

**THE EMPLOYEE COOPERATIVE AS A PLAN  
FOR  
BUSINESS SUCCESSION**

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Employee cooperatives – that is, cooperatives in which the company’s employees rather than customers are the Patrons – are not often encountered in the cooperative community. Perhaps this is because the business world has relegated the idea of “worker-cooperatives” to communards and denizens of the counterculture. More likely, it is because cooperatives are not widely understood in the business world, and, even if they were, a healthy, happy employee cooperative requires a special set of circumstances and attitudes to thrive.

Employee cooperatives have been formed in situations where the workplace is very egalitarian, or where employees want to save or prolong their jobs in a business on which the original owners have given up. Other businesses – most notably, partnerships of professionals or artists – have become cooperatives without knowing it because this form of business organization (but not the terminology) was an obvious choice for their needs.

For a long time, state cooperative statutes have not been helpful to employee cooperatives (and many other types of cooperatives) because most of these statutes were originally enacted as enabling statutes to permit the organization of farmer cooperatives. Enabling laws usually have a more limited purpose than a stand-alone corporation statute. Many of these cooperative statutes: (a) merely acknowledge the corporate legitimacy of cooperatives, but only if formed by agricultural producers; (b) specify a few unique cooperative characteristics such as member voting and structure of the board of directors, but very little about corporate organization and capital structure (stock); and (c) tie the cooperative statute with either the state’s general business corporation law or non-profit corporation law (or both, in some states) to provide other corporate law provisions such as those for merger, dissolution, capital stock, and shareholder rights. These enabling statutes have been either too restrictive or too meager to be taken seriously as a real option or “choice of entity” when organizing or reorganizing a business for employee ownership.

Some states have updated their cooperative statute to a comprehensive corporation statute with appropriate cooperative terminology. These statutes are now available to be added to the “choice of entity” list for closely-held companies seeking a plan for business succession when the owner wants to cash out and retire.

Many small and medium size companies are the result of the enterprise, vision and lifetime work of one or two individuals. When these individuals grow older, they begin to have intimations of mortality and realize that they must plan for retirement and sale of the business.

If the owner would like to see the company continue with his or her vision or if the most logical and desirable market for the company is some or all of the owner's closest business associates (the employees), the owner may consider some form of employee acquisition of the company. This inter-generational transfer may be within the owner's family, in which case, the owner may use traditional estate planning techniques. But many business owners (and family farmers) find that handing the business over to the next generation within the family is not an option. Even though the company's corporate culture may be like a "family", the next generation who will succeed the owner may not be members of the owner's family. In this case, the owner and the owner's family (or charitable beneficiaries, if the owner has no children) will expect to extract full value upon transfer of the company. This means a sale/purchase agreement with a plan for the ongoing organization of the company and its ownership. In this case, the owner-seller and the employee-purchasers have a number of organizational choices to evaluate. Their choice of entity will be based on considerations of tax, financing, shared vision for business continuity, employee interest and unity, special requirements of the company's business, market value and other matters relevant to the transaction. One of these organizational options can and should be an employee cooperative.

There are many reasons why an employee cooperative would be quickly ruled out of consideration. Some employees may not be interested in owning the company or sharing in the enterprise risk of the company's business. The employees may have no interest in participating in the governance of the company. They may not have an agreed plan for management of the company, or they don't have a long term commitment to the company. However, if the employees are somewhat in agreement to make a collective acquisition of the company, a cooperative may be a more satisfying and unifying plan than a more conventional corporate acquisition and ownership structure. Distribution of corporate profits to employees as patronage refunds may be more logical and tax-efficient than payment of dividends to shareholders. Employees are more likely to judge the relative values and obligations of company ownership in terms of their respective status and value as an employee rather than as a passive investor.

The following article was published in the summer, 2003 issue of *The Journal of Employee Ownership Law and Finance*, a quarterly journal of the National Center for Employee Ownership. This article focuses on Section 1042 of the Internal Revenue Code and its provisions for deferral of recognition of capital gain when an owner sells stock in his/her company to an Employee Stock Ownership Plan (ESOP) or a qualified worker-owned cooperative. The article was written for an audience who are familiar with ESOP's, but not very familiar with cooperatives. Some readers may recognize Section 1042 as the Code section under which an owner can defer recognition of capital gain in the sale of a "qualified refiner or processor" company to a farmer cooperative (IRS §1042(g)).

In spite of the following article's focus on a §1042 sale of stock, it may also be read as a very basic primer on the use of an employee cooperative in a business succession plan.

- Mark C. Stewart



Selling Stock to Employees Through a  
Qualified Worker-Owned Cooperative  
and Sheltering Capital Gain  
The IRC § 1042 Rollover  
Eric D. Britton & Mark C. Stewart

*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 an employee stock ownership plan (“ESOP”) to get a deferral of taxes on the capital gain from the sale. This tax law also provides the same tax advantage to Owners who sell their stock to an eligible worker-owned cooperative. This is the so-called “1042 rollover” tax break. As far as the authors can determine, there is no published comment or IRS pronouncement on the use of a worker-owned cooperative in a 1042 rollover – despite the fact that a worker-owned cooperative is simpler and more economical to establish, and can be done in a company with far fewer employees than the minimum required to justify the administrative burden and expense of an ESOP.*

*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 two new cooperative initiatives in employee business ownership. One of these was determining how to do a “1042 rollover” with a worker-owned cooperative. This article is a direct result of that initiative.*

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 IRC § 1042. A business Owner can also make an IRC § 1042 election to avoid immediate taxation of the capital gains when he or she sells the stock to an eligible worker-owned cooperative. Worker-owned cooperatives avoid some of the expense and legal complications associated with an ESOP, and, in the right circumstances, may be a more attractive business model for the sale of a business to employees.

