Selling Your Business to Your Employees

Employee Stock Ownership Plans (ESOP) & Worker-Owned Cooperatives

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1. Introduction

If you don't have an obvious heir in your family to carry on ownership and management of your business, one good alternative is to sell it to your employees. This generally insures that your business continues as an independent company and preserves the jobs of your employees.

Furthermore, there's a tax break for you as the seller: Sell 30% or more of the stock in your company to your employees through either an Employee Stock Ownership Plan (ESOP) or an employee cooperative, and you have the option of sheltering the capital gains on the transaction from the capital gains tax. This is the "§1042 rollover" which you will read more about in what follows.

There are two basic methods to sell to your employees. The most common is the ESOP. An ESOP is a very flexible, tax-advantaged tool in succession planning. It can be combined with other ownership succession strategies including majority family ownership or a management buyout. Less common but more useful in smaller businesses is the employee cooperative.

2. Comparing ESOPs and Cooperatives

As qualified employee pension plans, ESOPs have tax advantages that make them the employee-ownership structure of preference in companies that are profitable, capital intensive, and employ more than 20-25 employees. Contributions to the ESOP, like those to other pension plans, are deductible from the company's taxable income. Unlike other pension plans, however, ESOPs (1) invest primarily or exclusively in the stock of the employing company and (2) can borrow money. This makes them an ideal vehicle for employees to buy company shares from a retiring owner.

Companies that are 100% owned through an ESOP generally elect S-Corporation tax status. This frees them of Federal (and often state) income tax. In an S-Corporation, there is no income tax liability at the corporate level, but rather the income tax liability on profits passes directly to the owners at their individual tax rates. Since an ESOP is tax exempt, a 100% ESOP-owned S-Corporation has no income tax liability. Of course the ESOP participants will ultimately pay taxes when they cash out their accounts after they have left the company.

An ESOP is also the preferred choice when employees will acquire less than all of the target company's shares. There are two reasons for this. First, use of an ESOP does not require that the employee members elect a majority of the board, as would be the case with an employee cooperative. Second, experienced professional advisors believe that it is necessary for a cooperative to be committed to acquiring substantially all of the owner's stock in order to achieve the desired tax effects of a §1042 rollover.

Because ESOPs are Federally regulated, trusteed, and qualified employee retirement plans, the cost of establishing them ($40,000 and up) and maintaining them ($15-30,000 annually) makes them unduly expensive in smaller or less profitable companies. Furthermore, small ESOPs have great difficulty staying in compliance with the law because they try to save money on professional advice. That eventually catches up with them in expensive Department of Labor fines and ESOP plan corrections.

By contrast, employee co-ops are self-governing membership associations in which members elect the board and acquire direct ownership in the company. They are no more difficult to establish than other "C" corporations, but their governance, ownership, and tax environment are unique, so they do require specialized accounting and legal advice. They have different and smaller tax advantages than ESOPs, but they are less expensive to set up and to maintain. They would seem an ideal employee ownership solution in smaller companies, if the employees intend to acquire all of the company's stock over a period of years.

Then there is the matter of managing liquidity of the company. In a company that sponsors an ESOP, the company can preserve its cash reserves by contributing its stock to the ESOP in lieu of cash contributions. However, the company will be required to repurchase this stock (i.e., make a market for it) as ESOP retirement benefits become payable to employees. Intelligent ESOP plan design can make these repurchase obligations predictable and manageable.

A cooperative will be able to offset its tax liability by distributing its earnings as "patronage refunds" to its member employees. The cooperative can manage its cash and capital by retaining up to 80% of these patronage refunds for reinvestment directly in the cooperative. This member investment is redeemable only when the cooperative's financial condition (in the judgment of its board of directors) permits. Thus, a cooperative may have more control over its financial resources in the long run.

3. Selling to Your Employees Using an Employee Stock Ownership Plan

An ESOP is a qualified employee retirement plan. It differs from other qualified retirement plans in two ways: (1) it invests primarily in the stock of the employing company, and (2) it can borrow money. Since it is a qualified plan, company contributions to the ESOP are tax deductible, including when they are used to repay the principal borrowed to buy stock in the company. A company that sponsors an ESOP may also offset taxable income by contributing treasury stock to the ESOP as tax-deductible contributions to a qualified pension plan. In addition, there is a handsome tax break for owners of closely-held companies who sell their C-corporation stock to their employees through an ESOP.

Because the ESOP can borrow money, it can be a ready market for closely-held stock, including minority interests. A controlling owner can sell a minority portion of his or her holdings now, obtaining liquidity but retaining control until selling the controlling interest at some point in the future. As with other forms of leveraged buyouts, it will probably be necessary to provide collateral on the ESOP loan in the form of company assets. Thus, the same assets cannot be leveraged for other purposes.

A sale to an ESOP has five main advantages:

Fair market value: The selling shareholder can sell the stock for the fair market price, even when the owner wants to sell a minority interest, perhaps in a long-term staged sale. Minority interests are seldom marketable to other purchasers.

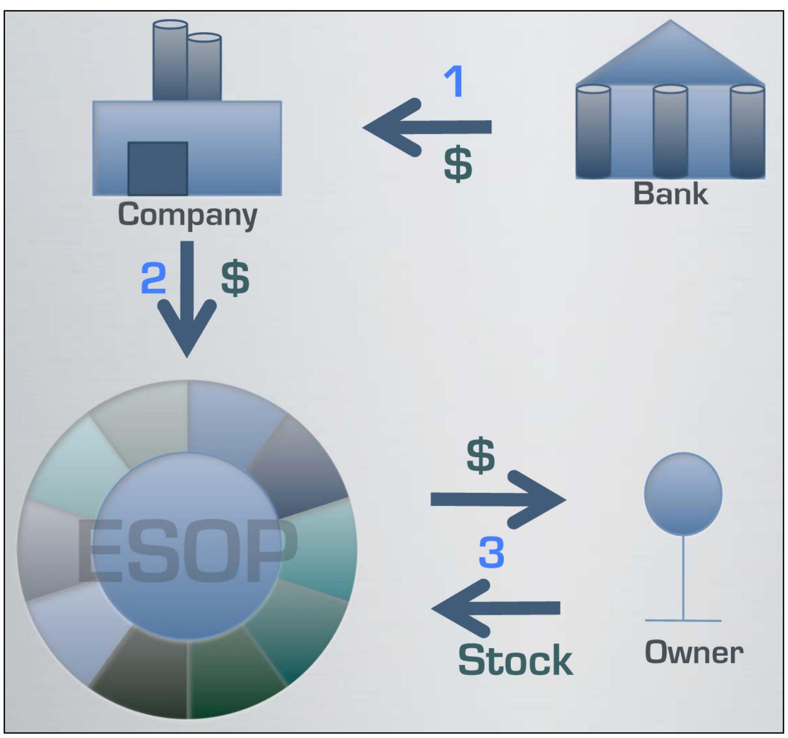
Reduced finance cost: In a transaction where dollars are borrowed to purchase the equity (a "leveraged ESOP"), financing a stock purchase through an ESOP reduces costs because the ESOP can buy C-corporation stock with pretax dollars. Both the principal and the interest on the payment are deductible, whereas only interest would be deductible for a non-ESOP company. Assuming an effective corporate income tax rate of 40% between state and Federal taxes, this means that the company must earn only $1.00 to buy $1.00 of stock, rather than earning $1.67 to pay $0.67 in taxes and have $1.00 to buy stock. In an S-corporation, the same reduction of finance costs holds true because contributions to the ESOP are tax-free both to the company and to the ESOP.

Employee job security: The ESOP can help to make employees feel secure through the difficult transition of leadership. Since the employees will share in the future success of the business, they are motivated to help the transition go smoothly and make the business successful in the future. Employees, though, are not guaranteed a job in an ESOP company as they can be subject to discharge or layoff as with a non ESOP company.

Defer capital gains taxes: Through a sale to an ESOP the selling shareholder can defer capital gains taxes, and perhaps avoid them all together.

Control: ESOP shares are held in a trust for the employees until they leave the company. Typically, the trustee of the ESOP exercises most of the "ownership rights" over the stock, and the trustee is usually appointed by the company's board of directors. ESOP plans can also be written to provide full shareholder rights to employee ESOP participants.

Here's how a leveraged ESOP purchase of company stock typically works. The ESOP purchase takes place in three stages:

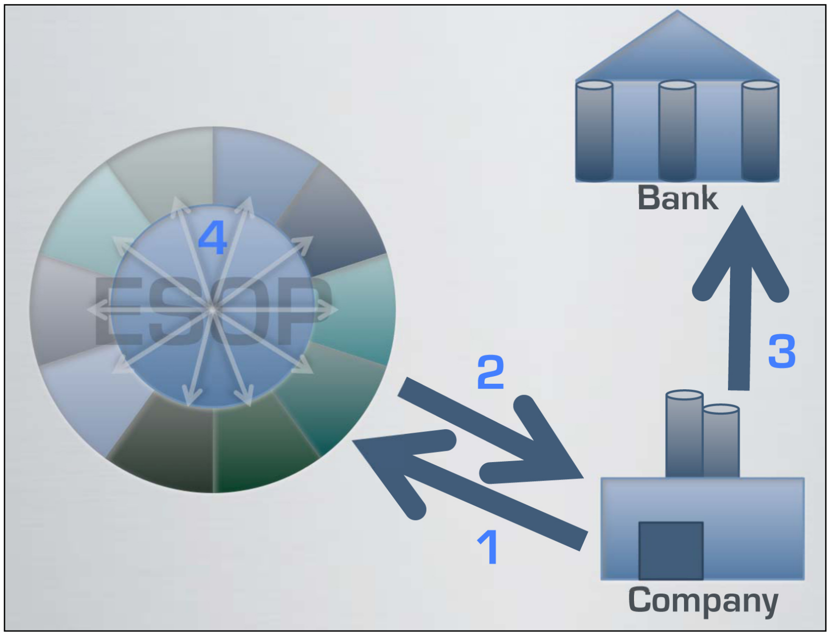


(1)The company establishes an ESOP and goes to a bank to get a loan for stock acquisition. Company assets are used as collateral.

(2)The company then loans that money to the ESOP. This is the ESOP note. (If the ESOP note has the same terms as the bank loan, it is sometimes called a "mirror loan" to the ESOP. Frequently the ESOP Note is longer term than the bank loan.)

(3)The ESOP uses the loan to purchase the stock from the original owner or his/her beneficiaries. At this point, the ESOP owns the stock, but it is in a suspense account. It has not yet been allocated to any of the individual ESOP participants.

After the stock is in the ESOP, the loan payments need to be made. These payments are accounted for as contributions to a qualified retirement plan. There are 4 steps:



(1)The company makes tax-deductible cash contributions to the ESOP.

(2)The payments are large enough to pay the principal and interest on the ESOP note. The ESOP uses the contribution to make a payment to the company for the ESOP note.

(3)The company makes a payment on the bank loan.

(4)As the ESOP note is repaid, shares of stocks are released from the suspense account and allocated into the individual accounts of ESOP participants.

Let us look at these ESOP tax incentives in greater depth. The company, the employees, and the seller all have tax advantages from ESOPs.

