



Department of Commerce – Report on Development of ESOPs

In accordance with p. 208 of the 2021 Joint Chairmen's Report

Submitted by
Maryland Department of Commerce

November 15, 2021

The Feasibility of Creating an Office of Employee Ownership Within The Maryland Department of Commerce

Introduction.

Page 208 of the 2021 Joint Chairmen's Report required that the Maryland Department of Commerce (Commerce), in consultation with the University System of Maryland (USM), create a report reviewing the feasibility of creating an Office of Employee Ownership within the Department.¹ This study is expected to investigate the "potential of Employee Stock Ownership Plans (ESOP) to encourage economic growth and improve business performance." This study is also expected to detail "the potential benefits and funding sources for establishing [an Office of Employee Ownership] to encourage companies to develop ESOPs that give workers shares in the companies at which they work" and should review "the practices of other states in reporting on the structure and placement of such offices; potential sources of funding for an office and any programs in the office; and any incentives or other programs to support the creation of ESOPs."

Types of Employee Ownership.

An Employee Stock Ownership Plan is one of many forms of company employee ownership. The main difference in these various structures is the level of control that an employee has over the running of the organization. There are three basic types of employee ownership structures: Worker Cooperatives, Employee Ownership Trusts (EOTs), and Employee Stock Ownership Programs (ESOPs).

Worker Cooperatives. In a worker-owned cooperative, each worker generally has the ability to purchase an equity stake in the cooperative. Workers with equity stakes have equal control over the company and have an equal vote in major company decisions. Company profits are generally shared among workers with equity stakes based on hours worked. In most cases, this control and profit-sharing is only open to those who are actively employed by the company, though there are exceptions.² Internationally, the most famous worker cooperatives are the Mondragon cooperatives of Spain, while a local example would be Red Emma's in the City of Baltimore. Stock or shares in the company generally do not circulate, though there can be exceptions.

Employee Ownership Trusts. Sometimes called Perpetual Employee Trusts, this business structure places ownership of all stock into a perpetual trust, overseen by a trustee to ensure that the long-term management of the business benefits employees. Like a worker cooperative, the structure generally benefits active employees only, not former employees or retirees. Unlike cooperatives, no buy-in is required. All current employees receive a share of company profits, and can vote to select the trustee and, depending on the structure of the trust, vote to direct the trustee to make decisions in their name. EOTs exist to protect the jobs and income of employees in perpetuity, so would generally not respond to purchase offers from outside entities. EOTs can also be structured to have built-in missions that the company must follow. These structures are known as Perpetual Purpose Trusts. As with cooperatives, company stock generally does not circulate and is entirely held by the trust.³

¹ Joint Chairmen's Report – Operating Budget, April 2021, p. 208

² Employee ownership options: Find the right fit for your company. <https://project-equity.org/learn-about-employee-ownership-options/>

³ Ibid.

Employee Stock Ownership Programs. Unlike Cooperatives or EOTs, ESOPs are considered IRC section 401(a) qualified defined contribution plans by the IRS,⁴ making them a form of stock bonus retirement plan. While stock ownership generally does not extend to non-employees, employees are allowed to transfer their ownership stake back to the company and place the resulting funds into a retirement account. These transfers have significant tax benefits, as does the company structure itself (though these tax benefits are beyond the scope of this paper). Unlike Cooperatives or EOTs, each worker who is a member of the ESOP has a personal ownership stake in the company. ESOPs can also have varying ownership stakes in a company, and are not required to own the entirety of a company's stock. Like an EOT, employee-owners are represented by a trustee, but unlike an EOT that trustee has a fiduciary responsibility to those whose retirement is dependent upon the ESOP, meaning that an ESOP's holdings can be sold if an acquisition offer is seen to maximize the shareholder's / employee's financial benefits. ESOPs are generally seen to be complex to administer, and these administration costs can make this structure unaffordable for small companies under 50 employees.⁵

Other Types of Employee Stock Ownership. The above are not the only ways that an employee can own stock in their employer.

Stock Bonus Plans. While an ESOP is a type of stock bonus plan, there are other ways that companies make stock freely available to their employees. Generally, companies are allowed under IRS rules to give yearly bonuses in the form of company stock that is contributed to a qualified retirement plan. Like other retirement plans, there are limits to an employee's ability to withdraw these funds before retirement.⁶

Employee Stock Purchase Plans. Some traded companies allow employees to purchase stock through an Employee Stock Purchase Plan (ESPP), which can give employees up to a 15 percent discount in the price of a stock. There are two types of plans: Qualified and Non-Qualified. Qualified plans are more regulated, but can have tax advantages for employees. Non-qualified plans are easier to implement, but lack these tax advantages. Either way, under these plans employees can purchase stock in their companies and build up an ownership share.⁷

