Selling to Your Employees through a Worker Cooperative - and Sheltering Your Capital Gain

Eric D. Britton & Mark C. Stewart

Editor's note: Since 1984, Federal Tax law has permitted owners who sell 30% or more of the stock in their closely held company to their employees through a worker cooperative to get the same deferral of taxes on the capital gain on the proceeds of the sale as they would have if they sold to their employees through an Employee Stock Ownership Plan. This is the so-called "1042 rollover" tax break. As far as the we can determine, that provision has never been used - despite the fact that cooperatives can economically be set up in companies with far fewer employees than ESOPs.

In 2001, the George and Gladys Dunlap Cooperative Leadership program of the Nationwide Foundation funded a collaborative effort by the Ohio Council of Cooperatives and the Ohio Employee Ownership Center to develop a number of new initiatives. Among these was determining how to do a "1042 rollover" with a cooperative.

Many business owners would like to take advantage of Section 1042 of the Internal Revenue Code (IRC§1042) to sell stock in their company without immediate taxation of their capital gains, but are deterred by the complex and potentially onerous rules imposed on Employee Stock Ownership Plans (ESOPs). However, selling to an ESOP is not the only way to defer capital gains under Section 1042. A stockholder can also use a Section 1042 election to avoid immediate taxation of the capital gains if he or she sells the stock to a worker cooperative. While workers cooperatives are less well-known than ESOPs, they avoid some of the legal complications associated with an ESOP, and in the right circumstances may be a more attractive way to sell a business to employees.

What is a cooperative?

A cooperative is incorporated to do business "on a cooperative basis." That means that, instead of generating a profit for stockholders as such, its primary goals are to benefit its members ("patrons") by providing common services or other inputs to members they cannot efficiently provide for themselves, or by marketing the product of its members. Any net margins (roughly equivalent to profits) that a cooperative business generates would be shared by the members in proportion to their use of the cooperative's services, or the type, quality and volume of product marketed through the cooperative, not in proportion to the capital they contributed.

A worker cooperative is, in effect, a business organized by employees to jointly market the services they can provide to potential customers. Employee member receive their salary or wages, and are also entitled to share any net income among themselves in proportion to the labor contributed, not their stock ownership or invested capital.

A sale of stock to a worker cooperative will be eligible for the Section 1042 election if the worker cooperative satisfies the following requirements:

- it must be organized as a cooperative and must do business on a "cooperative basis" so that it qualifies for federal income tax treatment as a cooperative under Subchapter T of the Internal Revenue Code (Sections 1381-1388);
- a majority of the members of a worker cooperative must be employees of the cooperative;
- a majority of the voting stock of the cooperative must be owned by members;
- at least half of the Board of Directors of the cooperative must be elected by the members on the basis of one-person, one-vote;
- a majority of the earnings (or losses) of the cooperative must be allocated to members on the basis of either patronage (i.e., the members' work furnished to the cooperative's enterprise) or capital contributions, or some combination of patronage and contributed capital.

What are the advantages and disadvantages of a cooperative vs. an ESOP?

Unlike ESOPS, worker cooperatives are not employee retirement plans and are therefore not subject to the numerous restrictions imposed by the Employee Retirement Income Security Act of 1974 (ERISA). As a result, using a worker cooperative as the buyer can avoid such regulatory burdens of an ESOP buyout as:

- extensive legal and consultant fees to establish the plan;
- hiring a bank trustee or other independent plan fiduciary to represent the workers'
- interests (although the employee group should have professional advisers in connection with the acquisition and formation of a qualifying worker's cooperative);
- an annual ESOP appraisal by an independent appraiser is not required;
- IRS and DOL plan audits for administrative compliance with ERISA;
- filing Form 5500 reports with the U.S. Department of Labor, making a plan
- subject to audits or ERISA enforcement action by the Department of Labor;
- the elaborate non-discrimination rules imposed on qualified retirement plans;
- the strict rules requiring ESOPs to provide terminating employees with a put
- option and offer to repurchase their equity (although as a practical matter a worker cooperative should have some plan in place to buy out the equity interests of retiring members).

