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Build Your Future: Business Succession Planning Guide for Construction Firms

Business succession planning is a topic that continues to gain prominence as business owners seek ways to transition their ownership. Closely-held, owner-managed companies face the biggest challenge when it comes to a successful transition. It is estimated that only 30% of construction companies survive after the founder dies, and that number drops to 20% through the third generation.

At some point, every business reaches a critical point. Most owners will start asking:

- **How do I monetize and diversify the value of my largest investment, my business, that I have built over years through hard work and sacrifice?**
- **How do I successfully transition this company?**
- **What are the tax considerations I need to think about? What are my options?**

This guide provides an overview of the various alternatives that construction businesses can consider as transition becomes a key factor to their survival.

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Contributing Authors: Peter Hilera, CPA, Partner, philera@withum.com, Emily Egkan, CPA, eegkan@withum.com, Torrey Hill, CPA, thill@withum.com, Ryan Paluso, CPA, rpaluso@withum.com

Withum's Construction Services Team

Peter Hilera, CPA, Partner
Tax Team Leader
Construction Services
philera@withum.com

Louis Sandor, III, CPA, CCIFP®, Partner
Practice Leader
Construction Services
lsandor@withum.com

Succession Planning Overview

> **The process of succession planning can be intimidating and confusing, and it often leads to frustration. Having a clear vision of what succession planning encompasses will allow owners to take a step-by-step approach to reach the goals of the founder, the business, and the current management team.**

The key components of succession planning are:

- Establishing how the business continues to operate with current owners and management while control is relinquished over time to the next generation.
- Providing an exit strategy for the owners that includes the adequate financial resources for their retirement.
- Understanding the tax implications of the transition.
- Allowing the owners to leave a legacy where they still have input into the future direction of the business.

Options in Transition Planning

Business owners have a number of options for successful transition planning, including:

ESOP - EMPLOYEE STOCK OWNERSHIP PLAN
COMPANY SALE
PRIVATE EQUITY
TRANSITION TO A FAMILY MEMBER

Let's dive into the details and logistics of each, along with a high-level discussion of the tax considerations that apply.

ESOP (Employee Stock Ownership Plan)

An ESOP is a qualified defined contribution plan that can be used to facilitate a transition of Company ownership while also providing substantial tax savings to the company. However, ESOPs are limited to S corporations and C corporations; partnerships cannot establish an ESOP.

S CORPORATIONS – Typically the retiring shareholder will sell his/her stock in the S corporation to an ESOP in exchange for a note from the ESOP, and the shareholder recognizes capital gain on the sale. The S corporation will issue a K-1 to the ESOP each year based on the shares owned by the ESOP; however, there is no need to make tax distributions to the ESOP because it is a tax-exempt qualified plan. This tax savings allows for the payment of the principal and interest on the note and provides greater cash flow to the S corporation. If the S corporation is wholly owned by the ESOP, the tax savings can be significant.

C CORPORATIONS – Similar to an ESOP with an S corporation, the sale of shares to an ESOP will generate capital gain to the selling shareholder. Assuming the shareholder has a long-term holding period in the stock, the gain will be subject to a maximum tax rate of 20%, plus the 3.8% net investment income tax (NIIT), regardless of whether the shareholder is active in the business.

One powerful tax savings opportunity that arises in the case of a C corporation is the deferral of tax on the selling shareholder's capital gain. Under section 1042 of the Internal Revenue Code, the selling shareholder can defer the entire gain recognized at the time of sale. In general, the following requirements must apply in order to qualify for the deferral:

- **The stock must be issued by a domestic C corporation.**
- **The stock must be common stock (or its equivalent).**
- **The seller must have held the stock for at least three years before selling to the ESOP.**
- **The seller must sell at least 30% of the company's equity to the ESOP.**

- The seller must purchase qualified replacement property within a 15-month period that starts three months before the closing date and ends 12 months after the closing date.
- Selling shareholders, and their immediate family, have certain restrictions in participating in the ESOP plan.
- A timely election under IRS Code Section 1042 must be made.

