State Programs to Promote Employee Ownership

National Center for Employee Ownership

Over half of all closely held companies are owned by baby boomers. The National Center for Employee Ownership estimates that about 150,000 businesses in the U.S. owned by these baby boomers are potential candidates for ESOPs. Yet few of these will ever even consider an ESOP, instead selling to another company or a private equity firm (both of whom may reduce employment as they create “synergies) or just liquidating over time by redeeming their shares. ESOPs in these companies could preserve company legacy and jobs, add new wealth to employees to spend in their communities, and generate more new jobs over time (ESOP companies grow about 2.5% per year faster than non-ESOP companies).

States today spend tens of billions of dollars in tax incentives to get companies to relocate or not leave, often at a cost of tens of thousands of dollars per jobs retained(at least in that state), but generating no more new net jobs and generating no new capita ownership for the people in these communities. For an immensely smaller amount of $150,000 to $500,000 per state per year, states or local non-profits at a state or regional level could set up highly effective outreach programs to inform and assist business owners with employee ownership. At a time when discussions on income and wealth inequality have permeated political discussion on both sides of the aisle, employee ownership is a bipartisan approach that can address these issues in an exceptionally cost-effective manner.

These local level programs provide outreach and initial assistance programs to bring the idea of employee ownership to companies that otherwise would not know about it. Because substantial tax and planning benefits already exist for ESOPs, additional incentives are not needed—just knowledge. Locally based outreach programs can draw upon existing networks of experts and infrastructures, such as colleges, universities, and successful ESOP companies themselves, with vast knowledge of how these plans work best. For example, the longest-standing existing state program, the Ohio Employee Ownership Center (OEOC) housed at Kent State University, provides outreach, technical assistance, and information for Ohio businesses. Since its founding in 1987, they have assisted employees in buying all or part of 92 companies, creating 15,000 employee owners. Their performance data shows that it costs roughly $800 per job created or saved.

Employee ownership can help state economies become stronger and more equitable in several ways:

- Employee ownership creates jobs, strengthens communities, and expands state economic growth. Encouraging broader use of employee ownership through Employee Stock Ownership Plans (ESOPs) is a highly cost-effective way to retain and create jobs, increase wealth for a broad sector of workers, and keep businesses in their communities. Notably, ESOPs have also been shown to significantly improve asset accumulation for workers in distressed communities.

- Congress designed ESOPs to encourage owners of private companies to transfer ownership to employees. They require *no funding* from employees, and yet they allow companies to remain locally-owned while giving employees a direct and meaningful stake in the performance of the business.

    - Business owners are assured their legacy will live on and employees are rewarded for preserving that legacy. It is a remarkable model translating tax law into real-world results.

- Research shows privately held ESOPs have measurable positive effects on company performance, growth, and jobs.

    - ESOP companies generate 2.5% more new jobs per year than these same companies would have generated if they did not have an ESOP.[i]
    - According to the General Social Survey, employee-owners are one-third to one-fifth less likely to be laid off compared to non-employee owners.[ii]
    - Employees accumulate 2.5 times the retirement assets as employees in other plans.
    - ESOPs participants are paid more and have greater access to benefits at work than those not in ESOPs.[iii]
    - Employee in ESOPs make a difference in distressed communities Privately held ESOPs in the most distressed zip codes communities hold $9.4 billion in plan assets, including $7.4 billion in employer stock. This equates to an average of approximately $61,000 in retirement plan assets for each plan participant

- Growing numbers of business owners will retire and consider exit strategies in coming years. ESOPs provide an attractive way to handle transition, but few business owners know much, if anything, about them. States can realize the potential of employee ownership by initiating programs to educate business owners about how to use ESOPs for business transition.

There are currently about 7,000 ESOPs in the U.S., employing almost 11 million people and holding $1.3 trillion in assets. Although a major part of the economy, ESOPs could be a much larger player if more people knew about them.

WHAT IS AN ESOP?