For the company: The company is able to repay debt used to acquire stock in the ESOP ***with pretax dollars.*** The loan payments take the form of a contribution to the ESOP. For both C- and S-corporation ESOPs, because the ESOP is a qualified retirement plan, the ESOP contribution is a pretax expense. Additionally, in a partial ESOP in an S-corporation, the S-corp distribution made to non-ESOP stockholders to cover their incremental tax liability must also be made on a pro-rata basis to the ESOP to cover the ESOP's presumed tax liability on its portion of the company's taxable income; but this amount ends up being tax-free to the ESOP because the ESOP is not a taxable entity. In a 100% ESOP S-corporation, since the company is effectively exempted from income taxes, there would be no requirement for the company to make an S-corp distribution and the contribution to the ESOP can be made without regard to income taxes.

The ESOP then uses the contribution to pay off the ESOP note. This means that the business needs to commit $1.00 of pretax earnings to pay for $1.00 of debt repayment. In traditional financing, the business must commit $1.67 of pretax earnings to pay $0.67 in taxes and have $1.00 to repay debt, assuming a combined state and Federal effective tax rate of 40%. So, an ESOP reduces a company's finance costs.

For the employees: Since an ESOP is a qualified retirement plan, ESOP participants pay no tax on their shares until they cash them out, presumably when they are in a lower tax bracket at retirement.

For the seller: In a C-corporation, the selling shareholder can take advantage of a tax-free rollover of his or her investment. If, after the sale, the ESOP owns at least 30% of the outstanding stock in the company, and the owner has held the stock for more than three years, he or she can take advantage of the "§1042 rollover." The §1042 rollover allows the selling shareholder to defer capital gains taxes on the proceeds of the sale, as long as he or she reinvests those proceeds into stocks or bonds of domestic operating businesses within a 15 month period. In this way, a sale to the employees via an ESOP often provides the best after-tax price to the seller. Here is how the tax computation works:

Example: *Fred initially invested $100,000 in his company and now has stock worth $2,100,000. If Fred sold it to someone else, he would have a taxable capital gain of $2,000,000 (current value minus the original investment). Assuming a federal capital gains tax rate of 15%, Fred's capital gains tax on this amount will be $300,000, leaving him $1,700,000 to spend or invest. If Fred sells the same stock to his employees through an ESOP, and he invests the proceeds in stocks and/or bonds of domestic operating companies, the capital gains tax is deferred until he sells the replacement securities. In this way, Fred is able to invest the full $2,000,000, rather than the after-tax $1,700,000. If Fred does not sell the new investments, he will never pay capital gains taxes. When the stock passes to his estate, the basis increases to current value. Thus, the business was sold and capital gains taxes were fully avoided. In this case, Fred has saved $300,000 in federal taxes on the capital gains. The new investments will be part of Fred's estate and will be subject to estate taxes, unless other plans have been made.*

For the seller to use the §1042 rollover, the following requirements have to be met:

- The stock being sold must be "C" corporation stock, and the stock must be closely held.
- The stock must have been owned by the selling stockholder for at least three years.
- Immediately after the sale, the ESOP must own at least thirty percent (30%) of the total outstanding stock of the company.
- Sale proceeds must be reinvested in "qualified replacement properties" (QRP) within a 15 month period. This "reinvestment period" begins three months before the date of the sale and ends twelve months after the date of the sale. QRP includes the stocks and bonds of US operating companies. Mutual funds are not eligible as QRP, and neither are investment in financial institutions. The selling owner should consult a QRP specialist so as not to inadvertently trigger the tax.
- If the replacement property is sold, the seller must pay capital gains taxes on the proceeds. The capital gain on which the tax is calculated will be the original basis for the company stock. In the example above, this means that Fred's capital gains tax would be based on the current value of the investments. Assuming $2,500,000 current value minus the original basis of $100,000, Fred's capital gain would be $2,400,000 and the tax at 15% would be $360,000. If the replacement securities pass into Fred's estate, the deferred tax liability goes away. His heirs could sell the replacement properties without capital gains tax. Of course, regular estate taxes apply to the rollover securities.

The §1042 rollover rules for sellers are explained in greater detail in Section 6 below.

The QRP can be contributed to various trusts which can provide a range of possibilities for assigning beneficiaries and reducing taxes.

An ESOP can be combined with continued majority family ownership, with a sale of part of the stock to management, and – more rarely – with sale of part of the stock to an outside investor. The attraction to the outside investor is generally that he or she will subsequently find the ESOP a good, tax-advantaged market for his or her stock.

C-corporation versus S-corporation status for ESOPs

Prior to 1998, ESOPs were not permitted in S-corporations. Effective January 1, 1998, ESOP rules were expanded to include S-corporations. While ESOPs in the C-corporation and in the S-corporation are fundamentally governed by the same rules (one exception: talk to your ESOP attorney about S-corporation ESOP anti-abuse rules, which are quite stringent and can cause problems for smaller S-corporation ESOPs with fewer than 30 employees), the tax situation for sellers is fundamentally different. This is something you will need to consider carefully. The fundamental issue is to what extent is there a taxable capital gain on your sale of stock to the ESOP.

In a C-corporation, income taxes are paid by the corporation at the corporate level, and your taxable basis in the stock is set at the time of your acquisition of the stock. In an S-corporation, there is no income tax at the corporate level, but income tax is assessed at the level of the individual owner, to whom the S-corporation income is assigned. As a consequence, your tax basis in the S-corporation stock ratchets up each year with the addition of the income assigned to your ownership position.

As a result, the capital gain in C-corporation stock tends to be quite high, and sometimes it may be essentially all the value of the stock. Hence the tax-free §1042 rollover (see Section 6 below) is highly advantageous. Other things being equal, the longer you hold C-corporation stock, the bigger the tax break from the §1042 rollover is.

On the other hand, the longer the corporation has selected S-corporation tax status, the higher the tax basis in your stock will be and the lower the value of the §1042 rollover will be.

If you are considering selling C-corporation stock to an ESOP, you will typically maintain C-corporation status throughout the sale because of the §1042 rollover advantages. If you and other owners don't intend to avail yourselves of the §1042 rollover, however, the choice between C- or S-status is purely a tax issue for the corporation.

If you are considering selling S-corporation stock to an ESOP, you will need to determine your tax basis in the company stock and the probable capital gain through a sale to an ESOP. (Of course, a fair market stock value for an ESOP transaction will deviate from your tax basis.) You should compute the value of sheltering that capital gain for yourself and for other selling owners and compare that to any tax costs of selecting C-status during an ESOP transaction. Typically, as a C-corporation, the shelter to the corporation from the deductibility of the corporate contribution to the ESOP will eliminate most or all corporate income tax liability during the period of paying off the ESOP debt.

If you decide to sell S-corporation stock to the ESOP, there cannot be a §1042 rollover on the proceeds of the transaction. The company must be a C-corporation at the time of the ESOP transaction in order for you to elect the §1042 rollover.

Independent of the §1042 rollover issue, S-corporation ESOPs have a significant advantage: Once the company is 100% ESOP-owned, it becomes income tax free. There is no income tax at the corporate level because of the S-election. And there is no income tax at the level of the individual ESOP participant because the ESOP is a non-taxable entity. Note, however, that individual ESOP participants pay taxes on their ESOP accounts at the time they cash them out, but that is intended to be at a time that they are retired and, presumably, will have a lower income and lower tax rate.

Once the ESOP is 100% owner of an S-corporation, the corporation need not continue distributing cash to its shareholders to pay their individual income taxes, since the only shareholder – the ESOP – is non-taxable.

A potential issue occurs in the period while the S-corporation is partly owned by individual shareholders and partly owned by the ESOP. During this period, the corporation must continue to distribute cash to all shareholders, including the ESOP (since S-corporations can have only one class of stock), so individual shareholders can pay their income taxes.

During a stepwise ESOP transaction, this is no problem, since the cash contributed to the ESOP can simply be used to pay down the ESOP debt.

However, for these partial ESOP S-corporations, the cash build up in the ESOP subsequent to payoff of the ESOP debt can become problematic in long-term partnerships between the employees in the ESOP and non-ESOP shareholders.

Another situation that deserves mention is dividends. C-corporation ESOPs often choose to issue dividends to the participants, which can be done in the form of cash dividends passed-through to participants or of contributions to the ESOP trust. If issued in cash to participants, these payments are taxable at the dividend rate to participants and are tax-deductible expenses for the company. If the dividends are contributed to the trust, but are not passed through in cash payments to participants, they are tax deductible to the company to the extent they are used to repay the ESOP note and are not taxable income to the participants until the participants cash out their accounts. The tax deduction of dividends is another tax advantage of ESOP companies vs. non-ESOP companies.

If an S-corporation wishes to issue similar rewards, they are referred to as "distributions" instead of dividends. In this case, all of the administrative rules for ESOP benefit distributions apply, such as the requirement in certain cases that a participant consent to receive the distribution, the option for tax withholding or a direct IRA rollover, and the possible application of a 10% tax penalty. Because of these and other issues, S-corporation ESOPs rarely pay dividends.

Because of the exemption from income tax, continuing the S-election is most attractive in situations in which an S-corporation's owners intend to sell 100% of the stock to the ESOP.

Steps in doing an ESOP

ESOPs are often put in place without much involvement of the employees. In these cases, there is often little employee buy-in to the ESOP, and the ESOP has little or no positive impact on company performance. The best practice in establishing an ESOP is to involve employees as willing and informed buyers – especially since it is highly probable that the selling owner will be the business partner of the employees for a number of years.

Here's a quick road map for doing an ESOP transaction.

1. Seller meets with advisors: Decision that the seller wants to establish an ESOP (willing seller).
2. Seller and advisors meet with employees: Explain ESOP, discuss roadmap, possibly vote on whether employees are sufficiently interested to determine feasibility of employee buyout. If employees are positive, a couple of employee representatives are selected to join the management buyout committee in pursuing ESOP (willing buyer).
3. If there is a threat of job loss, apply to your state's Rapid Response Unit for a grant to do a feasibility study including valuation, proformas with ESOP, and possible disclosure document if you are asking employees to put in their own money.
4. Interview & hire valuation/feasibility firm.
5. Obtain preliminary valuation/feasibility report.
6. Meet with ESOP buyout committee on choices in ESOP plan on issues like vesting schedule, counting prior service for vesting, formula for allocating stock, distribution, pass-through voting, etc.
7. Begin discussion with bank re financing the transaction.
8. Interview ESOP attorneys.
9. Retain ESOP attorney to draft ESOP plan and trustee agreement.
10. Board of directors selects trustee or trustee committee.
11. Continue discussion on financing – financial structure for the deal should be fairly clear by now.
12. Full valuation for ESOP completed & reviewed and approved by trustee or trustee committee.
13. Commitments for financing are obtained.
14. ESOP plan prepared in draft form for discussion.
15. Finalize ESOP plan – approved by the board of directors.
16. Close financing.
17. Celebrate initial ownership transition.

Multi-step transactions

Generally it is difficult to finance a 100% leveraged sale of a business to employees in a single step. Lenders are not comfortable at that level of financial commitment, especially if the owner walks out the door and catches a flight to Florida the moment the transaction is done.

Moreover, generally, a 100% leveraged transaction would require that the business take on more debt than it can afford, preventing it from growing and, often, putting its very survival in jeopardy.