An ESOP is a powerful business succession planning tool that allows the owners to monetize their investment However, to be successful this tool requires very careful analysis of both the tax and non-tax issues:

- In an ESOP the company is essentially 'sold' to the employees. The employees will be the participants in the qualified tax-exempt plan via employee ownership. The company will need to make sure that there is a strong enough management team that will allow the company to continue to be successful in the future. An ESOP will also work best when all employees think of themselves as owners by caring about the efficiency, profitability, and viability of the company.
- Establishing and maintaining an ESOP involves increased cost to the company, both in establishing the ESOP and in annual compliance costs.
- Bonding/Banks – The ability for a construction company to bond is important. To obtain proper bonding, a construction company will generally need to keep a certain amount of equity in the business. In a leveraged ESOP transaction, given the level of debt added to the balance sheet and strains on cash flow, company value and equity is negatively affected. Including the bonding company and the banks in the planning process will help to make sure the company can successfully operate after the ESOP transaction.
- Clearly understanding the structure (which can be complex) and the related accounting processes that will be required to record and account for the ESOP.

Company Sale

The lack of succession planning may leave owners with no option to monetize their investment other than through a sale of company assets or equity to an outside party. This may not fit into an owner's aspirations to leave a legacy because this path often leads to a complete overhaul of company operations, marketing, and philosophy. However, with a ready and available market, selling the company can be the most lucrative and immediate conversion to the desired payout.

Should the owner sell the company's equity or assets? Sellers typically desire a stock sale because it is the easiest and most efficient way to sell the assets and liabilities of the business and typically results in the most favorable tax consequences. Purchasers typically prefer to acquire assets for two reasons: (i) to avoid the assumption of any unknown liabilities (skeletons in the closet) and (ii) to acquire a cost (i.e., fair market value) basis in the assets that can immediately be deducted through depreciation and amortization deductions, including goodwill which is amortized over 15 years. This allows the buyer to recoup the investment much faster than the purchase of stock in a C corporation.

What are the tax implications of the structure of the existing entity if sold? Here is a summary of the tax implications per entity type (S corporation, C corporation, or partnership). For a more detailed analysis, please reach out to your Withum's Construction Services Team.

S CORPORATION – A sale of stock is most beneficial for the seller because the gain is taxed as a capital gain. The sale of assets also leads to capital gain treatment with two important exceptions: (i) cash basis sellers recognize ordinary income on the portion of the sales price allocated to zero tax basis accounts receivables and (ii) ordinary income is recognized to the extent depreciation was previously taken on the assets being sold. In addition, if the buyer prefers to acquire stock due to the seller's non-assignable contracts, and such contracts are an important component of the company value, the buyer may prefer or even require an election under section 338(h)(10). This election allows the stock sale to be treated as an asset sale for tax purposes, while maintaining the stock sale treatment for legal purposes.

C CORPORATION – Sellers of a C corporation rarely sell the assets of the business due to the fact that double taxation applies – tax at the corporate level and then a second level of tax at the shareholder level. This can lead to effective tax rates in excess of 50%. As a result, sellers of a C corporation almost universally sell stock and recognize capital gain on the sale, and long-term capital gain if the stock was held for more than one year. If there is sufficient time before a potential sale or if planning is being done with an eye towards the future, one tax planning strategy is to convert the entity to an S corporation and wait out the 5-year period where tax is imposed on certain built-in gains (often referred to as the BIG tax). After the 5-year period, only one level of tax applies. Of course, there are many factors that need to be considered in a C to S conversion, but the strategy can be very powerful if used properly.

PARTNERSHIP – The rules under Subchapter K are some of the most complicated rules in the Internal Revenue Code. In general, the sale of a partnership interest generates capital gain for the seller, subject to ordinary income treatment for certain hot assets, and allows the buyer to step-up the basis of the assets inside the partnership. Given the multitude of traps for the unwary under partnership tax accounting, careful analysis, consideration, and modeling needs to occur for the seller to understand the full scope of tax implications of a sale.

Earnouts? Often times an earnout is negotiated as part of the sales price and with that the entire sales price will not be paid at closing; rather, a portion of the sales price will be paid later via an earnout provision. An earnout provides the seller with the potential for additional payments in the future if certain financial goals are met. Since the payment is based on future company performance, the earnout generally is considered a contingent payment.

