Economic Growth Through Employee Ownership

How states can save jobs and address the wealth inequality gap through ESOPs

NCEO NATIONAL CENTER FOR EMPLOYEE OWNERSHIP

ESCA THE AMERICAN DREAM AT WORK

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Growth Through ESOPs

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.

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, including over 3,000 S corporation ESOPs with 760,000 employee-owners nationally, 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.[1]
- According to the General Social Survey, employee-owners are one-third to one-fourth as likely to be laid off compared to non-employee owners.[2]
- Employees accumulate 2.5 times the retirement assets as employees in other plans.[3]
- ESOPs distributed close to $92 billion to participants in local communities across the nation during 2013.[3]

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.

"ESOPs are more than just an employee benefit plan; they are a transition plan for business owners and a growth strategy for communities."

—Debi Durham,
director of the Iowa Economic Development Authority (IEDA)

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

[2] https://www.nceo.org/assets/pdf/articles/Employee-Ownership-and-Unemployment-2015.pdf

[3] All data on ESOPs are from NCEO analysis of Form 5500 data provided by the Department of Labor, and from filing year 2013, unless otherwise noted.

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 federal 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 not at 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.

State 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.

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. For example, the Ohio Employee Ownership Center (OEOC) housed at Kent State University provides outreach, technical assistance, and information for Ohio businesses.[4] Since its founding in 1987, they have assisted employees in buying all or part of 92 companies, creating 15,000 employee owners. Other centers are in place in Colorado, Vermont, Pennsylvania, and California.

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;
- 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.

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. 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:

- 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, for instance, has extended the deferral of state taxes on the sale of stock to an ESOP to S as well as C corporations.

[4] http://www.oeockent.org/

Research Highlights: The Untapped Potential for States

A recent study on S ESOPs, by former chief economist to Vice President Biden and current senior fellow at the Center on Budget and Policy Priorities Jared Bernstein, found that ESOPs increase capital ownership and reduce wealth inequality. 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, and Bernstein's report also showed that ESOP companies provide more stable employment than other businesses and were better able to weather the Great Recession. Other research has shown that ESOPs in C corporations also improve wealth, employment, and wages. S corporation ESOPs, which are more likely to be 100% employee owned than C corporation ESOPs, may have an even greater impact.

Conservative estimates put the savings to the federal government at $17 billion in 2014 as a result of lower unemployment rates.[6]

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.

There are now nearly 7,000 ESOPs in the United States, with a total of 13.5 million participants and $1.1 trillion in assets.[5] About half of those ESOPs are so-called S corporation ESOPs, meaning an S corporation that is owned by their employees. Because of unique tax features of S corporation ESOPs, those businesses tend to be majority or wholly employee-owned, often creating a multiplier benefit for employees who work for and own these businesses.

[5] All data on ESOPs are from NCEO analysis of Form 5500 data provided by the Department of Labor, and from filing year 2013, unless otherwise noted.

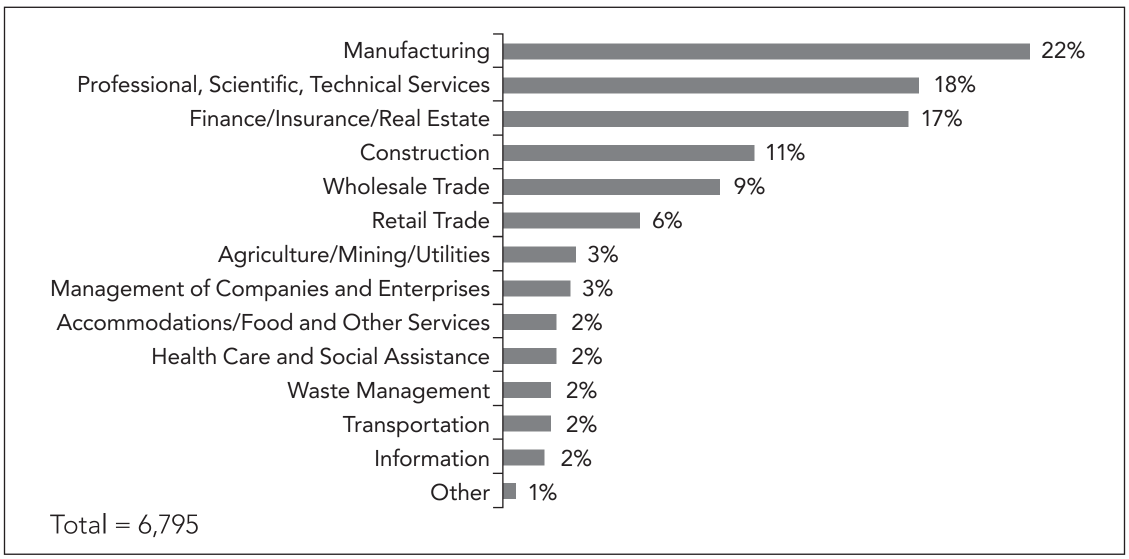
[6] https://www.nceo.org/assets/pdf/articles/Employee-Ownership-and-Unemployment-2015.pdf

ESOPs Throughout the Economy

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: This includes about 3,036 S corporation ESOPs. The rest are C corporations and a few LLCs.
- ESOP companies are present in every major private-sector industry group.

ESOPs by Industry Type



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

APPENDIX: 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

STATE	NUMBER OF ESOPs	TOTAL PARTICIPANTS
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

Thank you to the Richard A. Hassel Research Fund for funding this project.

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