The Employee Ownership Trust (EOT): An ESOP Alternative

by
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Table of Contents

1. Introduction to EOTs
2. The Employee Ownership Trust, An ESOP Alternative
3. The British Are Coming – ESOPs and Perpetual Trusts
4. Employee Ownership Trusts: A New Model of Employee Ownership?
5. Excerpts from the NCEO's *Employee Ownership Report*
6. Grantor Trusts: A Path to Employee Ownership

Introduction to EOTs

Introduction to EOTs

An **Employee Ownership Trust** (EOT) is a trust that holds some or all of the shares of a company on behalf of most or all of the employees of the company.

As with an **Employee Stock Ownership Plan** (ESOP), the profits or financial gains, the culture, and the corporate governance of an EOT-owned company are directed to the benefit of the company's employee-owners.

Unlike an ESOP, an EOT *does not* have individual employee share accounts. The EOT's distinct features flow from this primary difference…

U.K. Example of EOT

John Lewis Partnership

Employee-owned since 1950

$13.3B in 2018 revenue

83,000 employees (current)

U.K. Example of EOT

John Lewis Partners at Annual Year-End Meeting
Announcing 17% Bonus on Compensation

EOT Benefits

Employee Ownership Trusts are:

- not retirement plans, but…

- not regulated by ERISA

- “perpetual"

Employee Ownership Trusts avoid:

- annual valuations

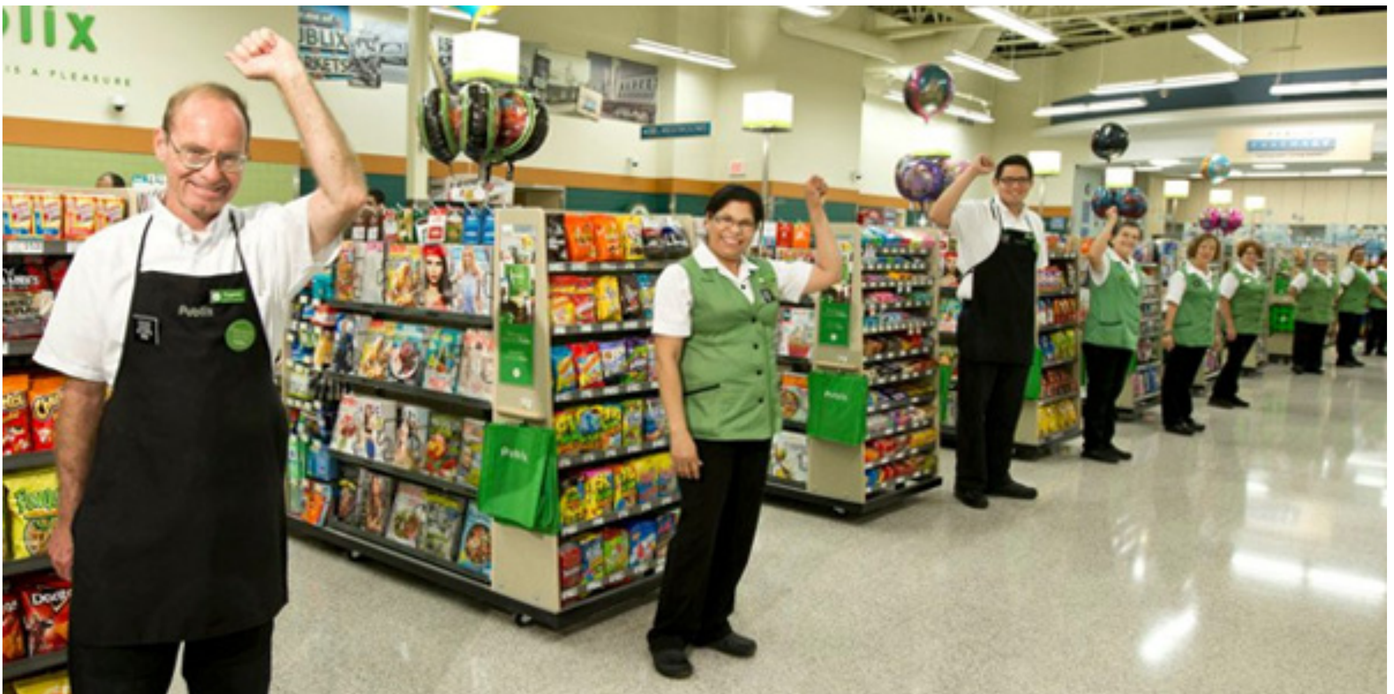
- repurchase obligations

- “haves and have-nots problem”

EOT Key Points:

1. No individual employee accounts
2. Once the shares go in, they stay in
3. Employees are “naked in, naked out”

ESOP Benefits



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ESOPs offer *very significant* tax benefits

40+ years of U.S. precedent for ESOPs

Large community of ESOP service providers

Comparison of ESOPs and EOTs

	ESOP	EOT
Tax benefits	✓	
Lots of precedent (U.S.)	✓	
Ownership culture	✓	✓
Corporate governance	✓	✓
Retirement plan	✓	401(k)
Current profit-sharing		✓
Perpetuity		✓
Simplicity (for seller)		✓
Simplicity (for employees)		✓
Low installation cost		✓
Low ongoing costs		✓
No repurchase obligations		✓
No regulation under ERISA		✓

What Kinds of Companies Might Explore an EOT?

1. Companies transitioning to employee ownership

2. ESOP companies interested in transitioning to EOT

3. Companies transitioning ownership for other types of social or environmental purposes (i.e., perpetual purpose trust)

U.S. Examples of EOT

MĒTIS
CONSTRUCTION

Metis Construction (30+ employees) converted to an EOT in early 2016 (featured in NCEO's *Employee Ownership Report)*

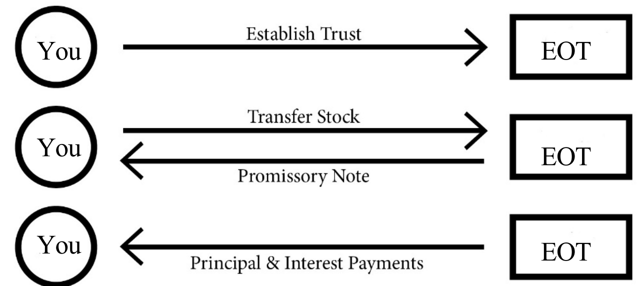
U.S. Examples of EOT

Organically Grown Company (200 employees; $100M+ revenue) converted from an ESOP to an EOT in mid-2018 (featured in *Forbes* and *Fast Company*)

F.A.Q.

1. I've heard a few different names for this. What is it called again?

- Employee Ownership Trust (EOT)
- Perpetual Trust
- Perpetual Purpose Trust (PPT)



2. How does the transaction work?

It's the same as an ESOP.

3. Are there any tax benefits for EOTs?

Sorry, none yet! But there are bills in Maryland and Wisconsin. These bills would provide a state capital gains exemption on sales to EOTs and ESOPs.

4. Does it have to be perpetual? What if I expect a future sale?

An EOT does not need to be perpetual. As the trustor, you can (and should) specify the precise conditions under which a sale would be permitted. Sale proceeds will be distributed as provided in the trust document, e.g., to charity.

5. What about governance?

In most cases, governance will be the same as an ESOP, i.e., a "circular" structure where the board appoints the trustee and the trustee appoints the board. However, if so motivated, the founder can also provide for limited or full voting rights, like a cooperative.

F.A.Q.

6. So what's the financial benefit to employees? And what about retirement?

An EOT-owned company shares a portion of its profits with employees. These profits are paid out at the corporate level as compensation and are therefore tax-deductible. Profits can be paid out as cash or as a contribution to a 401(k) plan.

7. Do I need special trust law in my state?

Nope! Your state may or may not offer adequate trust law. If not, an "administrative trustee" can be hired from another state for less than the cost of an ESOP trustee (due to lower litigation risk). Note: Your corporate domicile is the same.

8. Can I include other beneficiaries in my EOT?

Yes, that's a great place to start a discussion about installing an EOT.

9. Wait, no regulation under ERISA?

That's right. An EOT is not a retirement plan and is therefore not regulated under ERISA. The EOT is regulated under state trust law, which generally respects the wishes of the trustor. However, the IRS charges income tax on any portion of the sale price that exceeds FMV.

10. How much does this cost?

Well, an ESOP might cost more than $150K to install and $50K annually. An EOT should cost $50K to install and roughly $5K annually.

The Employee Ownership Trust, An ESOP Alternative

Originally published in the American Bar Association's
Probate & Property

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The Employee Ownership Trust, an ESOP Alternative

By Christopher Michael

For the last four decades, an employee stock ownership plan (ESOP) has been the optimal legal mechanism for transferring ownership of stock to employees in the company in which they work. A primary goal of ESOPs is often long-term employee ownership, as an ongoing employee reward program that leads to improvements in productivity and profitability and helps to ensure the longevity of the company. Unfortunately, the laws applicable to ESOPs have not kept pace with evolving trust law. In particular, legislators have not adapted ESOP policy to states' widespread reform of the rule against perpetuities. Even in states that have eliminated the rule against perpetuities, the "exclusive benefit" rule imposed by federal law requires ESOPs to prioritize employees' retirement income at the expense of employees' continued ownership of their business and thus prohibits a perpetual ESOP trust. As such, ESOPs are an uncertain vehicle when it comes to safeguarding the ownership of a firm by its employees. The ESOP structure is also exceedingly complex, which warrants additional concern. This article discusses perpetuity and other related problems with ESOPs and introduces the employee ownership trust (EOT) as a viable alternative.