In general, an asset or stock sale that includes an earnout provision is reported as an installment sale, and gain relating to the installment payments can be deferred. If the seller elects out of installment sale treatment, then tax is paid not only on the cash received at closing, but also on the fair market value of the expected additional cash that will be received via the earnout.

When an earnout applies there are several possible outcomes on how the earnout is calculated and how it is taxed. In some cases, the maximum sales price includes the expected amount of the earnout. In this situation, if the calculated sales price in the year of sale is later recalculated and changed, the installment gain will need to be updated. This can adversely affect the seller by having the unrecovered portion treated as a worthless receivable that has to be written off as a non-business bad debt deduction.

Another situation may arise when there is no maximum sales price and no fixed payment period. In this scenario, what was really sold? Was there a sale of the business, or does the transaction represent the sale of another asset, such as royalties, rentals, or if the seller will be active in the business after the sale, will the payment be characterized as some type of compensation.

If an earnout is part of the transaction, careful consideration must be given to the details of the earnout to clearly determine the tax impact to the seller.

Private Equity

An increasingly popular option among business owners is to sell a portion of their business to a Private Equity Group (PEG). This option allows owners to diversify their holdings and often provides them "another bite at the apple" by having the owners retain a remaining equity interest in the business and participate in the growth of the company. It is common for owners to retain from 5% to 25% of their current ownership depending on the agreement between the owners and the PEG. We will outline several benefits of selling to a PEG.

CAPITAL

PEGs usually have significant financial resources to contribute. Capital infusions can be used to grow and develop the business as well as investing in new technologies or fixed assets. If a business needs a cash influx, a PEG may be the answer.

EXPERTISE AND KNOWLEDGE

PEGs typically have industry knowledge and expertise. They work closely with management to develop strategies and support to accomplish business goals. They have access to talent, technology, research and development, and distribution networks that can boost growth and effectiveness.

EFFICIENCY

PEGs can help streamline processes and procedures. Its goal is to improve operations and efficiency. This may include centralizing certain aspects of the business, such as accounting and payroll. This can be beneficial to owners as they can focus more on growth and development of the business.

VALUE CREATION

Often times, PEGs buy companies with the plan to sell them in the future for a profit. The aim is to increase the value through the means discussed above. As business owners maintain an ownership in the business, their value increases as well. Business owners that sell to a PEG receive capital from the initial sale, but they also get to participate in a potential second transition as well.

From a tax perspective, the PEG will purchase the interest and seek to structure the transaction in a way that generates tax deductions for the purchase price. In general, this means that PEGs prefer asset acquisitions or stock acquisitions with section 338(h)(10) elections, as discussed above. A careful analysis will be required to understand the current structure and the resulting tax structure after the PEG investment along with the associated tax implication. Possible structures to consider are:

- The selling company is an S corporation. In this case the PEG will likely require the seller to restructure the company using a tax-free "F" reorganization. Under this strategy, the seller contributes his/her stock to a new holding company and then makes the subsidiary S corporation a disregarded entity, which later can be converted to an LLC. The PEG then acquires an interest in the LLC. From a tax perspective this will be treated as an asset sale.
- If the current selling entity is a partnership, the PEG's investment will be structured in a simpler manner if the only requirement is to purchase a percentage of the current owner's partnership interest.

However, keep in mind that, like most entrepreneurs, owners of construction companies are fiercely independent. They are used to making their own decisions and taking risks. Once a PEG invests in your company, the owner now has a business partner that is highly involved in the operations of the business and generally is more risk averse.

Transition to a Family Member

Transitioning a business to a family member, or members, is a common way small business owners plan for retirement. This method can be relatively simple, straightforward, and transaction fees are minimized. On the other hand, transitioning a business to a family member has its own unique set of challenges.

When dealing with these types of transactions, family dynamics play a key role in a smooth transition. Before contemplating whether to structure a family transition, there are important factors that may have an impact on the decision making. It is important to consider questions like: Do all family members participate in the business? Is the family member competent and qualified?

How do the succeeding family members interact with key employees? Does the succeeding member want to continue the company long-term? Depending on the answers to these questions, transitioning a business to a family member might be the perfect way to retire.