An ESOP is a kind of employee benefit plan, similar in some ways to a profit-sharing plan. In an ESOP, a company sets up a trust fund into which it contributes new shares of its own stock or cash to buy existing shares. Alternatively, the ESOP can borrow money to buy new or existing shares, with the company making cash contributions to the plan to enable it to repay the loan. Regardless of how the plan acquires stock, company contributions to the trust are tax-deductible, within certain limits. Most ESOPs are used for business transition, but some are used simply as an added employee benefit.

Shares in the trust are allocated to individual employee accounts. Generally, all full-time employees are included after a year of service. When employees leave the company, they receive their stock, which the company must buy back from them at its fair market value (unless there is a public market for the shares). Private companies must have an annual outside valuation to determine the price of their shares.

ESOPs have significant tax benefits:

1. Contributions of stock, cash to buy stock, or cash to repay an ESOP loan are tax-deductible: In business transition situations, this means that companies can redeem their stock in pre-tax, rather than after-tax dollars, saving about 60% of the cost.
2. Contributions used to repay a loan the ESOP takes out to buy company shares are tax-deductible.
3. Sellers to an ESOP in a C corporation can get a tax deferral on the gain by reinvesting in qualifying stocks and bonds.
4. In S corporations, the percentage of ownership held by the ESOP is not subject to income tax at the federal level (and usually the state level as well.)
5. Dividends are tax-deductible.
6. Employees pay no tax on the contributions to the ESOP, only the distribution of their accounts, and then at potentially favorable rates.

ESOPs allow owners of companies to sell gradually or all at once. They make it possible to preserve the legacy of a company, keep it in the community, and reward the people who helped build it.

They are not for every company, however. Generally, companies should have at least 20 employees to be able to absorb the transactional costs of an ESOP, have enough profits to purchase shares and still run the company, and have a culture open to sharing ownership.

POLICIES TO PROMOTE ESOPs

The largest obstacle to increasing employee ownership is a lack of awareness among business owners of the benefits of an ESOP, or even how to set up an ESOP transaction. States can create economic stability and local community wealth by educating business owners, employees, and economic developers on the benefits of ESOPs.

State Centers

Education and outreach can be cost-effective and powerful approaches. States can draw upon existing networks of experts and infrastructures, such as colleges, universities, and successful ESOP companies themselves, with vast knowledge of how these plans work best.

In order to increase the effectiveness and penetration of local outreach and education, states can:

- Create an Office of Employee Ownership with a dedicated staff person. The office could exist within a state agency or as a nonprofit receiving state funding;
- Provide grants to one or more nonprofits to run an outreach program;
- Hold seminars statewide in conjunction with professional, business, and trade publications and organizations;
- Publish and disseminate brochures and other material; and
- Work with the media to encourage stories on local ESOP companies.

To be effective against the alternative purchasers of the business, ESOP outreach should have several characteristics:

- It needs to be built around the moment at which a business owner is making the choice about who will own her business after her. Its primary focus should not be on start-ups, and its screen for candidates should be about retiring owners, rather than other intuitive criteria such as companies interested in progressive management.
- It should exploit the inherent advantages of employee ownership. Rather than trying to duplicate the massive outreach by third party purchasers of businesses, it should focus on the human side of employee ownership by using videos and other personal testimonials, and by contrasting the "story lines" of a company that is becomes employee-owned versus one that becomes owned by an outside investor.
- It should take advantage of the ESOP community, by facilitating peer-to-peer connections, where company leaders talk with their peers, ideally by emphasizing a connection between them, such as living in the same place or working in the same industry.

There are state organizations in Vermont, Ohio, Colorado, California, Massachusetts, Pennsylvania, and exploratory efforts in other states, as well as a city-based program in Newark, NJ. Only Colorado and Massachusetts have state funded programs, both set up in 2019.

As an example, in its first year the Pennsylvania Center for Employee Ownership (PaCEO) had a budget of $110,000 and has created testimony in the Pennsylvania legislature that may result in the state adjusting its tax code to encourage ESOPs, testified to the Philadelphia City Council, built connections and presented at institutes of higher education and at economic development organizations, and assembled a large pool of volunteers. Thirty-four companies began exploring employee ownership as a result of their first-year outreach, and four have begun a formal assessment of feasibility.