### **Decision to Elect Application of IRC § 1042.**

IRC § 1042 provides that a taxpayer may elect to defer long term gain from the sale of “qualified securities” to an “employee organization” where the qualified securities are stock in a domestic privately-held subchapter C corporation and the employee organization is either an ESOP or an eligible worker-owned cooperative<sup>[1]</sup>. This means that the business Owner must first decide whether the limited market for the Owner’s stock under IRC § 1042 is appropriate. Tax planning and the deferral of gain recognition are certainly attractive features, but employee ownership, whether indirect (in an ESOP) or direct (in a worker-owned cooperative) may not suit the Owner’s goals for sale price or terms, or the Owner’s (and employees’) notion of how the business should be continued after the Owner’s exit. IRC § 1042 becomes infinitely more attractive if the Owner and the employees consider employee ownership of the business to be a desirable plan for management succession and business continuity.

Once the Owner decides that a sale to an employee organization and election of a tax

deferral under IRC § 1042 is the right thing to do, the choice is between sale to an ESOP or sale to a worker-owned cooperative. Each of these choices will yield different tax and cost consequences for the business and a dramatically different employee experience in subsequent operation of the business.

### **What is a Worker-owned Cooperative?**

ESOPs are fairly well known to business advisors and Owners. An ESOP is an ERISA regulated employee pension trust. Under IRC § 1042, a business Owner would establish an ESOP for the benefit of the company's employees and then sell shares of the target corporation to the ESOP. The ESOP would then hold these shares in trust for the employees' retirement. The ESOP and the company would then agree to redemption of these shares as employees retire so that the ESOP can distribute retirement benefits in cash. In this case the company and the ESOP make a market for stock that would presumably not otherwise have a ready market. The measure of this stock value is based on appraisals of the market value of the company according to procedures and the ESOP administrator's fiduciary duties under ERISA.

Because worker-owned cooperatives are not as well known and understood as ESOPs, the business Owner and employees should be carefully informed about a worker-owned cooperative before they consider it as an alternative to an ESOP in a 1042 rollover.

IRC § 1042 defines an eligible worker-owned cooperative<sup>[2]</sup> as any organization:

- to which subchapter T of the Internal Revenue Code applies. This means a subchapter C (for federal income tax purposes) corporation that is "operating on a cooperative basis" as described in subchapter T of the Internal Revenue Code<sup>[3]</sup>;
- a majority of the membership of which is employees of such organization;
- a majority of the voting stock of which is owned by members;
- a majority of the board of directors of which is elected by the members on the basis of one person, one vote; and,
- a majority of the allocated earnings and losses of which are allocated to members on the basis of:
  - ❑ patronage (presumably the respective work inputs of member-employees)
  - ❑ capital contributions, or
  - ❑ some combination of these two methods.

This definition permits significant departures from conventional notions of cooperative operation that may provide important business planning options in a 1042 rollover to a worker-owned cooperative.<sup>[4]</sup> Because a 1042 rollover to a qualified worker-owned cooperative would probably involve transfer of control of the company, an Owner should not consider such a transaction unless the ultimate objective is to sell all or substantially all of the stock to the cooperative. However, if the Owner sells the shares in increments over several years, one or more of these unconventional features of an "eligible worker-owned cooperative" may permit the Owner to reserve certain rights to income and participation in governance until all the

shares are sold.

The IRC § 1042 definition of a worker-owned cooperative is more restrictive than conventional notions of cooperative operation in one sense. A majority of the directors must be elected on a one member, one vote basis. This eliminates the option to use patronage-weighted voting for this purpose at the time of the sale or during the period of sale in installments. <sup>[5]</sup>

The IRC § 1042 definition of a worker-owned cooperative provides some idea of the nature of an employee cooperative, but it is useful to understand more about the essential features of a cooperative in order to make an informed decision between an ESOP and a worker-owned cooperative under IRC § 1042.

The defining features of “doing business on a cooperative basis” are usually described in cooperative principles that provide a logical consistency for the economics and governance of a cooperative. We begin with first principles – the idea of “operation at cost” and “patron” – from which other cooperative principles logically follow.

**“Patron”** is a person with whom the cooperative makes a contract to provide goods or services or to market the person’s output on a cooperative basis (that is, collectively with the goods and services requirements or output of other patrons). Part of this contract is that the cooperative will return to the patron any profits (“net margins”) attributable to these transactions. In an employee cooperative, the employee would be the patron and the cooperative would “market” the employee’s work in the course of the cooperative’s business enterprise. By marshalling the collective efforts of a group of employees, the cooperative’s business enterprise should create greater value for the individual employee’s work, which value can be measured in corporate profits or net margins. Other corporations aggregate employees to create a more valuable work effort, but the difference in the case of an employee cooperative is that the employee-patrons would be entitled to this additional value in the form of an allocation of the net margins to the patrons in proportion to their work inputs. By contrast, other business organizations would typically distribute these profits to shareholders on the basis of invested capital.

**“Operation at Cost”** is a central theme of the patron contract and operating on a cooperative basis. A cooperative transacts business with or for its patrons at cost. This means that, to the extent a cooperative realizes a profit from its business transactions with or for its patrons (the “patronage transactions”), that profit belongs and will be allocated to the patron so that the net result of such “patronage refund” is that the patronage transactions are adjusted by the patronage refund from market price (the employee’s wage or salary) to the cooperative’s actual cost (in the case of an employee patron, the wages or salary plus the patronage refund). Thus the patronage transactions in the employee cooperative are conducted at cost and the cooperative operates at cost with respect to its patron. In theory, the cooperative earns its net margins on behalf of its patrons. A natural corollary of this cooperative principle is that capital ownership interests in the cooperative are subordinated (but not ignored or dismissed) to the interests of the patrons.