While cooperatives are much cheaper to establish and maintain than ESOPs are, they also have fewer tax advantages. Under Subchapter T of the Internal Revenue Code (IRC sections 1381-1388), cooperatives may exclude from their taxable income certain allocations of their "net margins" (i.e., profits) attributable to business done for or with cooperative's patrons. In turn, the members report this income as if they had received it in the first place. This "pass through" of income is, in some aspects, similar to a Subchapter S corporation. And, like a Subchapter S corporation, they normally distribute at least sufficient cash to their members to pay their taxes. So unlike ESOPs, where taxes are not paid when money goes into the plan but when it comes out in distributions to retiring ESOP participants, in co-ops taxes are paid when money goes into the members' accounts. On the other hand, because the taxes have already been paid, co-op member accounts are distributed to the members tax-free when they take the money out.

In this way the ESOP is similar to the regular Individual Retirement Account (IRA) because money goes into the account tax free and is taxed when it goes out. By contrast, the co-op is similar to the Roth IRA in that money that goes in has been taxed but the money that comes out is tax free.

The biggest non-tax difference between an ESOP and a cooperative is that an ESOP is a trusteed retirement plan in which employees who are ESOP participants may or may not have any influence on company policy. By contrast, a cooperative is a membership organization in which employees are active members and elect a majority of the Board on a one-person, one-vote basis.

When employees buy a business from the owner through a cooperative

When employees buy a business from the owner through an ESOP, extensive tax and U.S. Department of Labor regulations are supposed to protect employees or, more realistically, to permit them to sue when they believe they have been wronged. In a worker's cooperative, employees are decision-making members - rather than participants in a trusteed plan. To protect their own interests, the employee-members should exercise the same due diligence they would in buying any other business in their own names or, for that matter, buying a used car.

The Board (or other decision-makers) for a worker cooperative considering a buyout do not have to satisfy the strict requirements ERISA imposes on ESOP fiduciaries, but they do have fiduciary duties under state law in connection with the formation and operation of the worker cooperative. These include:

the duty to conduct the cooperative's business in the best interests of the employee members as patrons (first priority) and also in the members' interests as investor owners of the cooperative's equity capital (second priority). This subordination of capital interest to the interests of patrons is a unique feature of doing business on a cooperative basis; the requirement that the cooperative account for and allocate its profits (net margins) from employee-member work inputs in accordance with the tax rules of Subchapter T of the Internal Revenue Code - that is, in proportion to the value and amount of each employee's inputs; and if the worker cooperative is organized under a state cooperative law, rather than the general corporate law, it is likely that the cooperative law will be somewhat more restrictive as to issues of cooperative governance (membership control and election of directors) than is Code Section 1042.

The seller's options

A current owner who wishes to take advantage of Section 1042 has at least two options available under Code section 1042. The owner could either (A) encourage the employees to form a worker cooperative that would buy part or all of the stock and at least temporarily exist as a separate holding company to hold the part of the business's stock it purchases for the benefit of its employee-members, or (B) convert the existing corporation into a workers cooperative immediately, which would then redeem part or all of his or her common stock

The first structure is comparable to the ESOP. A separate entity will purchase an owner's stock in the target company. It may be necessary to use this kind of structure in those cases where the current owner is not selling all of his or her stock immediately and wishes to retain control of the business, because it will not require the whole business to be run as a cooperative until the employees have purchased majority control. This structure is cumbersome, however. The problem with this structure is that it causes the improbable result that the workers cooperative is merely a non-operating entity (without any reason for employees) whose only asset is stock in the target company. Clearly, a worker cooperative should have employees and a business enterprise from which "net margins" can be earned on account of member-employees' work inputs to the enterprise. Because a cooperative must have earnings (net margins) from transactions with or for its patrons (the member employees) it would need to sell the labor provided by its members to the business in order to provide an appropriate revenue stream from which it could allocate patronage refunds to the employee members. Mere stock ownership would not provide such income. The worker cooperative must, in effect, be an employee leasing company.