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Development of ESOPs

The ESOP was developed in the 1950s by a San Francisco lawyer named Louis Kelso. An ESOP is an employee benefit program under which employer stock is transferred to individual employee accounts within a tax-exempt trust. The employer is required to repurchase an employee's

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shares on his or her retirement. In 1974, Kelso worked with Senator Russell Long to pass legislation under the Employee Retirement Income Security Act (ERISA) that gives special status to ESOP trusts. Unlike other qualified retirement plans, ESOPs may borrow from an employer for the purchase of employer shares. 29 U.S.C. § 1108(b)(3). Over the ensuing years, additional benefits were conferred under the Internal Revenue Code, including capital gains deferral for owners who sell shares to an ESOP trust and reinvest sale proceeds in domestic securities. IRC § 1042. In recent years, many S corporations have opted for 100% employee ownership, as such companies are effectively tax-exempt because of the combination of pass-through tax treatment and the tax-exempt status of the ESOP trust. IRC §§ 501(a), 401(a), 1361(c)(6).

As a direct result of ESOP legislation, the United States has demonstrated that employee ownership can be a mainstream phenomenon. Today, 11% of the private-sector workforce (13.5 million employees) participates in an ESOP at 7,000 companies. Nat'l Center for Emp. Ownership, *ESOP (Employee Stock Ownership Plan) Facts*, www.esop.org (last visited June 24, 2016). And approximately 1.5 million Americans work at 4,000 majority employee-owned businesses. ESOP plans exist in nearly every industry and at companies of all sizes. The largest majority ESOP company is Publix Supermarkets with over 180,000 employees. These figures are unparalleled in other major industrialized nations, and constitute a significant advance over previous historical periods. See generally Joseph R. Blasi, Richard B. Freeman & Douglas L. Kruse, *The Citizen's Share*, 159–66 (2013). And yet, these achievements are the consequence of a modest formula—a package of financial incentives for business owners and companies—that has enjoyed bipartisan support in Congress for the last 40 years.

Naturally, four decades of ESOP practice have also yielded lessons and opportunities for improvement. Central concerns for many founders, employee-owners, employee ownership advocates, and ESOP professional service providers include the longevity of the ESOP structure itself, as well as its complexity. In the typical ESOP transaction, a retiring business owner aims to reward his or her employees and preserve the legacy of his or her business. The fiduciary duties of ESOP trustees, however, require the sale of an ESOP's stock on receipt of a profitable offer—which may be a boon to a single generation of employees, but eliminates ownership for future employees and diminishes the founder's legacy. Moreover, structuring the ESOP transaction is time-consuming and involves a significant learning curve, a feat that can be difficult for retiring owners. Although some business owners and managers embrace the technical side of ESOPs, many more retiring owners and estate advisors prefer to avoid the tightly regulated domain of ERISA trustee standards, employee share repurchase schedules, and an obscure section of the federal tax code.

Evolving Trust Law

In the postwar period, federal legislation supported the expansive growth of employee trusts. Yet, federal policy preceded an adequate state law framework. Vesting issues (with respect to future employees) threatened the trusts' viability under the common law rule against perpetuities. Christian Marius Lauritzen II, *Perpetuities and Pension Trusts*, 24 Taxes 519, 520–21 (1946). By 1950, the pensions of 7 million employees were jeopardized by this "serious legal problem." Article, *Insulating Pension Benefits from Creditors*, 3 Stan. L. Rev. 270, 279 (1951). At the same time, commentators were "unanimous in the view" that employee trusts should be exempted from the rule on policy grounds. Note, *Legal Problems of Private Pension Plans*, 70 Harv. L. Rev. 490, 493 (1957); see generally Lauritzen, supra, at 524–30. The states responded in due measure. By 1956, "[a]bout three-fourths of the states ha[d] adopted statutes exempting employee benefit trusts from . . . the Rule Against Perpetuities." Robert J. Lynn, James W. Foreman & William W. Wehr, *The New Inheritance: Employee Benefit Plans as a Wealth Devolution Device*, 11 Stan. L. Rev. 242, 254 (1959).

Of course, beginning in 1983 with South Dakota, a majority of states altogether eliminated, or substantially modified, the rule against perpetuities. S.D. Codified Laws § 43-5-8; accord Del. Code Ann. tit. 25, § 503; N.J. Stat. Ann. § 46:2F-9. In so doing, these states allowed the possibility of perpetual (or dynasty) trusts for any number of trust purposes. Perpetual trusts are now commonplace and simple.

The employee ownership policy enacted by Kelso and Long in 1974 did not fully leverage the availability of perpetual employee trusts across the United States. Neither did ESOP law incorporate advances in dynasty trust law more generally over the ensuing 40 years. Under current law, a trust provision that instructs an ESOP trustee to hold employer shares in perpetuity, thereby establishing a lasting program of employee ownership at the company, would conflict with the "exclusive benefit" rule under Title I of ERISA.

The "Exclusive Benefit" Rule

Under ERISA, ESOP fiduciaries must act with "the exclusive purpose of: (i) providing benefits to participants [employees] and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan." 29 U.S.C. § 1104(a)(1). For many years, discrepancies between the Department of Labor (DOL), the IRS, and federal courts permitted a range of opinion as to the types of benefits permissible under the law. According to a 1992 memorandum, the DOL and the IRS objected to a plan that incorporated nonfinancial benefits, such as "job security," "conditions of employment," "employment opportunities," and "the prospect of the Participants and *prospective* Participants for future benefits under the Plan." IRS Gen. Couns. Memo., No. 39,870, at

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2–3 (Apr. 7, 1992) (emphasis added). In a 1994 bulletin, the DOL issued a slightly more flexible interpretation that allowed for the consideration of collateral benefits "that were not related to the plan's expected investment return, only if such investments were equal or superior to alternative available investments." *Interpretive Bulletin Relating to the Employee Retirement Income Security Act of 1974*, 59 Fed. Reg. 32606-01, at 32,607.

In contrast, a majority of federal circuit courts adopted a fiduciary standard that (1) acknowledged Congress's goal of encouraging employee ownership through ESOP formation; (2) questioned the extent to which ESOPs are purely investment vehicles; and (3) reflected an understanding of ESOP legislation as a carve-out within the broader framework of ERISA. *Lanfear v. Home Depot, Inc.*, 679 F.3d 1267, 1278–79 (11th Cir. 2012); *Moench v. Robertson*, 62 F.3d 553, 568-72 (3d Cir. 1995); *Donovan v. Cunningham*, 716 F.2d 1455, 1466–67 (5th Cir. 1983).

Ultimately, a recent opinion by the U.S. Supreme Court clarified that ERISA benefits do not include "nonpecuniary benefits like those supposed to arise from employee ownership of employer stock." *Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459, 2468 (2014). Rather, the "exclusive benefit" rule "must be understood to refer to the sort of *financial* benefits (such as retirement income) that trustees who manage investments typically seek to secure for the trust's beneficiaries." Id. Thus, current law prohibits ERISA trustees from prioritizing nonfinancial benefits, such as working conditions, job security, or employee ownership, as "a goal in and of itself." *Moench*, 62 F.3d at 568. As such, existing fiduciary standards under ERISA would override a perpetuity provision in an ESOP trust document.

Additional Concerns

Even if ESOP policy in fact embraced nonfinancial benefits, thereby allowing perpetuity as a valid term of an ESOP trust, an additional problem would still threaten perpetual employee ownership. Under the common law, beneficiaries may dissolve a trust by unanimous consent. Thus, employee-beneficiaries of an ESOP could attempt to "bust the trust."

An even more recent development in trust law eliminates the requirement of a trust beneficiary and allows grantors to establish a trust with a noncharitable purpose. Of course, the law has long permitted trusts dedicated to charitable purposes, but noncharitable purpose trusts are new. Originally authorized in foreign territories such as Jersey and Bermuda, U.S. states witnessed a wave of purpose trust legislation in the last decade. Del. Code Ann. tit. 12, § 3556; Mass. Gen. Laws Ann. ch. 203E, § 409; S.D. Codified Laws § 55-1-20. Purpose trusts are now also included in the uniform trust code as model legislation recommended for adoption by all U.S. states. Unif. Trust Code § 409. In light of late-20th-century and 21st-century developments in trust law, a moderate improvement to ESOP law would allow founders to leverage jurisdictions, such as South Dakota or Delaware, that permit both dynasty and purpose trusts. Founders would then be able to achieve the strongest guarantee for perpetual employee ownership as a purpose of an ESOP trust.

Yet even then, another obstacle arises in the context of minority ESOP-owned businesses. A company may choose to refrain from contributing new shares to an established ESOP. This is not often a real-world problem, as employers typically "recycle" shares back into the plan. But absent fresh contributions of employer stock, a minority ESOP will terminate after the exit of all current employee-participants. A solution to this problem would require further legislative action.

As illustrated, ESOP law, which continues to recognize only financial benefits, treats an ESOP trust purely as a retirement vehicle. This purpose contrasts with Congress's intended use of the ESOP trust as a vehicle for employee ownership. *Martin v. Feilen*, 965 F.2d 660, 664 (8th Cir. 1992). The tension between these purposes argues for alternatives to an ESOP trust that do not involve such a conflict. To this end, American and British history reveals a tradition of employee ownership that pre-dates Kelso and ERISA, and, in turn, offers a workable solution.

Traditional Employee Ownership

Over 150 years ago, a popular conception of employee ownership developed in the United States and United Kingdom as a widely-shared response to the rise of the modern corporation, large-scale centralized manufacturing, and capital-intensive technologies. Government officials, academics, business elites, and working people on both sides of the Atlantic, of disparate professional and class backgrounds, believed that employee ownership was a moral imperative and an essential measure of human and industrial progress.

John Stuart Mill, the influential philosopher, political economist, and member of Parliament, was the most notable 19th-century advocate of employee ownership. Mill was frequently quoted by contemporaries for his belief that employer-owned firms would "be gradually superseded by

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partnership, in one of two forms: in some cases, association of the labourers with [employers]; in others, and perhaps finally in all, association of labourers among themselves." John Stuart Mill, *Principles of Political Economy*, at IV.7.14 (William J. Ashley ed., Longmans, Green and Co., 7th ed. 1909) (1870). He thought that employee ownership was not only inevitable, but held the potential for:

> a change in society, which would combine the freedom and independence of the individual, with the moral, intellectual, and economical advantages of aggregate production; and . . . realize, at least in the industrial department, the best aspirations of the democratic spirit, by . . . effacing all social distinctions but those fairly earned by personal services and exertions.