Individual Stock Purchasing. Employees of traded companies can also purchase stocks on their own, outside of a dedicated employee-ownership structure. Some 401(k) retirement plans now allow their owners to use pre-tax funds to invest in individual stocks through 401(k) brokerage accounts, also known as self-directed brokerage accounts (SDBAs) or a 401(k) brokerage windows.⁸ Even without using these vehicles, it is possible for an employee of a traded firm to

⁴ Employee Stock Ownership Plans (ESOPs). <https://www.irs.gov/retirement-plans/employee-stock-ownership-plans-esops>

⁵ Employee ownership options: Find the right fit for your company. <https://project-equity.org/learn-about-employee-ownership-options/>

⁶ How Does a Stock Bonus Plan Work? <https://www.fool.com/knowledge-center/how-does-a-stock-bonus-plan-work.aspx>

⁷ Employee Stock Purchase Plan (ESPP). <https://www.investopedia.com/terms/e/espp.asp>

⁸ The Rise of 401(k) Brokerage Accounts. <https://www.investopedia.com/articles/personal-finance/061314/rise-401k-brokerage-accounts.asp>

use a standard brokerage account to invest in their own company's stock. The benefits of this investment would vary widely, as some stocks pay dividends that can be reinvested (a form of profit-sharing), some stocks can split over time to increase an owner's level of investment, and the value of a stock can vary owing to that company's economic performance.

One major difference between Stock Bonus Plans, ESPPs and individual purchasing is that, while the value of a Cooperative or an EOT is set internally, and while the value of an ESOP is often (but not always) set by an audit overseen by the trustee, the value of a traded stock is entirely dependent upon the market. There are many instances where retirement accounts based on traded stocks have been negatively affected by stock downturns or bankruptcies. However, stock ownership usually vests the owner with a vote in certain company decisions, such as the approval of boards of directors, so this is a potential method for employees to have a say in the operations of their employers if their employer has not instituted a formal employee ownership system.

Employee Ownership Comparison

Ownership Type	Job Protection	Company Control	Retirement Account Funding	Employee Buy-In	Profit Sharing
Worker Cooperative	Yes	Yes	No	Yes	Yes
Employee Ownership Trust	Yes	Through Trustee	No	No	Yes
Employee Stock Ownership Program	No	Through Trustee	Yes	Varies	Yes
Individual Stock Purchasing / ESPP / Stock Bonus Plans	No	Stock Voting Rights	Through some 401(k) types	Yes	Dividends, splits, price increases or decreases

How an ESOP Works.

When a company creates an Employee Stock Ownership program, it is creating a special type of retirement plan that is controlled by IRC section 401(a) as a qualified defined contribution plan. An ESOP allows this special retirement plan to purchase up to 100 percent of the shares in a company, sometimes with borrowed funds, making the employees part or full owners of that company through that retirement plan. To protect the interests of the employees, each ESOP has a trustee who is the actual manager of those company shares and exercises shareholder rights on behalf of the plan participants (employees and retirees). ESOPs are the only type of retirement plan allowed to borrow funds to make investments.⁹

When the ESOP is formed, there are some options as to how it functions and what rights the employees and retirees have over the company's operation. All ESOPs are required to give ESOP participants the right to vote over certain major decisions such as the sale or dissolution of

⁹ <http://www.hollandhart.com/articles/For-Many-Companies-Major-Benefits-ESOP.pdf>

the company, with all other shareholder votes being controlled solely by the trustee. However, some ESOPs have been structured to give participants additional control over company decision-making and allow individual participants the ability to vote on issues that a traditional shareholder would have the ability to vote on.¹⁰

Once the ESOP is formed, it can use the flow of funds into the ESOP retirement plan from the plan participant members (a group which may or may not include all employees of the company) to purchase company shares directly or to collateralize a loan from a third party that can be used to purchase some or all of a company's shares or otherwise invest in company operations [leveraged ESOPs]. ESOPs can also be used to create new company shares that are added to each participant's account balance. When each participant retires or otherwise leaves the company, they use the number of shares that have accumulated in their name as the method for valuing their retirement account. The issuance of new shares through the ESOP creates share value dilution, which can be a problem if the increase in the number of plan participants exceeds the increase in value of newly-issued shares over time. Note that an ESOP, like any stock option plan, can also dilute the value of publicly-traded stocks if and when the option to purchase stock through the ESOP is exercised, causing new shares to be issued by the company.