Consequently it makes more sense -- unless there is strong reason to the contrary -- to convert the company to a worker cooperative and provide that the cooperative redeem the owner's stock in the company being purchased. This redemption would be the legal equivalent of a sale of the owner's stock in the company to a worker cooperative as contemplated in IRC Section 1042.

There are no conceptual or legal problems with this strategy if the employees buy 100 percent of the stock in the company in a single redemption. That, however, will often create significant financing problems. Those are generally solved through a multi-stage sale over a period of years.

However, if the owner sells shares to the worker cooperative in several stages, the owner may find the conversion of the company into a worker co-op worrisome, since control of the board passes from the owner to the members of the cooperative at the time the company is converted into a cooperative. One way to deal with the owner's potential concern over loss of control is to build in protections (through supermajority voting requirements) for the owner until all of his or her stock has been redeemed.

Converting to a worker cooperative immediately has one notable advantage from the seller's perspective relative to an ESOP: it justifies a control premium for the initial sale of stock, even if it is a minority stock interest, because the majority of the Board is elected by the members of the worker cooperative on a one-person, one-vote basis.

An additional advantage from the seller's perspective is that the Seller and other close relatives who cannot participate in an ESOP can be included as coop members - provided that they are active employees and became members of the cooperative under the same rules that pertain to other members and provided they do not receive 1042 rollover stock. They can, however, participate in patronage allocations within the cooperative.

In order to carry out the sale, the owner will enter into a Stock Redemption Agreement with the cooperative whereby the co-op will redeem (purchase) at least 30 percent of Owner's stock for an agreed purchase price. The Agreement will also provide for one or more subsequent redemptions of the owner's remaining stock in the company on a schedule to be agreed on between owner and the employees (who are members of the cooperative). The redemption price for each subsequent redemption would be determined by a current appraisal using a method agreeable to the owner and the employees.

It makes sense for the employee cooperative members, the company (which is now a worker cooperative) and the owner to arrange financing sufficient to fund the initial redemption and to plan to fund subsequent redemptions. This will probably involve the owner's consent to allow the company's assets to be pledged to secure corporate borrowing from a bank or other institutional lender, but it certainly should include some personal cash investment by each employee-member of the cooperative. In exchange for this investment, each employee would receive equity interests and membership rights in the reorganized company.

The reorganization of the company will involve new Articles, Bylaws, and a Board of Directors in which the employee-members have voting rights, rights to allocation and distribution of profits, and minimum investment obligations that:

- •conform to the cooperative requirements of Subchapter T of the Internal Revenue Code (§§1381-1388) and Ohio's Cooperative Law (or those of the state in which your cooperative is incorporated);
- •conform to the defining requirements of IRC§1042; and
- •make sense to and are considered fair by the owner and the employees.

There are at least two threshold issues that come out of this set of worker cooperative requirements that are a pre-requisite for the transaction and a personal watershed for the owner and each employee-member:

- •At least 50 percent control of the company's Board must shift to the employee-members at the first redemption of the owner's stock. This is necessary to obtain IRC Section 1042 tax benefits for owner. (It also enables him/her to receive a control premium for this sale.)
- •Each employee-member's pay and share of the company's profits will depend on a determination of the relative value of the employee's work for the new worker cooperative. In the past, the "boss" has made this determination. In a worker cooperative, employee peers (perhaps through the Board or a special committee of members) will be the "boss" on this subject. Other management decisions may be delegated to a CEO or other management arrangement by agreement of the owner and the employees.

Each employee's salary may become the measurement of the value of their work. Each employee will receive a share of corporate profits (a "patronage refund") based on the value of their work contribution, rather than on the basis of their investment in the company. The employees may also agree that each of them must invest in the worker cooperative in proportion to their respective share of the profits. This is almost exactly backwards from the way these things work in an investor-oriented company.