As a result, most sales of closely held businesses to ESOPs are multi-step transactions. In a typical first step, the owner sells the 30% necessary to qualify the proceeds for the 1042 rollover treatment of the capital gains. The bank that lends for that 30% transaction has the security of knowing that the owner still has a 70% interest in the business and remains deeply involved in running it. After the initial 30% is paid down, the owner typically sells an additional 19%, retaining a majority position. When that is paid off, the remaining stock is sold to the employees. By this point the lender has the security that the employees already own 49% outright. Hopefully, a management succession plan has largely been implemented by this point as well, so that the lender is comfortable with the new management.

Frequently, lenders require personal guarantees from sellers and often use the replacement property as collateral.

Multi-step transactions typically take 5 to 10 years to complete. If that time is available, it is almost always possible to structure the transaction so that it can be done successfully.

Management succession planning

In addition to ownership succession, the owner also needs to plan for management succession. Generally, in a small business, the owner wears multiple hats: president, chief sales person, liaison with the bank, and perhaps chief engineer or operations manager to boot. If the owner is to sell the business successfully, there needs to be an adequate replacement in each of his/her roles. That takes advance planning and training.

One of the major advantages of a multi-step sale of the business to the employees is that it provides time to develop and implement a management succession program.

Major decisions to make about the content of the ESOP plan

Federal law on ESOPs is a bit like the frame around a painting. Anything you paint outside the frame disqualifies the plan, but you can paint many different pictures inside the frame.

ESOP legal boilerplate generally meets only the minimum federal standards for qualifying the plan. If you want your ESOP to have more effect on making employees feel (and act) like owners, you will want to go beyond the legal minimums. That's especially true if you take our advice above and involve your employees in designing the plan.

What are those decisions? There are basically three groups of decisions that need to be made: first, those concerning employees' financial rights under the plan; second, those concerning ESOP administration; and, third, those concerning employee involvement in decision-making and corporate governance.

1. Financial rights

a. Participation in the plan. The government-allowed maximums for eligibility for participation in the ESOP plan are that the participant is 21 years of age, has 12 months of continuous service, and has worked 1,000 hours in the previous year. That generally works fine unless your business is one where employees tend to hire in at 18 and make a career of it or unless you have a seasonal work year for reasons of weather or the like. In those cases, you would want to tailor the participation rules to your company. The basic rule of thumb is to be sure to include all full-time, permanent employees in the plan.

b. Vesting. "Vesting" is acquiring a guaranteed right to your stock in the ESOP, so it is very important to employees. The law permits you to vest quickly (immediately is possible) or slowly (up to 6 years) or somewhere in-between. The two most common vesting schedules are the slowest: "cliff vesting" at 3 years (nothing vested up to 3 years in the plan, then 100% vested) or 20% vesting per year starting in year 2, 40% in year 3, etc., and ending with 100% in year 6. In setting up a new ESOP plan, your employees generally will want to count prior service for vesting, and so will you if you want to reward past service and seniority.

c. Allocation. Allocation determines how much stock goes into individual employee accounts. Allocation of ESOP stock is always based on labor input into the business during the past plan year. The question is, how is that labor input measured? It cannot be less equal than W-2 earnings, but it can be more equal. At the extreme of equality, labor input can be measured by hours worked (i.e., every hour is worth the same regardless of skill, which is presumably rewarded in pay). You can mix and match, including W-2 earnings, hours worked, and even seniority in your company's allocation formula. Allocation based on W-2 earnings has an advantage in that it is considered by the IRS to be a safe haven formula, meaning that the company avoids having to perform a couple of discrimination tests if it is used.

d. Distribution. Your ESOP plan's distribution formula determines how your employees get their money out of the ESOP, and it matters intensely both to the employees and to the company. The balance: The company needs to avoid committing itself to distribute cash too quickly when it cannot guarantee that it will always have available cash, while employees want to see their retirement funds be maximized and paid as quickly as possible. The company has a legal obligation to make all ESOP benefit distributions per the terms of the ESOP plan; therefore, it is important to be able to plan for, manage, and fund the repurchase obligation.

The value at which employees cash out their stock is set by the legally required annual ESOP valuation. Companies may distribute the value of the employee account in cash, if they wish to remain substantially employee owned (and about three-fifths of Ohio ESOP companies report that they distribute only cash), or in stock. All S-corporation ESOPS and most C-corporation ESOPs have restrictions in their bylaws or articles of incorporation prohibiting ESOP benefit distributions in the form of stock; that is, their ESOP benefit distributions must be paid in cash.

If the company distributes in stock, employees have right to "put" the stock back to the plan or company at the current valuation or at the valuation in the year immediately following their leaving employment with the company, and the company is obligated to honor the "put" and repurchase the shares.

ESOP participants are entitled to a distribution from their accounts on retirement, death, disability, or following termination. Most ESOP plans begin distribution more rapidly at retirement, disability or death, while those who quit or who are terminated must wait a longer period of time to begin to receive their distributions. Essentially, distributions for death, disability, and retirement begin within one year of the date of the event, and distributions for other terminations can be delayed for up to 5 full plan years after termination.

Most companies pay a "lump-sum" distribution for small accounts, typically $5,000. They then write into the plan the option to distribute larger accounts on an installment basis over a five year period, paying the cash value of 1/6 of the shares in cash immediately and with five subsequent annual payments of the then-current cash value of 1/6 of the shares. With installment distributions, problems related to a person being "penalized" for being unlucky to die or retire in a down year or, conversely, to a person being unduly rewarded for leaving after a good year are avoided. Correspondingly, the incentive is for all employees to work for the long-term success of the company – the desired outcome.

Companies also have the option to defer distribution until the acquisition debt on the stock is paid off. While electing this option during the loan years helps cash flow, it may impose serious repurchase obligations on the company immediately after the loan is paid off.

ESOP participants who are eligible to begin receiving their ESOP benefit distribution and who have ESOP accounts greater than $5,000 must consent to the distribution before it can be paid to them.

ESOP participants also have a right to "diversify" their accounts as they approach retirement by cashing out a portion of their ESOP stock and replacing it with a diversified portfolio of securities. ESOP participants who have reached the age of 55 and have been participants for 10 years have the right to diversify 25% of their account for a five year period and 50% of their account in year 6. This option disappears in years 7 and beyond.

Employees who are receiving distributions before retirement (and especially before 59½) should be encouraged to roll the distribution over into another tax-sheltered retirement plan. Otherwise, they face immediate taxation on the distribution and, if they are younger than 59½, an additional 10% excise tax.

2. Administering the ESOP

The ESOP is a trusteed retirement plan, so you will need a trustee to be responsible as a fiduciary for the plan. The trustee is responsible to protect the interests of the plan participants. Trustees are selected/approved/hired by the board of directors.

In addition to managing the assets of the ESOP trust, the trustee is responsible for voting the ESOP participants' shares at the stockholders' meetings and for approving the ESOP stock price. The trustee hires a qualified independent valuation advisor to analyze the company and prepare a valuation report (40-80 pages) recommending a stock price. The trustee should review the valuation report and accept/reject the recommended stock price. As such, it is the trustee who determines the ESOP stock price.

Here there are several choices. The trustee may be an internal trustee who works in the company or an external trustee, like a bank. The trustee may be independent (i.e., making up his/her own mind on how to vote the stock) or directed by the board, an ESOP administration committee, or by a vote of the plan participants.

a. Internal vs. external trustee. The choice between an internal or external trustee generally involves a trade-off between educating the internal trustee adequately and paying the external trustee. Trustees have a fiduciary responsibility to act solely for the benefit of plan participants.

Internal trustees are usually a manager familiar with company financial affairs (such as the CFO) or a trustee committee (typically including the CFO). ESOP fiduciary liability is like other fiduciary liability: It is a personal liability, meaning that a fiduciary's home, car, or life savings could be at risk The trustee or trustee committee needs to become familiar with his/her fiduciary obligations, and should be covered by fiduciary insurance. By law, internal trustees can not receive additional compensation for trusteeing the plan above their normal salaries, but the company bears the costs of educating them through conferences and seminars and the costs of providing fiduciary insurance.

External trustees are trust departments of banks or similar institutions. They charge significant annual fees, generally in the range of $9,000 to $25,0000. Their fees are driven primarily by the possibility that they might be sued successfully for breach of fiduciary responsibility.

Generally speaking, larger companies use external trustees and smaller companies use internal trustees. In the 2004-06 Ohio survey, a bit over half the ESOP companies reported having internal trustees.

One caution: In closely held companies in which the previous owner or owner's family is selling stock to the ESOP, the owner or a family member of the owner should not trustee the plan.

b. Independent vs. directed trustee. Independent trustees exercise their own judgment in voting shares – both allocated and unallocated – and otherwise acting on behalf of plan participants, except on super-majority issues (see below under "governance") on which Federal law requires pass-through of voting rights to ESOP participants. (The law also permits full pass-through of voting rights to ESOP participants; see below.) Directed trustees act on the basis of direction received from pass-through voting of shares by ESOP participants or direction from ESOP Administration Committees or the board of directors. Generally speaking, any of the three provides some protection against fiduciary liability by the trustee. Being a "directed trustee" may be a valuable protection for an internal trustee and may reduce the cost of an external trustee. Ultimately, however, trustees' fiduciary responsibilities trump all other concerns, and directed trustees should ignore direction that would cause them to violate their fiduciary responsibility if followed.

c. ESOP Administration Committee. Federal law does not require an ESOP Administration Committee, but it is good practice to have one. This committee oversees plan administration, and is typically made up of representatives of plan participants, both hourly and salaried. Many ESOP plans give discretion to the Plan Administrator in developing specific policies and procedures for the ESOP. The ESOP Administrative Committee is responsible for developing those policies and procedures. As such, ESOP Administrative Committee members are fiduciaries and have a fiduciary responsibility to perform solely for the benefit of ESOP plan participants.

The committee considers issues to which the plan does not speak, and its basic rule is to maintain records of its decisions so as to treat people in similar circumstances similarly.

d. Plan record keeping. ESOP record keeping and plan administration may be done in house or through a "third-party administrator" (TPA) which specializes in ESOP administration. In either case, the company needs to maintain the data relevant to plan administration.

3. Governance and decision-making

Curiously, the only Federal requirement for ESOP participant involvement in corporate governance is voting on so-called "super-majority issues": corporate mergers or consolidations, recapitalization, reclassification, liquidation, dissolution, or sale of substantially all of the assets of the company. (The law doesn't require an ESOP participant vote on an acquisition, on the sale of ESOP stock, on the sale of all the stock in the company, or on a board of directors election.)

More than anything else, how you structure employee governance rights under your plan and employee participation alongside your plan will determine whether your ESOP has much impact improving the long-term performance of the business. Studies of the empirical performance of ESOP companies make it clear that those that combine employee ownership with employee participation systematically outperform non-employee-owned companies and also outperform employee-owned companies that do not provide employee participation. But employee participation, other than voting rights, generally isn't addressed in the plan itself.

a. Full pass-through of voting rights. ESOP law does not require that employees have full voting rights to their shares in closely held companies (although it does in publicly traded companies). Instead, it accords voting rights to the trustee as the default. But your plan may be drafted to provide employees full voting rights pass-through, and about one-third of closely held companies in Ohio provide for full voting rights pass-through.

Full pass-through of voting rights has two notable advantages: (1) Employee owners expect the right to vote their shares on normal shareholder issues and (2) employees voting their shares provides full instructions to trustees on employee-owner preferences. It is clearly a protection for the trustee against a hostile takeover offer opposed by the employees. If you choose full pass-through of voting rights, you should also provide that "unallocated shares" (those still not paid for and in the suspense account) will be voted by the trustee as allocated shares are voted by their employee owners; otherwise the trustee has to vote the unallocated shares as he or she sees fit and may find him/herself voting against the way the employees vote the allocated shares.