The value of an ESOP's shares is set in one of two ways. For shares that are not traded publicly (i.e., for ESOPs that own 100 percent of a firm), the ESOP trustee relies on an independent third-party valuation firm to calculate the Fair Market Value (FMV) of the company, or "the price at which property would change hands between a willing buyer and seller, neither having the compulsion to buy or sell and both having reasonable knowledge of the relevant facts."¹¹ Once the FMV of the company has been established, the share price is calculated using the number of outstanding shares. For companies that are only partially owned by an ESOP, that share price would be dependent on the market value of the market share price. The job of the ESOP trustee generally is to protect the fiduciary needs of the shareholders they represent. "Under the Employee Retirement Income Security Act of 1974 (ERISA), which governs ESOPs, ESOP trustees are 'fiduciaries' of the ESOP. As such, they have a duty to:

- Act solely in the interest of ESOP participants and beneficiaries.
- Act for the exclusive purpose of providing benefits to ESOP participants and their beneficiaries and defraying reasonable expenses in administering the ESOP.
- Exercise the same care, skill, prudence and diligence that a prudent person acting in a like capacity and familiar with such matters would exercise in the conduct of an enterprise of a like character and with like aims."¹²

Employees must "vest" into an ESOP, as they must vest into any retirement plan. Vesting into an ESOP is controlled by law, and an ESOP "must comply with one of the following two minimum schedules for vesting:

- No vesting at all in the first years, followed by a sudden 100% vesting after not more than three years of service ("cliff" vesting); or

¹⁰ <https://www.esoplav.com/workplace-democracy-and-participation>

¹¹ <https://www.ksmpa.com/insights/how-is-the-annual-price-of-your-esop-shares-determined/>

¹² <https://mcdonaldhopkins.com/Insights/May-2018/ESOP-trustees-are-becoming-targets>

- Twenty percent vesting after the second year of service, with 20% more each year until 100% vesting occurs after the sixth year of service ("graded" vesting).¹³

Once an employee is vested and becomes a plan participant, their plan accounts collect shares based on the terms of the ESOP. Shares may be distributed on the basis of time worked at the company, through profit-sharing, through share purchasing plans, or through any combination of those methods. Because an ESOP is a retirement account, upon retirement, death, or disability the shares held by each employee are converted to cash and are often invested in another retirement vehicle. Generally, the ESOP has to distribute the participant's retirement funds within a year after one of these "events." However, if an employee/participant leaves their job before retirement, distribution rules can be different and can give the ESOP more time to distribute the participant's shares.¹⁴ This is especially true in cases where an ESOP is leveraged and may have to pay back borrowed funds to make a distribution available.

As mentioned above, a company's employees exercise control over their employer through the Trustee, who is the ultimate decider. In some cases, the trustee is elected by the employees, and an unresponsive trustee can be removed. In other cases, the trustee is appointed by the Board of Directors. While important strategic company decisions, such as mergers and acquisitions, must be put up to a vote by the employee-shareholders, other decisions are solely the province of the trustee or the Board. At best, an ESOP can be structured to allow for individual plan participants to have similar voting rights to shareholders in public companies. In all cases, day-to-day operational decisions are made by the Board of Directors with little input from the trustee and no control is exercised by employees, meaning that, while employees can own a company through an ESOP, they cannot exercise much control over it. Day-to-day control of an ESOP-owned company is essentially performed by company management in the same manner as any other shareholder-owned company.¹⁵ As noted by the National Center for Employee Ownership, "ESOPs will improve corporate performance only if combined with opportunities for employees to participate in decisions affecting their work."¹⁶

A Short History of Employee Stock Ownership Programs.

The first Employee Stock Ownership Program was created in 1956, when the retiring owners of Peninsula Newspapers, Inc. wanted to transfer their ownership stake to their employees instead of selling the company to a third party. To cover the cost of the owner's shares, a then-novel funding structure was established where future contributions to the employee's retirement fund were used to guarantee a loan. In other words, the employee's retirement fund would become the owner of the company. This had the added benefit of all of the repayment funds being pre-tax funds, meaning that more money was available to pay off the loan. This structure required IRS approval, but the company and its lawyers were able to devise a system that worked to the IRS's

¹³ <https://www.nceo.org/articles/esop-vesting-distribution-diversification>

¹⁴ <https://www.nceo.org/articles/esop-vesting-distribution-diversification>

¹⁵ <https://rsmus.com/what-we-do/services/tax/compensation-and-benefits/who-controls-an-esop-owned-company.html>

¹⁶ <https://www.nceo.org/articles/esop-employee-stock-ownership-plan>

satisfaction, and the funding mechanism was approved. This was the first instance of an IRS-approved retirement plan being used to plan business succession.¹⁷

While the first ESOP was used to purchase 100 percent of a company, it was soon realized that ESOPs could be used to purchase partial shares of companies to buy out individual owners, while leaving the rest of the ownership in the hands of others. This made ESOPs easier to use, and made it easier for companies to plan for succession. But, because early ESOPs had to be approved individually by the IRS, they were seldom used. This began to change in 1974 with the passage of the Employee Retirement Security Act of 1974 (ERISA), which made ESOPs an allowable business funding structure.¹⁸