- •Worker cooperatives allocate the profits ("retained earnings") among members on the basis of their labor input. It is up to the worker cooperative to determine what measurement of labor input in the business should be used. It can be anything from W-2 earnings to hours work to seniority (past labor input). These can be mixed and matched so that part of allocations are based on current labor (W-2 earnings or hours work) and part on past labor (seniority).

Here's how you do it

The steps that would be necessary to implement a sale of stock of an existing business to a worker cooperative under Section 1042 are not particularly complicated. They should include the following:

The employees who are interested in pursuing the buyout form a Co-op steering committee authorized to act on their behalf. This committee may include the current owner if he or she will continue as an active employee, but should not be dominated by the owner.

The steering committee obtains professional advisors to assist them, including a financial advisor to prepare a prefeasibility study to evaluate whether a buyout could be financed successfully at a purchase price the owner would find attractive. As was discussed above, obtaining an independent appraisal of the value of the company's stock would make sense at the time of each transaction.

If the Co-op steering committee decides to form a new workers cooperative (instead of converting), they will need to incorporate a cooperative under the relevant state law (or arranges with the owner for conversion of the existing company), and appoint a Board of Directors and officers of its own. If they instead wish to convert the existing corporation into a worker cooperative, the steering committee will need to revise the articles and bylaws to be more suitable for a worker cooperative. In either case, Ohio's new Cooperative Law is likely to be more amenable to a worker cooperative than most states' cooperative statutes.

The Co-op steering committee and Board should work with their professional advisors to develop an appropriate set of articles and by-laws for the worker cooperative, defining who will be eligible to be a member, how the business will be operated on a cooperate basis (e.g., how net margins will be defined and how each member's labor inputs to the cooperative should be quantified and compensated), how any net margins of the cooperative will be allocated and distributed, the amount of equity capital each member will be required to invest in the cooperative, and the members' right to participate in control of the worker cooperative.

The worker cooperative's articles or by-laws will need to specify that voting will be predominantly on a one-person, one-vote rule, not by share ownership. Also, if the existing owner or members of the owner's family will be members, the bylaws should prevent the stock purchased in the Section 1042 sale from being redistributed to either the current owner or immediate family members. These provisions must apply to the worker cooperative, but need not apply to the business itself if it continues to exist as a separate company jointly owned by the worker cooperative and the current owner.

If the business is now being taxed as an S corporation, the owner will need to terminate the S election in order to obtain the Section 1042 tax advantages. This could possibly have other adverse income tax consequences to the business, which should be carefully evaluated. The employees will need to become employees of the worker cooperative by the time the buyout closes. In cases where the worker cooperative and existing business will remain separate, this may require a carefully designed employee leasing arrangement whereby the worker cooperative provides employee staffing to the existing business.

The new worker cooperative and current owner work together to locate financing for the buyout. Most lenders will be reluctant to finance a new worker cooperative, and are likely to ask for a corporate guaranty and additional collateral from the existing business. The worker-members should be prepared to resist requests for personal guaranties, as many bankers expect personal guaranties from the principal owners of a business in other contexts. However, the worker members should expect to shoulder most or all of the equity capital investment burden for their cooperative over time.

In some cases, the owner could provide some seller debt financing, although this should generally be avoided to obtain the full benefit of the Section 1042 election. (The 1042 rollover provisions require that the owner designate rollover securities within 12 months after the transaction, and he/she can do that with seller financing only to the extent that he/she have adequate additional assets above and beyond the company.)

If less than all of the stock is sold, the seller will, in effect, be helping to financing the employee acquisition by remaining an investor in the business. There's no problem with doing so - and it is often done in ESOP transactions - but both buyer and seller need to be aware of the facts.

The current owner and the steering committee (or Board) of the cooperative negotiate the terms on which the cooperative will purchase some or all of the owner's stock. If the initial purchase is only part of the stock, the agreement should include a plan to acquire the balance of the stock over time. The agreement should also include adequate warranties from the seller on the key information about the business's finances and liabilities and a plan to finance the purchase price prudently.