Three other cooperative principles logically flow from the notion of “operation at cost” and its “patron” corollary:

- **limited return on equity capital.** Cooperatives usually prohibit or limit the

amount of dividends that may be paid on capital stock and other equity interests and would not normally issue capital stock or other equity interests that appreciate (or decline) in value in connection with retained earnings (or losses). Instead, most of the retained earnings are accumulated from amounts that have been allocated to the patrons as part of their patronage refund.

- **democratic control of the cooperative by its members.** This usually, but not always, means voting on a one member, one vote basis rather than on the basis of invested capital or share ownership. [\[6\]](#)
- **member ownership.** A company whose profits and control are devoted to its patrons will not be attractive to other investors. Therefore, the members and other patrons must furnish most of the equity capital for the business. Thus, the profits and control of a cooperative are supported by corresponding member ownership. [\[7\]](#) An employee member in an employee cooperative would tend to view her or his investment in the cooperative as a purchase of a share of the company's profits rather than as a passive investment upon which a return on capital is expected.

Finally, a word about “members” and “patrons” of a cooperative. Patrons are described above. “Members” is a term of cooperative governance. The members normally exercise most or all of the voting control of a cooperative. The Internal Revenue Code, the IRS and many cooperative advisors often use the terms “member” and “patron” interchangeably because members and patrons are often the same group. However, it is important to remember that members of a cooperative are likely to be patrons, but many cooperatives have other patrons who are not members and have no vote in the affairs of the cooperative. As noted previously, the IRC § 1042 definition of an eligible worker-owned cooperative provides the unusual (and non-cooperative) possibility that some members may not be employee-patrons at all. The IRC § 1042 definition also uses the term “members” where the term “patron” is probably intended. The members of a cooperative should be considered the cooperative's voting polity and the patrons, who are usually also the members, are the persons with whom the cooperative has contracted to operate at cost.

With this understanding of the essential nature and terms of a cooperative, the Owner and employees can consider some of the differences between an ESOP and an employee cooperative (even one so oddly defined in IRC § 1042) for purposes of a 1042 rollover.

### **Workplace and Corporate Culture Considerations.**

The business Owner's sale of stock to an ESOP would likely have less impact on the workplace and corporate culture of the company than a sale to an employee cooperative. The employees' involvement in corporate decision making and ownership would normally be hardly noticeable in the case of ESOP ownership. Because the ESOP trustee has particular fiduciary obligations under the ESOP and ERISA, the company's business would presumably be conducted so as to maximize the value of the stock that was purchased from the Owner. This may be similar to the Owner's own goals and incentives. Therefore, a sale to an ESOP may result in little change in the business and the employees' workplace; at least in the near term. If the goal of the 1042 rollover transaction is to sell only a minority interest in the company, an ESOP transaction is clearly preferable.

In contrast, sale of stock to an employee cooperative in a 1042 rollover will likely result in significant changes in the workplace and corporate culture of the business. IRC § 1042 describes a sale of stock to either of two “employee organizations.” Both employee organizations focus on employee ownership of the business, but the ESOP is subtle, indirect, and its effect will be felt only over the long term, while the employee cooperative immediately and directly involves the employees. Selection of an employee cooperative business model can be enormously satisfying in certain situations, but it is not appropriate for every business application.

There is normally some adversarial tension between the employees and management in a company. An employee cooperative must overcome this conflict and the natural reluctance of employees to assume responsibility for investment in, and management of, their employer. An employee cooperative may be an appropriate business model in situations where the employees:

- recognize their common interest in working together to sustain the business and, therefore, their jobs and careers;
- believe they will create and gain greater value (however they define “value”) from their work in a collectively owned and managed workplace;
- want to acquire the full value of their work in the form of a share of the business’s profits, as opposed to an expectation of appreciation or other monetary return on invested capital; and
- are willing to subordinate some of their individual business decision-making to corporate business decision-making with fellow employees. This does not mean that the workplace should be managed by an endless series of member votes, but it does mean that the employees will collectively determine how they will be managed and, more importantly, determine the relative value of each employee’s work for purposes of dividing business profits at the end of the year. [\[8\]](#)

Obviously, a business with high employee turnover or a low level of employee loyalty to the business would not be a good candidate for a worker cooperative. On a less philosophical level, a business in which the employees are unwilling to make significant capital investment or financial commitment to invest in the business is also not a good candidate for an employee cooperative.

### **Other considerations in Comparing a Worker-owned Cooperative With an ESOP**

Unlike ESOPs, employee 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 an employee cooperative as the buyer in a 1042 rollover can avoid such regulatory burdens (and related expense) of an ESOP buyout as:

- extensive legal and consultant fees to establish the ESOP;
- hiring a bank trustee or other independent plan fiduciary to represent the employees’ interest (although the employee group should have professional advisers in connection with the acquisition and formation of a qualifying employee cooperative);

- an annual ESOP appraisal by an independent appraiser;
- 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 an employee cooperative should have some plan in place to buy out the equity interests of retiring member-employees).

Because an ESOP is a qualified ERISA regulated retirement plan, it is considered tax-exempt for federal income tax purposes. This tax status presents some very attractive tax planning opportunities in a 1042 rollover because the funding for an ESOP purchase of the Owner's stock typically comes from the target company (either from the company's working capital or from the proceeds of a loan to finance the stock purchase) in the form of tax-deductible employer contributions to a qualified employee retirement plan. The practical effect of this is that funding for an ESOP purchase of stock in a 1042 rollover is achieved with tax exempt income. Thus, using an ESOP as the purchaser in a 1042 rollover has become a popular transaction for Owners seeking immediate tax benefits for their company, and, particularly, for Owners who intend to sell less than all or a controlling interest in their company.

