Why ESOPs are Becoming More Popular Among Architecture and Engineering Firms

Every year, the National Center for Employee Ownership (NCEO) [publishes a list of the nation's 100 largest employee-owned companies](#).* In 2024, architecture and engineering (A&E) firms accounted for 24 of these companies making these sectors some of the most prominent on the list.

Of the A&E firms on the list, 100% utilize an employee stock ownership plan (ESOP) rather than other employee ownership options, such as worker cooperatives, to achieve broad employee ownership. An ESOP is a unique ownership transition tool that allocates a firm's stock to employees over time, capturing value attributable to future growth, motivating employees, and empowering them to think like owners.

ESOPs are qualified retirement plans, regulated under the Employee Retirement Income Security Act of 1974 (ERISA), that allocate shares to employees over time, typically as a percentage of total compensation. Using an ESOP as a succession planning strategy can help clearly define a firm's ethos, especially for A&E firms that thrive on reputation, legacy, and employee morale.

*The Employee Ownership 100 published by the National Center for Employee Ownership (NCEO) highlights the largest broad-based employee-owned companies in the United States. To qualify for this list, companies must be at least 50% employee-owned.

Maintaining Reputation and Culture

A&E firms are typically founded by a few practitioners who build a reputation that is tied directly to the founders' names and core principles. As founding shareholders approach retirement, maintaining their longstanding reputation in the community becomes one of their primary goals. A founder's legacy may be at risk with a typical outside sale. For example, a financial buyer will be driven to achieve a certain return and, therefore, may look to reduce overhead and other fringe benefits, and a strategic buyer may bring in an entirely different culture, to the detriment of current employees. ESOPs can create a flexible path for shareholders to transition ownership at fair market value while preserving the legacy and culture of the businesss.

Employee Retention

A&E professionals are highly sought after, with many A&E firms facing the ongoing challenge of qualified talent shortages. In fact, according to a report from BCG and SAE International, every year, the U.S. needs about 400,000 new engineers to meet demand — but a third of those roles may go unfilled, a trend that could continue through 2030. This demand leads to competing firms poaching top talent by offering higher salaries and/or better benefits.

An ESOP is an effective tool to both attract and retain talent that provides year-over-year value to professionals, especially those with the longest tenure. An employee that is an ESOP participant would need to consider the "switching cost" or opportunity cost before moving to another firm. From a recruitment perspective, an ESOP may make attracting young and qualified professionals easier by enticing them with an immediate opportunity to build equity in the business, and could be a key differentiator, not only because of the financial benefits but also due to the culture of the business.

There have been cases where established A&E firms have a group of key managers that are ready to become owners but do not have the financial resources to buy out the current shareholders. This creates a dilemma for A&E firms that would like to retain their most senior and key employees that are seeking ownership but do not have a mechanism to provide meaningful ownership in the firm. An ESOP can be an attractive option for these firms.

Tax Benefits

ESOPs can provide a range of tax benefits to the sellers and the firm, including potential deferral of capital gains for the seller on the **sale of the business**, a reduction or elimination of the income tax burden to the firm, deductibility of ESOP contributions, and an opportunity for tax-deferred growth on the retirement benefit to employees.

If the firm transacts as a C corporation, Section 1042 of the Internal Revenue Code provides that the sellers may be able to indefinitely defer paying tax on capital gains derived from the sale. When the seller passes away, the estate receives a step-up in basis, making the deferral permanent. If following the sale, the ESOP-owned firm is an S corporation, all income attributable to the ESOP shares is passed through to an income tax-exempt qualified retirement plan, making that income exempt from federal income taxes and most state income taxes. This creates a cash flow advantage for the firm, with the extra cash available to be used to pay off debt created by the leveraged ESOP sooner and grow the business in a more efficient and effective manner.