Documents necessary for the transaction

(a) Articles/Bylaws. The company should amend its Articles of Incorporation and Code of Regulations (which would become "Bylaws" if the Ohio Cooperative Law is used) to achieve the desired worker cooperative structure. This will involve:

- •Separation of voting control of the company from share ownership so that the requisite cooperative member control (member voting and election of directors) for a qualifying worker cooperative can be provided for the employee-members in the Articles and Bylaws.
- •Limiting dividends on company stock so that most company income is distributed on the basis of member "patronage" (i.e., work inputs) rather than on the basis of share ownership;
- •Provisions anticipating future stock redemptions, both for subsequent redemptions from the owner and for eventual retirement or withdrawal from the cooperative by other members. These provisions should commit the worker cooperative to the Stock Redemption Agreement with Owner (see below).
- •Provisions for the determination and allocation of company income to employee-members on a patronage basis. These provisions should authorize the Board (or the Members of a "Compensation Committee") to establish the relative value of each employee-member's work inputs for purposes of patronage allocations.
- •Balancing the interests of the owner as a shareholder (until owner's original shares are redeemed) against the interests of the employee-members. This would include providing owner certain voting rights, veto powers, and rights to participate on the Board and in management of the company, while providing majority control to the employee-members. These provisions would also describe what, if any, profits of the company would be distributed to the owner with respect to his remaining investment in the company.
- •Provisions describing requirements for employee-member investment, the application of patronage refunds to these investments and rights and obligations of employee-member investment as they enter or leave membership in the cooperative.

(b) Stock Redemption Agreement. An agreement of the employees and the company to redeem all of the owner's existing stock starting with an initial 30% following the company's reorganization as a worker cooperative. The employees would enter into this agreement for the sole purpose of committing their control of the company to assure its performance of the agreement. The purchase price for this purchase would be fixed in the agreement. The agreement would also provide that the company would purchase or redeem owner's remaining original stock in the company in one or more subsequent installments at a purchase price or prices to be determined by fair market value appraisals conducted at the time of purchase. The agreement would include assurances to the owner that the company would act so as to protect owner's remaining share ownership and owner's right to elect coverage of Section 1042 for the proceeds of his sale of stock under the agreement. The agreement would also describe owner's support of financing stock purchases and redemptions under the agreement either by allowing the company to secure borrowed money by encumbering its assets or by guaranteeing employee borrowing for investment in the company, or both.

(c) Offering Statement. The Offering Statement will be a general written disclosure to the owner and prospective employee-members of the cooperative of:

- •the risks of sale of shares and transfer of control;
- •the risks of investment by employees in the company;
- •securities law and tax issues of the transaction and continuing operation of the company;
- •description of reorganization of the company into a worker cooperative, including attachment of Articles and Bylaws;
- •description of the company's business plan and financing;
- •description of share purchase and redemption obligations of the company under the Stock Redemption Agreement; and
- •description of employee-member investment and employment obligations in cooperative. This will be augmented by a Subscription and Membership Agreement to be attached to the Offering Statement and completed and signed by each prospective employee-member.

The purpose of the Offering Statement is to make as fair a disclosure of the risks and obligations of participation in the transaction as we can. This will be valuable for everybody's understanding; to help a lender understand the transaction for purposes of financing; and to avoid possible accusations of investment fraud in the future.

(d) Subscription and membership agreement. This will be part of the Offering Statement and will describe the prospective member-employee's commitment to make capital contributions to the cooperative. It will also describe employee's application to become a member of the cooperative and some of the conditions of membership.

(e) Financing documents. Depending on the financing arrangements to fund cash purchases of the owner's stock, there will be financing documents associated with the transaction. These may include promissory note(s), a security agreement, and/or a financial guaranty.

(f) Related agreements. The transaction should include additional agreements with the owner to use or acquire other assets owned by the owner that are necessary for the company's business, such as a license to use patents and a lease of the business site.