A primary focus in a 1042 rollover with an ESOP is stock value. The value of the company's stock is not only the measure of the sale price of the Owner's stock in a 1042 rollover (as it is in a sale to a worker-owned cooperative), but also the ongoing measure of the retirement benefits that accrue for the employee beneficiaries of the ESOP. By contrast, a primary focus of the employee's interest in an employee cooperative is a share of the company's annual profits and control of the company's management. In an employee cooperative, share acquisition is a means to achieve these goals, whereas an ESOP functions as a private stock market for the company's stock.

An employee cooperative is much less expensive to establish and maintain than an ESOP, but it has fewer immediate tax advantages beyond the IRC § 1042 deferral of recognition with respect to gains from the Owner's sale of stock. A subchapter T cooperative is not a tax exempt entity. Under subchapter T of the Code, an employee cooperative may exclude substantially all of its profits (net margins) from its taxable income for federal income tax purposes to the extent that it allocates and distributes these net margins on a patronage basis to its patrons within 8-1/2 months after the end of the cooperative's taxable year.<sup>[9]</sup> Subchapter T prescribes several procedural requirements for this exclusion<sup>[10]</sup> (the IRS has characterized the exclusion as a "deduction"), the most important of which is that the patron agree to include her or his patronage refund in gross income for federal income tax purposes. The result of this is that the cooperative's income (net margins) is taxed only once in its journey from the cooperative's business operations to the patron. This single tax treatment is similar to the pass-through of income in a subchapter S corporation or a limited liability company and is consistent with "operation at cost." Subchapter T also permits similar allocation and pass-through of most tax credits and losses. An employee cooperative is not a tax exempt entity, but single tax treatment

of its income is clearly available. In addition, an employee cooperative may establish a qualified retirement plan that is simpler, safer, and more cost-effective than an ESOP to which it can make tax-deductible contributions.

A subchapter T cooperative is unlike a subchapter S corporation and other true “pass-through entities” in important respects. For example:

- the terms and conditions of a patronage refund to a patron depend on the wording of the contract between cooperative and patron (usually in the cooperative’s bylaws) rather than an automatic and complete flow-through provided in the Code for “pass-through entities.” The deductible patronage refund or “patronage dividend” is based on a narrower set of requirements for source and distribution of income. A patronage refund consists only of the net margins attributable to the patronage transactions of the patron to whom the refund is allocated. Thus, the aggregate patronage refunds may consist of less than all of the cooperative’s net margins and may be subject to set off or forfeiture in favor of the cooperative under certain conditions of default in the cooperative/patron contract;
- if the cooperative makes a tax deductible allocation and distribution of patronage refunds, this tax deduction will be available to the cooperative for the tax year in which the net margins were earned. However, the patron need not report this amount until the patron’s tax year in which notice of the patronage refund is received. [\[11\]](#) Since a cooperative may allocate and distribute patronage refunds within 8-1/2 months after the end of its tax year, there is typically a one year delay between the time a cooperative earns a net margin and the patronage refund is reported as income by the patron.

Not only does the cooperative/patron contract act as a sort of control valve on the flow of income from the business to the employee patrons, but the income earned by the cooperative in one tax year will be reported for the first time as taxable income (by the patron) in a subsequent tax year when it is distributed to the patron.

Like most businesses, a cooperative’s primary source of equity capital is its own earnings. Recalling the cooperative principle of member investment and ownership of the cooperative, an employee cooperative is not likely to distribute the full amount of its patronage refunds to patrons in cash. The cooperative/patron contract usually grants some authority to the cooperative to retain some or all of each patronage refund for reinvestment by the patron in the cooperative. Thus, the patron receives the income, and her or his ownership interest in the cooperative is increased according to the amount of the refund that is retained and reinvested.

[\[12\]](#) Subchapter T provides that the cooperative must distribute at least 20% of the patronage refund in cash in order to exclude the patronage refund from its taxable income. [\[13\]](#) As a practical matter, the members usually expect and require that the cooperative distribute at least enough cash to cover the patron’s tax liability for the patronage refund.

Cooperative net margins that are allocated, distributed and taxed under subchapter T do not provide the immediate and long term tax deferral advantages of a tax exempt ESOP, but patronage refunds, to the extent paid in cash, are available for current use and disposal and the retained portions (equity interests) may be redeemed without any subsequent tax events for the

company or the employee.

Converting the company to an employee cooperative at the time of the 1042 rollover has an advantage from the Owner's perspective relative to an ESOP: it may justify a control premium for the initial sale of stock, even if it is a minority stock interest, because the majority of the board of an eligible employee cooperative will be elected by the employee members on a one-person, one-vote basis.

An additional advantage of a 1042 rollover with an employee cooperative from the Owner's perspective is that the Owner and other close relatives who cannot participate in an ESOP can be members of the employee cooperative, under the same rules that pertain to other members (even if they are not employees) provided they do not receive 1042 rollover stock in the course of becoming members. In addition, if they are employee members of the cooperative after the sale, they may participate in patronage refund allocations from the cooperative along with other employee members.

### **How to Do a 1042 Rollover With A Worker-owned Cooperative.**

When employees buy a business from the Owner through an ESOP, extensive tax and U.S. Department of Labor regulations protect employees as beneficiaries of the ESOP trust. In an employee cooperative, employees are decision-making members – rather than beneficiaries of a trustee plan. To protect their own interests, the employee-members should exercise the same care and discriminating judgment they would in buying any other business or, for that matter, in making any major financial decision.

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

- The duty to conduct the cooperative's business in the best interests of the employee members as patrons and also in the members' interests as investor-owners of the cooperative's equity capital;
- the requirement that the cooperative account for and allocate its profits (net margins) from employee-member work inputs in proportion to the value and amount of each employee's work input; and
- if the employee cooperative is organized under a state cooperative law, rather than a general corporate law, it is likely that the cooperative law will be somewhat more definitive as to issues of cooperative governance (membership control and election of directors) and the cooperative's fiduciary duties to its members and patrons than is provided in IRC § 1042.