ESOPs began to be used for new purposes in the late 1970's, when companies saw them as a method for rescuing failing companies. The Chrysler Corporation, Weirton Steel, and United Airlines all attempted to use ESOPs to shore up company finances. Chrysler employees in 1979 voted to create an ESOP funded by a 30 percent drop in wages to pay back a \$1.5 Federal billion bailout loan. In return that ESOP gave those employees 25 percent ownership in the company. However, that ESOP was discontinued after 1983 when the company repaid that loan. Employees at Weirton Steel voted to create an ESOP in 1984 to purchase 100 percent ownership of an entire steel plant to prevent its shutdown at the cost of a 20 percent wage cut plus five years of wage freezes. This allowed the company to survive for another 20 years before succumbing to bankruptcy. Finally, employees at United Airlines voted to bail out the airline in 1995 using an ESOP to purchase 55 percent of the company at the cost of employee pay cuts up to 15 percent for employees. Unfortunately, the events of September 11, 2001 forced the company into bankruptcy.¹⁹

Starting in the 1970's, ESOPs found other uses as well. They were used to facilitate the divestiture of company subsidiaries, spinning them off to employee control. ESOPs were also used to take publicly-traded companies private when undervalued stock prices (an issue in the late 1970's) made that possibility attractive financially.²⁰ Finally, ESOPs were used to help block hostile takeovers by ensuring that enough of a company's stock was controlled by the ESOP that any takeover attempt would be blocked. One well-known example of this is the Polaroid Corporation, which was a takeover target in 1988. That takeover was blocked by the growing an already-existing ESOP from 5 percent to 14 percent of the company's outstanding shares.²¹ The legacy of that decision was a requirement for each Polaroid employee from that point on to spend 8 percent of their salaries to purchase Polaroid shares through the ESOP. Unfortunately, Polaroid's subsequent bankruptcy in 2001 caused the value of these shares, which were also publicly traded, to diminish to virtually nothing. This meant that Polaroid employees lost years of investments and a large portion of their retirement benefits.

¹⁷ The Origin and History of the ESOP and Its Future Role as a Business Succession Tool.

<https://www.menke.com/esop-archives/the-origin-and-history-of-the-esop-and-its-future-role-as-a-business-succession-tool/>

¹⁸ Ibid.

¹⁹ Ibid.

²⁰ Ibid.

²¹ Leveraged ESOPs, Wealth Transfers, and "Shareholder Neutrality:" The Case of Polaroid. Robert F. Bruner and E. Richard Brownlee II. *Financial Management*, Vol. 19, No. 1 (Spring, 1990), pp. 59-74 (16 pages).

As the creation of ESOPs fell out of favor for large firms, they again began to be seen as a method for creating orderly succession planning for small- and medium-size business owners. One legal change that supported this change was the Small Business Job Protection Act of 1996, which allowed S-corporations to form ESOPs and opened up access to this business planning tool to smaller businesses. A 2008 report from the University of Pennsylvania estimated that, just 10 years after they were allowed, 40 percent of all ESOPs in the U.S. were S-corporations.²²

ESOPs in Maryland and the Nation.

According to an analysis of Form 5500 from the U.S. Department of Labor's Employee Benefits Security Administration (EBSA) for the 2019 filing year, there were 134 active ESOPs in Maryland, with 271,324 active members and 12,281 retired members.²³ Maryland had 2.1% of the Nation's 6,450 ESOPs and 2.7% of the Nation's 10,217,388 active participants in that year. The vast majority of Maryland's active ESOP participants in the 2019 tax filing year were listed as belonging to one of two companies' ESOPs: Lockheed Martin, which listed 128 thousand participants in seven different plans, and Marriott, which listed 120 thousand participants in one plan. Since data for these plans is reported based on the mailing address of the plan administrator, and these plans are operated by very large, international firms, it is likely that these plan participants are not all located within Maryland. However, there are large employers with locations in Maryland whose plan address is located outside of the State, and whose workers would be counted in those states. Examples of employers with large memberships in ESOPs and multi-state establishment locations are Walmart (1.5 million active participants in 2019), Home Depot (369 thousand), Lowe's (265 thousand), and many others.

ESOP Plans Managed by Maryland Firms, 2019

Company Supersector	Plans	Active Participants
10 - Natural Resources and Mining	1	8
20 - Construction	23	2,174
30 - Manufacturing	20	134,251
40 - Trade, Transportation, and Utilities	19	1,526
50 - Information	3	266
55 - Financial Activities	16	931
60 - Professional and Business Services	48	11,883
65 - Education and Health Services	2	22
70 - Leisure and Hospitality	1	120,247
80 - Other Services	1	16
All Plans Managed in Maryland	134	271,324

Source: U.S. Department of Labor, Form 5500, 2019

²² S Corp ESOP Legislation Benefits and Costs: Public Policy and Tax Analysis. Steven F. Freeman and Michael Knoll. Graduate Division, School of Arts and Sciences, Center for Organizational Dynamics, Working Paper #08-07 July 29, 2008

²³ ESOPs were defined as those reporting Plan Characteristics 20 (non-leveraged ESOP), 2P (leveraged ESOP), or 2Q (S-Corp ESOP) on Line 8a of the 2019 Form 5500. Plan location was derived from the "SPONS_DFE_MAIL_US_STATE" variable. Data downloaded from <https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/public-disclosure/foia/form-5500-datasets>

In Maryland, the majority (81) of ESOP retirement plans are operated by S-Corporations, while the remainder (53) are operated by C-Corporations. Due to the size of the Lockheed Martin and Marriott plans, the majority of active plan participants (256,232) were in C-Corp-sponsored plans.