Id. at IV.7.62.

Echoing popular sentiment, Mill felt that an economic system in which employee ownership was the predominant structure "would be the nearest approach to social justice, and the most beneficial ordering of industrial affairs for the universal good, which it is possible at present to foresee." Id.

At heart, Mill's views, and the views of like-minded Americans and Brits, were sustained by a fundamental belief that:

> intelligent, educated labor possesses the capacity for the accomplishment of any undertaking or enterprise, and need not wait for an individual called an employer to associate its effort, and direct and control the industry out of which it earns wages and pays premium to capital. . . . Intelligent labor need not wait until some [person] has hired it. It can . . . employ itself.

Bureau of Labor Statistics, State of California, *Third Biennial Report*, at 324 (1888).

The preceding passage was authored by U.S. Senator, railroad magnate, and founder of Stanford University, Leland Stanford. At the time, he was writing from his seat in the U.S. Senate in support of model employee ownership legislation for the District of Columbia. 49th Cong. (1886).

Employee ownership was synonymous with a culture of personal responsibility, industrial harmony, workplace health and safety, individual dignity, just compensation, and temperance.

Traditional principles of employee ownership, as advocated by Mill, Stanford, and many others, involve profits, voting, and culture. Reformers were particularly interested in the fair distribution of profits, and tended to praise financial structures that rewarded employees on the basis of labor input. Voting rights were pervasive in definitions of employee ownership, and employee-owned firms were understood to be enterprises in which employees elected the board of directors, and voted on shareholder issues, on a "one person, one vote" basis. Mill, supra, at IV.7.21. Finally, employee ownership was synonymous with a culture of personal responsibility, industrial harmony, workplace health and safety, individual dignity, just compensation, and temperance. When employees made a financial investment in the firm, being issued a fair reimbursement upon exit was a matter of due course. The primary aim of employee ownership, however, was not to generate a profit for exiting employee-owners.

Perpetual Trusts: Flexibility, Efficiency, and Accountability

Perhaps more in line with these traditional principles of employee ownership is the employee ownership trust. One of the mainstream forms of employee ownership in the United Kingdom, an EOT does not involve assigning and repurchasing shares for individual employees. Rather, stock is transferred to a perpetual trust and administered on behalf of all present and future employees. The best example of an EOT is John Lewis Partnership. Originally founded in 1894, the popular British retail chain employs 91,500 associates and has been held in trust for its employees since 1929.

John Lewis, unlike an ESOP company, has no obligation to repurchase the stock of individual employees. Instead, employees are "naked in, naked out." They earn a percentage of profits while working at the firm but exit without realizing any growth in the firm's value, much as in a law partnership. John Lewis also has a constitution that accords voting rights to all of its employees, empowering them to elect the firm's governing body. The Constitution of the John Lewis Partnership (June 2015), https://www.johnlewispartnership.co.uk/about/our-constitution.html (last visited Oct. 21, 2016). Finally, John Lewis trustees are required to preserve the business and its employee-owned structure for the benefit of the employees—a benefit that is understood to include both financial and nonfinancial elements and is best expressed in the culture of the firm, that is, the quality of working relationships among employee-owners.

In the United States, an EOT is able to give voting rights to employees by means of a power to direct the trustee. This power can be as narrowly or widely tailored as the settlor wishes. In this way, current employees can be granted effective control of high-level decisions, such as electing board

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directors and voting on shareholder issues, while maintaining trustee discretion over critical matters, such as the sale of the company and its substantial assets. Some states, like South Dakota and Delaware, have directed trustee statutes that not only allow such a bifurcation but also allow trust planners to substantially limit the liability of directed trustees. Del. Code Ann. tit. 12, § 3313(b); S.D. Codified Laws §§ 55-1B-2, -5.

Planners should keep in mind that ERISA specifically excludes trusts that do not systematically defer income until retirement. 29 U.S.C. § 1002(2)(A); *McKinsey v. Sentry Ins.*, 986 F.2d 401, 405–06 (10th Cir. 1993); *Murphy v. Inexco Oil Co.*, 611 F.2d 570, 574–76 (5th Cir. 1980). As such, perpetual employee ownership can be achieved today, without any regulatory or legislative changes, by means of establishing an EOT in a perpetual and purpose trust jurisdiction. An EOT can be used for both minority and majority ownership of a company, and nothing precludes the combination of a majority EOT (for perpetuity) and a minority ESOP (for tax benefits).

Of course, no business lasts forever. EOTs should have an independent co-trustee or trust protector that can approve the liquidation or sale of the company when the close of the business is unavoidable. This function is strengthened when the co-trustee or trust protector is (1) appointed on creation of the trust; (2) not subject to employee election or recall; and (3) self-appointing with respect to successor co-trustees or trust protectors. Under the terms of the trust, the principal might be reserved for distribution to an organization that supports employee ownership.

An additional benefit of the EOT is that certain "constitutional protections" can be locked into the structure. For example, the EOT might require the company to (1) safeguard earnings by fixing base compensation in line with market rates; (2) retain a percentage of annual net income as permanent reserves; (3) allocate funds for employee education and engagement; (4) join a lobbying association

Perpetual employee ownership can be achieved today, without any regulatory or legislative changes, by means of establishing an EOT in a perpetual and purpose trust jurisdiction.

for employee-owned businesses, such as the ESOP Association; or (5) make annual contributions to a charity in support of employee ownership, such as the National Center for Employee Ownership. Naturally, planners should tailor such protections, and the overall package of employee benefits under the EOT, to the needs and interests of their clients.

Finally, and of central importance, the EOT is a simple structure. It takes a fraction of the time required to implement an ESOP, and because of the lack of any repurchase obligation or corresponding need for annual valuations, ongoing administration costs for an EOT are minimal. Whereas one of the greatest challenges for ESOP firms is communicating the ESOP's retirement benefits to plan participants, the real-time benefits of an EOT are easy to explain to employee-owners. In turn, the EOT is arguably more efficient as a reward-based feedback mechanism, which is critical when increased productivity is one of the goals of an employee ownership program. At John Lewis Partnership, the rewards are self-apparent, not only in the culture of the company, but at annual meetings where the companywide bonus is declared on a raised placard as a single- or double-digit percentage of salary.

Employee Ownership for the 21st Century

In 2014, the United Kingdom passed new EOT legislation. Thanks to the leadership of Graeme Nuttall at Fieldfisher LLP, author of *The Nuttall Review of Employee Ownership*, British business owners are entitled to a 100% capital gains exemption on the sale of shares to an EOT in the year that the trust achieves majority ownership of the target company. Taxation of Chargeable Gains Act §§ 236(H)–(U). Under British law, trustees must administer shares for the benefit of employees as employees, not as investors. Id. § 236(H). If business conditions require that the target company be liquidated or sold, the trust principal may be donated to charity. Id. §§ 236(K)(2), (L)(5). An EOT is not restricted to majority ownership or a charitable remainder holder, although the capital gains tax exemption is accorded only in the case of majority ownership.

In the United States, serious attention should be dedicated to amending interpretations of the "exclusive benefit" rule that refers to the immediate financial interests of current employees. Congress should reaffirm its original intention for ESOP legislation as a carve-out under ERISA that would "bring[] about stock ownership by all corporate employees" by addressing "regulations and rulings which treat [ESOPs] as conventional retirement plans." Tax Reform Act of 1976, Pub. L. No. 94-455, § 803(h) (1976) (quoted in *Dudenhoeffer*, 134 S. Ct. at 2466). In reviewing ESOP legislation, Congress might consider the evolution of trust law over the past 40 years and provide ESOP founders the option to (1) install perpetual employee ownership as a purpose of an ESOP trust and (2) require ESOP trustees to consider the long-term, financial and nonfinancial interests of current and prospective employees. Finally, Congress might legislate a seamless mechanism for the transition of existing ESOP trusts into perpetual EOTs.

At the same time, business owners can now use an EOT as a practicable alternative to an ESOP that embodies

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the traditional principles of employee ownership. Likewise, attorneys and trust companies would do well to offer the EOT as a low-cost service option. That said, for many companies, an EOT is not presently a cost-efficient alternative to an ESOP. Notwithstanding lower implementation costs and negligible maintenance costs, EOTs are not able to compare with the substantial tax savings that are available using an ESOP. For this reason, Congress should take action to level the playing field between ESOPs and EOTs. A major step in this direction would be for Congress to (1) qualify EOTs as tax-exempt trusts under IRC § 501(a) (granting EOT companies treatment equivalent to that of ESOP S corporations) and (2) permit capital gains tax deferrals on sales to EOTs under IRC § 1042.

Beyond this federal measure, states should seek to enact incentives for EOTs. New York recently witnessed the introduction of a bill (similar in spirit to the new British law) that allocates a capital gains tax exemption for employee ownership successions that result in majority employee ownership. The bill embraces both EOTs and ESOPs. Assemb. 9618(5), 201st Leg., 238th Sess. (N.Y. 2015). Further, Wisconsin lawmakers are now considering model employee ownership legislation drafted by the author, which includes an array of tax incentives for EOTs, ESOPs, and other forms of employee ownership, in addition to a loan and loan guarantee program, procurement preferences, and a state university-based center.