An Owner who wishes to take advantage of a section 1042 rollover with an employee cooperative may structure the transaction under IRC § 1042 either of two ways. The Owner could either (A) encourage the employees to form a separate employee cooperative that would buy part or all of the stock and exist as a separate holding company to hold the target company's stock for the benefit of its employee-members, or (B) convert the Owner's corporation into an

employee cooperative, which would then redeem part or all of the Owner's stock. [\[14\]](#)

The first structure is comparable a stock sale to an ESOP. The separate entity would purchase the Owner's stock in the target company. The Owner may wish to use this kind of structure in the case where the Owner is not selling all of her or his stock immediately and wishes to retain control of the company, because it will not require that 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 employee cooperative is merely a non-operating entity (without any need for employees) whose only asset is stock in the target company. Clearly, an employee cooperative must 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 target company 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 in affiliation with the target company.

Unless there is strong reason to the contrary, it makes more sense to convert the target company to an employee cooperative and provide that the cooperative redeem the Owner's stock in the company. This redemption would be the legal equivalent of a sale of the Owner's stock in the company to an employee cooperative as contemplated in IRC § 1042. [\[15\]](#) There are no conceptual or legal problems with this strategy if the employees buy all or substantially all of the stock in the company. For practical as well as tax and legal reasons, a 1042 rollover to a qualifying worker-owned cooperative is suitable for the sale of all or substantially all of the Owner's stock, but would rarely be advisable for sale of a minority interest in the company.

Such a sale, done all at once, may create significant financing problems, or the Owner may be planning a gradual exit from the business. These conditions are usually dealt with through a multi-stage sale over a period of years. However, if the Owner sells shares to the employee cooperative in several stages, the Owner may find the conversion of the company into an employee cooperative before the first sale 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 for the Owner's interests (through supermajority voting requirements and other reserved rights to withhold consent for major corporate changes) until all of the Owner's stock has been redeemed. Such protections would normally appear in the Stock Purchase Agreement, or in the cooperative's Articles and Bylaws, or perhaps in employee subscriptions for the purchase of stock in the cooperative, or in all of these documents. As previously mentioned, the IRC § 1042 definition of a qualified worker-owned cooperative permits non-employee membership, non-member stock ownership, and distribution of earnings on other than a patronage basis. All of these non-cooperative features can aid in protecting the Owner's interests until subsequent stock sales are consummated.

Once the employee cooperative is established, the Owner would enter into a Stock Redemption Agreement with the cooperative whereby the cooperative will redeem (purchase) an IRC § 1042-qualifying amount of the Owner's stock for an agreed purchase price. The Agreement should also provide for one or more subsequent redemptions of the Owner's remaining stock in the company on a schedule specified in the Agreement. The redemption

price for each subsequent redemption could be fixed in the Agreement or the Agreement could provide that subsequent purchase prices be determined by a current appraisal using a method agreeable to the Owner and the employees. Because the 1042 rollover plan depends on the employees' commitment to invest in the cooperative and permit the cooperative to fund stock purchases from the Owner, the Owner should actually negotiate terms of the Stock Redemption Agreement with the employees as part of the 1042 rollover plan.

It makes sense for the cooperative's employee members, the company and the Owner to arrange financing sufficient to fund the initial redemption and to make plans to finance or otherwise 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 investment by each employee member of the cooperative. In exchange for this investment, each employee would receive equity interests and membership rights in the cooperative.

The reorganization of the company will involve new Articles of Incorporation, Bylaws, and a board of directors, the majority of whom are elected by the members. The Articles and Bylaws should specify member voting rights, the patrons' rights to allocation and distribution of net margins, and minimum investment obligations of members and patrons. The newly organized employee cooperative must:

- conform to the requirements of subchapter T of the Code and applicable state cooperative law;
- conform to the definition of an eligible worker-owned cooperative in IRC § 1042; and
- make sense to and be considered fair by both the Owner and the employees.

There are at least three threshold issues in using an employee cooperative for a 1042 rollover that should be acknowledged and accepted by the Owner and the employees, each of which is a personal watershed for the Owner and the employees:

- majority control of the company's board of directors must shift to the employee members prior to the first redemption of the Owner's stock. This is necessary to obtain IRC § 1042 tax benefits for the Owner. (It may also enable the Owner to receive a control premium, or at least avoid a minority discount, for this sale).
- Each employee-member's pay and share of the cooperative's profits will depend on a determination of the relative value of the employee's work for the new cooperative. In the past, the Owner has made this determination. In an employee cooperative, employee peers (perhaps through the board or a special committee of members) may take the place of the "Owner" on this subject. Such management decisions may be delegated to a CEO or other management arrangement by agreement of the Owner and the employees. If the Owner is not yet ready to leave the company, the Owner may negotiate an agreement to continue as an employee and manage the company as part of the 1042 rollover plan. The employees should also agree that each of them will invest in the employee cooperative in proportion to their respective share of the profits either through direct capital contributions or by retention and reinvestment of a portion of their compensation or patronage refunds, or a combination of these.

- An employee cooperative allocates its profits (net margins) among employee members on the basis of the relative value of their labor input rather than on the basis of their investment. It is up to the employee cooperative to determine what measurement of value should be used. There are some businesses in which the work is essentially the same for all jobs, but most businesses include a wide diversity of job skills and productivity that should be valued accordingly in order to be fair, and to make this pay scheme attractive to qualified employees. The measure of value might include salary or wage (market value), hours worked (volume), seniority (past labor input and wisdom), or skill, experience, education or especially valuable productivity (quality). These and other factors such as basic productivity and responsibility within the cooperative can be mixed and matched to a formula that the members agree is a fair representation of the true value of their work. All of these factors are commonly used to determine pay in non-cooperative companies, but such a formula could potentially conflict with the company's pre-existing pay scale, if it is the product of historical accident, office politics, or other important but non-economic considerations.