In the case of a legacy C corporation transaction where a seller elects Section 1042 treatment, in some circumstances, the firm can immediately convert to an S corporation following the transaction, enabling both capital gains tax deferral for the seller and an income tax exemption for the firm. If the firm chooses to convert from an S corporation to a C corporation for the transaction, the firm must remain a C corporation for five taxable years. Thereafter, the firm can make an “S” election and benefit from an income tax exemption. As an employee-owned C corporation, the firm realizes a tax benefit through the deductibility of ESOP contributions and optional dividends to the ESOP. Finally, since the ESOP is a qualified retirement plan, much like a 401(k) plan, participants benefit from tax-deferred growth, paying ordinary income tax when distributed from the plan, usually when the employee retires. There are clear tax advantages for all parties in an ESOP transaction, making the ESOP structure a win-win scenario for all.

ESOP Issues Unique to A&E Firms

The A&E professions are highly regulated, demanding a proactive approach to compliance and posing significant challenges with respect to the sale of stock in an A&E corporation. Each state has unique requirements and restrictions on corporate structure, ownership, nomenclature, and supervisory functions. These requirements can vary by type of license—architecture, landscape architecture, engineering, surveyor, geologist, etc. Any transaction will directly affect corporate structure and ownership. In most cases, entity type will not prevent an A&E firm from doing business, but it is important to confirm that the transaction structure follows the relevant rules in each state.

Here are several examples of differences in state licensing and ownership rules:

ARIZONA

The voting shares of a professional corporation may be held only by licensed individuals, certain partnerships, other persons if total ownership of other persons does not exceed 49%, and ESOPs. In the case of an ESOP, all voting trustees of the plan are required to be licensed in Arizona and the ownership interest must be directly owned by the employee stock ownership trust or licensed professionals.

IOWA

There are no specific ownership restrictions for architecture or engineering firms, but professional services are limited to firms that regularly employ one or more licensed professionals who directly control and service any professional work.

NORTH CAROLINA

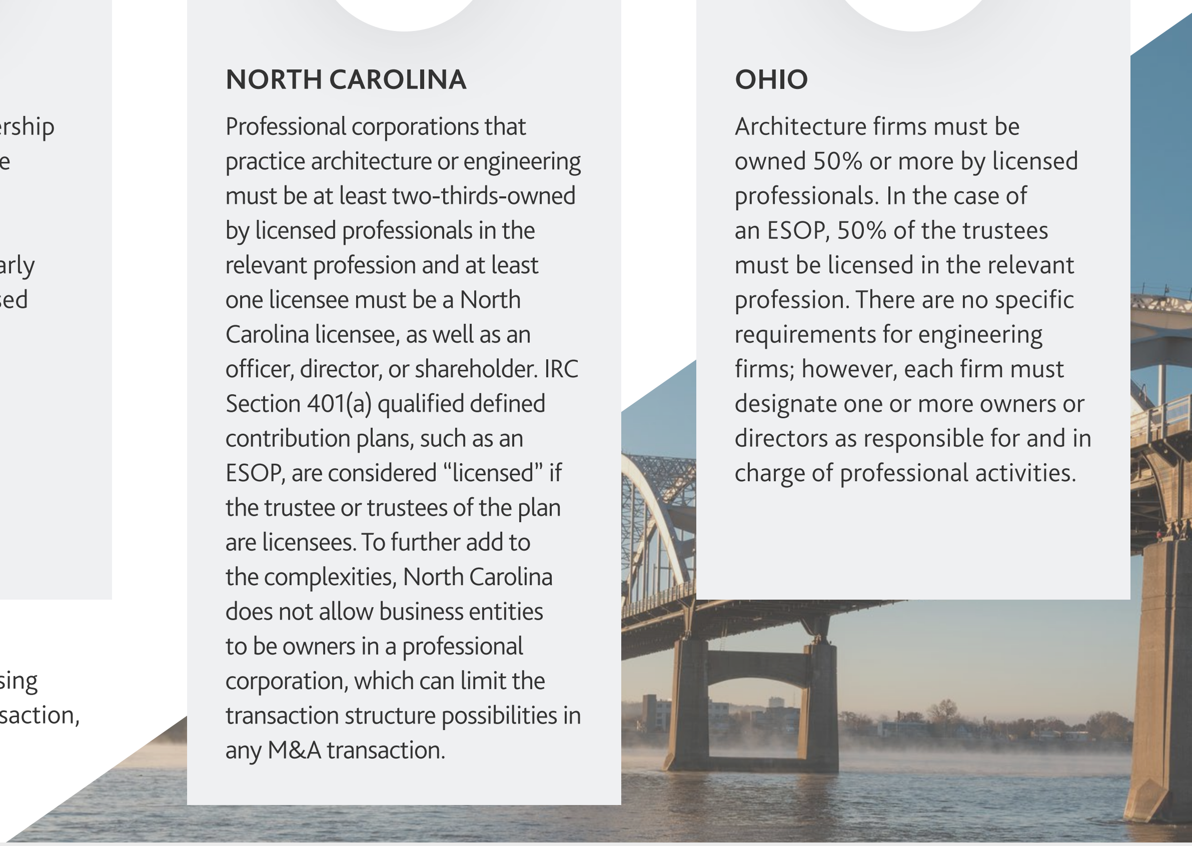
Professional corporations that practice architecture or engineering must be at least two-thirds-owned by licensed professionals in the relevant profession and at least one licensee must be a North Carolina licensee, as well as an officer, director, or shareholder. IRC Section 401(a) qualified defined contribution plans, such as an ESOP, are considered "licensed" if the trustee or trustees of the plan are licensees. To further add to the complexities, North Carolina does not allow business entities to be owners in a professional corporation, which can limit the transaction structure possibilities in any M&A transaction.