As the employee ownership community works to expand state and federal incentives for ESOPs, attention should be given to according the same or similar benefits to EOTs and other substantial all-employee ownership plans. In every instance, the primary focus should be on easing the process of employee ownership successions—and thereby broadening access to employee ownership—by means of simple, efficient, and dependable legal mechanisms. ■

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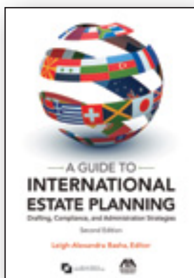

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The British Are Coming – ESOPs and Perpetual Trusts

Originally published in *Employee-Owned America*

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The British Are Coming — ESOPs and Perpetual Trusts

By Christopher Michael

In the United States, the employee ownership community has its favorite example: Publix Supermarkets (http://www.publix.com/). Founded in 1930, Publix started an employee ownership program in 1959. With more than $34 billion in revenue, Publix now manages 193,000 employees at over 1,200 establishments across seven states in the Southeast. The British have their own favorite example of employee ownership: John Lewis Partnership (https://www.johnlewispartnership.co.uk/)(which includes the Waitrose supermarket chain (https://www.johnlewispartnership.co.uk/about/waitrose.html)). Originally founded in 1894, the popular retailer employs 88,900 associates and has been held in trust for its employees since 1929. In recent years, both conservative and liberal British governments have promoted the idea of moving to a "John Lewis economy." (https://www.gov.uk/government/speeches/responding-to-nuttall-next-steps-to-a-john-lewis-economy)

Both companies demonstrate employee ownership's potential to build wealth for workers, transform labor-management relations, and improve customer service. But there is a significant difference between American and British styles of employee ownership.

Publix uses an employee stock ownership plan (https://www.nceo.org/articles/esop-employee-stock-ownership-plan) (ESOP), a tax-qualified retirement program that acquires shares of the employees' company and credits them to individual employee accounts. When an employee retires, the company must repurchase an employee's shares with cash. ESOPs, while popular in the US, entail several challenges for companies that adopt them. An ESOP's system of stock allocation, annual valuation, and repurchase—tracked for each employee—is complex and expensive. The fiduciary obligations of the trustees who are charged with managing employee shares, which are determined under federal law and regulated by the Department of Labor and the Internal Revenue Service, are demanding. Employee stock at ESOP companies like Publix must be managed in the best interests of employees as participants in a retirement plan. If a strategic buyer—for example, an even larger national supermarket chain—made a sufficiently high offer for Publix stock, ESOP trustees might have a legal obligation to sell. Although possibly in the interest of current employees (as retirees), a sale would end employee ownership of the company.

By comparison, John Lewis Partnership's employee ownership structure is simple. It is not based on individual stock ownership, and employees at the company do not have share accounts. Rather, all of the shares are held by trustees on behalf of all the employees. So John Lewis employees are not bought out at retirement. Rather, they enjoy profit-sharing during the years that they work at the company. The firm is therefore not subject to repurchase obligations or the need for annual valuations, and it avoids the workload that goes into planning for these requirements.

Moreover, the company is managed with the expectation of preserving the company's employee ownership for current and future generations of employees. John Lewis's goal is to improve the lives of its workers, not to create a retirement nest egg. During their working lives, John Lewis employees enjoy a workplace culture that

treats every employee with the dignity of a partner and co-owner. Employees are equal partners in the business, from the first day on the job to the last, under the terms of the John Lewis Partnership Trust and the company's Constitution (https://www.johnlewispartnership.co.uk/about/our-founder/our-constitution.html).

John Lewis himself must be credited as the genius behind the John Lewis Partnership Trust. But the basic concept of a perpetual employee ownership trust (EOT) is not particularly British. Developments in US trust law over the last few decades have yielded a host of useful trust law tools, including perpetual trusts, non-charitable purpose trusts, directed trusts, and trust protectors. Combined, these tools make it possible to design an EOT—akin to the John Lewis trust—right here in the United States.

Some companies have done just that. Mētis Construction (http://metisconstructioninc.com/), a Seattle-based firm, transitioned ownership to an EOT in early 2016. As at John Lewis, Mētis employee-owners share profits and enjoy a workplace culture that values the employees as equal partners. Also like John Lewis, the company is managed for the benefit of current and future employees in their roles as workers, not only as future retirees. Mētis used employee ownership as a succession strategy. As in a standard ESOP transaction, owner Matthias Scheiblehner sold his shares to the employee ownership trust, to be repaid over time from the future profits of the company. Around the same time, Equity Atlas (http://equityatlas.com/) was launched as a startup home mortgage company, with an EOT created at the company's inception. Brad Hippert and other founders liked the idea of a perpetually employee-owned company.

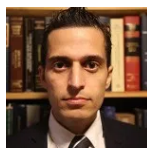
Some ESOP advocates worry that employee ownership trusts won't allow workers to build up nest eggs that capture the value of a successful, growing company. But an EOT-owned company can use a portion of its annual surplus to make an employer contribution to a standard diversified 401(k) plan. This satisfies a major critique of ESOPs, which is that employees have all their eggs in one basket. As to whether an ESOP account will be more valuable over time than a profit share (paid out in a mix of cash and 401(k) contributions), the analysis can cut both ways. The fact that EOT companies retain some surplus for reinvestment in growth suggests that owning ESOP stock may be worth more than a profit share. On the other hand, an EOT company that reaches an efficient size may not need to reinvest much. Also, after a period of time, a portion of an ESOP company's surplus is used to repurchase the shares of retiring employees. So an EOT company's payout in cash and 401(k) contributions may, over time, add up to something very close to the value of an ESOP account. And the diversification of a 401(k) reduces employee risk.

Although EOTs are legal and practicable in the US today, the next step in broadening access to this simpler, less expensive, and perpetual form of employee ownership is public policy. The author has helped to develop legislation in Maryland, Wisconsin, and New York that would provide a 100% state capital gains tax exemption to business owners who sell a majority of their shares to an EOT or an ESOP. These bills are similar to a new British la (http://www.fieldfisher.com/publications/2015/09/new-tax-exemptions-for-companies-owned-by-employee-ownership-trusts#sthash.dtm8G990.dpbs)w (http://www.fieldfisher.com/publications/2015/09/new-tax-exemptions-for-companies-owned-by-employee-ownership-trusts#sthash.dtm8G990.dpbs) passed in 2014 (http://www.fieldfisher.com/publications/2015/09/new-tax-exemptions-for-companies-owned-by-employee-ownership-trusts#sthash.dtm8G990.dpbs), thanks to the advocacy of Graeme Nuttall, the UK's leading employee ownership attorney (see the Nuttall Review (https://www.gov.uk/government/publications/nuttall-review-of-employee-ownership)).

Finally, we should look to Congress to level the playing field between ESOPs and EOTs. One major step in this direction would be for Congress to smooth the process of transitioning from an ESOP to an EOT. Such a provision would provide more options for employee-owned businesses. Organically Grown Company (https://www.forbes.com/sites/annefield/2018/07/21/a-novel-restructuring-allows-an-organics-pioneer-to-maintain-its-mission/), for example, switched from an ESOP to a perpetual trust in the interest of ending the typical haves-and-have-nots problem of

ESOP companies (new employees benefiting less from the ESOP than longer-term employees). Organically Grown Company was also interested in ending the constant cycle of repurchase obligations—the proverbial "snake eating its tail"—and expanding its governance model to consider the interests of non-employee stakeholders. Action by Congress to facilitate similar company transitions would require rules allowing ESOP trustees and companies to redeem ESOP shares over time through tax-deductible payments. To this end, Congress should grant EOTs the major benefit currently afforded to ESOP companies: EOTs should be qualified as tax-exempt and eligible to hold stock in S corporations. These measures would equalize the tax treatment of EOT-owned S corporations and ESOP-owned S corporations, and allow a hybrid ESOP/EOT for a single S corporation, when desired. Finally, as a broader measure, business owners should receive the same federal capital gains tax benefits on sales to an EOT that they enjoy on sales to an ESOP.

Who knows? Maybe even Publix will want to transition to an EOT and become the "John Lewis" of the United States.



Christopher Michael is an attorney for employee ownership trusts and ESOP companies. He advised Mētis on the creation of its EOT, and Organically Grown Company on its transition from ESOP to perpetual trust. For more information, see his website: www.eolaw.com (http://www.eolaw.com/).

Employee Ownership Trusts: A New Model of Employee Ownership?

Originally published in the Ohio Employee Ownership Center's
Owners At Work

Employee Ownership Trusts: A New Model of Employee Ownership?

Christopher Michael
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Chris Michael is an attorney based out of New York City that has been involved in the creation of ESOPs, worker-owned co-operatives, and now Employee Ownership Trusts. While gaining some traction in European countries (predominately in the UK) EO Trusts are a relatively new concept here in the USA. OAW talked to Chris to get an overview of EO Trusts, how they are used, and a sense of the pros and cons of the model.

Q: Chris, thanks much for talking with us today.
A: Thank you––it's an honor to be speaking with the OEOC.

Q: After some time working with both ESOPs and worker owned cooperatives, you've begun working on what is, in the US at least, a new model of employee ownership. Can you briefly describe what is an Employee Owned Trust, and what prompted your interest in it?
A: An employee ownership trust (EOT) is a legal structure that allows a company to remain employee-owned in perpetuity. In short, the company shares go into a trust and stay there forever. The company is operated by the trustee on behalf of the employees like at an ESOP company. The company culture should also reflect its employee ownership structure like an ESOP. However, unlike an ESOP, an EOT is not a retirement plan. Employee-owners are "naked in, naked out." They don't have to make any contributions on the way in, and they don't get bought out when they exit. Employee-owners don't accumulate shares in individual accounts. Rather, they receive a percentage of ongoing profits, in accordance with a formula, throughout the duration of their employment. Of course, some of these profits can be channeled into a diversified 401k plan for retirement purposes.

I spend a lot of my time as an attorney working with employee-owned businesses, but I'm also a Ph.D. student writing a dissertation on the history of employee ownership. I tend to think long-term about things. And I'm just not quite satisfied with the idea of building employee-owned businesses that might sell out at any time in the future. Of course, the economy is constantly in motion, and business enterprises aren't always intended to last forever. Nevertheless, it seems to me that we should be aiming for stability and preserving the employee ownership structure as long as possible. We shouldn't make it easy to eliminate employee ownership at a company, and we certainly shouldn't impose requirements on companies to sell out. The EOT offers a common-sense solution to this problem.