The major fear in full voting right pass-through is that employees will turn the board of directors into a popularity contest and suddenly replace the entire board. Let's see how to deal with that issue in the next section.

Pass-through of voting rights (or non-pass-through of voting rights) needs to be addressed in the ESOP plan. The other governance and participation issues below should not be addressed in the ESOP plan, but need to be a matter for careful consideration in designing ESOP companies for high performance.

b. Employee seats on the board of directors. ESOP law does not require that non-managerial employees elect any members of the board of directors, although employee representatives on corporate boards – no matter how the company is owned – are common in many countries. Yet the evidence is that non-managerial employee directors bring a useful perspective to the board on the core business of the company while conveying the message to other ESOP participants that employee ownership is real.
About one sixth of Ohio employee-owned companies had non-managerial directors on their boards in our

2004-06 survey. Findings ranged from 5% among minority employee-owned companies to 21% among companies that were 50% to 99% employee owned and to 48% among companies that were 100% employee owned.

Generally speaking, ESOP companies with non-managerial directors have a balance between inside directors (both managerial and non-managerial) and outside directors. In 100% employee-owned companies, often the balance is two management directors, two non-managerial directors, and three outside directors. Non-managerial directors are frequently nominated by the employees through an internal nominating process and voted on directly by employees in contested elections before being sent to a shareholder vote with the rest of the board slate.

One innovative Ohio company holds its nominations a year before the election and then sends all the nominees through training seminars on understanding financial statements, fiduciary rights and responsibilities of directors, and understanding the basics of business before the election to the board.

Non-managerial directors obviously bring different expertise to the board than managerial and outside directors, but their presence does not alter the basic task of the board: review of financials, supervision of management, long-term planning, and the like. Non-managerial directors provide insight into operational decisions that outside directors do not have, and a modest amount of this discussion at the board level is very useful for the outside directors. If the operational discussions begin to take precedence over the usual board discussion, the inside directors need to conduct at least part of those discussions outside the regular board meeting.

c. Employee participation in decisions on the job. While ESOP law does not require participation by employee owners in making decisions on the job, as far as we know every study over the last 20 years suggests that closely held ESOP companies that involve employee owners in day-to-day decisions on improving quality, customer service, and productivity outperform those that do not. A lot of the improvement is derived from employees improving those aspects of production that they deal with directly: reducing waste, cutting rework, eliminating bottlenecks, etc., as well as from freeing up supervisors do deal with bigger issues since they do not have to spend time micro-managing the employees.

Shop floor employee participation is also very useful on investment decisions such as buying new equipment, retrofitting old machines, and laying out the shop for smoother flow of work. Many employee-owned companies include non-managerial employees in these decisions as a matter of course.

In smaller employee-owned companies or shops (50 employees or less), there isn't much need for a formal employee participation system, provided management is committed to employee participation on a daily basis. In larger companies, and especially in union shops, some sort of formal employee participation system may be advisable. Here a standardized, documented system for employee involvement and for feedback can be developed.

In both cases, basic training in group decision making processes including consensus decision making is useful.

d. Open book management. Sharing information about the financial situation and the operational performance of the business has become relatively common in conventionally owned American businesses, and it is certainly advisable in employee-owned firms. It's hard for employees to provide input or to exercise the other rights and responsibilities of ownership in an information vacuum. Communicating financial and operational information to employee owners regularly is an important part of making employee ownership work on a daily basis.

The level of financial information shared often varies from company to company. However, two considerations are important: (1) The data must be understandable and accurate. (2) Company leadership must be willing and able to explain the numbers and how each employee owner can affect them.

People sometimes have the misconception that sharing financial information means sharing individual pay information. That is not so. Typically, nothing good ever comes from employees knowing each other's pay. Aggregate pay information should be shared, but individual pay information should not.

e. Employee training. Nothing in most employees' backgrounds indicates that they understand the financial and business information that the company decides to communicate or that they have the group process skills for involvement in decision-making in the shop. Moreover, the ESOP as a structure for company ownership is difficult to understand. All three require some systematic training to get the optimal impact from your company's ESOP in creating a "culture of ownership" in which employees feel like owners, understand how their jobs contribute to improvement the business's performance, and act like owners on a daily basis.

4. Selling to Your Employees Using an Employee Cooperative

There are situations in which you may want to sell to your employees but find that an Employee Stock Ownership Plan (ESOP) is too expensive or that your employees would prefer direct ownership of the company. There is a less-expensive option: Selling to your employees through an employee cooperative.

Selling to employees through a cooperative gets the seller the same tax break using the "§1042 rollover" as an ESOP does. If you sell 30% or more of the stock in a C-corporation to the employees of a qualified worker (employee) cooperative, you may defer the capital gains on the part of the proceeds you roll over into other qualified domestic securities – exactly as with an ESOP. The other rules that apply for a §1042 rollover in an ESOP apply in a cooperative as well.

Because cooperatives are not qualified employee retirement plans, they are not as highly regulated as ESOPs are. Therefore they are cheaper to put in place and to maintain from year to year. But they have different tax benefits – other than the identical tax benefit to the seller – that may be less attractive than an ESOP.

Generally, the tax advantages of an ESOP make it preferable in larger companies and in cases where less than 100% of the company's ownership will eventually be transferred to the employees. The lower costs of setting up co-ops make them preferable in smaller companies. The dividing line for balancing the lower cost of a cooperative vs. the immediate tax benefit of an ESOP is typically about 25 employees.

What is an employee cooperative? Employee cooperatives are part of the broad family of cooperative businesses which include farmers' cooperatives, like Sunkist, Welch's and Ocean Spray, rural electric cooperatives, consumer cooperatives like natural food stores, small business cooperatives like Ace Hardware, and financial cooperatives like credit unions and mutual insurance companies. All are owned by their members and achieve economies of scale that their individual members could not achieve alone. Most are established as C-corporations with cooperative principles laid down in their articles and bylaws.

An employee cooperative is a corporation owned and controlled by its employees that jointly markets the products or services produced by its member-employees in the same way as a farmers' cooperative markets its members' production of grain or milk. It is owned (or will eventually be owned) by its members. In most employee cooperatives, each member-employee has one vote in the selection of the cooperative's board of directors. The cooperative's profits are allocated among the members on the basis of the value of the labor ("patronage") each contributes to the co-op, typically based on compensation, hours worked, years of service, or a combination thereof. In co-ops, financial ownership is generally separated from voting control and distribution of profits.

Like most businesses, cooperatives are financed primarily through retention of their earnings. Employee cooperatives allocate these earnings to their member-employees per the formula described above, but retain a portion of the "patronage refunds" for re-investment in the cooperative. The retained portions of each member's patronage refunds are accumulated in that member's capital account. This way, each member gains additional ownership in a profitable cooperative as the member continues to work for the cooperative. These ownership interests can be redeemed for cash without additional taxation when the cooperative's financial condition permits and as determined by the cooperative's board of directors.

The rules for employee cooperatives are simpler than those for ESOPs. Members set qualifications for membership that typically include a probationary period before membership and some amount of initial investment or membership fee. This initial investment or "membership stock" is paid either in a lump sum or over time and may be smaller or larger depending on the capital needs of the cooperative. If the cooperative has just made a substantial payment to purchase an owner's stock, the cooperative is likely to have a corresponding need to replace that capital, so the initial investment may be larger.

In return for a member's purchase of membership stock, the member receives a membership certificate or voting share. Members usually elect the board of directors on a one-person, one-vote basis, and the board hires the management. The basic governance procedures for the cooperative are laid out in the articles of incorporation and bylaws.

Unallocated reserve account, members' capital accounts and taxes: Employee cooperatives typically divide their annual profits between a modest unallocated reserve account and the members' capital accounts. The reserve account is designed to absorb losses or to otherwise provide "permanent capital" for the cooperative. Annual losses may be debited against the reserve account or they may be debited to members' capital accounts, depending on the nature and circumstances of the loss.

Allocations to an "unallocated reserve account" are taxed at the normal corporate income tax rate, and those taxes are paid by the cooperative. Co-op patronage allocations to members' accounts, however, are not taxable at the corporate level (so there's no "double taxation") but are taxable to the members as personal income to the extent they are allocated on a patronage (i.e., value of labor input) basis.

An employee cooperative may pass its income through to its employees from year to year without taxation at the corporate level. However, the employees must include these "patronage refunds" in their gross income for federal tax purposes when they receive a notice of allocation from the cooperative (within 8-1/2 months after the end of the cooperative's tax year). Coop members would receive in cash each year from the company a sufficient percentage of their "patronage refund" to pay their incremental income taxes on their individual income tax return. Thus, the cooperative achieves a tax benefit similar to that available to a company sponsoring an ESOP, but the coop employees must recognize and pay taxes on the income currently, rather than later when they receive pension benefits as with an ESOP. The trade-off for current taxation of amounts received by the employees is that the employees gain current and direct ownership of the cooperative and its profits.

Under Federal tax law, 20% is the minimum cash distribution in order for the cooperative to deduct the allocation from its gross income for tax purposes. In practice, the percent of the members' allocation paid as cash is often equal to the highest marginal tax rate for individual members, but all members must receive the same percent allocation.

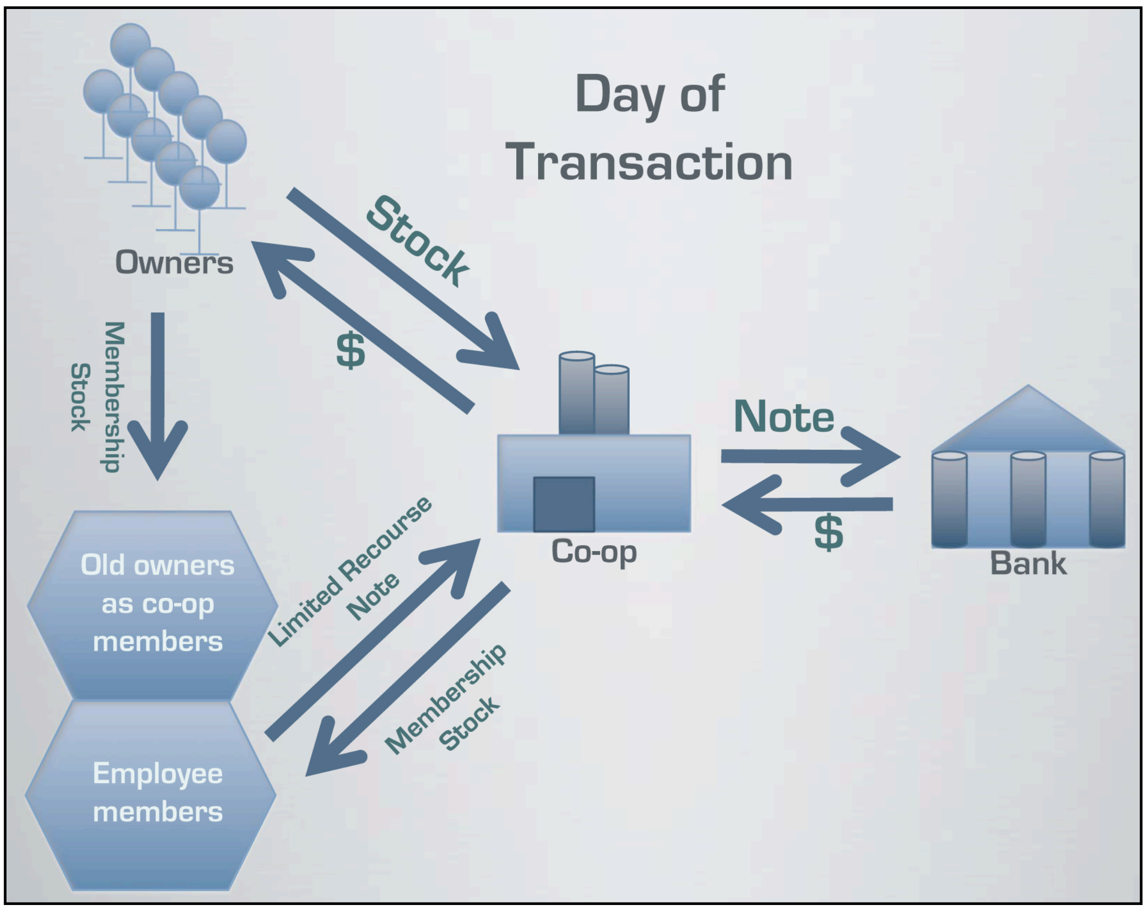
When a member's cash capital account is redeemed (cashed out), the member does not pay income tax on what he/she receives because the tax was paid when the money went into the member's capital accounts initially.