Other state centers have taken different approaches and one, the Ohio Center for Employee Ownership, has decades of track record and data back up their success at bringing employee ownership to Ohio. The OEOC, housed at Kent State University, provides outreach, technical assistance, and information for Ohio businesses.[iv] Since its founding in 1987, it has assisted employees in buying all or part of 92 companies, creating 15,000 employee owners.

States can set up the centers as part of a state agency, as Colorado did in 2019. The state will work closely, however, with the nonprofit Rocky Mountain Employee Ownership Center to implement the program. Alternatively, states can follow the model set by Massachusetts in 2019 when it allocated $200,000 annually for fund two nonprofit organizations to run its new outreach and education program on employee ownership. We believe this may be the most stable and cost-effective approach. The nonprofit can seek other contributions from service providers to ESOPs, ESOP companies, and foundations, as well as generate income through meetings, publications, and other services. The centers can:

- Hold seminars statewide in conjunction with professional, business, and trade publications and organizations;
- Publish and disseminate brochures and other material; and
- Work with the media to encourage stories on local ESOP companies.
- Network directly with business consultants and exiting employee ownership companies to identify potential non-ESOP candidates.
- Send mailings to businesses with owners of companies who meet the criteria for ESOP candidates

Other state initiative possibilities

Another approach would be to provide purchasing preferences for ESOP-owned companies. This could, for instance, be limited to majority ESOP companies whose top executive and a majority of whose board meet the qualifying individual requirements for set-asides, such as ownership by minorities, disabled veterans, or women. Currently, set-aside programs almost universally exclude any company where a majority of the stock is held by an ESOP. That is because the stock is legally held by the ESOP trustee, and the trustee is, by definition, not a qualified individual for set-asides. This leads to the anomalous situation where a company that is majority owned by employees, often in the qualifying group, and run by people in that group, do not qualify, whereas a company owned by just one individual of that group does qualify.

This change could both make it more practical for businesses qualifying for set-asides to move to majority employee ownership as well as encourage some companies who might otherwise not qualify to become eligible. By requiring leadership to be in the qualifying status category, there is also a presumed greater likelihood that employees would be hired from those groups as well, and could accumulate assets in the ESOP.

States have attempted other ways of encouraging ESOP formation, including:

- Provide loan funds, loan guarantees, and incentives for ESOP loan providers.
- Provide funding for ESOP feasibility studies.
- Extend and expand tax breaks to owners of companies selling to an ESOP.
- Create tax abatement programs for companies with ESOPs or other broad-based employee ownership structures. Iowa and Missouri, for instance, have extended the deferral of state taxes on the sale of stock to an ESOP to S as well as C corporations.

Appendix: RESEARCH HIGHLIGHTS: THE UNTAPPED POTENTIAL FOR STATES

Although some critics fear that ESOPs come at the expense of higher wages or other company benefits, this isn't true. In fact, ESOP companies tend to pay better wages and are more likely to offer 401(k) plans. One of the major threats to middle-class wealth accumulation is job insecurity, but, according to data cited above from the quadrennial General Social Survey, employees in employee ownership companies are laid off at a rate one-third to one-fifth that of those in companies not with these plans, depending on the year of the study. That difference saves states literally billions in unemployment costs.