### **Documents to Implement a 1042 Rollover Plan With an Employee Cooperative – The Offering Documents**

The format of an ESOP in a 1042 rollover has become highly formalized in conformity with ERISA regulations and the requirements of the Department of Labor and the Internal Revenue Service. A plan for a 1042 rollover using an eligible worker-owned cooperative would not be subject to as much prescribed form and content. A great deal more of the plan would be directly responsive to the business and financial goals of the Owner and the employees as they are able to agree. This will require clear and comprehensive written documents describing the employee cooperative and its purchase (redemption) of stock from the Owner. The transaction involves:

- a significant commitment by the employees to invest in and own their employer;
- the Owner "letting go" of the business, entrusting it to the employees, and, in cases where sale of the target company is done incrementally over several years, trusting that the business will sustain itself and thrive in the future;
- compliance with IRC § 1042 and subchapter T in order to gain the desired tax benefits;
- adaptation of the business to the new corporate culture and governance of an employee cooperative (although this may not be a great leap for some small businesses that have been managed in a participatory style);
- issues of securities regulation and investor protection law. The transaction is a sale and purchase of corporate securities. It is more common than not that both the Owner and the employees are not sophisticated investors;
- reorganization of the target company under applicable corporate statutes.

Thus, the transaction documents should provide written evidence of the parties' agreements, intentions, their understanding of the relevant facts (the "due diligence"), and compliance with

applicable laws.

Because these documents serve essential functions of disclosure, legal compliance, and a fair and clear description of the agreements between the Owner and the employees with respect to the target company, they should be drafted and compiled and distributed among the parties in form and fashion similar to a prospectus or offering statement for a stock offering. Even though the Owner's sale of stock to an employee cooperative may qualify for exemption from state and federal securities laws, the function of the "offering documents" is similar to that of documents used in a public stock offering. They should protect the both the Owner and the employees by providing the discipline of full disclosure, enforceable agreements, and a clear record of what the parties understood and intended when the 1042 rollover plan was made and implemented. The documents, taken together, should make as fair a disclosure of the risks and obligations of participation in the transaction as possible. This will be valuable for the Owner's and employees' understanding; to a lender or outside investor to understand the transaction for possible financing of the transaction; and to reduce the risk of possible disputes or accusation of investment fraud in the future.

Here are some necessary documents for the transaction:

(a) **ARTICLES/BYLAWS** – The target company should amend its Articles of Incorporation and Bylaws (or a separate employee cooperative should adopt new Articles and Bylaws, depending on how the employee cooperative is formed) to achieve the desired cooperative structure. This will involve:

- separation of voting control from share ownership so that the requisite Member control (member voting and election of directors) for a qualifying worker-owned cooperative is provided to the employee-members.
- limiting dividends on capital stock so that most of the cooperative's 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 employee-members. These provisions should commit the employee cooperative to the Stock Redemption Agreement.
- provisions for determination and allocation of income (net margins) 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's work inputs for purposes of patronage refund allocations.
- balancing the interests of the Owner as a shareholder (until the Owner's original shares are redeemed) against the interests of the employee-members. This may include providing the Owner certain voting rights, veto powers, and rights to participate on the Board and in management of the target company, while providing majority control to the employee-members. These provisions would also describe what, if any, profits would be distributed to the Owner with respect to the Owner's remaining investment in the target 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 employees enter or leave membership.

(b) **STOCK REDEMPTION AGREEMENT** – An agreement of the cooperative to purchase or redeem the Owner's stock in the target company. This agreement would provide that the employee cooperative would purchase or redeem the Owner stock following its formation. The employees should join in this agreement for the purpose of committing the cooperative to performance of the Agreement. The purchase price, or an objective method for determining the purchase price, for this purchase should be fixed in the Agreement. The Agreement may also provide that the cooperative will purchase or redeem the Owner's remaining original stock in one or more subsequent installments at a purchase price or prices agreed upon by the parties or at prices to be determined by fair market value appraisals conducted at the time of purchase. The Agreement should include assurances to the Owner that the cooperative will act so as to protect the Owner's remaining share ownership in the target company and the Owner's right to elect tax deferral under IRC § 1042 with respect to proceeds of the stock sale. In turn, the Agreement should provide appropriate seller's warranties from the Owner with respect to the stock and the company. The Agreement may also describe the Owner's support of financing stock purchases and redemptions under the Agreement either by allowing the target company to secure borrowed money by encumbering its assets or by guarantying Employee borrowing for investment in the cooperative, or both.

(c) **OFFERING STATEMENT** – The Offering Statement would be a general written disclosure and description of the 1042 rollover plan for the Owner and prospective employee-members. It would describe:

- risks to the Owner of sale of shares and transfer of control;
- risks of investment by employees in the cooperative and purchase of the target company;
- securities law and tax issues of the transaction and continuing operation of the cooperative;
- description of reorganization of the target company into an employee cooperative, including the Articles of Incorporation and Bylaws, member agreements and how the cooperative will operate;
- description of the reorganized target company's financial condition and its business plan and financing going forward;
- description of share purchase and redemption obligations of the cooperative under the Stock Redemption Agreement; and
- description of employee-member investment and employment obligations in the cooperative. This will be augmented by a Membership Agreement to be attached to the Offering Statement.

