

How to Sell Your Business to Your Employees through a Worker Cooperative – and to Shelter 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 received if they sold to their employees through an Employee Stock Ownership Plan. This is the so-called "1042 rollover" tax break. As far as we can determine, that provision has never been used for cooperatives – despite the fact that cooperatives can be set up economically in companies with far fewer employees than ESOPs.

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 §1042. A stockholder can also use a §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 a cooperative formed by employees primarily to jointly market their services or the products of the labor of the employee-members. Employee-members receive their salaries or wages, and are also entitled to share any net margins, in proportion to the work they have contributed. Further, 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, and 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.

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; conducting regular independent ESOP appraisals; 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 have fewer tax advantages. Under Subchapter T of the Internal Revenue Code (IRC §'s1381-1388), cooperatives may exclude from their taxable income certain allocations of profits attributable to business done with or for the cooperative's patrons. In turn, the members report this income as if they had received it in the first place. This "passthrough" of income is in some respects similar to a Subchapter S corporation. And, like a Subchapter S corporation, co-ops normally

distribute at least enough cash to their members to pay their taxes. So unlike ESOPs, where taxes are not paid when money goes into the plan but only 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. There is also no tax penalty or further tax on the employee's current access to his/her account, as would be the case in an early distribution from an ESOP.

The biggest non-tax difference between an ESOP and a cooperative is that an ESOP is a trustee 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.

How do employees buy a business through a cooperative?

When employees buy a business from the current owner through an ESOP, extensive tax law and U.S. Department of Labor regulations are supposed to protect employees. In a worker cooperative, employees are decision-making members – rather than participants in a trustee 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 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 as a cooperative; and
- 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.

Choices in selling to a cooperative

A current owner who wishes to take advantage of §1042 by selling to the employees through a cooperative has at least two options available under Code §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. This structure is cumbersome, however. 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, and operates somewhat like 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 §1042.

There are no conceptual or legal problems with this strategy if the employees buy 100% 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 two notable advantages from the seller's perspective relative to an ESOP. First, 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. Second, the seller and his/her close relatives (who cannot participate in the ESOP) can be included as coop members in patronage allocations – provided their they are actively employed in the business and become members of the worker cooperative under the same rules that pertain to other members and provided they do not receive 1042 rollover stock.

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 §1042 are not particularly complicated.

First, the employees who are interested in pursuing the buyout form a Co-op steering committee authorized to act on their behalf. It should obtain professional advisors, including a financial advisor to prepare a feasibility study to evaluate whether a buyout could be financed successfully at a purchase price the owner would find attractive. Obtaining an independent appraisal of the value of the company's stock also makes sense at the time of each transaction.

Second, if the Co-op steering committee decides to form a new worker cooperative instead of converting the existing business, they will need to incorporate a cooperative under the relevant state law, and appoint a Board of Directors and officers of its own. If they instead wish to convert the existing business into a worker cooperative, the steering committee will need to revise the articles and by-laws to be 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.

Third, 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 cooperative. The 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.

Fourth, the new worker cooperative and current owner work together to locate financing for the buyout. In some cases, the owner could provide some seller debt financing, although this should generally be avoided to obtain the full benefit of the §1042 election.

Fifth, 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 ("Stock Redemption Agreement"). 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.

Sixth, there should be an offering statement which discloses to the owner and prospective employee-members of the cooperative the risks involved, the securities and tax law issues, the description of the company's business plan and financing, how the company will be reorganized into a worker cooperative (including attachment of Articles and Bylaws), and description of share purchase and redemption obligations of the company under the Stock Redemption Agreement. It should note clearly that the 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. The purpose of the Offering Statement is to make as fair a disclosure of the risks and obligations of participation in the transaction as possible.

Last and not least, it is necessary to balance the interests of the selling owner as a shareholder (until all of the owner's original shares are redeemed) against the interests of the employee-members. This would include providing the 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.

Obtaining the tax advantages for the owner

To obtain the benefit of §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 business is now being taxed as an S corporation, the owner will need to terminate the S election in favor of a C corporation election in order to obtain the §1042 tax advantages, with possibly adverse income tax consequences that this may occasion.) The 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 seller's immediate family. After the buyout is completed, the selling owner will file a properly documented §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.

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 also 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.

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. 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 bring with them 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 more extensive version of this article which includes a further description of how to do a §1042 cooperative transaction and the documents required may be requested in hard copy for \$5 from the OEOC (309 Franklin Hall, Kent State University, Kent, OH 44242) or accessed directly without charge on the OEOC website at <http://dept.kent.edu/oec/oeclibrary/Coop1042Rollover.htm>. The legal research on this project was funded by the George and Gladys Dunlap Cooperative Leadership program of the Nationwide Foundation.

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.