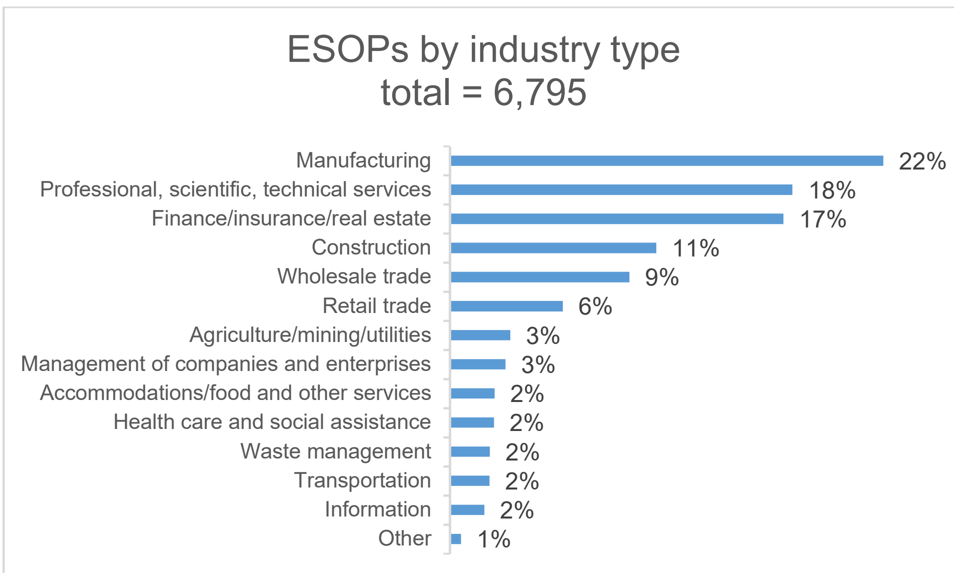
Every state can harness these advantages --retaining capital, growing jobs, addressing wage and wealth gaps, and generating more positive impacts for local communities--by creating an environment that promotes more employee-ownership.

Instead of allowing their companies to shut down or sell to outside investors who may not be interested in preserving and growing local jobs, retiring owners can sell their shares to employees, who can own the company up to 100 percent through a trust set up by their company.

As qualified retirement plans, ESOPs are subject to substantial federal oversight and reporting requirements.

- They have longevity: 54% of plans have been around for 20 years or more.
- They work well in large, mid-sized and small companies ESOPs range in size from a few participants to well over 100,000, with the vast majority having fewer than 500.
- They are present and successful across business types, sizes, and industry.
- ESOP companies are present in every major private-sector industry group (Figure 1).

FIGURE 1: ESOPs by Industry Type



There are at least eight ESOP-owned companies and 1,500 employee owners in each state. See the table below for information on the number of ESOPs by state and region.

Number of ESOPs and Total Participants by Region and State

STATE	NUMBER OF ESOPs	TOTAL PARTICIPANTS
New England	***306***	***1,036,450***
Connecticut	74	675,958
Maine	27	6,320
Massachusetts	125	139,541
New Hampshire	30	4,239
Rhode Island	15	204,990
Vermont	35	5,403
Middle Atlantic	***809***	***2,241,654***
New Jersey	158	679,973
New York	341	1,151,522
Pennsylvania	309	410,159
East North Central	***1,204***	***2,251,664***
Indiana	169	126,337
Illinois	365	933,728
Michigan	216	271,958
Ohio	280	730,875
Wisconsin	174	188,765
West North Central	***909***	***1,091,549***
Iowa	173	83,361
Kansas	116	75,747
Minnesota	271	758,008
Missouri	199	108,339
Nebraska	75	31,465
North Dakota	53	28,281
South Dakota	22	6,347
South Atlantic	***1,028***	***2,819,693***
Delaware	8	59,900
District of Columbia	17	10,001
Florida	184	445,710
Georgia	146	546,875
Maryland	136	343,286
North Carolina	134	797,834
South Carolina	65	41,546
Virginia	310	570,053
West Virginia	28	4,488

East South Central	***346***	***373,050***
Alabama	71	45,725
Kentucky	113	125,716
Mississippi	52	27,529
Tennessee	111	174,080
West South Central	***629***	***2,315,741***
Arkansas	60	1,296,122
Louisiana	88	40,585
Oklahoma	91	56,561
Texas	390	922,473
Mountain	***436***	***152,114***
Arizona	113	42,904
Colorado	114	33,068
Idaho	35	22,203
New Mexico	44	6,991
Montana	33	6,310
Utah	58	26,944
Nevada	24	8,771
Wyoming	15	4,923
Pacific	***1,125***	***1,645,420***
Alaska	25	1,813
California	852	1,078,376
Hawaii	63	15,856
Oregon	76	62,985
Washington	109	486,390

[i] https://www.nceo.org/articles/research-employee-ownership-corporate-performance

[ii] https://www.nceo.org/assets/pdf/articles/Employee-Ownership-and-Unemployment-2015.pdf
[iii] www.ownershipeconomy.org
[iv] http://www.oeockent.org/