Single-stage sale to a cooperative: If the selling owner is able to able to sell substantially all of his/her shares to the employees in a single transaction, it is simple to do so with a co-op. The employees simply set up a co-op, and buy the shares from the owner, or the existing corporation is transformed into a cooperative that redeems all of the owner's shares. An ESOP-style ***fair-market value appraisal*** should be done in order to justify the purchase price for the employees. The seller may need to guarantee the loan and put up his/her replacement securities as additional collateral for any financing of the purchase.

Multi-stage sale to a cooperative: A multi-step sale gets around the problem of financing 100% leveraged transactions. Here the owner sells at least 30% of the company's stock -- the minimum to trigger the §1042 capital gains deferral -- to the employees in the first step and sells the remainder to them in one, two, or more additional steps after the initial debt has been paid off. In this case, the existing corporation's articles of incorporation and bylaws are first changed to provide for co-op ownership. Second, the co-op redeems (purchases) at least 30% of the sellers' stock with an agreement to purchase the rest of the stock on specific terms in the future. Third, the redeemed stock is re-sold to the employees in the same proportion that they will receive their annual allocations of cooperative earnings. The members purchase this stock with limited recourse notes and pledge their patronage allocations to repay the notes. Members are not risking their personal assets with these limited resource notes. Proceeds from repayment of the members' notes are applied to repaying the loan that financed the original purchase of the stock from the owner. For obvious reasons of fairness, there should be a fair-market valuation at each stock sale to the cooperative. The owner's remaining unsold equity makes the deal easier to finance, since he/she is still a stakeholder in the business. In addition, the owner's continuing involvement for several years enables the owner to transfer management skills and corporate values to the co-op members.

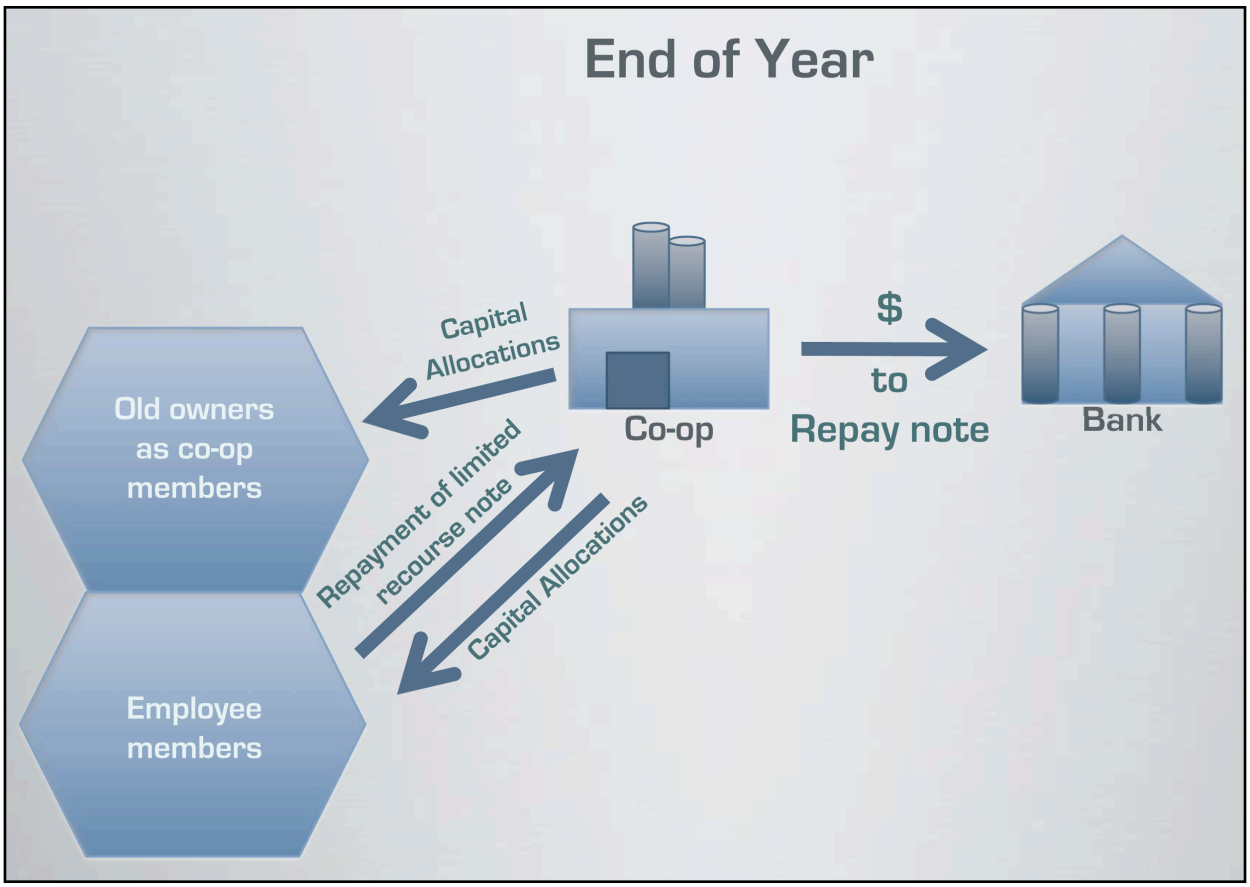
This model has two distinct financial advantages for the selling owner beyond the §1042 tax deferral. First, there is no need for a "minority discount" on the price paid to the owner on the first stock redemption, even if it is a minority stake (as there is in an ESOP), because a co-op by definition must be controlled by its members. Second, the owner can be a member of the co-op as long as he/she remains employed, and thus the owner can receive patronage allocations from the cooperative's profits annually. As in an ESOP, an owner cannot receive any of the stock he/she sold.

The selling owner has to be comfortable with a board elected on a one-member, one-vote basis and with the inherently democratic nature of the cooperative. Likewise, the employees must be comfortable with accepting the responsibilities of capital ownership and management of the cooperative. The corporate culture of an employee cooperative should include an atmosphere of mutual trust and support among the employees and a participative style of management.



Unlike ESOPs, which are trusteed pension plans and whose trustees act on behalf of the employees' retirement benefit interests to buy the stock (the U.S. Department of Labor oversees and audits ESOPs), a cooperative and its members act on their own behalf. The members of a cooperative buy the company without any formal legal regulation of the transaction. The formal regulation of an ESOP does not guarantee that the employee's interests will be immune from an unfortunate stock purchase decision, but the transaction is subject to certain objective standards of fairness to the employees. Cooperative members' recourse for a misguided purchase of stock might be against the owner for fraud in the sale of the company, but there may be no fraud, just an absence of pertinent information. So it is in the interest of both the cooperative and the selling owner that the members are fully informed about the transaction and its risks.

What is required: One tool to do that is a written ***offering statement***. It describes the company (how it will be run and something of its financial condition and business prospects), the proposed transaction, the intent of the owners to sell their remaining stock to the cooperative, how the cooperative will purchase the owners' stock, the members' obligations (including their obligation to invest in the cooperative), how the company will be managed, the various legal documents necessary to establish the co-op and complete the transaction, and the business risks involved. The offering statement need not be a formal prospectus, as in public stock offerings, but it performs the same role of informing the potential co-op members about what they are buying and the risks involved in doing so.



This offering statement may describe future operations of the company as a cooperative, or there may be a separate feasibility study with pro forma projected operating results to supplement the offering statement.

After reviewing the offering statement, the feasibility study, the valuation, and the financial statements of the company, company employees should decide whether they want to own the company. Assuming they do, they should discuss and make key decisions about the structure of the cooperative including qualifications for membership, member investment, how they are going to pay for the purchase, and how to allocate company earnings among themselves.

So what then needs to happen?

- The ***existing articles of incorporation*** of the company should be amended and restated to establish the firm as a cooperative under the cooperative law in the state of incorporation. Not all state cooperative laws are adaptable to employee cooperatives, so some thought should be given the appropriate state of incorporation. ***New bylaws*** appropriate for the cooperative should be written to replace existing bylaws or code of regulations of the company.

- Co-op members elect a board of directors on a one-person one-vote basis. The board may include the selling owner -- who may also join the co-op as a member.

- The board authorizes the stock redemption and borrowing the money to fund it. The board also enters into agreements on behalf of the cooperative with each member to provide for the member's employment and the member's purchase of the requisite portion of cooperative stock or other equity interests.

- The documents for the transaction are prepared. They include a stock redemption agreement which establishes the terms and conditions for redeeming the remaining stock from the original owner; membership, stock subscription, and limited recourse promissory note agreements for the new co-op members; a business plan; employment agreements for the co-op members; and the original owner's employment agreement which provides the owner with certain reserved rights as a "protected shareholder" until the rest of his/her stock is redeemed.

Because a §1042 rollover assumes conveyance of the owner's stock to the employees, the stock redeemed from the owner is re-sold to the members of the co-op as membership stock in return for limited recourse notes by which the members pledge to pay for the stock with their patronage allocations and stock pledge agreements that put up the stock as collateral for the limited recourse notes. The redeemed stock would normally be sold to the members in the same proportion as initial patronage allocations will be made. If the selling owner is a member of the cooperative during the period of the sale, then he/she will agree to retain a portion of his/her remaining stock to satisfy the member investment requirement.

Over time, as new employees join the cooperative, their respective investment obligations must be determined and the weighting of the earnings allocation formula will be adjusted to include the new members. The members' capital accounts may ultimately have to be rebalanced.

While the patronage allocations to members other than the owner will initially go to pay down the notes used to acquire their stock, the owner will receive patronage allocations without this offset because the owner already owns membership stock. So the owner, as a member, can build a capital account in the co-op without reacquiring any of the stock that he/she sold to the cooperative.

As with any transfer of a business to employees, a key additional issue in cooperative ownership succession is that the selling owner use the period of the sale to train other co-op members to run the business successfully. This should be spelled out in a formal business plan with a timeline for the transfer of management roles.

