Identifiable Stock Ownership
Ronald J Gilbert & Corey M Rosen

In 1987, WesRay, an investment firm led by former U.S. Treasury Secretary Bill Simon, a man of considerable financial acumen, sold AVIS to the AVIS Employee Stock Ownership Plan (ESOP). In addition to being attracted by a major new tax incentive that had just been enacted to encourage owners to sell their stock to an ESOP, Mr. Simon was optimistic that the new employee owners would identify as such.

Several years later an AVIS car was stolen from an AVIS lot in broad daylight. An AVIS employee owner jumped into another car and was able to force the thief over to the side of the road and keep him there until police arrived. "Why did you do that!?", an incredulous police officer asked. "That was dangerous!" "He stole my car," was the reply from the AVIS employee owner. (Avis was sold in 1996 for almost three times what the ESOP paid for it).

Focused Identification

Focused identification as an owner was vividly brought to my attention in October of 1989 in Warsaw, Poland. Kris Ludwiniak and I had just begun our efforts to privatize Polish state-owned enterprises and make them employee owned. In Warsaw's Central Square we met with the employees of a company that manufactured replicas of antique furniture. After briefly explaining how the employee stock ownership program would work, an older employee in the front row stood up and said "They told us we owned everything, we learned that we owned nothing, and now we want to own something."

(Note: Using Louis Kelso's concept of access to capital credit, approximately 1,000 Polish state-owned enterprises were successfully privatized and became 100% employee owned.)

Why Do U.S. ESOPs Work So Well?

Forty years of extensive research in the U.S. has demonstrated that ESOP companies improve job security and are three to five times less likely to lay off employees depending on the study year. ESOPs fare better during economic downturns. During the COVID-19 pandemic, ESOPS were nearly four times more likely to retain jobs. During the Great Recession, employment grew by 1.9% among ESOPs while it fell by nearly 3% overall. ESOPs improve retirement security. 60 - 64-year-old employee owners had, on average, approximately ten times greater wealth than their peers. National Center for Employee Ownership research shows that controlling for size, industry, and region, the average ESOP participant retirement balances were about two times, or $67,000 higher than the comparison group in non-ESOP companies that had retirement plans (about twice as high). If that weren't enough, ESOP companies also perform better than their peers, and ownership remains in the local community.

Research

It is essential to note that the research cited above refers to U.S. Employee Stock Ownership Plans (ESOPs), a qualified retirement plan under the U.S. Employee Retirement Income Security

Act, ERISA which was enacted in 1974. The term employee ownership is widely used, and can refer to numerous employee ownership models. What is essential to note is that the research cited above, was specific to the ESOP, and primarily conducted by independent entities. The ESOP research does not apply to other forms of employee ownership that are cousins in terms of their relationship to the U.S. ESOP. The independence of any research on these other forms of ownership should be firmly established to insure credibility.

My 46 years of experience which began working with Louis Kelso has led me to the following conclusions as to the top ten essential aspects that are responsible for the stellar ESOP company performance cited above.

1. Allocated account. ESOP participants have an individual account within the ESOP which states the number of shares allocated to their account, the current value of the stock, (determined annually by an independent appraiser), the number of shares that are vested, and any "other investments" in the ESOP account.
2. Vesting. ESOP accounts must have a vesting schedule, with 100% vesting required after 6 years of service. Vesting is accelerated to 100% in the event of death, disability or retirement. ESOPs, can, and should, give employees full past service credit for vesting.
3. No Employee Investment. Approximately 99% of ESOPs in privately-held companies do not require any employee investment. It is also rare for the ESOP to be combined with any wage reduction.
4. Independent Valuation. ESOPs are required to have an annual independent valuation of the company.
5. Trustee. ESOP stock is held in trust. The trustee of the ESOP has a fiduciary duty to act for the "exclusive benefit of plan participants and their beneficiaries".
6. Yearly Payouts Timetable. The ESOP payout timetable is defined and there is a time limit on the installment period. Payout of the full account must begin upon death, disability, retirement or other termination of service, the payment can be deferred for up to 5 years. All ESOPs must offer a diversification option for employees 55 or older with 10 years of service, and some plans offer an earlier diversification option.
7. Tax Benefits.
   a. Income attributable to stock owned by an S corporation ESOP is tax free from federal and most state taxes.
   b. All assets in the ESOP account grow on a tax deferred basis and are only taxable to recipients upon payout.
   c. Some selling shareholders to C corporation sponsored ESOPs are eligible to defer capital gains tax on the sale and in many instances make the deferral permanent.
8. Clear and Consistent Communication about the ESOP. Over time with clear and ongoing communication more and more employees "think like owners" and understand that the ESOP is a very significant wealth building opportunity.
9. Job Level Input. While there are many corporate governance structure options for ESOP owned companies, research demonstrates that job level input is essential to maximize the effectiveness of the ESOP. Once an employee identifies as an employee owner, that person frequently wants to make things better. The company must provide structures

to use valuable employee input. Communications committees are one proven way to accomplish this.