OHIO

Architecture firms must be owned 50% or more by licensed professionals. In the case of an ESOP, 50% of the trustees must be licensed in the relevant profession. There are no specific requirements for engineering firms; however, each firm must designate one or more owners or directors as responsible for and in charge of professional activities.

These examples clearly illustrate that understanding and navigating state licensing and ownership requirements is challenging and requires experience. In any transaction, extensive state-by-state due diligence should be performed.

With respect to an ESOP transaction, close attention should be paid to ownership restrictions in each state in which the firm does business or plans to conduct business. In an ESOP structure, a trust becomes the direct owner of the shares, while the employees are considered beneficial owners once vested. When applying ownership rules, states may look at the trustee(s) of the ESOP, the beneficial ownership of the participants, or neither.



Case Study: Navigating State Specific ESOP Challenges

A civil engineering firm decided to pursue an ESOP using BDO Capital's ESOP Advisory Services team as their exclusive financial advisor to the transaction. The firm was founded over 60 years ago, is headquartered in the mid-Atlantic, and offers a variety of engineering services to a diverse group of markets in the public and private sectors. At the time of the transaction, the firm conducted business in seven states, including North Carolina, and had plans to expand into four additional states in the immediate future. While most of these 11 states did not present any challenges to the ESOP structure, North Carolina's ownership restrictions created a significant transaction hurdle. As described above, North Carolina requires that at least two-thirds of the owners be licensed professionals. A look through to the trustee(s) or participants is not acceptable.

The firm then assessed the North Carolina ownership requirement. Engineering firms doing business in North Carolina as corporations or limited liability corporations that were permitted by law to practice engineering before June 5, 1969, may be exempt from the ownership requirement. These "pre-1969" entities must apply to the North Carolina Board of Examiners for Engineers and Surveyors for the exemption. However, architecture firms must have applied for this exemption from the North Carolina Board of Architects before October 1, 1979.

Having advised on the structuring of several ESOP transactions for A&E firms across the country, BDO was able to guide the owners through key financial and operational considerations, including coordinating with legal counsel where appropriate. BDO successfully facilitated the firm's transition to a 100% employee-owned company, allowing it to realize many of the benefits outlined above.

How BDO Can Help Your A&E Firm

If your organization is eager to drive growth and boost employee recruitment, retention, and engagement, BDO Capital's team of **ESOP Advisory professionals** will work closely with your business's accounting and legal teams to help meet your unique ESOP needs. Whether you are ready to start planning your transition or want to determine if an ESOP is right for your A&E organization and its employees, BDO can offer support.

What makes a company a good candidate for an ESOP? Explore common characteristics for structuring a successful ESOP in **our insight**.

Is An ESOP the Right Fit for Your Company?

A complimentary BDO ESOP Review can help determine how an ESOP may suit your exit and liquidity objectives.

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