5. How Much is My Business Worth? Valuing Your Business

One of the most important steps for a business owner looking to transition out of his or her company is to determine what it is really worth in the market. That means investing in a qualified, thorough valuation of the company. Many owners look at the added expense of professional valuation as an unnecessary waste of money. They think that they already know the value of the business. Unfortunately, what the owner believes to be the value of the business is not necessarily what someone else would be willing to pay for it. This can be due to several factors:

1. Much of the value of a small business is a result of the time, energy, and skills of the owner. However, if proper planning is not done, once the owner exits, much of the value may be lost.
2. Business owners are often very busy with the day-to-day tasks of running the business. Therefore, they may not have the time to take a step back and think objectively about the value of their business.
3. A business owner may hear of a similar company having recently sold for a certain amount, or may have gotten prices from brokers who want to sell the business, or offers subject to "due diligence." An owner should always look at these numbers as not necessarily representing what the company may be worth in the market.
4. A business will almost always be more valuable to the person who has spent the better part of his or her adult life building it than it will be for others.

Most owners err by placing a value on their businesses that is higher than the actual market value. The consequence is that they find it difficult to sell.

Essentially, the value of a business is what someone else is willing to pay for it. Some buyers are willing to pay more than others. For example, competitors, customers, or suppliers may be interested in buying a business in order to expand into new markets, diversify, or expand. They may be willing to pay a premium to do so. This is what is called Strategic Value, and is generally the highest value that an owner can hope to get for the business. Conversely, buyers purchasing businesses to run as stand-alone operations – that is, strictly as a financial investment – typically pay less because they generally are looking only at the cash flow of the company. Then there are bottom fishers looking to buy a good business for as little as possible simply because the owner has to sell.

If an owner sells to key managers or employees, the general rule that applies is Fair Market Value; indeed, in selling to an ESOP, the price the ESOP pays cannot be above Fair Market Value. Fair Market Value can be defined as "… the price at which property changes hands between a willing buyer and a willing seller when each is under no pressure to act and both have reasonable knowledge of the relevant facts." In a sale to managers or employees, the price of the business is limited by its ability to service debt, so here the owner is looking at a "stand-alone business" value, not a strategic value.

There are many firms that do valuations for ESOPs; there is a list of valuators as well as other ESOP professionals on the OEOC's website (http://www.oeockent.org/ – see top right corner of front page under "resources" for link). You must select a firm that is ***independent*** (that is, does not have another business relationship, such as doing your accounting) of your company. Get bids from several valuators who have had experience valuing businesses similar to yours. An initial ESOP valuation will typically cost between $8,000 and $12,000 and subsequent valuations (an ESOP valuation is required annually) normally cost roughly half as much.

When appraising a company, a valuator generally uses one or more of the following approaches:

1. Income Approach - Looks at the income the business can produce. This approach utilizes projections and other economic factors. When using this approach, income and expenses need to be normalized. The most common adjustment is to identify "excessive" compensation (multiple club dues, luxury company car, company-owned boats, condominia, etc.) for the owner that is added back to the value of the company.

2. Market or Comparable Company Approach - Compares this business to recent sale prices of similar companies in same and/or similar industries and conditions (company size, geographic area, etc.).

3. Asset Approach - Looks at the market value of the assets on the balance sheet. It can also take into account items such as goodwill. Unless the cooperative plans on selling the assets, this is usually the least relevant method.

Which approach is used depends on the type of business and whether it is profitable. Often a valuation may utilize two or more these approaches in which an average between them is used.

Once the base value has been determined, there may be premiums and discounts. The most common example of this is when there are multiple shareholders that hold unequal amounts of stock. If a business worth $1,000,000 has one owner with 70% and another with 30% of the shares, the 30% owner's shares are not worth $300,000. This due to the fact that the minority owner has essentially no control over the business; he or she cannot elect the board of directors, control budgets or business plans. Correspondingly, a minority position carries a minority discount. On the other hand, selling a majority stake can command a "control premium." Shares for which there is no ready market will carry a "lack of marketability discount."

An owner who sells to employees using a co-op will find it wise to get an ESOP-style valuation at the time of the transaction, since it establishes a fair market value. If the owner intends to take the §1042 rollover, a valuation must be done at each transaction, but is not required in years when there is no transaction.

In the co-op §1042 redemption model, the selling owner qualifies for a control premium even for a minority stock sale because once the company adopts the co-op organizational form, co-op members elect a majority of the board of directors.

6. Basics of the §1042 Rollover for Selling Owners

If you sell your closely held business to your employees through an ESOP or a co-op, you should consider whether the IRS "§1042 rollover" is appropriate. It enables the selling owner to rollover the entire proceeds of the sale into "qualified replacement property" while deferring the capital gains tax.

While you'll need some professional advice on the specifics of the "§1042 capital gains rollover," the basic rules are the following:

1. You must sell at least 30% of the stock in your business to your employees using either a sale to an ESOP or a redemption by a co-op. Once the employees hold 30% of the stock, every subsequent sale of additional stock to employees qualifies for the tax-free capital gains rollover, even if it is only a few percent.

2. Only sale of "C corporation" stock qualifies for the §1042 rollover, so taking the rollover requires making a "C corporation" election for the transaction period.

3. The ESOP or co-op must remain at least 30% employee owned for at least 3 years following the transaction.

4. The sale must be a stock sale. The §1042 rollover doesn't apply to asset sales.

5. You must reinvest the proceeds of the sale in "Qualified Replacement Property" (QRP), which basically means direct ownership of stocks and bonds in domestic companies that produce goods and services in the US. They may be closely held or publicly traded firms. You have three months prior to the sale and 12 months after the sale to select and purchase the replacement securities, and you must notify the IRS of what is designated as replacement property.

6. Gold, paintings, rare coins, mutual funds, foreign securities, financial institutions' stock, etc. don't qualify. It's wise to seek a QRP specialist to assure that you don't inadvertently make a non-QRP investment and trigger the capital gains tax.

7. If you sell part or all of the replacement property, you are taxable on the proceeds of that sale. The tax basis in the replacement property is your original basis in the company stock that you sold to the employees.

8. Consequently you would prefer not to be forced to sell replacement property.

9. So, you should buy replacement property you intend to hold.

10. If you want to trade actively with the proceeds of the sale, you shouldn't trade the replacement property itself. You can put the replacement property in a brokerage account, borrow on margin, and trade with the borrowed money. (There are shelf issues of floating rate bonds that are non-callable for 50 years available through larger brokerages specifically designed as §1042

replacement property for this trading strategy, but you can do it with a variety of other QRP as well). That way, you never sell the replacement property but can trade to your heart's content and not trigger the tax.

11. Obviously, you can also borrow against the replacement property and spend the borrowings.

12. If the replacement property passes into your estate, it passes in at the stepped up basis, so the deferred tax on the capital gain goes away.

13. Please note that the stock that you sell with the §1042 rollover cannot be allocated subsequently to members of your immediate family.

This is quite a limitation in an ESOP for family members, since ESOPs use stock as the basis for financial ownership. There are ways around this issue if family members are to be involved in the ESOP, but it does make the ESOP more complicated.

It is less a limitation in a co-op, since co-ops use capital allocations to provide financial ownership. If your co-op structure is designed to transfer the stock redeemed from the seller to other members of the co-op as membership stock, remember that family members' membership stock can't be part of the stock redeemed from the seller.

7. Using an ESOP or a Co-op to Grow Your Company

Some owners who are not ready to start planning for ownership succession still find an ESOP or a co-op to be a good way to involve their employees in the business as partners in order to grow the business. For these owners, employee ownership offers three things:

1. a means to bring additional capital into the business, generally at a reduced cost;
2. a means to involve the employees in improving the business as part owners (i.e., as partners with the owner); and
3. an early structure for an eventual ownership succession plan.

For owners who want to grow the business to a new level before worrying about ownership succession planning ten or fifteen years down the road, employee ownership has considerable advantages – if the owner likes the idea of partnering with his or her employees to grow the business. (If the owner doesn't like the idea of that kind of partnership, employee ownership should be saved for an ownership succession strategy.)

Both ESOPs and co-ops offer a mechanism for bringing additional capital into the business.

In the case of an ESOP, the company can make a tax deductible cash contribution into the ESOP, and the ESOP can use this cash to buy newly issued shares of stock in the company: or the company can borrow money through the ESOP to buy stock from the company and pay the principal on the loan back in pre-tax dollars. The cost, in both cases, is to dilute the ownership stake of the current owner, but if it leads to accelerating company growth, it can easily be a win-win in financial terms for the current owner and the new employee owners.

In the case of a co-op, employees bring some capital to the business in the form of membership fees, and the patronage allocations to their member accounts remain in the business (less whatever is necessary to pay their income taxes on their patronage allocations). Again, this dilutes the ownership stake of the current owner, but increases the possibility of growth.

One issue: ESOPs are clearly compatible with long-term partnerships between family owners and employees. In fact, only a small minority of ESOPs are 100 percent employee owned. By contrast, cooperatives usually are 100 percent employee owned, and partial cooperative ownership is generally only a transitional stage in ownership succession. Thus, a long-term or permanent "partial co-op" would be an unusual outcome.

Both ESOPs and co-ops can be tools for increasing employee involvement in the business. Evidence is now overwhelming that companies that combine employee ownership with employee participation produce improvements in the business's performance relative to conventionally owned businesses and relative to employee-owned businesses without employee participation[1]. This is especially true when they understand the business and what drives it, as well as where their jobs fit into making the business successful. Not surprisingly, employees who are co-owners of the business and who have the opportunity to participate in business decisions, particularly at the job level, improve those aspects of the business that are under their immediate control: product quality, productivity, on-time delivery, and the like. Other things being equal (which is, of course, rarely the case), this improves the bottom line.

Of course, putting employee ownership in place to grow the business can also be a first step toward a viable strategy of selling to your employees at retirement. The employees will already have some equity, which makes lenders more comfortable. The existing employee stake may be close to or over the 30% employee ownership threshold which triggers the §1042 rollover to defer capital gains taxes for the seller. And, if things have gone well, your employee-partners will have an appetite for owning the rest of the business.

[1] For reviews of the research, see Steven F. Freeman, "Effects of ESOP Adoption and Employee Ownership: Thirty Years of Research and Experience." *Organizational Dynamics Working Papers* (University of Pennsylvania: 2007), #07-01; John Logue and Jacquelyn Yates, *The Real World of Employee Ownership* (Ithaca, NY: Cornell University Press, 2001), pp. 78-81; and Douglas Kruse, "Research Evidence on Prevalence and Effects of Employee Ownership," testimony before the Subcommittee on Employer-Employee Relations, Committee on Education and the Workforce, U.S. House of Representatives, February 13, 2002.

8. Additional Resources

Resources on ESOPs

Books

John Abrams, Companies We Keep: Employee Ownership and the Business of Community and Place (White River Junction, VT: Chelsea Green, 2008). A thoroughly enjoyable and informative account of South Mountain Company, a design-build construction company on Martha's Vineyard.

J. Robert Beyster with Peter Economy, The SAIC Solution: How We Built an $8 Billion Employee-Owned Technology Company (Hoboken, NJ: Wiley, 2007). The story of how Bob Beyster built a six person firm into a 40,000 employee science and technology company through employee ownership.