Q: My understanding is that this model had its genesis in the UK.
A: That's right! The best-known EOT company is John Lewis Partnership, which is one of the biggest and oldest EO businesses in the world! It was founded in the late 1800s, transitioned to full employee ownership in 1950, and currently has 95,000 employee-owners. All employees are owners on day one of employment. Also, many folks don't know this, but all employee-owners at John Lewis have equal voting rights. I should add that John Lewis is kind of like the Macy's of the UK––a very upscale department store chain.

Q: How many Employee Ownership Trusts have you helped put in place?
A: I've put in place about half a dozen EOTs, and designed about another half a dozen that are soon to be implemented.

Q: What in your view are the basic pros and cons of the model as compared to both ESOPs and worker owned cooperatives?
A: EOTs are significantly less expensive and less time-consuming than ESOPs. When I describe the EOT concept to ESOP folks, it takes them quite a while to wrap their head around how simple it is. EOTs don't require annual valuations. They aren't retirement plans, so there is no reason for them to be regulated by the Department of Labor. There is far less reason for litigation, so trustee costs should be much lower. There are no repurchase obligations, and so there is no need for a fancy financial analyst to help with scheduling. You can see where I'm going with this...

As per worker-owned cooperatives, a lot of folks are nervous about the unrestricted democracy. In contrast, an EOT can be structured just like most ESOPs, with a circular "board appoints trustee, trustee elects board" structure. However, an EOT can also be structured as a "constitutional" democracy where employees have equal voting rights, but constitutional protections ensure basic elements of good governance and financial management, such as requiring reinvestment of a percentage of earnings back into the business. I should add that it's also much easier to accommodate business owners during a sale to an EOT. I have a pet theory that most selling business

owners aren't altogether that worried about employee-owners having equal voting rights––they're just worried about employee-owners having equal voting rights while they're still "on the hook" with seller financing! An EOT can easily resolve this concern by providing for an independent trustee during the sale period. After the loan is paid back and the business owner is fully "cashed out" of the company, a provision in the EOT trust document can toggle on employee voting rights. You get the benefits of a worker-owned cooperative without the commonplace obstacles that prevent their formation. I'd add that this same "staging" process for employee voting rights can also be used in ESOP transactions.

Perhaps the main differentiator is that EOTs can be structured to maintain the company under perpetual employee ownership. We know that the ESOP trustee has a duty to sell the company out of employee ownership when presented with a sufficiently high offer. We also know that demutualization is a longstanding historical problem with the worker-owned cooperative. For selling business owners whose primary concern is legacy and the perpetuity of the employee ownership structure itself, and who are willing to sacrifice certain tax benefits, then an EOT is the best option.One last note here––a lot of folks also like the fact that certain core values can be locked into an EOT, such as making sure that the company is environmentally responsible, or that it donates some percentage of net income to their state center for employee ownership!

Q: One of the complaints I've heard about the model is that there are insufficient protections for employees, both at the time of the deal and as an ongoing entity. How would you respond to this?

A: For better or worse, a business owner can do about whatever they want with their company. They can shut the business down forever and sell the physical assets. They can attempt to preserve the business by giving it to a family trust. They can also preserve the business by selling to an employee ownership trust. All of these things can be done on a business owner's terms without interference from the government. An ESOP is distinguished because selling business owners and businesses receive certain tax benefits. In exchange for these benefits, ESOP transactions and ESOP companies are tightly regulated. Right now, business owners do not receive any tax benefits by selling to an EOT, and so they are not burdened by regulation. I would add that, as with an ESOP transaction, employees are not paying out of their own pockets on an EOT deal. So, again, a business owner can do whatever they want with their company––as long as employees and taxpayers aren't paying for it. I'm not unconcerned about problems that may arise, but I also don't see this as a pressing issue. The business owners that I work with are selling to an EOT for the right reasons.

Q: What in your view would be an ideal scenario in which an Employee Ownership Trust makes sense or work best?
A: Right now, ESOPs enjoy immense tax benefits. So, for any company with a valuation greater than $1M, an ESOP is probably going to be the best fit. An EOT would be great for anything smaller than that. Putting aside company size, if a selling business owner really values the idea of creating a perpetually employee-owned company that can never be sold out, and they are willing to sacrifice the tax benefits, then an EOT would be the way to go.

Q: Looking at the current legal and regulatory framework here in the US, what if any impediments do you see that would, or can, impede the growth of the model?
A: My contribution here has been to identify the appropriate legal framework for an employee ownership trust in the United States. I published two law review articles about this––one in a top tax law journal, the other in a top trust law journal. I don't see any legal or regulatory impediments to the EOT. The EOT can be used today by any company in any state in the country. That said, the main issue moving forward is whether Congress will give EOTs the same tax benefits enjoyed by ESOPs. The quickest way to do this would be to make the EOT an eligible holder of S corporation stock and grant tax-exempt status to EOTs. This would give S corp EOT companies the same tax benefits as S corp ESOP companies.

It would also be smart to ensure that ESOP companies can transition to an EOT without suffering any adverse tax impact. I've recently spoken with a couple of ESOP companies that would love to transition to perpetual employee ownership and eliminate their endless repurchase obligations, but the tax impact of a transfer to an EOT is just too burdensome. As a final plug, I would add that I recently drafted model state legislation that features the EOT, alongside ESOPs and other forms of direct employee share ownership. We don't have to wait for federal legislation. In 2017, the Ohio legislature might create a state-level capital gains exemption for business owners who sell to an EOT or an ESOP.

Q: Chris, as always I appreciate your time.
A: Likewise, Chris!

More information on EO Trusts, their uses, and relevant laws can be found at the following links:

www.eolaw.com

Excerpts from the NCEO's *Employee Ownership Report*:

"Can ESOP Participants Say No to a Takeover Offer?" by Theodore Becker

NCEO Case Study on "Employee Ownership through Perpetual Trusts"

Originally published in the January-February 2017 issue

Can ESOP Participants Say No to a Takeover Offer?

If an ESOP company receives an offer to purchase substantially all its assets or stock and the directors are in favor of accepting the offer, then the ESOP trustee is required under ERISA to exercise its fiduciary duty in deciding whether to vote the ESOP shares in favor of or against the proposed transaction. In certain circumstances, ESOP participants have a right to vote on the transaction. Can they vote "no" and force the trustee to vote "no" as well? Under current law and practice, the answer is unclear.

Do Trustees Need to Follow the Participants' Vote?

The answer depends on the circumstances. If there are unallocated shares, the trustee will vote those shares. If the plan document requires mirror voting of unallocated shares based on participants' votes of allocated shares, the trustee does not necessarily have to follow this direction. Even if the ESOP participants are allowed to vote a controlling number of shares on a proposed offer, the trustee may need to override the participants' vote if the trustee believes it would be a breach of fiduciary duty under ERISA to follow the participants' vote. That could happen, for instance, if the participants voted "no" on an offer with a very large premium from a buyer that would lay off employees, relocate operations, or offer continued employment but for lower compensation. Employees could be put in the difficult situation of losing their jobs or working for less pay, in return for a relatively small amount of money for their stock.

In *Herman v. NationsBank of Georgia, N.A.*, a case concerning a hostile takeover bid for Polaroid, the Department of Labor took the position that the ESOP trustee must essentially ignore participant directions if it concludes that the offer would substantially increase the value of plan

assets. In a 1995 letter to the AFL-CIO, Olena Berg, the Assistant Secretary of Labor at the time, said that trustees cannot "automatically assume that following plan provisions [providing for participant voting] in every case will come out with a result that is prudent under ERISA." But in those cases where a trustee does not follow the participants' vote, the trustee needs to show in writing why it followed its own course. Trustees ordinarily should give deference to the participants' vote, but can still override it if the trustee believes the participants' decision is inconsistent with ERISA requirements. This effectively expands the range of acceptable offers. Some offers that the trustee normally might accept could be rejected, but higher offers could not be rejected if doing so would be a breach of fiduciary duty. In the absence of clear guidance, however, trustees may be more likely to err on the side of caution.

Providing the Vote

If the offer is structured as an asset purchase, the law entitles ESOP participants to pass-through voting. If the offer is to purchase stock, however, pass-through is not required by ERISA, but a company can choose to include pass-through voting in its plan documents. If a company does so, participants must be given adequate disclosure materials to make their choice. The trustee (not the company) should hire an advisory firm to prepare detailed material on the offer, explaining the risks and considerations in language ordinary participants can understand. Company management needs to be exceptionally cautious to play a neutral role in this process. Management should, however, make sure that employees understand how ERISA works in acquisitions, ideally by bringing in an independent third party. Acquirers need to be told in advance, in detail, what this process will involve and how much it might cost in dollars and time.

Employee Voting Still Makes a Difference

Requiring a pass-through vote by ESOP participants may, in itself, discourage potential buyers who are not comfortable with the prospect of going through a long, expensive process of making an offer in the face of an uncertain election. Even the possibility of a "no" vote could be perceived by a potential buyer as making the acquisition of an ESOP company more expensive than a company without an ESOP.

Should You Allow Employees to Vote?

Most ESOPs do not provide more than the mandatory minimum voting rights on acquisition offers, presumably because management and boards want to have more control over that decision. In practice, however, we know of only a few cases where employees and management have gone different ways on a vote, and these cases sometimes presented unusual scenarios, such as feuding family members serving on boards and ESOP trust committees. ■

The NCEO thanks Theodore Becker of Drinker Biddle & Reath LLP for his input on this article. Any conclusions and errors are the NCEO's, not his.

The NCEO is launching a project to explore the desirability and viability of regulatory changes on this issue. We very much welcome your comments, which should be sent to Corey Rosen at CRosen@nceo.org or Loren Rodgers at LRodgers@nceo.org.

