Old Tax Law May Launch New Worker Co-ops

By Jeannine Kenney

A little known and apparently never used provision of the federal tax code may help launch a new wave of worker-owned cooperatives.

A new study commissioned by the Ohio Employee Ownership Center (OEOC) and the Ohio Council of Cooperatives suggests a provision of tax law that led to the formation of thousands of ESOPs—businesses with employee stock ownership plans—may do the same for worker-owned co-ops.

Since 1984, Section 1042 of the Internal Revenue Code has allowed independent business owners to sell their companies to their workers through ESOPs plans, and defer taxes, on capital gains realized from the sale. They're allowed to roll them over into qualified replacement securities.

That attractive tax benefit, says John Logue, executive director of the Ohio Employee Ownership Center (OEOC), is responsible for the formation of at least 60 percent of his state's 400 ESOPs. He believes it had a similar effect nationally.

1042 Applies to Worker Co-ops

But the "1042 rollover" provides the same tax benefits if business owners sell stock in their company to a worker-owned cooperative made up of the company's employees. Unfortunately, business owners have rarely, if ever, taken advantage of tax deferral benefits from selling to a worker co-op, partly because few people knew Section 1042 applied to worker co-ops.

And even those who had long understood that worker co-ops were eligible for 1042 had never seriously explored how to apply the law to cooperatives. "We kept promoting the idea," says OEOC's John Logue, "but no one took us up on it." That was, in part, because no one had done the legal legwork to determine how to apply 1042 to start co-ops.

So Logue and Tom McNutt of the Ohio Council of Cooperatives applied for and received a grant from Nationwide Foundation to fund the legal research. They contracted with attorneys Eric Britton and Mark Stewart to conduct the study. The result is a comprehensive report that lays out why small business owners may want to sell to their workers through a co-op and how to go about doing so.

More Viable, But Poorly Understood

Britton and Stewart are partners of the law firm Shumaker, Loop & Kendrick LLP, based in Toledo, Ohio, which has both national ESOP and co-op practices. Their research concludes that for some small businesses, using 1042 to form a worker co-op may be more attractive than forming ESOPs. But in their research, they didn't find a single co-op that had been formed using the 1042 rollover.

Loren Rodgers, executive director of the Massachusetts-based consulting firm Ownership Associates, says that one reason the provision has been little used to form co-ops, is that small business owners don't understand what worker co-ops are. "There's a psychological barrier that business owners have toward co-ops," Rodgers says. That barrier, he says is the perception of co-ops as businesses for the "granola-loving, Birkenstock-wearing" crowd.

Though the new OEOC study does little to change that attitude, Rodgers believes it will go far in changing another. "This study makes the case for co-op formation as a hard-nosed, calculated, good business decision," he says. "It confronts the perception that co-ops are inherently driven by ideology, and that wise business owners never adopt a co-op structure."

Because of its attractive tax benefits, Section 1042 may change that perception among small companies for which ESOPs are too costly to form and maintain. Worker co-ops may provide a sound business alternative.

The Burden of an ESOP

"You would not set up an ESOP for a company with fewer than 25 employees, or for less than a $3 million deal," says Britton. OEOC's Logue agrees. He says that for small companies, the costs of setting up an ESOP would likely overwhelm the tax benefits to the business seller. Though experts differ on the threshold at which an ESOP becomes unaffordable, for some firms, they're clearly not an option.

ESOPs must establish an independent plan trustee to represent the workers' interests and comply with a series of complex federal requirements and regulations under the Employment Retirement Income Security Act (ERISA) that drive up costs both at startup and in the out-years. The combination is a deterrent for small business owners to sell through an ESOP.

The Co-op Advantage

Worker-owned cooperatives, on the other hand, are less expensive to establish and maintain because the employees, not the federal government, are in charge. And because they are not retirement plans, ERISA regulations do not apply.

And, in a worker cooperative, the employees, rather than an outside trustee, conduct the "due diligence" in determining whether the business is a sound investment. They also manage their company through a member-elected board of directors.

Still, Susan Cole Halevi, an attorney specializing in worker ownership, cautions worker co-ops not to cut corners in getting an independent valuation of the company.

Tax Benefits Differ

On the downside, the study's authors say, there is fewer tax advantages associated with a worker co-op compared to an ESOP. In an ESOP, taxes are not paid on income going into the retirement plan, but instead, when it is paid out to retirees years later. In addition, Halevi points out; ESOP debt is effectively repaid with pretax dollars, while co-op debt is repaid with after-tax dollars.

