Types of Employee Ownership

When selling your business to your employees, determining what the best structure to adopt is a critical part of the process. In general, there are three forms your employee owned firm can take: a cooperative, an ESOP, or a hybrid that combines elements of both. You must weigh the financial and tax impact the sale will have on both the seller and the new company and the culture you wish to create. The charts below are designed to give both interested sellers and existing workers a basic overview of the key differences between the three forms.

Worker Cooperative	A type of firm where the employees directly own and control the business on a democratic basis of "one person, one vote". Typically all workers, including management, are eligible to be member owners after meeting certain requirements, including paying membership fee. In a worker cooperative, ownership and control of the business derive from *working* in the company, rather than from simply investing capital in it.
Employee Stock Ownership Plan (ESOP)	An ESOP is a specialized stock bonus plan that is allowed to invest primarily in employer stock. ESOPs are governed by both the Internal Revenue Service and the Employment Retirement Income Security Act (ERISA). In an ESOP, workers do not own the stock of the company directly, but rather through a trust. An ESOP plan can allow workers to control how shares are voted, although this is not necessary or particularly common.
Hybrid Worker Owned Firm	A type of firm that shares ownership with its employees. This can be take on many forms and structures.

Issue	Worker Cooperative	ESOP	Hybrid Worker Owned Firm
Ownership Structure	One share per person common stock. Can also have preferred stock (return on preferred stock is limited).	Very flexible. Ranges from equal distribution to a formula based on salary, seniority, and hours worked. Allocated according to predetermined formula.	Not regulated. Can be based on any formula chosen.
Legal structure.	Simple, but not familiar to all attorneys. Can be organized as a Cooperative Corp., C-Corp, or an LLC if articles and by-laws are structured appropriately.	Relatively complex, but familiar to many attorneys. Can incorporate as a C-Corp or S-Corp.	Regular C-Corp, S-Corp, or LLC.
Regulation	Little, except for tax issue	Highly regulated	No additional regulation

Issue	Worker Cooperative	ESOP	Hybrid Worker Owned Firm
Voting Rights	One person, one vote	One share, one vote, *or* one person, one vote. One share, one vote on supermajority issues.	One share, one vote, *or* one person, one vote. One share, one vote on supermajority issues.
Adding new members	Membership must be open, although co-op sets probationary period and other eligibility requirements.	Everyone over 21 who works more than 50% time, with one year of service becomes a member.	Not regulated. Requires careful planning to ensure that model is dynamic and provides clear blueprint for adding members.
Allocation of profits	Based on hours worked or wages earned. May take into account other factors such as seniority.	Based on shares held. ERISA requirements ensure that allocation policy will be clear.	Based on shares held. Important that there is a clear blueprint for how future stock allocations will be handled.
Tax implications to company paying dividends	Patronage dividends are a deductible business expense at the corporate level.	Tax deductible.	Not tax deductible for C-corp. LLC taxed as partnership has only shareholder-level taxation.
Tax implication to individual of paying dividends	Can be paid out in cash, or into "internal capital account" of individual. Patronage refunds are taxed as ordinary income.	Taxed as dividend income with a maximum rate of 15%.	In a C-Corp, taxed as dividend income with a maximum rate of 15%. For LLC taxed as ordinary income.
Need to withhold Social Security on dividends declared for worker owners.	In dispute, although if dividends are retained for at least 3 years, the IRS is unlikely to treat patronage at wages.	No	Not likely
Worker owner sale of stock	Not permitted. When members leave, they must sell them back to the company or an incoming member.	Usually not permitted. When a member leaves the company, must offer them an opportunity to sell stock back to the company.	May or may not be permitted, determined by by-laws and articles.
Valuation of individuals' "ownership stake."	Book value	Fair market value based on independent appraisal performed annually.	Valuation method can be book value, independent appraisal, or pre-agreed formula.
Valuation of company if sold to a 3rd party.	Fair market value	Fair market value	Fair market value
Cost to set up	$5,000 to $20,000	$20,000-$35,000 (more if complex)	$5,000 to $20,000
Annual maintenance cost	None, unless chosen design requires valuation.	$7,500 to $15,000	None, unless chosen design requires valuation.

Issue	Worker Cooperative	ESOP	Hybrid Worker Owned Firm
Potential tax benefit to seller	Can defer capital gains tax on the capital gains tax on the proceeds of the sale if they are invested in 'approved securities.' At least 50% of sales proceeds to employees	Can defer capital gains tax on the capital gains tax on the proceeds of the sale if they are invested in 'approved securities.' At least 30% of sales proceeds to employees	None
Outside equity investors	Permitted with various restrictions.	Permitted. The stock held by the ESOP trust must be voting common stock with the greatest dividend and voting rights of any class of common stock, or preferred stock that is convertible.	Permitted with no restrictions.
Potential for seller to retain partial ownership after sale to workers	Yes. Seller can participate as a member or own shares outright. The nature of the ownership will determine 1042 rollover eligibility.	Yes, but seller's holding must be outside the ESOP	Yes
Bank Financing	Cooperatives not well known to banks, although CDFI's such as LEAF are familiar.	Well understood by banks. In a C-Corp ESOP, loan interest and principle can be tax deductible, improving cash flow.	Well understood by banks.

Related Publications:

ICA has developed a series of best in class materials designed to help worker co-ops and other democratic firms succeed.

Model By-Laws for a Worker Cooperative: This publication provides a comprehensive introduction to worker cooperatives and includes a compendium of model by-laws for stock corporations, LLCs, or non-profits. Also included are annotations to the by-laws, as well as multitude of model & sample legal forms.

The Internal Capital Account System: Value in a worker co-ops is tracked using a system of internal capital accounts. This guide covers the basics of co-op finances, including the difference between capital shares and capital accounts, tax treatment for worker co-ops and how to deal with financial losses.

Ensuring Your Legacy – Succession Planning & Democratic Employee Ownership: Many business owners look to employee ownership as a way to cement their legacy, yet the process can be confusing and perceived as risky. This report walks owners through the process of converting to a democratic firm helps owners address whether this is the right thing for them.

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