CASE STUDY

Employee Ownership through Perpetual Trusts

Most conversation about employee ownership in the United States focuses on three vehicles: ESOPs, equity compensation plans, and worker cooperatives. Recently a few company owners have been considering a perpetual trust, an employee ownership model imported from the United Kingdom. The March-April 2016 issue of this newsletter covered the design firm WATG, a U.S. company whose shares are owned by a U.K.-based trust on behalf of employees. This article explores a related approach.

In 2008, Mattias Scheiblehner founded Metis Construction, which does commercial and residential construction. In February 2016, he sold all of the shares to a trust. The sale price was calculated to reflect the time and direct expenses Scheiblehner had invested to establish the company. Metis is based in Seattle, and the trust is a noncharitable purpose trust, a form of trust that exists in many but not all states. The trust is intended to be the permanent owner of the company shares, but state law only allows it to exist for 150 years after the death of the settlor or the final beneficiary. Scheiblehner hopes that when that time comes, the laws of the state of Washington will have changed, but otherwise, the founding documents of the trust instruct it to move to a state with laws that do allow actual perpetuity.

Trust Ownership at Metis Construction

Of the 34 current employees, 18 are employee-owners, or more precisely, beneficiaries of the trust. Another 16 employees are not yet owners, but they are on track to become owners over time if they remain at the company. People who were Metis employees as of six months before the transaction had the chance to become owners immediately. All employees who joined later are automatically given the option of becoming members if they are still employed by Metis at the conclusion of a five-year probationary period.

The trustees of the Metis trust are a subset of Metis employee-owners. Prospective trustees put their names forward and then all employee-owners vote on who will be trustees. In addition, the company has one independent outside trustee.

Scheiblehner sees this structure as simply the right thing to do because "any other organization misses the point of who is doing the work and who is making the profit." He also sees a transformation in the increased responsibility employee-owners are taking on themselves.

Contrast with ESOPs and Co-ops

In an ESOP, participants receive shares or the cash value of shares, generally at retirement, but the financial benefit to Metis employee-owners is that they annually receive a share of company profits. By default, Metis pays 70% of each year's profits as profit sharing, which goes to employees based on hours worked.

Company shares, both at Metis and at ESOP companies, are held by trusts, but the trust that owns Metis shares is dramatically different from an ESOP trust.

- Since the Metis trust does not pay retirement benefits to employees, it is not subject to ERISA. By contrast, ESOPs have requirements for participation, allocation of benefits, fairness to non-highly-compensated employees, distribution, and more.
- The Metis trust is intended to be the owner of the company in perpetuity, but the trustee of an ESOP, by contrast, may find it difficult to resist an offer to buy the shares if the terms are sufficiently favorable. *(See the article on page 4.)*
- ERISA provides standards for the valuation of shares in transactions involving ESOPs, but shares held by the Metis trust are intended never to circulate, so once they enter the trust, the shares do not need to be valued. The valuation standards for determining the price for the sale of shares to the trust depends on state trust law, not on federal ERISA rules.

The tax treatment of ESOP companies, especially S corporation ESOPs, does not apply to Metis. The Metis model has some similarities with worker cooperatives, such as democratic governance and egalitarian treatment of profits. Scheiblehner himself describes the company as a cooperative, although in a traditional cooperative, members own their shares directly, rather than through a trust.

Other Approaches

Metis was an ongoing business that converted to trust ownership, but other models are possible. Equity Atlas, for example, is a mortgage and financial services company that was founded by Brad Hippert in 2016, and its shares have been owned by a perpetual trust since its founding.

Chris Michael of the ICA Group, who worked with both Metis and Equity Atlas, says that two main reasons might lead a business owner to choose employee ownership via perpetual trust. First, the model may be especially attractive to business owners who want to ensure that employee ownership lasts in perpetuity without the risk of an unwanted buyer. Second, the lower cost and increased simplicity of perpetual trusts can make trust ownership a good approach for companies that are too small for ESOPs or that want to avoid the cost and complexity of an ESOP transaction and the ongoing costs of complying with ESOP requirements. ■

Learn more about perpetual trusts at the NCEO annual conference. Chris Michael also has an article about U.S. perpetual trusts in the October 12, 2015, issue of *Tax Notes.*

Grantor Trusts: A Path to Employee Ownership

Originally published in *Tax Notes*

Grantor Trusts: A Path to Employee Ownership

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This article outlines a method of transferring ownership of a company to employees. The specific technique used is the intentionally defective grantor trust (IDGT), a common estate-planning tool. Since 1985 the IDGT has been a reliable method for transferring assets to family members without incurring capital gains, gift, or estate taxes. IDGTs may also be applied to employee ownership. IDGTs offer the following advantages vis-à-vis traditional employee stock ownership plans: (1) perpetual employee ownership, (2) suitability for corporations and limited liability companies, (3) reduced transaction costs, (4) exemption (not deferral) of federal *and* state capital gains tax, (5) no repurchase liability, (6) the advantage of not necessarily being covered by ERISA, (7) no 30 percent floor for stock transactions, and (8) the opportunity to sell the company at a premium. Finally, vis-à-vis democratic ESOPs (DESOPs), the IDGT offers the following advantages: (1) democratic employee voting of registration-type securities, (2) industry-specific selection of probationary period, and (3) inclusion of seller, seller's family, and 25 percent shareholders.

The essential structure of an IDGT business transfer is as follows: The grantor creates a grantor-owned trust, ''sells'' its stock to the trust, and takes a loan note from the trust. In 1985, the IRS ruled that type of transaction is not a taxable event: A single taxpayer cannot sell property to itself.[1] No capital gain is recognized. No gift is recognized. And interest on the note is not recognized.

To achieve that outcome, the trust document must attribute ownership to the grantor. This is done in one of several ways that are pertinent to employee ownership:

1. Any person has the right to add beneficiaries[2] designated to receive the corpus;[3]

2. A non-adverse trustee has the right to apply trust income to the payment of life insurance premiums for the grantor or grantor's spouse;[4]

3. The trust's corporate shares are controlled by anyone acting in a nonfiduciary capacity, for example, current part- and full-time employees;[5] or

4. The grantor retains[6] a reversionary interest in the corpus.[7]

Any of those techniques will shift recognition of all tax attributes of the trust to the grantor's personal income tax return. In doing so, the transfer will be viewed as a nontaxable event and will have all the benefits described above.

However, the method would be lacking, if the grantor remained liable for the trust's taxes. To this end, the trust document might include a non-mandatory provision that allows the trustee to reimburse the grantor for any trust-related personal

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[1]Rev. Rul. 85-13, 1985-1 C.B. 184.

[2]Section 674(c). The trust document can limit this person in their selection of beneficiaries to charitable or educational organizations, as well as descendants. *Madorin v. Commissioner*, 84 T.C. 667, 668-669 (1985); LTR 9304017. In principle, the trust might also limit the selection of additional beneficiaries to charitable or educational organizations dedicated to employee ownership.

[3]The grantor should be excluded from potential beneficiaries and should not have the power to add beneficiaries. Sections 2036(a)(2) and 2038; Philip M. Lindquist, Lora G. Davis, and Judith K. Tobey, *Drafting Defective Grantor Trusts* 13 (2012).

[4]Section 677(a)(3).

[5]The stock holdings of the trust in the target corporation must be ''significant'' in terms of voting control, which typically requires majority voting control. It is unclear whether this technique applies to limited liability companies or to LLCs that elect to be treated as corporations for tax purposes. Section 675(4)(B); TAM 200733024.

[6]If the target company is sold or liquidated, the corpus would revert to the grantor, albeit without any step-up in cost basis. Section 673(a).

[7]A grantor's (or any non-adverse party's) power to revoke will also qualify the trust as grantor-owned. Section 676(a). However, a grantor's power to revoke should be removed before death, otherwise the trust assets will not avoid estate tax. Section 645(a) and (b)(1).

income tax. These reimbursements would have no tax consequences. Alternatively, the trust document could include a mandatory provision that requires annual tax reimbursement — however, such a provision would cause the full value of the trust's assets to be included in the grantor's estate.[8] Finally, the trust should terminate grantor status after payment of the note is complete to avoid any future personal income tax liability to the grantor, and in the case of a mandatory tax reimbursement clause, to remove the trust's assets from the grantor's estate.[9]

Regarding the sale price, the IRS must view the sale as commercially reasonable to avoid gift tax. A qualified professional should perform a valuation of the company stock. Of course, a valuation for the purpose of an IDGT is not subject to the same requirements as an ESOP valuation. An IDGT valuation permits some flexibility and, depending on the nature of the transaction, may warrant a premium.

The promissory note itself is traditionally structured as an installment sale with interest-only payments and a balloon payment at the expiration of the term.[10] No arbitrary limits exist on the term of years, and the interest rate should be equal to or greater than the minimum applicable federal rate at the time of the sale.[11] The trust document should be drafted to allow the trustee to prepay without penalty.[12] And again, the transaction may warrant a premium interest rate.

To qualify the transaction as a sale, the trust is typically funded by a gift of 10 percent of the stock.[13] In that way, the trust has enough equity for the loan to appear commercially viable. At the same time, the gift allows the trust to make a cash down payment on the sale.[14] In capitalizing the trust, the grantor will likely use up a portion of its lifetime gift tax exemption. If the 10 percent gift exceeds the lifetime exemption, gift tax will be imposed on the balance. Although the gift is a loss, as is the impact on the grantor's lifetime gift tax exemption, the net benefits are plain in comparison with the capital gains rate. For example, in New York City the total federal, state, and local capital gains taxes are approximately 33 percent. Thus, the grantor nets 23 percent of the total "sale" price, even after making the 10 percent "gift" to the trust. Also, any "loss" may be counterbalanced by a premium on the sale price and interest rate.[15] As an alternative to the 10 percent gift, a not-for-profit or government beneficiary may guarantee the promissory note.[16]

Some ambiguity exists regarding the tax consequences of the grantor's death before completion of payment on the note. Any unpaid balance on the promissory note is included in the grantor's estate. However, it is unclear to what extent any gain on the underlying assets would be realized in the grantor's estate.[17] Thus, it is ideal to plan for the

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[8]Rev. Rul. 2004-64, 2004-27 IRB 7. Should such a provision be desired, it is important to note that some states allow a grantor's creditors to attack a trust in which a trustee has the discretion to reimburse the grantor for their tax liability. Other states, *e.g.*, New York, specifically protect trusts from grantors' creditors on this account. Section 2036(a)(1); Lisa S. Presser, Lance T. Eisenberg, and Kristen A. Curatolo, "Sales to IDGTs: A Hearty Recipe for Tax Savings," Cardozo Alumni Quarterly (Fall 2014); N.Y. Est. Powers & Trusts Law section 7-3.1(d); local law as applicable.