Because there are many large plans that have active participants located in multiple states, to ensure that the total effects of ESOPs on the economy are captured properly it is more accurate to review existing ESOPs on a national level.

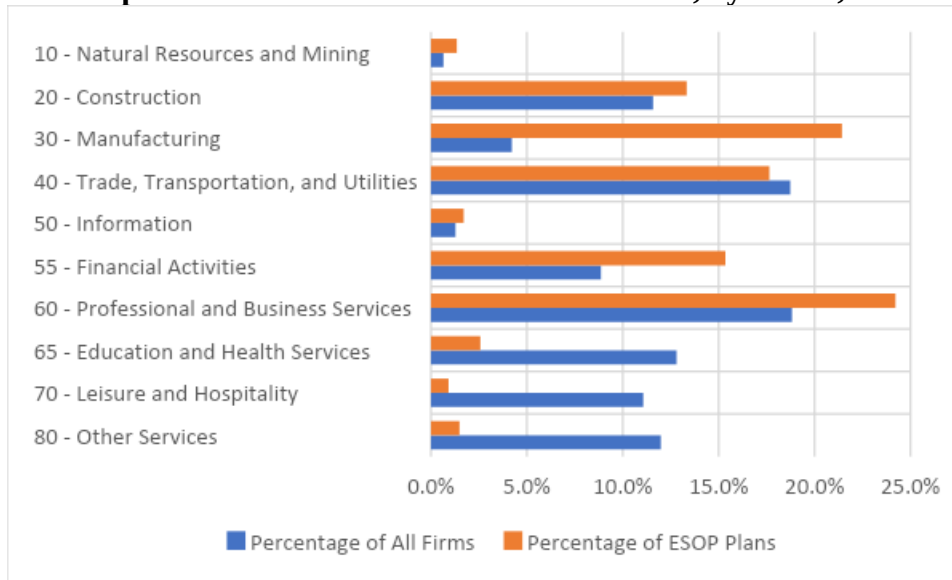
ESOP Plans in the United States by Company Type, 2019

Supersector	C-Corp Plans	C-Corp Active Participants	S-Corp Plans	S-Corp Active Participants	Total Plans	Total Active Participants
10 - Natural Resources and Mining	42	27,462	45	7,583	87	35,045
20 - Construction	217	47,296	643	104,093	860	151,389
30 - Manufacturing	606	2,389,822	776	131,372	1,382	2,521,194
40 - Trade, Transportation, and Utilities	484	3,800,009	654	179,481	1,138	3,979,490
50 - Information	60	607,460	50	5,357	110	612,817
55 - Financial Activities	612	1,190,581	378	55,064	990	1,245,645
60 - Professional and Business Services	694	961,318	868	188,350	1,562	1,149,668
65 - Education and Health Services	47	55,545	119	44,705	166	100,250
70 - Leisure and Hospitality	27	353,221	32	8,509	59	361,730
80 - Other Services	34	50,648	62	9,512	96	60,160
Grand Total	2,823	9,483,362	3,627	734,026	6,450	10,217,388

Source: U.S. Department of Labor, Form 5500, 2019

In total, there were 6,450 ESOP plans in the United States in 2019, according to the Department of Labor. As the table above shows, the majority (56 percent) of these plans were operated by S-Corporations. However, the vast majority (93 percent) of active plan members were in plans operated by C-Corporations. S-Corp plans outnumbered C-Corp plans in all supersectors of the economy in 2019 except for Information and Financial Activities. Construction was the only supersector where the number of active plan participants in S-Corp plans outnumbered those in C-Corp plans.

Comparison of Number of ESOPs to All Firms, by Sector, 2019



Sources: U.S. Department of Labor, Form 5500, 2019; U.S. Census Bureau, Business Dynamics Statistics, 2019

Firms with ESOP retirement plans are not evenly distributed throughout the economy. The Manufacturing, Financial Activities, and Professional and Business Services are all over-represented, while industries such as Leisure and Hospitality and Education and Health Services are underrepresented. While manufacturing firms make up only 4.2 percent of all firms, they make up 21.4 percent of all ESOPs. Conversely, while Leisure and Hospitality firms make up 11.1 percent of all firms in the United States, they only account for 0.9 percent of all ESOP plans.

Average ESOP Plan Membership vs Average Firm Size, by Sector, 2019

Supersector	Average ESOP Plan Size	Average Firm Size
10 - Natural Resources and Mining	403	22.5
20 - Construction	176	11.3
30 - Manufacturing	1,824	53.1
40 - Trade, Transportation, and Utilities	3,497	27.6
50 - Information	5,571	51.4
55 - Financial Activities	1,258	18.4
60 - Professional and Business Services	736	24.1
65 - Education and Health Services	604	35.6
70 - Leisure and Hospitality	6,131	28.4
80 - Other Services	627	8.7
Grand Total	1,584	24.5

The average count of active plan participants in ESOP plans (a proxy for average firm size) is much larger than the average U.S. firm size across all industries. Overall, the average size of an ESOP plan in the U.S. in 2019 was 1,584 active participants, while the average firm size was only 24.5 workers in that year.