Obtaining the tax advantages for the owner

To obtain the benefit of Section 1042 for the selling owner, the worker cooperative must make an initial purchase of at least 30 percent of the stock of a C corporation. If the seller will continue to hold the rest of the stock, the worker cooperative should obtain specific, binding commitments on its rights as a stockholder, including representation on the Board and how earnings of the business will be paid to the owner and to the employees. If there is a separate worker cooperative, there should be an arrangement to employ the cooperative members in the business.

Although no formal appraisal is required for ERISA purposes, the workers cooperative would be prudent to obtain either an objective appraisal or an equivalent justification of the purchase price from a qualifying professional.

To enable the seller to take advantage of Section 1042, the workers cooperative will need to agree to be subject to IRS excise taxes if the acquired stock is resold by the worker cooperative within 3 years, or if purchased shares are allocated to the seller or the sellers family.

After the buyout is completed, the selling owner will file a properly documented Section 1042 election form with the IRS. The seller will also need to invest the proceeds in "qualified replacement property" no later than 12 months after the closing date.

In most cases, the worker cooperative will repay its buyout financing out of future net income of the business. This will depress its cash flow and most likely force it to allocate and distribute some or all of its net margins to employee members in the form of equity interests in the cooperative, rather than as a cash payment, until the financing has been repaid. This reinvestment of the members' share of business earnings and the corresponding deferral of cash payments will be a factor in the members' own financial planning. The employee members will receive current income of the business but it will be committed to investment in the worker cooperative. It will not be available as disposable income to the employee members during the term of the financing and it will be exposed to the enterprise risk of the business.

Looking forward

The worker cooperative's plan of operation should take into consideration the interests of employees who are hired after the buyout. Membership, patronage refunds, equity redemption at retirement and the benefits of the buyout should be available to all future member-employees. But new employees should be required to furnish their fair share of the worker cooperative's equity through personal investment in the worker cooperative in order to obtain these benefits. A worker cooperative would not have the suspense account or delayed allocations typically used with ESOPs. The cooperative's income and equity allocation formulas will therefore need to be structured to avoid allocating a disproportionate part of any unallocated surplus of the cooperative to those new employees until they have finished contributing the funds needed to invest their fair share of the equity.

Worker cooperatives can be an attractive alternative to ESOPs in the proper circumstances. The financial challenge of financing the stock acquisition and redeeming each employee's ownership interest in the business are about the same for an ESOP and a worker cooperative. However, a worker cooperative introduces other issues that are unique to the cooperative way of doing business.

An ESOP is more expensive to form and administer, and is typically subject to more restrictive government regulation, but a worker cooperative is more of a challenge to the corporate culture of the business. The democratic control and employee self-determination inherent in a worker cooperative brings with it the corresponding messiness of democracy and the shared burden of investment and management of the business by all of the employee members. This will require a more informed understanding of the economics of the business and the risks and responsibilities that each employee has as an owner.

A worker cooperative is not a tax-exempt entity, but it can pass profits (net margins), losses and other tax benefits through to its employee members without federal taxation at its corporate level. The employee-recipient of this allocated income must report this income in the year he or she receives notice of the allocation from the cooperative. Subchapter T of the Code requires this distribution and notice to be sent to the employee at any time during the 8-1/2 months following the end of the cooperative's fiscal year. Income distributed by the worker cooperative to employees or for their account will be taxed sooner than in an ESOP. By the same token, such income would also be available to the employee sooner than in an ESOP, because the employee need not wait until retirement to receive economic benefit from his or her share of the business. And there is no tax penalty or further tax on the employee's current access to this income, as would be the case in an early distribution from an ESOP.

This is only a brief sketch of the comparison between an ESOP and a worker cooperative acquisition of corporate stock under Section 1042. It may beg more questions than it answers, but our intention is to illustrate some comparative advantages of a Section 1042 acquisition by a worker cooperative.

About the authors: Eric Britton and Mark Stewart are attorneys at Shumaker, Loop & Kendrick, LLP, in Toledo. Britton has a well-established ESOP practice and Stewart is Ohio's leading expert on cooperative law.