[9]Note that "toggling off" grantor trust status generally has no adverse tax consequences for the grantor, as long as payment on the note is complete — otherwise, gain is recognized in the amount of the difference between the grantor's basis in the transferred stock and the outstanding note. 26 CFR section 1.1001-2; Deborah V. Dunn and David A. Handler, "Tax Consequences of Outstanding Trust Liabilities When Grantor Status Terminates," *J. Tax'n* (July 2001); Philip A. Di Giorgio, "Grantor Trust Basics," New York State Bar Association Trusts and Estates Law Section Newsletter, vol. 42, no. 3, at 23 (Fall 2009).

[10]Presser, Eisenberg, and Curatolo, *supra* note 8.

[11]"For term loans, in determining whether a loan is a below-market loan, section 7872(f)(1) and (2) requires use of a discount rate equal to the applicable federal rate in effect under section 1274(d) on the date the loan was executed. Section 1274(d)(1)(A) uses the applicable federal long-term rate for debt instruments with a term of over nine years. Thus, in general, under section 7872, a promissory note for a term longer than nine years is not treated as a below-market loan if the interest rate on the note is equal to or higher than the applicable federal long-term rate, compounded semiannually." LTR 9535026.

[12]Elizabeth M. Nelson, "Unraveling Trusts: Grantor Trusts and The Reciprocal Trust Doctrine," Probate & Pumpernickel (Nov. 2014).

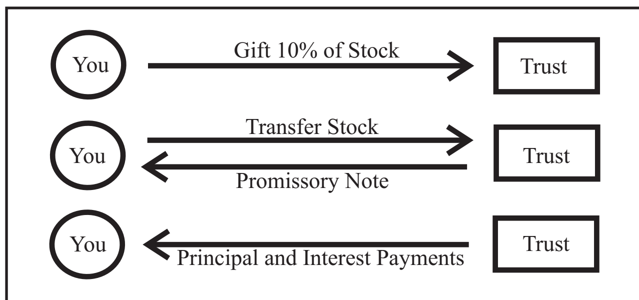
[13]Presser, Eisenberg, and Curatolo, *supra* note 8.

[14]As one potential issue, the grantor may not possess cash (or marketable securities) in the amount of the required 10 percent gift. However, in theory, the "10 percent gift and down payment" could occur in a single transaction at minimal cost: (1) The grantor borrows 10 percent of the total assets to be transferred; (2) the grantor gifts the ten percent to the trust; (3) the grantor transfers the assets; (4) the trust makes the down payment and issues the promissory note; and (5) the grantor returns the 10 percent to the lender. The trust may be drafted so as to require the reimbursement to the grantor of any fee charged for this transaction.

[15]A control premium of 25 percent above market price was acceptable to the IRS. *Estate of Desmond v. Commissioner*, 77 T.C.M. (CCH) 1529, 7-8 (T.C. 1999).

[16]For example, a beneficiary not-for-profit employee ownership fund or economic development corporation could guarantee the promissory note, given adequate control rights in case of default. To ensure that the loan guarantee is not viewed as a gift, the trust might pay an additional guarantor's fee. *See* Milford B. Hatcher Jr. and Edward M. Manigault, "Using Beneficiary Guarantees in Defective Grantor Trusts," 92 *J. Tax'n* (Mar. 2000); Howard M. Zaritsky, *Tax Planning for Family Wealth Transfers At Death: Analysis With Forms*, para. 12.07[3][e][vi] (2015).

[17]Nelson, *supra* note 12, at 11-12.



note to expire before the grantor's death. That can be accomplished through a timely installment schedule or a self-canceling note.

Tangentially, a grantor retained annuity trust (GRAT) could also fulfill many of the basic elements of this transaction. GRATs are similar vehicles to IDGTs, and some care should be taken to select the appropriate structure.[18] A full discussion is not possible here, but in short, GRATs serve to eliminate capital gains, gift, and estate taxes. In lieu of a promissory note, the GRAT grantor receives an annuity for lifetime or a term of years. In many cases, an initial transfer to the GRAT can avoid the gift tax implications of the IDGT capitalization. GRATs are advantaged inasmuch as they are statutory creations, whereas IDGTs evolved through IRS rulings and case law. However, GRATs are more regimented in their payout timeline. Also, if the grantor dies before the term's expiration, part or all of the GRAT assets pass back to the estate.

A. Impacts on Employee Ownership

The ESOP is a powerful tool for employee ownership, and several ESOP benefits are not offered by the IDGT, including a tax-favored approach to capitalization and federal tax-exempt retained earnings for S corporation ESOPs. Additional advantages include a tax deferral available to employees and the possibility of a future deferral through a rollover to an IRA or other plan. Perhaps most importantly, the ESOP is a long-tested and reliable mechanism for employee successions. In contrast, the IDGT employee succession faces uncertain treatment by the IRS and the Department of Labor. The IDGT is more narrowly tailored to individual owners and does not provide a vehicle for capitalization to companies.

Another key difference is that the ESOP offers a regimented set of employee benefits, while the IDGT is a transitional mechanism that can lead to a wide variety of employee succession configurations. The grantor, trustee, and employees will likely maintain varying levels of control over the IDGT and the interest held by the IDGT throughout the transition period.[19] However, after the loan note is finished, grantor trust status is ''toggled off'' — and the full spectrum of employee control and profit-sharing options is available for implementation. Thus, this article refers to both the transitional ''intentionally defective grantor trust'' and the resulting forms of employee ownership. This article emphasizes particular approaches to employee ownership that minimize the tax impact on grantor and employees, reduce regulatory and transactional costs, enhance sale price, maintain the plan's perpetuity, and maximize the dignity of employees. The following lists several potential advantages of this broader IDGT employee ownership strategy — relative to ESOPs — for individual sellers.

1. Perpetuity. A planner may not always be able to guarantee an ESOP's perpetuity because a company may choose to cease distribution of shares into the ESOP plan. This might relate to a change in management; the ESOP trustee in a minority ESOP-owned company not having sufficient control; or the trustee of a majority ESOP-owned company, acting in accordance with his fiduciary duty, being reluctant to purchase additional company stock. However, while companies are not required to distribute additional shares to ESOPs, they are required to repurchase shares upon the exit of company workers. This can and does lead to an ever-diminishing percentage of ESOP ownership, with some companies ultimately closing their ESOP plans.

The IDGT functions differently. All of the trust shares may be held in the beneficial interest of the employees. Without any repurchase obligation or corresponding need for new distributions of shares, the trust offers a perpetual vehicle for employee ownership. Of course, the owners are free to transfer additional shares to the IDGT, but once transferred, those shares may remain in the trust. While shares could be distributed from the trust to company workers, that practice is not generally recommended without additional provisions to guarantee the perpetuity of employee ownership within the target company, for example, nontransferability of shares, mandatory redemption upon termination of employment, and trust veto rights over major shareholder decisions.

Of course, some states limit the perpetuity of trusts. However, that can be circumvented by creating the trust in a ''Tier 1'' state, such as South

[18]Lindquist, Davis, and Tobey, *supra* note 3, at 18-20.

[19]Factors determining the balance should include financing, leadership development, and the owner's desire to stay involved, as well as legal considerations regarding grantor trust status.

Dakota or Delaware.[20] An out-of-state trust may be maintained at a low cost by hiring a trustee in the foreign state. Alternatively, many states allow for perpetual employee trusts.[21] When the client intends to provide for democratic employee voting, it is likely possible to characterize the trust as having an educational purpose and, thus, to qualify as a charitable trust and as exempt from the rule against perpetuities in any state.[22]

Finally, the trust should include non-employees as beneficiaries. When the designated beneficiaries are limited to employees, the trust is susceptible to challenge. As a countermeasure, the trust document should be designed to preserve the principal for a charitable beneficiary, for example, a not-for-profit organization that operates to support employee ownership. That way, the employees have no motivation to terminate the trust and liquidate the company.[23] Moreover, the policy preserves the company's wealth in the case of dissolution and for reinvestment in efforts to build and sustain employee ownership.

2. Applicability to LLCs and S corporations. The ESOP plan is applicable only to C or S corporations, and the ''1042 rollover'' is restricted to C corporations. The IDGT capital gains exemption may be used with C or S corporations, LLCs, and unincorporated partnerships. In the latter cases, the grantor transfers a percentage of his membership or partnership interest to the IDGT in lieu of stock.

Note, as well, that S corporation and LLC trusts will benefit from state tax-exempt retained earnings when the business is located in trust-friendly states such as Alaska, Florida, Nevada, South Dakota, and Wyoming.[24] When the trust beneficiaries are out of state, for example, in the case of charitable beneficiaries, this list expands to include Delaware, New Hampshire, Ohio, and Tennessee.

3. Reduced transaction costs. The IDGT is expected to significantly reduce transaction costs. Similar to an ESOP, the setup fees will include a valuation and legal fees. However, the IDGT does not require ongoing maintenance costs in the form of annual valuations or plan administration that complies with Department of Labor guidelines. Beyond the initial transfer, it is recommended that company stock remain inside the trust. Stock is not transferred into individual employee accounts. Finally, the trust is not coupled with any repurchase liability. An exiting employee has no claim on any company stock or stock-related compensation. In turn, due to the lower administration requirements of the trust, annual trustee costs should be lower on average than ESOP trustee costs.