Co-op members, on the other hand, pay taxes on patronage income from the co-op when they receive it. For some workers, though, that may be more attractive. After debt is paid off, the profits of the business are available to employees when they are earned—in the form of patronage refunds and retained equity—not 30 years later in retirement benefits. The workers have the flexibility to invest that income as they see fit. They don't have to keep it in company stock.

How to Convert to a Co-op

Britton and Stewart analyzed the different options for business owners seeking to sell to a cooperative and take advantage of the 1042 rollover. If the company is organized as a subchapter S corporation, it must convert to a C corporation and then take advantage of subchapter T tax treatment for patronage dividends paid by a cooperative. The authors say that co-ops may be able to organize under state law as a corporation, but it would be more prudent to incorporate as a cooperative under state law if that option is available.

Though selling the company's stock outright is the simplest approach, the authors caution that financing such a large sale can be difficult. Alternatively, the business could be sold in stages, with an initial sale of at least 30 percent of company's stock—a 1042 requirement. Or, workers can set up a separate company, organized as a co-op, that jointly owns the original company with the seller. Over time, the co-op would take full ownership. In all cases, co-op members must elect and control a majority of the board.

The Opportunity to Stay Involved

For the business seller, co-ops offer yet another advantage. The sellers can become members of the co-op until they're ready to exit the business. By contrast, though business owners who sell their company to an ESOP can remain involved in the company, the law prohibits them from participating in the ESOP retirement plan if they've used the 1042 rollover.

For some small business owners, though, selling less than a majority of their company to a co-op while losing their ability to control the business may be hard to swallow. They still have the risks of losing money and equity on their remaining ownership share—which could be as much as 70 percent. But, Britton and Stewart say the co-op can structure its bylaws to require a supermajority vote of the board for some critical business decisions. That gives a seller who retains a financial interest in the company the ability to veto certain actions of the board.

Building an Ownership Culture

Though selling to a worker co-op is less expensive and more flexible for both workers and owners, the cultural issues may be harder to overcome, say Britton and Stewart.

"The democratic control and employee self-determination inherent in a worker cooperative brings with it the corresponding messiness of democracy," they contend. That includes not only eliminating the "us vs. them" mentality of workers with regard to management, but also how to value the relative contribution of employees for purposes of dividend distribution.

"The question is, will [employees] be comfortable with that collective decision making?" asks Stewart. But, he says this shift in members' thinking is not so different than in other types of co-ops, such as agricultural cooperatives. To make the co-op work, farmers "have to think of the co-op as an extension of their farming operation."

This shift in attitudes, which requires educating new co-op members about their new ownership role, is not necessarily required to make an ESOP work. But, in a worker co-op, "you have to think of yourself as both an employee and an entrepreneur," Stewart adds.

Still, Ownership Associates' Rodgers contends that once that ownership culture is created, worker-owned co-ops can provide sellers who retain some equity in the business with an additional benefit. He says data show that employee-owned companies with high levels of worker participation outperform other types of companies. That can mean greater income growth for the seller if he or she retains some level of ownership.

New Co-op Possibilities

Section 1042 creates a number of new co-op opportunities. First, for business owners who are already members of purchasing cooperatives, like ACE Hardware, the 1042 rollover option may be particularly appealing. "These small business owners already understand the concept of a cooperative, because they're already members of one," says Paul Hazen, president and CEO of the National Cooperative Business Association. "This may not be a tough sell for them," he adds.

Attorney Susan Cole Halevi agrees. "This is a great opportunity for a company that has value to provide a strategy for the retiring shareholders or those who would like to see ownership go to employees who have helped build the business," she says.

The tax benefit may also help existing worker co-ops acquire new businesses. Collective Copies, a worker-owned copy co-op in Massachusetts, hopes to grow the number of copy centers it operates. Randy Zucco, president of the co-op, says that 1042 might help the co-op acquire smaller mom and pop copy shops. Stewart and Britton say nothing in the law would prevent owners from selling to an existing co-op, as long as their existing employees became members.

John Logue of the Ohio Employee Ownership Center believes that 1042 applied to worker co-ops may be particularly appealing for small business owners in rural areas, where potential buyers are few and far between. "Whether you're talking about an agricultural implement dealer or some other business in a small town," Logue says, "so much of the rural infrastructure is drying up and blowing away. Often the only option is to liquidate the business. . .but when you do that, you're liquidating employees also." Others suggest that it's equally hard for business owners in depressed urban areas to find buyers. Section 1042 may provide more options for businesses in the city and the countryside.

Regardless of how 1042 is applied, OEOC's Logue says the study reveals huge opportunities for new cooperative business development. He'd like to see the 1042 rollover do for cooperatives what it did for ESOP's—launch thousands of new businesses. "This offers real opportunities for the co-op movement."