Key employees are often critical to the success of the business, and when the owner transitions the business to the next generation of family members, issues can arise if not handled properly. There are ways to successfully transfer the ownership of the business to family, while incentivizing key, long-time employees to continue performing. If offering a minority ownership interest to the employees is not desired, this could be an opportunity for the owners to build into the deal options like a phantom stock or deferred compensation plan to keep key employees happy and content. It might be wise to have key employees' part of the decision making, depending on how seasoned the succeeding family member is in the business. In addition, the transition of job duties and responsibilities should take place over an extended period, so that it is not a surprise to the employees when retirement day comes and allows the new owner to be set up for success.

There are several options for structuring a family succession transaction:

SALE TO FAMILY MEMBERS THAT WILL CONTINUE TO OPERATE THE BUSINESS.
This involves selling equity in the business, and this can happen gradually over time, or all at once.
There needs to be a proper valuation for multiple reasons. This will help family members and other owners agree to a fair price. Also, if the sale price is challenged, the valuation is support that can be provided to the IRS.
With family sales, it is common to see a discount on the company price. This may be due to lack of control or marketability. This will also help keep the cost lower to the buyer and increase the likelihood the seller will get paid the full amount because it will be more affordable to the buyer. However, the IRS does closely scrutinize the use of valuation discounts, so this is something to consider.
Generally, the sale is financed with a note between the seller and the buyer. The company provides the liquidity via bonuses or distributions to satisfy the note between the purchasers and sellers. If the company is a flow-through entity and has sufficient basis, distributions are used to maximize the section 199A qualified business income deduction.
The transaction can be structured as an installment sale so the seller's tax is recognized as proceeds are received. The seller can also "elect out" of the installment method and recognize all the gain up front, which might be an option for taxpayers who have large capital losses in the year of sale, or if they are concerned about increasing tax rates in the future.
The seller does not need to pay the 3.8% net investment income tax on the gain because there is a special rule excluding sales of partnership interests and stock in S corporations are attributable to non-passive activities that the taxpayer materially participates in.

GIFT OF OWNERSHIP
Like structuring a sale, a proper valuation will need to be done if the owner decides to gift the company to family member(s).
It can be structured so that the gift is to a generational trust that benefits the children and grandchildren.
Gifting is a good option when the owner has a large estate and needs to maximize the lifetime gifting exclusion to reduce estate taxes. The 2024 lifetime gifting exclusion is $13.61 million per person. Gifting will also transfer future appreciation of the business out of the owner's estate.
Gifting is a good option only if the owner has enough liquid assets and other streams of revenue to live comfortably, whereas they do not need to sell their business to fund their lifestyle.
Issues can arise when there are siblings that do not participate in the business. Gifting can feel unfair to siblings who do not participate in the business if the business is gifted to some, but not all family member(s). The gifting can be structured in ways to help the family members maintain fairness by allowing for greater ownership for the siblings that participate in the business and lower ownership for those that do not. Also, perhaps the siblings who do not participate in the business can have a greater share in other family assets outside of the business.

PARTIAL SALE AND GIFT
There can be a combination of both a gift and sale of the business.
Owners may want to maximize the lifetime gifting exemption and hold onto the remaining stock to sell to a family member or a third party.
Another option is to do multiple gifts and/or sales over time, however there will need to be valuations of the business each time there is a transaction.

It is important to note that gifted stock or partnership interests have a carryover tax basis, meaning the tax basis in the hands of the family member is the same as it was for the original owner. Therefore, when the person eventually sells the interest or stock, they will most likely have a substantial capital gain. On the other hand, if the owner dies while still owning the stock/interest, the asset will receive a step-up in basis. This might be useful for gifting part of the stock/interest to get the asset out of the estate, and the remaining shares stay in the trust for a step up in value.

We hope that this summary of the key concepts associated with succession planning has helped you understand the basic considerations. Each option presented has its own set of tax rules and challenges along with logistical and planning considerations. A careful analysis of all the options will allow a business to consider which option is better suited for their needs and provide for a successful transition to future generations of business owners.

For more information on this topic, a more detailed analysis pertinent to your business or a tailored business succession plan for your construction firm, please contact Withum's Construction Services Team.