4. Exemption from federal and state capital gains tax. The ESOP ''1042 rollover'' allows an owner to defer capital gains tax by reinvesting sale proceeds in domestic securities.[25] No capital gains tax is due if the seller defers until death. Alternatively, an IDGT sale receives an outright exemption of capital gains tax that is immediate and available in the seller's lifetime.

The 1042 rollover is limited to federal capital gains tax.[26] IDGT tax treatment is identical at federal, state, and local levels. Accordingly, the capital gains exemption is complete. Again, an IDGT sale is viewed as a nontaxable event by the IRS.

5. No repurchase liability. ESOP and IDGT employee successions share a common interest in the dignity of employees as essential stakeholders and valued participants in the life of the company. At a technical level, ESOPs are structured as retirement plans: Shares are allocated to employee accounts and repurchased upon termination of employment. In contrast, the IDGT is not coupled with any repurchase liability.

Rather, IDGTs offer a flexible vehicle for employee ownership — and need not be tied to retirement.

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[20]S.D. Codified Laws section 55-1-20; Del. Code Ann. tit. 25, section 503(a).

[21]N.Y. Est. Powers & Trusts Law section 9-1.6; Tex. Prop. Code Ann. section 121.004; Or. Rev. Stat. Ann. section 128.520.

[22]*See Peth v. Spear*, 63 Wash. 291, 295, 115 P. 164, 165 (1911) (holding that a trust established to maintain a cooperative has an educational purpose and is thus charitable).

[23]That construction of the trust may also have favorable tax consequences. In a family succession scenario, the IDGT sale is a nontaxable event, although it might be perceived as a gift from the grantor to the family. By analogy, in an employee succession scenario, the IDGT sale should also be a nontaxable event, even though it might be perceived as income to the employees. If the transfer is treated as a taxable event, employees would be liable for income tax on the value of their beneficial interest in the transferred stock. Those liabilities would be minimized when the trust principal is reserved for one or more charitable organizations. Additional provisions may also help to minimize any potential employee tax liability, such as nontransferability of employee interests and distributing trust income in proportion to employees' labor contributions.

[24]Scott Martin, ''Alaska, Delaware, Nevada, South Dakota Remain Top Trust States,'' *The Trust Advisor*, Feb. 5, 2011, *available at* http://thetrustadvisor.com/tag/most-trust-friendly-states.

[25]Section 1042.

[26]A notable exception is Iowa, where sales to an ESOP benefit from a 50 percent state capital gains exemption. Iowa Admin. Code section 701.40.38(10).

As more traditional vehicles for employee ownership, that is, employee control and profit sharing, a range of options are available in lieu of the ''share allocation and repurchase'' ESOP benefit. For example, current part- and full-time workers could direct the trustee in voting on shareholder issues and electing board members. Trust income could be distributed directly as cash payments to current part- and full-time workers. Or, for majority trust-owned companies, the trustee might vote for employee bonuses that effectively function as profit shares.[27] Funds might be directed toward enhancing the work environment or increasing the number of pre-tax employee benefits, for example, new technology or subsidized transportation.

6. Not necessarily covered by ERISA. The IDGT is not itself a statutory mechanism subject to ERISA. Generally, the types of benefits proposed here do not correspond to the employee benefit plans regulated by ERISA, for example, those relating to sickness, unemployment, retirement, and legal services.[28] One major exception involves situations in which trust income is distributed to employees. That arrangement would likely involve distributions to retirement-age employees, which would qualify as an ERISA-type benefit.[29] However, the IDGT is a creation of the selling owner or owners and not an employer or an ''employee organization'' — which is a necessary condition for ERISA coverage.[30] Thus, IDGT employee trusts are not likely to be regulated by the Department of Labor.[31] That said, some attention from Labor should be expected.

However, the potential for Labor involvement could be significantly reduced when beneficiaries are limited to a single charitable organization or class of charitable organizations. In the latter scenario, employee ownership might be a function of direct control over company shares — and the corresponding ability to regulate salaries and benefits — rather than an indirect beneficial interest in company shares.[32]

Also, to the extent that employees are permitted to directly vote company shares as nonfiduciaries, trustees' responsibilities are limited. Likewise, without employee beneficiaries, trustees face fewer potential plaintiffs.

In all of the above, trustee fees and valuation costs should be adjusted to reflect any diminished potential for regulation and litigation.

7. No 30 percent floor for stock transactions. To gain the benefit of a 1042 rollover tax deferral, a seller must transfer at least 30 percent of the company stock to the ESOP. A sale to an IDGT does not require any minimum transfer of interest and can be accomplished at any percentage interest of the target company.

8. Premium sale price. Valuation for an IDGT sale is not regulated by Department of Labor guidelines. Thus, IDGT sale prices are not subject to ESOP repurchase liability or lack of marketability discounts.[33] Also, IDGT valuations may receive the benefits of a control premium and a strategic price.[34] Control premiums alone can yield 20 to 30 percent above market price.[35] In combination, those factors are likely to result in a significant advantage to the grantor, in terms of sale price, over an ESOP.

Also, whereas Labor is most concerned with the overvaluation of company stock in ESOP sales, the IRS is more likely to be concerned with undervaluation of an IDGT sale. This is because IDGTs are traditionally used to avoid gift tax in family business succession planning. As long as the sale price is commercially reasonable, the IRS should not be unduly concerned by the valuation accorded to an IDGT sale.

B. Impacts on Democratic Employee Ownership

Although ESOPs are infrequently used as a mechanism for democratic employee voting on shareholder issues (one person, one vote), the law

[27]In the context of employee control, it is recommended that the trust documents place limits on compensation, *e.g.*, capping bonuses at 20 percent or 30 percent of net annual income.

[28]29 U.S.C.A. section 1002(1), (2)(A).

[29]29 U.S.C.A. section 1002(2)(A).

[30]29 U.S.C.A. section 1003(a).

[31]Ruth Simon and Sarah E. Needleman, ''U.S. Increases Scrutiny of Employee-Stock-Ownership Plans,'' *The Wall Street Journal*, June 22, 2014 (''Since the start of fiscal 2010, the Labor Department has recovered over $241 million through suits or investigations that were resolved without going to court, nearly all of which involve valuations. Overall, the agency has filed 28 suits tied to employee-stock-ownership plans since October 2009, double the total in the previous six years, according to an internal tally reviewed by *The Wall Street Journal*.'').

[32]Avoiding employee beneficiaries would further minimize potential employee tax liabilities (in relation to the initial transfer) and provide additional guarantees against challenges to the trust. If perpetuity is a goal, the planner might establish a noncharitable purpose trust in a state that exempts those trusts from the rule against perpetuities.

[33]''Valuation Discounts in ESOPs,'' National Center for Employee Ownership, *available at* https://www.nceo.org/articles/valuation-discounts-esops.

[34]*Id.*

[35]Barbara S. Petitt and Kenneth R. Ferris, *Valuation for Mergers and Acquisitions* 9 (2d ed. 2013).

provides for that client goal. That said, the DESOP faces a few obstacles that may be more easily managed in an IDGT employee succession. Several potential advantages of the IDGT employee ownership strategy relative to DESOPs are listed below.

1. Democratic voting. The law mandates direct share voting of publicly traded securities that are included within an ESOP plan.[36] In theory, that requirement could be circumvented by a shareholders agreement under which DESOP participants agree to vote their shares in accordance with the outcome of an employee vote. Although that strategy would work — and should be considered by ESOP companies moving in a more democratic direction — an IDGT succession is less cumbersome. It would not require the additional step of a shareholders agreement or vetting potential employees based on their willingness to sign the agreement.

ESOP plans generally require direct share voting on major shareholder issues.[37] However, a statutory carveout expressly allows ''one participant, one vote'' employee voting on major shareholder issues in lieu of share voting.[38] In turn, the trustee votes plan shares accordingly. The statute is somewhat ambiguous whether block voting of plan shares, in accordance with an employee vote, is allowed on major shareholder issues.[39] An IDGT succession may be preferable in that a trust might permit, or even require, block voting.

2. Flexible probationary period. Once a class of employees is designated for an ESOP plan, any new employee within the designated class must generally be included after one year of employment.[40] Although international standards relating to democratic employee ownership sanction a six- to 12-month probationary period, flexibility is encouraged. Industries with a high degree of technological or administrative complexity — or which are capital-intensive in nature — may ordinarily require up to a three-year probationary period (as well as a costly buy-in).

As a solution, a DESOP trust document may provide employee voting on non-major shareholder issues but only for employees who have completed the longer company-specific probationary period. A shareholders agreement and careful vetting of employees may accommodate the balance of major shareholder issues — and voting in the case of publicly traded securities. However, an IDGT succession avoids these additional steps. A trust can be drafted to include voting rights on all issues — without respect to the registration status of the securities held in the trust — for only those employees who have completed the company-specific probationary period. (As warranted, the trust may limit voting to employees who have made buy-in contributions.)

3. Inclusion of seller, seller's family, and 25 percent shareholders. Application of the 1042 rollover capital gains deferral for ESOP sales prohibits inclusion of the seller, the seller's family, and any remaining owners of more than 25 percent of the outstanding stock of any class of the corporation.[41] However, for a client whose goal is democratic employee ownership, it is preferable for all current part- and full-time employees to possess equal votes. Thus, it might be desirable for the seller, the seller's family, or any other owners who remain at the company to be included as equal ''members'' of the DESOP trust alongside other employees. Creative use of a shareholders agreement or a new membership share class would resolve those exclusions. However, an IDGT succession dispenses with any extra steps. The trust can easily provide for the broad-based inclusion of all employees in voting on shareholder issues and board elections, without any statutory conflicts.

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[36]Section 409(e)(2), (4).
[37]Section 409(e)(3).
[38]Section 409(e)(5).
[39]Section 409(e)(5)(B).
[40]Section 410(a)(1)(A)(ii).
[41]Section 409(n)(1).