10. Rigorous Research. Decades of rigorous research by The National Center for Employee Ownership, Rutgers University, The Employee Ownership Foundation, and others have demonstrated that ESOPs excel in good times and have remarkably higher survival rates in bad times, as noted earlier. This has convinced lawmakers across the political spectrum to become strong ESOP supporters.

<u>What Isn't Required</u>

One unique aspect of ESOPs is that they give employees a long-term incentive. Account details are reported annually to track the appreciation of their individual ESOP account. Combining the ESOP with short term and midterm compensation will maximize employee performance. What is not required is the sale of the company. As cited earlier, one of the advantages of U.S. ESOPs is promoting local economic prosperity. Plans structured that only can reward employees if the company is acquired are contrary to this long-term goal. While many ESOP companies have been acquired, it is a voluntary decision made by the company's board of directors and owners. Many ESOP companies have been successfully operating for 20 years or more, and there are those like ComSonics, Inc. that is celebrating its 50th anniversary of an employee-owned company.

<u>Comparing ESOPs to Other Employee Ownership Plans</u>

There are two relatively new types of employee ownership plans that warrant attention. First is the Employee Ownership Trust (EOT), first introduced a decade ago in the U.K. and more recently in the U.S. The EOT has become very popular in the U.K. but has had, and I expect will continue to have, limited applicability in the U.S., in great part because the U.S. EOT does not provide direct share ownership or any tax advantages. Smaller less profitable companies will find the lower cost of the EOT attractive.

It should be noted that EOTs as structured in most U.K. plans are not employee ownership in the traditional meaning of that term. Employees do not have any equity claims on the company. This may change the way employees think about the company and how it chooses to invest money for growth versus a profit payout, and may encourage a sale down the road unless the EOT is structured so that sale proceeds go to some other purpose. The new Canadian EOT law stipulates that on the sale of the company, proceeds have to be divided up among current and possibly former employees.

The second plan is sometimes referred to as the PE (Private Equity) model. Championed by KKR and the nonprofit Ownership Works, and with other PE firms also announcing their intention to provide an employee ownership benefit, these plans offer employees the possibility of a payout, which could be substantial, but only upon the sale of the company. The plan usually allows the benefits to be provided to most or all employes, but could be limited to senior staff. Since the classic PE model calls for the company to be sold within a relatively short period of time, 5 to 7 years, this model, like the EOT, has limited applicability. It is only available to those

employees who work for a company acquired by a PE firm, and it is by definition a short, or at best, mid-term incentive plan that allows employees to share in the company sales proceeds.

While EOTs and the PE model have the potential to provide cash payouts to employees, often only upon the sale of the company, they are very different from the ESOP as the accompanying comparison tables provided by Corey Rosen illustrate.

That said, the identifiable stock ownership communities and proponents in the U.S. and U.K. should look for ways to collaborate with these relatively new additions to the employee ownership family in order to advance the cause of broadened employee ownership.

U.S. ESOPs In the U.K.?

U.S. ESOPs have performed incredibly well over the past 50 years, and have many unique aspects not available in an EOT or in other forms of employee ownership in the U.S. and U.K. Can a way be found to allow U.K. employees to participate in a U.S. ESOP on a tax deferral basis? A tax treaty idea has been referenced in a new report by Rutgers University and recently discussed at the International ESOP Conference at Oxford University that could provide a roadmap for this to occur.

Tax Treaty

Lawmakers across the political spectrum in both the U.S. and the U.K. support broad-based employee ownership. U.K. laws are enacted, in the case of employee ownership, through His Majesty's Revenue and Customs (HMRC). The IRS has an oversight function for U.S. ESOPs. A tax treaty may only need the approval of the IRS and HMRC. Since numerous U.S. companies operate with U.K. employees who are taxed as U.K. citizens, a tax treaty could provide a tax exemption for the allocation of stock in the U.S. based company's ESOP to the account of the participating U.K. citizens, and any tax would be deferred until the stock account is cashed out under the rules of the U.S. ESOP. While many countries do not tax the stock allocation until it is cashed out, the U.K. does impose a tax on the stock allocation at its inception.