The mix of industries represented by firms operating ESOPs differs from the National mix, which has an effect on the average income that would be expected to be measured. In 2019, the average income of all persons working in all industries covered by Unemployment Insurance was \$59,202. Using income levels for each supersector to create an estimated average wage for active ESOP plan members estimates that they were paid an average of \$67,263 in 2019, a full 13 percent more than the national average pay. This pay discrepancy would not be due to any pay differential between firms with ESOP plans vs the National average, but would only be caused by fact that ESOPs are more prevalent in higher-paid industries.

ESOP Age vs Firm Age in the United States, 2019

ESOP / Firm Age	ESOP C-Corps	ESOP S-Corps	All ESOPs	All Firms
Less than One Year	3.5%	3.9%	3.7%	8.1%
1 to 5 Years	13.8%	23.8%	19.4%	25.1%
6 to 10 Years	9.1%	15.3%	12.6%	15.1%
11+ Years	73.6%	56.9%	64.2%	51.6%

Sources: U.S. Department of Labor, Form 5500, 2019; U.S. Census Bureau, Business Dynamics Statistics, 2019

While comparing the ages of existing ESOP plan to the ages of all firms in the United States is somewhat of an apples-to-oranges comparison, the data shows that ESOP plans, and by extension the companies that provide them, tend to be older than the average firm. Approximately two-thirds of all ESOP plans are more than 10 years old, as compared to about half of all firms in the US.

Reasons for ESOP Adoption.

While bankruptcy avoidance, hostile takeover defense, and company privatization are no longer common reasons for creating ESOPs, companies still use ESOPs for succession planning, low-cost borrowing, or creating worker benefits.

Transition and Succession Planning. Current research shows that about two-thirds of current ESOPs have been adopted to allow closely-held companies a method for allowing owners to sell their share of the firm while allowing it to continue as an independent enterprise.²⁴ The ability to create a method for allowing employees to purchase a company from its retiring owners helps both the owners, who get to fund their retirement, and the employees, who get to keep their jobs. Many sources point out that the “baby boomer” generation has started to retire. Project Equity estimates that there are “2.34 million privately-held businesses with nearly 25 million

²⁴ Employee Stock Ownership Plan (ESOP) Facts. <https://www.esop.org/>

employees” owned by baby boomers who may wish to sell their ownership stake and retire.²⁵ This “silver tsunami” of retirements is one reason why ESOPs are gaining in popularity.²⁶

Lower Cost Borrowing. ESOPs can use their retirement account status as a method for borrowing money in a “tax-favored” manner.²⁷ ESOPs are the only retirement benefit plans allowed to borrow money. “The company then makes tax-deductible contributions to the ESOP to repay the loan, meaning both principal and interest are deductible.”²⁸

Employee Benefits. Companies can use ESOPs to create additional employee benefits at little cost, either by issuing “new or treasury shares to an ESOP, deducting their value (for up to 25% of covered pay) from taxable income,” by contributing cash to buy shares “from existing public or private owners,” or, in the case of public companies, matching employee savings into savings plans with ESOP stock, “often at a higher matching level” than cash alone.²⁹

Increasing Worker Involvement. Studies have shown that employee ownership and control of businesses can lead to better employee retention, better business stability, and higher on-the-job employee satisfaction. As mentioned above, these benefits only come when a company creates opportunities for employees to participate in a firm’s decision making.

Employee Asset Building. A recent study from Rutgers examined “the asset building impacts of employee ownership for low- and moderate-income employees and their families,” and found that “ESOPs provide an opportunity to build wealth not available through income alone.”³⁰ As many wage earners do not have enough excess income to make their own investments and build their own wealth, ESOPs can be their path to wealth building.

ESOP Issues.

Lack of Retirement Fund Diversification. Employees can be harmed if their retirement funds are heavily invested in a company’s ESOP if that company suffers a business downturn or goes bankrupt. There are laws and regulations that can mitigate this, but it is usually up to the employee to take advantage of any potential diversification strategies that their ESOP may offer. Any ESOP that is also part of a 401(k) plan must by law allow ESOP members the ability to diversify their retirement fund holdings by selling ESOP shares and investing those funds in other stocks or funds. In addition, any ESOP member of a plan that is not a 401(k) must be allowed to diversify their holdings if they meet the combined milestones of reaching age 55 and having at least 10 years of participation in the ESOP.³¹

²⁵ <https://www.nextavenue.org/boomer-entrepreneurs-selling-businesses/>

²⁶ Ibid.

²⁷ Ibid.