(d) **MEMBERSHIP AGREEMENT** – This may be both a separate document and part of the Offering Statement. It should describe the prospective member-employee's

commitment to make capital contributions to the cooperative. It will also describe the 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 may 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 may include additional agreements with the Owner to use or acquire other assets owned by the Owner that are not in the target company, but are necessary for the business, such as a license to use patents or a lease of real property. The employees and the employee cooperative may also want to consider employment agreements, plans for member equity redemption, or even an agreement with the Owner for continuing management of the cooperative.

### **Steps to Implement a 1042 Rollover with an Employee Cooperative**

The steps to implement a sale of stock of an existing business to an employee cooperative under IRC § 1042 are not particularly complicated. They should include the following:

The employees who are interested in pursuing the buyout should form a co-op steering committee authorized to act on their behalf. If the employee group is small in number, the entire employee group should be the committee. This committee may include the Owner if the Owner will continue as an active employee, but the Owner should not dominate the committee.

The steering committee should retain 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. An independent appraisal of the value of the company's stock would make sense at this time. The employees may be reasonably familiar with the company but there are many things about its financial condition and business prospects that the employees are usually not in a position to know. Therefore, they should develop an appropriate "due diligence" checklist to educate themselves on the proposed investment, the same as they would for the purchase of any other business.

If the steering committee decides to form a new employee cooperative instead of converting the target company, they will need to incorporate a cooperative under an appropriate state cooperative statute and appoint a board of directors and officers of its own. A better plan will usually be to convert the target company into an employee cooperative. To do this, the Owner will need to revise the articles and bylaws of the target company to be more suitable for an employee cooperative. In either case, the Ohio Cooperative Law is likely to be more amenable to an employee cooperative than most states' cooperative statutes.

The steering committee and board should work with their professional advisors to develop an appropriate set of articles and bylaws for the employee cooperative defining who will be eligible to be a member, how the business will be operated on a cooperative basis (e.g., how net margins will be defined and how each members' labor inputs to the cooperative should be quantified and compensated), how any net margins of the cooperative will be allocated and distributed, how each member's investment requirements will be determined, and the members' right to participate in control of the cooperative. The employee cooperative's articles or bylaws

should specify that voting will be on a one-person, one-vote basis for election of directors. If the Owner or members of the Owner's family will be members, the bylaws and other offering documents should prevent the stock purchased in the 1042 rollover sale from being redistributed to either the Owner or the Owner's immediate family members.

If the company is operating under a subchapter S (tax) election, the Owner will need to terminate the S election prior to the Stock Redemption Agreement in order to obtain the IRC § 1042 tax advantages. Termination of an "S" election could have other income tax consequences for the business, which should be carefully evaluated.

The employees will need to become employees of the employee cooperative by the time the stock sale occurs. In cases where the employee cooperative and target company will remain separate, this may require a thoughtfully designed employee leasing arrangement whereby the employee cooperative provides employee staffing to the target company.

The employee cooperative and the Owner work together to locate financing for the stock sale/purchase. Most lenders will be reluctant to finance a stock purchase by a new employee cooperative, and are likely to ask for a financial guaranty and other collateral from the target company and from the Owner and employees. The employee 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 employee members should expect to shoulder most or all of the equity capital investment burden for their cooperative over time and will probably need to make some immediate personal financial sacrifices in order to gain control and ownership of their cooperative. In some cases, the Owner could provide some debt financing to the employee cooperative or the member employees although this should generally be avoided to obtain the full benefit of the IRC § 1042 election. IRC § 1042 requires that the Owner invest the stock sale proceeds in "qualified replacement property" after the transaction.<sup>[16]</sup> This will preclude use of the sale proceeds to finance the purchase either by the employee cooperative or by the employee members. The Owner can finance the employee cooperative only to the extent that she or he has adequate additional assets above and beyond the sale proceeds. If less than all of the stock is sold in the early stages of a multi-step sale, the Owner will, in effect, be helping to finance 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 the Owner and the employees need to take this into consideration as they negotiate terms of the 1042 rollover plan.

The Owner and the steering committee (or board) of the employee cooperative negotiate the terms on which the cooperative will purchase the Owner's stock. The agreement should also include adequate warranties from the Owner on the key information about the company's finances and liabilities and a plan to finance the purchase price prudently.

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. To obtain the benefit of IRC § 1042 for the Owner in the first purchase, the employee cooperative must own at least thirty percent (30%) of the stock of the company after the purchase.<sup>[17]</sup> If the Owner will continue to hold the rest of the stock, the Owner should obtain specific, binding commitments on the Owner's 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 employee cooperative, there should be an arrangement with the employee cooperative to employ the cooperative members in the company's business.

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

To enable the Owner to take advantage of IRC § 1042, the employee cooperative will need to agree to be subject to federal excise taxes if the acquired stock is resold by the employee cooperative (other than to employee members as part of a member capitalization plan for the employee cooperative) within 3 years, or if purchased shares are allocated to the Owner or the Owner's family. [\[18\]](#)

After an IRC § 1042 sale is completed, the Owner will file a properly documented IRC § 1042 election with the IRS.<sup>18</sup> The Owner will also need to invest the proceeds of the sale in "qualified replacement property" no later than 12 months after the sale closing date. [\[19\]](#)

## **Looking Forward**

In most cases, the employee cooperative will repay its buyout financing out of future net income of the business. This may make significant claims to its cash flow and most likely force it to allocate and distribute some or all of its patronage refunds 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 cash flow and financial planning. The employee members will receive current income of the business, but most of it will be committed to investment in the employee cooperative. Patronage refunds may not be immediately available as disposable income to the employee members during the term of loan repayment and the resulting equity interests will be exposed to the enterprise risk of the company's business.

The employee cooperative's plan of operation should take into consideration the interests of employees who are hired after the buyout. Membership, patronage refunds, equity redemption before or 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 employee cooperative's equity through personal investment in the cooperative in order to obtain these benefits. An employee cooperative is not required to have the suspense account or delayed allocations typically used with ESOPs, but it could establish such accounting and allocation devices in its bylaws or in policies and member agreements. The cooperative's income and equity allocation formulas should 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.