Joseph R. Blasi, Richard B. Freeman, and Douglas L. Kruse, editors, Shared Capitalism at Work: Employee Ownership, Profit and Gain Sharing, and Broad-based Stock Options (Chicago: University of Chicago Press, forthcoming 2010). The most recent academic work on employee ownership edited by the leading scholars in the field from the National Bureau of Economics.

John Case, Corey Rosen, and Martin Staubus, Equity: Why Employee Ownership Is Good For Business (Cambridge, MA: Harvard Business Press, 2005). A good survey of what we know about employee ownership in the United States, including a number of case studies.

John Logue and Jacquelyn Yates, The Real World of Employee Ownership (Ithaca, NY: Cornell University Press, 2001). Reports on the reality (including weaknesses as well as strengths) of a total population study of ESOP companies in Ohio with a particular focus on performance issues.

John Logue, Richard Glass, Wendy Patton, Alex Teodosio, and Karen Thomas, Participatory Employee Ownership: How It Works (Pittsburgh: Worker Ownership Institute, 1998). How to do employee buyouts, employee participation, governance, open book bargaining, and much more in unionized, employee-owned companies. Written for the United Steelworkers' Worker Ownership Institute.

Corey Rosen and Scott Rodrick, Understanding ESOPs (Oakland, CA: NCEO, 2008). An up-to-date primer for business owners on ESOPs in the United States.

Robert Smiley, Ronald Gilbert, David Binns, Ronald Ludwig, and Corey Rosen, Employee Stock Ownership Plans: ESOP Planning, Financing, Implementation, Law and Taxation, 2 volumes (San Diego, CA: Beyster Institute, University of California, 2006). The definitive treatment of legal and financial issues in Employee Stock Ownership Plans. Particularly recommended for law libraries.

Good web sources include:

ESOP Association	www.esopassociation.org
National Center for Employee Ownership	www.nceo.org
Beyster Institute	www.beysterinstitute.org
Ohio Employee Ownership Center	www.oeockent.org
Massachusetts Employee Ownership Office	www.masseio.org
Vermont Employee Ownership Center	www.veoc.org

Resources on co-ops

Information on employee cooperatives is a bit more sparse, especially when it comes to cooperatives in ownership succession and using the 1042 rollover. Most of what is available is in the OEOC library at http://www.oeockent.org/index.php/library in the co-op section. These include several articles by Eric Britton & Mark Stewart on the 1042 rollover model. See, in particular, "Selling to Your Employees through a Worker Cooperative - and Sheltering Your Capital Gain", and the Select Machine case study.

On starting cooperatives, visit the US Federation of Worker Cooperative's website (http://www.usworker.coop). Additional information is available on the ICA Group's website (http://www.ica-group.org).

Appendices

The following information may be useful during initial orientation for employees who may become ESOP members or co-op members. Feel free to reproduce it for distribution in employee meetings.

Appendix 1. What is an ESOP? ESOP basics for employee owners

Appendix 2. What is an employee cooperative? Co-op basics for employee members

Appendix 1.
What is an ESOP? ESOP basics for employee owners

Employee Stock Ownership Plans, or ESOPs, were designed as a way to spread capital ownership and put corporate equity into the hands of American workers. The first ESOP was set up in 1956, but they remained few until the passage of the Employee Retirement Income Security Act (ERISA) in 1974, which recognized the ESOP as a qualified employee pension plan. Since then, they have become common. Today an estimated 11,000 companies in the US have ESOPs, and they include an estimated 12 million workers, or about 8% of the private sector labor force. The laws enacted to encourage employee ownership provide certain incentives for lenders, selling owners, and ESOP companies. The tax advantages of ESOPs also often make them a lower-cost source of corporate financing than conventional sources.

An ESOP is a qualified retirement plan with special features. These features make ESOPs quite different from other types of retirement plans. ESOPs must meet governmental regulations issued by the Department of Labor (DOL) and the Internal Revenue Service (IRS).

Key characteristics of ESOPs

An ESOP can borrow money to purchase a company or some portion of it. Other pension plans cannot borrow funds. ESOPs can also borrow funds for company expansions or capital improvements. An ESOP invests primarily or exclusively in employer stock, whereas regular pension plans normally diversify their investments. ESOPs can own anywhere from a fraction of 1% to 100% of a company's stock.

ESOP stock is held outside the company in a separate trust. The trustee is required to act on behalf of, and in the best interests of, all the employee participants. Within the trust, separate accounts are maintained for the individual ESOP participants.

Common questions about ESOPs

Q: As an ESOP participant, am I personally liable for the company's debts?
A: No, your personal property is not at risk. Like regular corporate stockholders, ESOP participants are not personally liable for the debts of the corporation.

Q: Who gets the profits in ESOP companies?
A: Company earnings may be kept in the company, in which case they increase the value of your stock. The company's board of directors may elect to make a cash contribution to the ESOP trust, and you would receive an allocation of your portion of that contribution into your individual ESOP account. Or, your portion may be distributed to you in the form of a dividend, in which case you will receive a cash payment. The board of directors determines what portion of the earnings will be distributed to stockholders and what portion will be retained by the company.

Q: Can I vote my stock?
A: It depends. In most cases, the trustee votes the stock because the stock is held in trust. However, federal law requires that voting rights be passed through to all ESOP participants on major issues such as

liquidation, merger or consolidation, or sale of substantially all assets. Some ESOP plans provide that the trustee must vote according to the participants' instructions on all issues; in these companies, ESOP participants have essentially the same voting rights as typical owners of common stock – but this is optional, not required.

Q: What happens if the company goes under?
A: If a company fails, employee owners have a claim on the company's assets after all debts of the company have been paid. There is not likely to be much left.

Q: Can I sell my stock?
A: Not until it is distributed to you, which, since ESOPs are pension plans, usually happens at retirement. Then you can sell it, although generally you sell it back to the company according to the ESOP agreement. (Many plans call for distributing cash rather than stock at that point.) There are, however, rules that permit older employees to diversify part of their accounts after age 55 if they have at least 10 years participation in the plan.

The ESOP Trust

The trust has two basic parts, a suspense account for unallocated shares, and individual accounts that hold the stock allocations for each participant in the ESOP. Remember that the trust is a separate entity from the company.

The suspense account holds stock shares until they are allocated. Upon allocation, the stock moves from the suspense account into individual accounts.

Individual accounts hold the allocations of shares and cash, interest earnings, and any reinvested dividend or dividend interest earnings accumulated by individual participants. It is the responsibility of the ESOP trustee to insure that the transactions are made according to the ESOP plan rules, and to represent the interests of ESOP participants at shareholder meetings.

The purchase

A simple transaction involves only four parts.

1. The bank makes a loan to the company. (Since the ESOP has no assets, the bank prefers to make the loan to the company, secured by the assets of the company, rather than to the ESOP).

2. The company then makes a loan to the ESOP (the ESOP note).

3. The ESOP pays the original owners to purchase their stock. Another option is to set up a new company. Then the ESOP purchases stock from the new company, and the new company uses the cash to purchase the assets from the original company.

4. The company then makes regular contributions to the ESOP, which are used to repay the ESOP note. The company pays down the bank loan.

How your account grows

The company's contributions to the ESOP, which are used to repay the ESOP note, release stock equivalent to the repayment of the ESOP note from the suspense account. The stock is released in amounts proportionate to the amount of the loan that is repaid. (For example, if the company pays 1/10 of the loan, then 1/10 of the stock in the suspense account is released or allocated into the individual accounts.) Those released shares are then allocated into the individual employee accounts. The number of shares allocated to individual accounts depends on the amount of the company's contribution and the allocation formula established by the ESOP. Under DOL guidelines, allocations must be based on a fair formula, such as W-2 earnings, hours worked, years of service, equally, a combination of these factors, or some other formula that meets federal guidelines. W-2 earnings is the most common.

Once the stock is allocated to individual accounts, it is subject to a vesting schedule, like other pension plans. Although stock may be allocated to your account, you do not have a full claim on it until you are 100% vested. Federal law requires that employees in new ESOPs be completely vested after six years of being in the plan, although many ESOPs vest more quickly.

The stock allocated to your account is treated as deferred income for your income tax, just like company contributions to other pension plans. So, you pay no income tax when it is goes into your ESOP account; instead you pay taxes on it when you receive your ESOP benefit in cash, usually at retirement. You may also roll your ESOP distribution over into another qualified pension plan, such as a 401(k) or an IRA to keep it tax deferred, if you choose.

Getting the value of your stock at retirement

Typically, employees receive the stock allocated to their individual account (distribution) at retirement. A distribution can be in stock or cash, depending on the plan rules.

Cash distributions are most common. They may be paid in a single lump sum, in installment distributions over a maximum of five years with the amount of each distribution fluctuating up or down with stock price, or via an up-to-five year note with fixed payments plus interest. The form of payment applicable to you will depend on the specific rules of your ESOP plan.

If the company's stock is not readily tradable (not traded on a public stock exchange), and the company's bylaws and/or ESOP plan allow stock distributions, the participant has the right to exercise a put option, which is a right to sell back the shares to the company. In turn, the company has an obligation to purchase your shares. Nowadays, put options being used are rare.

The company is required to pay you the value of the shares in your ESOP benefit distribution at the price determined by the valuation of the ESOP stock for that year. Valuation is a determination of the "fair market value" of the stock. Federal guidelines specify that valuations should be conducted at least annually, and that they should be done by a qualified, independent appraiser. The trustee hires the appraiser, and the final determination of the valuation is then the responsibility of the trustee.

Fair market value is the amount at which an asset would change hands between a willing seller and a willing buyer when neither is acting under compulsion and when both have reasonable knowledge of the relevant facts.

Getting the value of your stock if you terminate employment prior to retirement

If you terminate employment for reasons other than death, disability, or retirement, you are still entitled to receive your vested ESOP account benefit; however, the company has the right to delay commencement of payment to you until either the ESOP Note has been paid off or until you have been gone from the company for five complete plan years.

Advantages of ESOPs

The ESOP is a flexible way to hold company stock. An ESOP can own as little as a fraction of 1 percent of the company stock, or as much as 100 percent of the company stock. The ESOP is one form of corporate ownership that can be combined with other forms of stock ownership among employees and outside shareholders.

ESOPs can help to improve company performance. Studies have shown that companies that combine employee ownership and employee involvement are likely to outperform comparable conventional companies in productivity, job creation and overall corporate performance.

On top of improving their performance, ESOP companies enjoy significant tax advantages. The tax incentives make ESOPs an excellent mechanism for low cost corporate financing, as well as another form of tax-deferred income for employees.

These tax advantages are:

Company: Company contributions and dividend payments held within the ESOP are tax-deductible, with certain restrictions. A leveraged ESOP, one in which a loan is used to finance the purchase of stock by the ESOP, offers added tax benefits. Both principal and interest payments are pre-tax expenses. Normally, only interest expense is tax deductible.

S-Corp: Subchapter-S corporations do not pay federal income tax directly. The shareholders of S-corporations show their share of the company's profit as personal income on their own individual tax form and pay tax according to their own personal tax rate. Normally, an S-corp distributes, at a minimum, sufficient cash to the shareholders to enable them to pay their tax liability. Since an ESOP is a tax exempt retirement trust, it has no tax liability.