"Road Map" Private Letter Ruling

In 2014 the IRS issued a ground breaking Private Letter Ruling (PLR) defining the terms under which citizens and tax payers of other countries could participate in the U.S. company's ESOP. The IRS should be able to utilize this PLR for the tax treaty.

Table 1-1. ESOPs versus EOTs		
	Form of employee ownership	
	ESOPs	**Employee ownership trusts**
What kinds of companies typically use these plans?	Established companies with owners looking to do a partial or complete ownership transition. A minority of plans are used by companies simply to share the wealth employees help create. Companies must be C corporations, S corporations, or LLCs taxed as a C or S corporation.	Companies looking to do a business transition that want legal protection for preserving their legacy, community benefit, or social and environmental goals, or that do not want to comply with the rules and costs of an ESOP and are willing to trade off the tax benefits and proven performance benefits of ESOPs to do so. Trusts can be designed to be permanent to prevent a sale to another buyer, something that may not be possible in an ESOP.
Primary uses	1. To be a new owner of the business, often when the current owner wants to retire. 2. Providing incentives and rewards broadly to the workforce.	1. Preserving the culture, protecting the workforce, or maintaining a values-based decision-making process. 2. Business transitions in closely held companies.
Tax benefits to owners of companies	1. Sellers can defer capital gains taxes on a sale to ESOP if the sale meets certain requirements. 2. The purchase of shares by the ESOP can be funded with pretax dollars out of future profits. Stock redemptions outside of ESOPs must be funded with after-tax dollars.	None
Tax treatment for companies	1. Contributions to an ESOP are tax-deductible, including both principal and interest when repaying a loan to the ESOP to purchase shares. 2. The profits attributable to the ESOP trust in an S corporation ESOP are not taxable. 100% ESOP-owned	EOT companies often pay profit sharing to employees, which is a deductible expense. Contributions to the employee ownership trust may be tax-deductible to the company.

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	S corporations thus pay no federal income tax.	
Tax treatment for employees	ESOPs are taxed the same way as other tax-qualified retirement plans are. Employees pay no tax on the contributions to the trust until they receive a distribution of their account balances, generally after termination of employment. Taxes can be further deferred on any amount rolled into another retirement account, usually an IRA.	EOTs often pay annual profit sharing, which is taxable to employees the same way a bonus is, i.e., subject to payroll taxes.
Who must be included in the plan	Generally, at least all employees who work 1,000 or more hours in a plan year, have a year of service, and are aged 21 or older. Companies may choose to include employees earlier. Some segments of the workforce may be excluded.	Companies can choose which employees they want to include, but most EOTs include most or all employees.
How are equity allocations determined?	Employees get an allocation of annual company contributions to the plan based on their relative compensation among eligible employees or a more level formula. Pay over a certain amount ($345,000 as of 2024, indexed annually) does not count for allocation purposes.	Companies choose their own formulas for profit sharing. The EOT, not the individual employees, owns the shares. If the company is sold, any equity value is generally divided between employees there at the time of the sale, based on a formula the company determines. Companies can choose to set up some kind of equity-sharing plan, such as stock options, restricted stock, or synthetic equity, in addition to the EOT.
When do equity allocations become non-forfeitable (vest)?	Vesting must start no later than after the second year of service. A year of service is a plan year with 1,000 hours of service or, if the company chooses, a smaller number.	Because there are no actual equity allocations, vesting is not an issue.

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When do employees get paid for their ownership share?	Distribution of employee account balances generally must start no later than five years after the end of the plan year except for terminations due to death, disability, and retirement, in which case distribution must start no later than one year after the end of the plan year.	Employees normally receive profit shares from the company.
Governance	The ESOP trust is the legal shareholder. The trustee is appointed by the board. The trustee votes the shares. Employees have limited voting rights unless the company chooses to provide greater rights.	Companies can choose the control rights the trust exercises and whether employees have any say. The seller generally determines the purpose under which the trust must operate and what role the employees have in governing the trust. Most trusts are designed to be permanent, however, so that the company is not sold.
Valuation	The ESOP trust cannot pay more than fair market value, defined as what a willing financial buyer would pay for the percentage of the company the ESOP trust is purchasing. The trustee hires the appraisal firm. Appraisals must be done annually. ESOPs generally can pay what most other financial buyers would pay, but about 10% to 20% of potential sellers to ESOPs could get a substantial premium by selling to a synergistic buyer.	There are no rules for how shares are appraised, although a valuation is advisable.
Fiduciary issues	The ESOP trustee is responsible for assuring that the plan is operated in the best interest of plan participants. This includes making sure the appraisal is done properly and that the plan operates within	Fiduciary issues depend on the state law governing the trust.

