered to 21% in the prior administration), many business owners are looking to be proactive at finding ways to minimize/eliminate taxes.

The above potential tax changes are significant factors in determining whether to sell to an ESOP. The potential changes in tax policies (including increased individual capital gains tax rates as well as increased corporate income taxes) increase the value of an ESOP to a selling shareholder. A recent article in *The New York Times* quoted a wealth advisor who stated, "ESOPs may become more popular next year [2021] if the Democrats hit the trifecta and raise the capital gain rates to 39%."

MARKET CONDITIONS

The pandemic-induced recession was particularly harsh in 2020, but surprisingly short; many top economists have stated it was the shortest recession in U.S. history. The pandemic caused a halt in M&A activity beginning in March 2020, as uncertainty in the economy loomed for sellers and lenders. In spite of the continuing uncertainty caused by the pandemic, the economy regained momentum, and companies were forced to find innovative ways of operating (starting in late summer 2020), while important trends started to emerge. Capital markets were eager to lend to qualified candidates. And, importantly, owners of privately held businesses who had halted consideration of selling in early 2020 began expressing interest in ESOPs as potential buyers.

ESOPs provide a tax-advantaged exit to selling shareholders and have shown greater resilience to market disruption due to their tax-advantaged structure and the inherent alignment, in an ESOP, among the interests of employees, the company and the seller(s).

EMOTIONAL READINESS TO SELL

Amid the COVID-19 pandemic roller coaster, the adjustment of operations, the reopening of the economy and the recovery of many companies in the construction industry, a few items that have surfaced as motivators in the consideration to sell (and particularly to consider an ESOP), including the following.

- Succession planning, a planning area that is often tabled, has risen on the list of priorities by construction business owners. There is realization that an exit on "their terms" versus an event triggering a forced exit is optimal and requires focused consideration.
- Reflecting on the business roller coaster and personal experiences forced by the pandemic, many owners are finally seeing the light at the end of the tunnel. Business owners experienced significant stress and teetering emotions. As market conditions and the general construction market have started to bounce back, business owners have a renewed optimism that they could actually now exit at a strong multiple.

What do the statistics tell us about current M&A activity through quarter 3, 2021? They show that the total number of M&A deals that have closed is up 29% compared to last

year, and the valuation multiples are markedly stronger (average valuation multiples based on earnings are up approximately 28% through August 2021 versus multiples in the similar time period in 2020), according to S&P Global's S&P Capital IQ Platform. While it is premature to know how many companies are choosing ESOPs versus other alternatives, the looming tax change coupled with strong valuation multiples is creating a compelling case for business owners to consider selling to an ESOP.

The anecdotal evidence seen by Marcum's ESOP Group reveals that business owners are prioritizing the following items in considering the sale of their construction companies:

1. The negative impact of a potential tax increase, in the individual capital gains tax rate and in corporate income taxes;
2. The positive impact of attracting/retaining employees (an extreme challenge in the construction industry) and rewarding long-time employees by providing continued employment and an enhanced retirement benefit, post-sale of their company; and
3. The desire of shareholders to sell what is oftentimes the largest, yet most illiquid, asset in their portfolio (their stake in their company). By using an ESOP, owners have flexibility in structuring the exit that best fits their needs and their timing.

This anecdotal evidence and the number of closed and pending transactions, as of September, for sales of construction companies to ESOPs is compelling. The fourth quarter 2021 and at least several years in the foreseeable future could be the time of the "ESOP Trifecta," given that many of the above-discussed factors are here to stay.

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