If the ESOP owns less than 100% of an S-Corp, the ESOP must receive the same pro-rata distribution as the other shareholders to cover its "tax liability," however, the ESOP has no tax liability, so the cash can be held in the ESOP participants' accounts for tax-free investment growth. If the ESOP owns 100% of the S-Corp, the company has no income tax liability. This is a huge benefit!

Seller: The seller has a tax incentive called the §1042 rollover or the capital gains rollover. This amounts to a deferral of capital gains tax payments on sale of stock in closely held C-corporations to employees through an ESOP or a co-op. To take advantage of this tax incentive, the ESOP or co-op must own at least 30% of the stock in the firm.

Employees: Company contributions to the ESOP are tax-sheltered for employees; so is the increase in value of employee accounts. Employees do not pay taxes on the stock and cash in their ESOP accounts until they cash out at retirement or after leaving the company.

Appendix 2.
What is an employee cooperative? Co-op basics for employee members

An employee cooperative is a membership organization set up to market the labor and skills of its members through owning a business. It is owned by the members. Each member has one voting share. Its profits are allocated among the members on the basis of how much labor they put into the co-op. In co-ops, financial ownership is separated from share ownership, and each member has an internal account which holds his/her financial interest in the co-op.

Employee cooperatives are part of a broad family of cooperative businesses, which include agricultural co-ops like Land of Lakes or Welch's, which are owned by their farmer members; credit cooperatives like credit unions, which are owned by their depositor members; mutual insurance companies like Nationwide and State Farm, which are owned by their policy holder members; and consumer co-ops like some natural food stores, which are owned by their customer members.

This introduction assumes that you are buying the business in which you are working from a retiring owner using a cooperative, and makes regular references to redeeming the shares of former owners and paying down the debt incurred to do so. If you are starting an employee-owned cooperative business from scratch, just ignore the language that pertains to retiring owners.

Becoming a member

Employees will work for a period before becoming eligible to become voting members and owners. Members pay a membership fee, which may be smaller or larger depending on the capitalization needs of the cooperative. In return for the payment of the membership fee, the member receives a voting share.

Future employees will also have the opportunity to become members and owners after a probationary period.

Members receive the Articles of Incorporation and the Bylaws of the cooperative.

Governance

The basic procedures for the co-op are laid down in the company's articles of incorporation and bylaws.

Members elect the board of directors on a one-person, one-vote basis, and the board hires the management.

There's an annual membership meeting for all co-op members, and regular and special meetings may be called.

Your financial interest in the co-op

Initially, the value of your financial interest in the co-op is the value of your membership share. The value of your ownership interest will build over time, however, if the co-op makes a profit. Co-ops typically divide their profits ("net margins") among two accounts -- (1) an "unallocated reserve account" which absorbs losses if the business loses money and (2) members' accounts -- and a cash allocation to members. The board decides how each year's retained earnings are divided between the collective account and the members' accounts and members' cash allocations.

How retained earnings are allocated depends typically on the age of your co-op (new co-ops need to build their capital and pay more into their collective reserve accounts while making the minimum legal cash distribution to members), your co-op's capital needs (including paying down debt taken on to redeem shares from retiring owners selling to you), and how profitable your co-op is.

Here's how it works initially in a new co-op business that employee members bought from a retiring owner:

Early years while paying for the business:

> Annual profit
> - significant allocation to unallocated reserve account to provide capital for investment and to cover potential losses.
> --
> = allocations to members:
> 60-80% goes to members' capital accounts in co-op
> 20-40% to members in cash to pay their additional taxes (20% is legal minimum)

In later years after the business has been paid for, capitalized, and reserve account is adequate:

> Annual profit
> - little or no allocation to reserve account to provide capital for investment and to cover potential losses
> --
> = allocations to members:
> 50-75% to members' capital accounts in co-op
> 25-50% to members in cash to pay taxes (20% is legal minimum)

Alternatively, the co-op may "revolve" more senior members' accounts, as discussed below.

If the co-op's losses exceed the amount in the collective reserve account, the additional loss is deducted from the members' accounts.

Once the collective account reaches an adequate level to absorb eventual losses, most or all of the additional annual retained earnings are allocated to members' accounts or distributed in cash to members.

Allocations among the members' accounts and cash allocation follows a labor-based formula laid down in the co-op's bylaws. The formula is based on labor input ("patronage") into the cooperative. You can use W-2 earnings, hours worked, seniority up to a cap, or other measures of labor input. The formula is as follows: divide each member's labor input (however measured) by the total input of all members and multiply that fraction by the total dollars being allocated among all the members' accounts.

Here's how it works:

$$\frac{\text{Your labor input}}{\text{Total members' input}} \times \text{Total \$ to be allocated among all members} = \text{Your allocation for that year}$$

The co-op can make its allocation in what is called a "capital allocation" into your account.

Taxation

In tax terms, co-op allocations to the "unallocated reserve account" are taxed at the normal corporate income tax rate, and the taxes are paid by the cooperative. Co-op allocations to members, however, are not taxable at the corporate level (so there's no "double taxation") but are taxable to the members as personal income. Consequently, you need a cash distribution to pay your additional taxes.

Therefore, in new cooperatives which typically need to retain capital in the business, 60-80% of the members' allocations are retained in the members' accounts and 20-40% is allocated in cash to members to pay their taxes. Twenty percent is the legal minimum cash distribution because you need at least that much to pay your income tax on your capital allocation in your account in your co-op.

On the other hand, when you take your account out of the co-op, you don't pay income tax because you paid the tax when your money went into your account originally.

Getting the value of your ownership in cash

While you can't tap your capital account in your co-op to buy a car when you want to as you would your credit union or bank account, it is your personal property and you will eventually get the cash value in the future.

While you pay down the debt the co-op took on to buy the business from the owners by redeeming their stock, the co-op will be putting all its profits into paying down the loan. When the debt is paid off, the board of directors will determine what portion of the profits need to be kept in the business and what part can be paid out in cash to members. You shouldn't expect to get much cash out of the co-op in these early years.

Your financial interest in the co-op includes your membership fee and annual allocations. If the co-op makes money, your account will grow every year, and the longer you work in the co-op, the bigger it will be.

Initially, members' accounts stay in the co-op, capitalizing the co-op by buying tools, paying off borrowed money, building working capital to buy supplies, pay wages, etc. Once the co-op has adequate capital between the unallocated reserve account and the members' accounts, it may begin to pay out a larger portion of its "net margins" or profits (assuming there are profits) to members in cash dividends each year.

Additionally, after the co-op has paid off its debt to redeem the selling owner's shares and has adequate cash for business needs, the board can choose to "revolve" members' accounts. That means that the board can decide to pay out to members money that was -- for example -- allocated to their accounts ten years ago. That rewards folks for their seniority in the co-op.

Here's how it works when your co-op is fully capitalized and the board decides to "revolve" the members' accounts:

Cindy was an original member of the co-op when it bought the company from the retiring owner ten years ago. In the following years, she got the following allocations to her capital account in the co-op (after deducting the cash she received to pay her income taxes):

Year 1 of the co-op	$3,000
Year 2 of the co-op	$3,500
Year 3 of the co-op	$4,000
Year 4 of the co-op	$1,500
Year 5 of the co-op	$1,500
Year 6 of the co-op	$ 0 (no profit)
Year 7 of the co-op	$1,500
Year 8 of the co-op	$3,500
Year 9 of the co-op	$5,500
Year 10 of the co-op	$4,000
Year 11 of the co-op	$2,000

Bill joined the co-op at the beginning of year 5. In the following years, he got the following net allocations to his capital account in the co-op:

Year 5 of the co-op	$1,500
Year 6 of the co-op	$ 0 (no profit)
Year 7 of the co-op	$1,500
Year 8 of the co-op	$3,500
Year 9 of the co-op	$5,500
Year 10 of the co-op	$4,000
Year 11 of the co-op	$2,000

In year 11, the co-op board determines that the co-op has been fully capitalized and can afford to revolve members' accounts on a 10 year basis. Members who have been in the co-op for all 11 years get their first year's capital allocation paid to them in cash.

So, in year 11 Cindy gets $3,000 in cash, representing her capital allocation in year 1. It's tax free because she paid her income tax on it when she got it 10 years ago.

Bill doesn't get his account "revolved" because he didn't get a capital allocation 10 years ago since he wasn't a co-op member then.

If the co-op makes money and is able to continue revolving accounts, Cindy will get her year 2 capital allocation of $3,500 in year 12, her year 3 capital allocation of $4,000 in year 13, etc.

Bill will start getting his account "revolved" when he has been in the co-op for 10 years, i.e. in year 15. That's because he didn't become a member until year 5.

Co-ops that start revolving accounts may not do so every year, because they may have capital needs to replace old equipment or to expand the business. They may stop revolving accounts because they cease to be profitable. Or they may stop revolving accounts because they have heavy payouts at the retirement of founding members. These decisions are made by the board of directors.

There will be a mechanism through which members who leave the co-op will receive the value of their accounts. If you die, then your account passes into your estate, and the co-op will cash it out to your heirs. Your co-op's board will set the policies for these payouts.

Key decisions to be made on your co-op's structure

1. Qualifications for membership:
   - i. What should the probationary period of employment be before a new employee becomes eligible for admission as member? (When you are setting up the co-op initially, you would usually count past employment against the probationary period.)
   - ii. What should the amount of membership fee be?
   - iii. What are the options for paying membership fee (such as, payroll deduction vs. cash up front)?

2. "Patronage dividends": How will each year's profits be allocated to members?
   - i. To qualify as a co-op, the formula for allocation has to be based on labor input into the co-op.
   - ii. Labor input can be measured by (1) W-2 earnings, (2) hours worked, or (3) other measures of labor input, including seniority.
   - iii. You need to decide what measure (or which measures) of labor input you will use in your co-op.
   - iv. You can decide on one of those above or you can "mix and match" these. You can, for example, distribute 25% of "net margins" (profits before taxes) on the basis of hours worked during the year, 25% on seniority with the company up to some cap (such as five years), and 50% on W-2 earnings. Or you could distribute 33 1/3% on the basis of hours worked during the year and 66 2/3% on the basis of W-2 earnings. It's up to you and your fellow co-op members as long as your allocation reflects labor input into the co-op.
   - v. If you use seniority as part of your formula for allocation, it needs to be capped at a reasonable level such as 5 or 10 years. (For instance, if you set a 10 year cap, employees with more than 10 years have their seniority for allocation purposes only counted as 10 years.)
   - vi. If you are setting up the co-op to buy the company from a retiring owner, you can

choose to count seniority in employment with the company (rather than from the start of the co-op).

3. Board structure
    i. To qualify as a cooperative, a majority of the members of the board have to be elected by the members of the cooperative.
    ii. How many board members will there be?
    iii. How long is their term?
    iv. You will need to specify the officers
    v. How to provide financial protections for the owners selling to the co-op while they still have more capital in the business than other co-op members (assuming they continue working in the business for several years and become members of the co-op) or to protect their financial interest until they sell the remainder of their stock to the co-op (assuming they leave the business)

4. Annual meeting(s)
    i. When
    ii. Procedures
    iii. How members can call additional meetings

5. How will members be paid out & when?
    i. Members who leave
    ii. Do you want a provision that permits "revolving accounts" of members who stay?
    iii. You want to give basic guidance and leave the details to the discretion of the board which needs to evaluate the financial position of the business.

6. Fiscal year
    i. You will need to set the date on which your "fiscal year" (i.e., your accounting year) ends; e.g., December 31.