Table 1-1. ESOPs versus EOTs		
	Form of employee ownership	
	its rules and the requirements of the law.	
Costs	ESOPs generally cost between $150,000 and $300,000 to set up but can cost more in larger and complex deals. Nonleveraged ESOPs have much lower setup costs. Costs are generally less than the costs of selling to a third party. Ongoing costs are about $20,000 to $30,000 annually for most ESOPs, with costs going up with size.	Initial costs are generally from $30,000 to $100,000; ongoing costs are not significant.
Financing	ESOPs are paid for by the company, not the employee. ESOPs can be financed by annual cash contributions to the plan in a gradual sale, or by leverage when the ESOP buys more up front. ESOP loans can come from seller notes, banks, and/or mezzanine lenders.	The trust is funded by the company.
Complexity	ESOPs are subject to detailed federal rules and require that the company devote internal resources to compliance. Setting up an ESOP is similarly more complicated than other employee ownership plans but less complicated than a sale to another company.	Because EOTs are not covered by any specific set of rules, they are less complicated and more flexible than ESOPs to set up and administer.
When these plans do not fit	1. Because of their initial costs, ESOPs generally do not work for companies with fewer than 15 to 20 employees. 2. Good candidates for ESOPs need to have successor management in place if the sellers do not plan to remain as employees. 3. Companies must have sufficient after-tax profitability to pay the	Companies looking for tax-favored means of providing liquidity to current owners are not good fits for EOTs.

Table 1-1. ESOPs versus EOTs		
	Form of employee ownership	
	added expense of buying out one or more owners. 4. Companies must be comfortable with the idea of most employees owning shares. While ESOPs can provide additional equity outside the plan to selected individuals, they cannot base awards on discretionary decisions.	

Table 1-1. ESOPs versus PE/Ownership Works Model		
	Form of employee ownership	
	ESOPs	**Ownership Works**
What kinds of companies typically use these plans?	Established companies with owners looking to do a partial or complete ownership transition. A minority of plans are used by companies simply to share the wealth employees help create. Companies must be C corporations, S corporations, or LLCs taxed as a C or S corporation.	Mid-market to larger companies bought by private equity firms, most notably Blackstone and KKR
Primary uses	1. To be a new owner of the business, often when the current owner wants to retire. 2. Providing incentives and rewards broadly to the workforce.	To provide employees of target firms with a partial (usually under 10) ownership stake in the company
Tax benefits to owners of companies	1. Sellers can defer capital gains taxes on a sale to ESOP if the sale meets certain requirements. 2. The purchase of shares by the ESOP can be funded with pretax dollars out of future profits. Stock redemptions outside of ESOPs must be funded with after-tax dollars.	None

Table 1-1. ESOPs versus PE/Ownership Works Model		
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Tax treatment for companies	1. Contributions to an ESOP are tax-deductible, including both principal and interest when repaying a loan to the ESOP to purchase shares. 2. The profits attributable to the ESOP trust in an S corporation ESOP are not taxable. 100% ESOP-owned S corporations thus pay no federal income tax.	When stock rights are exercised by employees, the company receives a tax deduction for the taxable value to employees.
Tax treatment for employees	ESOPs are taxed the same way as other tax-qualified retirement plans are. Employees pay no tax on the contributions to the trust until they receive a distribution of their account balances, generally after termination of employment. Taxes can be further deferred on any amount rolled into another retirement account, usually an IRA.	Employees pay ordinary income tax on the sale of securities.
Who must be included in the plan	Generally, at least all employees who work 1,000 or more hours in a plan year, have a year of service, and are aged 21 or older. Companies may choose to include employees earlier. Some segments of the workforce may be excluded.	PE firms decides but plans have included all employees
How are equity allocations determined?	Employees get an allocation of annual company contributions to the plan based on their relative compensation among eligible employees or a more level formula. Pay over a certain amount ($345,000 as of 2024, indexed annually) does not count for allocation purposes.	PE firms decide; typically has been allocated annually