²⁸ <https://www.nceo.org/articles/esop-employee-stock-ownership-plan>

²⁹ Ibid.

³⁰ [Building the Assets of Low and Moderate Income Workers and their Families: The Role of Employee Ownership.](#) Joseph Blasi and Douglas Kruse. 2019. Institute for the Study of Employee Ownership and Profit Sharing, Rutgers University.

³¹ <http://www.pensionrights.org/publications/fact-sheet/problems-esops>

In addition, in cases where the economic health of a firm decreases to the point where plan participant employees need to be laid off, this could trigger a situation where “the plan must cash out those workers’ shares in the ESOP, which can create even more cash-flow problems and lead to more layoffs, creating a ‘death spiral’ that could ultimately sink the company – and the value of the employees’ ESOP accounts.”³² Some “mature ESOPs struggle with that repurchase obligation, which is why ESOPs have to set aside enough cash to repurchase the shares of employees when they retire, which is an added company expense.”³³

Cost and Complexity. Many sources point to the fact that ESOPs are more expensive to administer than other retirement plans due to high regulatory oversight and “because an independent party must be hired each year to value the company’s stock.”³⁴ According to the National Center for Employee Ownership, “the cost of setting up an ESOP is also substantial—perhaps \$40,000 for the simplest of plans in small companies.” Additionally, “any time new shares are issued, the stock of existing owners is diluted. That dilution must be weighed against the tax and motivation benefits an ESOP can provide.”³⁵

Do ESOPs Encourage Economic Growth and Improve Business Performance?

Research sponsored by the Employee-Owned S Corporations of America (ESCA) has found that “ESOPs have been shown to lead to higher wages, wage growth, job stability, and higher retirement plan contributions.”³⁶ Employees with stable, well-paying jobs (as compared to other employers in the same sector as an ESOP firm) will have higher consumer spending, which supports local economies, as will retirees with well-funded retirements.

Another study found small but real effects on company performance, with “ESOP companies enjoy[ing] greater longevity as well as 2.3–2.4 percent higher sales, employment, and sales per employee annually than would otherwise have been anticipated.”³⁷ Still other studies have found that “productivity [of ESOP employees] improves by an extra 4–5% on average in the year an ESOP is adopted, and the higher productivity level is maintained in subsequent years.”³⁸ A study specific to S-Corporation ESOPs found that there were an estimated “\$33 billion in productivity gains yearly” from S-Corps with ESOPs, and that “the benefits owing to S ESOPs extend to the economy at large, given the increases in productivity and sales S-ESOPs induce.”³⁹

Finally, survey data from the time of the Great Recession of 2007-2009 found that “while overall U.S. private employment in 2008 fell by 2.8%, employment in surveyed S-ESOP companies rose by nearly 2 percent. Comparisons between S-ESOPs and non-S-ESOPs in the manufacturing sector were even more favorable: surveyed S-ESOP manufacturers lost no ground where

³² Ibid.

³³ <https://ownership.rutgers.edu/esops-attractive-baby-boomer-business-owners>

³⁴ Ibid.

³⁵ <https://www.nceo.org/articles/esop-employee-stock-ownership-plan>

³⁶ An Analysis of the Benefits S ESOPs Provide the U.S. Economy and Workforce. 2012. Alex Brill. Matrix Global Advisors, Washington, D.C.

³⁷ <https://www.nceo.org/articles/research-employee-ownership-corporate-performance>

³⁸ <https://community-wealth.org/sites/clone.community-wealth.org/files/downloads/article-kruse.pdf>

³⁹ An Analysis of the Benefits S ESOPs Provide the U.S. Economy and Workforce. 2012. Alex Brill. Matrix Global Advisors, Washington, D.C.

employment was concerned, while their non-S-ESOP counterparts shed about 6 percent of their jobs.”⁴⁰

It is clear from multiple studies that companies that are partly- or fully-owned by ESOPs contribute to the economy more than would be expected as compared to other companies in their sectors. While the effect of ESOP ownership may not be large on an annual basis, the cumulative effect of higher growth rates over time, coupled with the stability of employment and longevity of firms, means that ESOP firms contribute to long-term economic growth and can have a positive effect on business performance.

What States Have Offices of Employee Ownership?

There are 19 states that have some form of an Office of Employee Ownership, with two offices being located within or funded by State government agencies, three offices being located within institutes of higher education, and 14 being operated by non-profit entities.

State Government Offices.

- **Colorado.** The State of Colorado announced the creation of an Employee Ownership Office in October 2020 as a standalone center in the Colorado Office of Economic Development and International Trade (OEDIT). This office has been funded with \$1.75 million over two years. It has two full-time staff members and is assisted by two more OEDIT staff members on a part-time basis. <https://oedit.colorado.gov/colorado-employee-ownership-office>. Colorado also has an Employee Ownership Commission that was created in 2019 by executive order and advises OEDIT and the Ownership Office. It has 10 members. <https://oedit.colorado.gov/colorado-employee-ownership-commission>
- **Massachusetts.** Massachusetts operates the Massachusetts Office for Employee Involvement and Ownership (MASSEIO), which is funded through the Commonwealth’s Office of Business Development (MOBD) but the operation of which is contracted to the ICA Group. MASSEIO has six contract employees. The FY2022 Massachusetts State Budget requires that MOBD expend “not less than \$150,000” on MASSEIO.⁴¹ <https://www.masseio.org>

Offices in Institutes of Higher Education.