## **Conclusion**

Employee cooperatives can be an attractive alternative to ESOPs in a 1042 rollover. 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 an employee cooperative. However, an employee cooperative introduces other issues that are unique to the cooperative

way of doing business.

An employee cooperative should be considered in connection with a 1042 rollover only when the Owner is contemplating selling all or substantially all of her or his stock in the company.

An ESOP is more expensive to form and administer, and is typically subject to more restrictive government regulation, but an employee cooperative is more of a challenge to the corporate culture and management of the business. The democratic control and employee self-determination inherent in an employee cooperative brings with it the corresponding messiness of democracy and the shared burden of investment and management of the business by 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.

An employee 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 employee cooperative to employee-patrons 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 not an exhaustive comparison of an ESOP and an employee cooperative acquisition of the company's stock in a 1042 rollover. It may beg more questions than it answers, but our intention is to illustrate some comparative advantages and special considerations of an IRC § 1042 sale of stock to an employee cooperative.

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[1] 26 USC §1042(b)(1)

[2] at 26 USC § 1042(c)(2)

[3] Subchapter T of the Internal Revenue Code describes the single tax treatment of certain income of corporations that are "operating on a cooperative basis." See 26 USC § 1381(a). Subchapter T consists of 26 USC §§ 1381, 1382, 1383, 1385, and

1388 and the regulations thereunder. 26 USC § 1388 and Reg. § 1.1388-1 provide several useful descriptions and definitions of terms for “operating on a cooperative basis.”

[4] For example, an IRC § 1042 worker-owned cooperative may:

- have persons other than employees (patrons) in its membership;
- issue voting stock to nonmembers;
- include a significant minority of directors on the cooperative’s board of directors who are not elected by the members on a one member, one vote basis;
- allocate and distribute some or all of its earnings and losses on the basis of capital contributions, and up to 49% of these earnings and losses to persons other than members.

However, the owner and employees should consider the sizeable body of case law, audit experience, and IRS pronouncements interpreting subchapter T and “doing business on a cooperative basis” that may further refine and restrict one or another of these broad departures before incorporating them in the design of the worker-owned cooperative.

[5] But the IRC § 1042 requirement as to the method for electing directors does not limit patronage-weighted voting on other matters of the cooperative, nor does it prescribe a method of voting for the minority directors.

[6] Another commonly used cooperative voting scheme is “patronage-weighted” voting, meaning that the member patrons have individual voting power in the same proportion as their patronage refund is determined – that is, volume or value of patronage transactions. Some cooperatives employ other voting arrangements including voting on the basis of equity ownership, but nearly all restrict voting to members only. The IRS has issued some very restrictive private letter rulings on the subject of “democratic control” as a necessary part of “doing business on a cooperative basis” under subchapter T. The authors advise that voting on the basis of equity ownership and nonmember voting should be avoided or strictly limited in an employee cooperative because such voting schemes may create problems for the cooperative under applicable securities law, state cooperative statutes, or subchapter T of the Code. State cooperative statutes usually address the issue of voting control of a cooperative. The Ohio Cooperative Law (Chapter 1729 of the Ohio Revised Code) is particularly flexible in this respect at ORC§1729.17.

[7] There is an often-stated adage in business that the “golden rule” is “he who has the gold, makes the rules.” This is as logical in a cooperative as it is in any other form of business because the rights of ownership are combined with, and not in opposition to, the responsibility of ownership. Contrary to the assumptions of some business owners a cooperative business model is consistent with American capitalism.

[8] Most cooperatives select and operate under forms of management and management organizational charts that resemble those of non-cooperative business. After all, management and operation of an employee cooperative’s business must be just as disciplined and competent in order to be profitable. This means that some employee or employees will be the “boss” and others will follow their direction. The chief distinction of management in an employee cooperative is that management is hired or appointed by a member-elected board of directors and the business is operated to benefit the members as patrons rather than the shareholders as such. Of course, the imperatives of business competition apply equally to both cooperatives and non-cooperatives.

[9] 26 USC§1382(b) and 26 USC§1388(a)

[10] 26 USC§1388(c)

[11] 26 USC§1385(a)

[12] This accumulation of profits in the company is probably how most Owners in 1042 rollovers have previously accumulated the value of the stock they are selling.

[13] 26 USC§1388(c)(1)

[14] It is possible to organize an employee cooperative under some states' general business corporation statutes, but a state cooperative statute is preferable because general business corporation statutes include many terms and provisions that are incompatible with "operating on a cooperative basis." Many state cooperative statutes are devoted solely to agricultural applications, or are antiquated and incomplete corporate statutes, or both. The Ohio Cooperative Law (Chapter 1729 of the Ohio Revised Code) is particularly adaptable to a wide variety of cooperatives, including employee cooperatives. The Ohio Cooperative Law provides for conversion of an ordinary corporation to a cooperative in its merger and consolidation provisions and, in a separate provision for Ohio corporations, at ORC§1729.42. The Wisconsin and Colorado cooperative statutes are others to consider.

[15] The authors could find no case law or IRC pronouncements directly on point, but our review of the Internal Revenue Code and IRS interpretations that we believe to be relevant have led us to the conclusion that such a redemption would be regarded as a true sale and not a disguised dividend if the initial commitment to the stock sale includes a binding agreement to sell/redeem all or substantially all of the Owner's stock in the Company.

[16] See 26 USC§1042(a)(2) and (4)

[17] 26 USC§1042(b)(2)

[18] 26 USC§1042(b)(3) and (4)

[19] 26 USC§1042(c)(3) and (4)

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