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When do equity allocations become non-forfeitable (vest)?	Vesting must start no later than after the second year of service. A year of service is a plan year with 1,000 hours of service or, if the company chooses, a smaller number.	When there is a liquidity event
When do employees get paid for their ownership share?	Distribution of employee account balances generally must start no later than five years after the end of the plan year except for terminations due to death, disability, and retirement, in which case distribution must start no later than one year after the end of the plan year.	When there is a liquidity event
Governance	The ESOP trust is the legal shareholder. The trustee is appointed by the board. The trustee votes the shares. Employees have limited voting rights unless the company chooses to provide greater rights.	Ownership rights formula determined by PE firm
Valuation	The ESOP trust cannot pay more than fair market value, defined as what a willing financial buyer would pay for the percentage of the company the ESOP trust is purchasing. The trustee hires the appraisal firm. Appraisals must be done annually. ESOPs generally can pay what most other financial buyers would pay, but about 10% to 20% of potential sellers to ESOPs could get a substantial premium by selling to a synergistic buyer.	Payout based on transaction price and PE firm determined formula
Fiduciary issues	The ESOP trustee is responsible for assuring that the plan is operated in the best interest of plan participants. This includes	None

Table 1-1. ESOPs versus PE/Ownership Works Model		
	Form of employee ownership	
	making sure the appraisal is done properly and that the plan operates within its rules and the requirements of the law.	
Costs	ESOPs generally cost between $150,000 and $300,000 to set up but can cost more in larger and complex deals. Nonleveraged ESOPs have much lower setup costs. Costs are generally less than the costs of selling to a third party. Ongoing costs are about $20,000 to $30,000 annually for most ESOPs, with costs going up with size.	Minimal
Financing	ESOPs are paid for by the company, not the employee. ESOPs can be financed by annual cash contributions to the plan in a gradual sale, or by leverage when the ESOP buys more up front. ESOP loans can come from seller notes, banks, and/or mezzanine lenders.	PE firms issue additional shares
Complexity	ESOPs are subject to detailed federal rules and require that the company devote internal resources to compliance. Setting up an ESOP is similarly more complicated than other employee ownership plans but less complicated than a sale to another company.	Simple structure; usually a restricted share grant
When these plans do not fit	1. Because of their initial costs, ESOPs generally do not work for companies with fewer than 15 to 20 employees.	The PE model could be used by any company buying another company

Table 1-1. ESOPs versus PE/Ownership Works Model		
	Form of employee ownership	
	2. Good candidates for ESOPs need to have successor management in place if the sellers do not plan to remain as employees. 3. Companies must have sufficient after-tax profitability to pay the added expense of buying out one or more owners. 4. Companies must be comfortable with the idea of most employees owning shares. While ESOPs can provide additional equity outside the plan to selected key individuals, the ESOP itself cannot be based on discretionary decisions.	

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Ronald J. Gilbert ("Ron") is cofounder with Susan Gilbert, and President of ESOP Services, Inc., an international consulting firm specializing in Employee Stock Ownership Plan ("ESOP") transactions for privately held companies. With offices in Virginia, the firm's clients are in a majority of the U.S.

Ron holds a Bachelor's Degree in Commerce from the McIntire School of Commerce at the University of Virginia and a Master of Financial Services from The American College. He served on The ESOP Association's Board of Directors and its Legislative and Regulatory Advisory Committee, and served on the board of directors of eight ESOP companies. He is a former member of the board of directors of The National Center for Employee Ownership.

With over forty years of experience, Ron is a frequent speaker at ESOP seminars sponsored by The World Bank, The ESOP Association, The National Center for Employee Ownership, banks, colleges, national and state governments, etc., and has spoken in nine countries. Ron was instrumental in obtaining the first IRS private letter ruling sanctioning an international ESOP for a U.S. based company.

Ron Gilbert is co-author and co-editor of ***Employee Stock Ownership Plans: ESOP Planning, Financing, Implementation, Law and Taxation***, the most comprehensive work on the subject, published by the Beyster Institute. He has also authored numerous ESOP articles for various publishers, including the Brookings Institution Press and The National Center for Employee Ownership. Publications include the ***Journal of Employee Ownership, Law and Finance; Don't Do That;*** and ***Selling to an ESOP.***

COREY ROSEN

Corey Rosen is the founder of the National Center for Employee Ownership in the U.S. He co-authored, along with John Case, *Ownership: Reinventing Companies, Capitalism, and Who Owns What* (Berrett Kohler, 2023). Over the years, he has written, edited, or contributed to dozens of books, articles and research papers on employee ownership. He has been called the leading expert on employee ownership in the world. He has been interviewed widely by major media and spoken around the world.

Corey received his Ph.D. in political science from Cornell University in 1973, after which he taught politics at Ripon College in Wisconsin before being named an American Political Science Association Congressional Fellow in 1975. He worked on Capitol Hill for the next five years, where he helped initiate and draft legislation on ESOPs and employee ownership. In 1981, he formed the NCEO. He serves on several ESOP company boards.