- **New York / New Jersey.** New York and New Jersey are both served by the NY/NJ Center for Employee Ownership, operated out of the Rutgers School of Management and Labor Relations. The Center does not seem to have full-time employees, but rather is led by “faculty and supported by volunteers from employee-owned companies, service providers, and educational institutions.”⁴² <https://ownership.rutgers.edu/>
- **Ohio.** Kent State University operates the Ohio Employee Ownership Center as a non-profit outreach center. It was founded in 2002 and has four staff members. It is largely

⁴⁰ <https://www.esoppartners.com/blog/bid/88945/S-Corporation-ESOPs-Perform-Better-During-a-Recession>

⁴¹ <https://malegislature.gov/Budget/FinalBudget,Section7007-0300>.

⁴² <https://ownership.rutgers.edu/about-us>

self-supporting through memberships and other business contributions.

<https://www.oeockent.org/>

- **California.** The California Center for Employee Ownership (CCEO) is a Center at the Beyster Institute of the Rady School of Management at the University of California, San Diego campus. It does not seem to have any full-time employees.
<https://www.ownershipcalifornia.org/>
- **Pennsylvania.** Montgomery County Community College (Pennsylvania) is in the process of creating the Baker Center of Excellence for Employee Ownership and Business Transformation, an institute that is dedicated to promoting the creation of ESOPs in Pennsylvania.⁴³ This Center is funded with a donation of \$3 million from Kenneth D. Baker, CEO of NewAge Industries in Southampton, PA, which became an ESOP in 2006. <https://www.mc3.edu/news/2021/02/baker-center-of-excellence>

Nonprofits.

- **Vermont.** The Vermont Employee Ownership Center was founded in 2001. The Center's IRS Form 990EZ form reported \$165,273 in expenditures and one paid employee in 2019. <http://www.veoc.org/>
- **Connecticut.** The Connecticut Center for Employee Ownership (CTCEO) is operated by the Employee Ownership Expansion Network (EOX) and seems to have no separate funding or existence from this organization. Legislation was introduced in the 2021 session to create a Center in state law (H.B. 6120 of 2021), but it did not pass.
<https://ctceo.org/>
- **Greater Washington.** This area (defined as the Washington Metro area, covering parts of Maryland and Virginia, as well as Washington, D.C.) is served by the Greater Washington Center for Employee Ownership, a project of the Washington Area Community Investment Fund. This Center launched in July 2021 and seems to have two employees. <https://gwceo.wacif.org/>
- **Pennsylvania.** Pennsylvania has been served by the Pennsylvania Center for Employee Ownership (PaCEO) and is a subsidiary of the National Center for Employee Ownership (NCEO), a 501(c)3 public benefit corporation. According to PaCEO's IRS Form 990 from 2019, it had two employees and \$295,626 in expenses. The Center also claims to be supported by "volunteers from among Pennsylvania ESOP companies, service providers, educational institutions, and other interested parties."⁴⁴ It is unclear how this organization will interface with the new <https://ownershippennsylvania.org/>.
- **Indiana.** The Indiana Center for Employee Ownership is a 501(c)(3) public charity. According to IRS tax documents, it was founded in 2017. The organization filed an IRS Form 990-N in 2019, meaning that its expenses for that year were under \$50,000. Employment numbers are unreported. <https://inceo.org/>
- **Michigan.** The Michigan Center for Employee Ownership (MICEO) is operated by the Employee Ownership Expansion Network (EOX) and seems to have no separate funding or existence from this organization. <https://miceo.org/>

⁴³ <https://www.mc3.edu/degrees-and-programs/career-training-and-professional-development/baker-center>

⁴⁴ <https://ownershippennsylvania.org/our-work/>

- **Minnesota.** The Minnesota Center for Employee Ownership (MNCEO) is partnered with the Employee Ownership Expansion Network (EOX). It does have its own Executive Director who seems to be separate from EOX, while other involvement in the organization seems to be on a volunteer basis. Guidestar reports that MNCEO had \$98,379 in gross receipts in 2020, as reported in the organization’s IRS Master Business File. <https://www.mnceo.org/>
- **Colorado.** The Rocky Mountain Employee Ownership Center (RMEOC) is a 501(c)(3) that was founded in 2012. It had reported expenditures \$184,330 and reported three employees on its 2020 IRS Form 990. <https://www.rmeoc.org/>
- **Texas.** The Texas Center for Employee Ownership (TXCEO) is operated by the Employee Ownership Expansion Network (EOX) and seems to have no separate funding or existence from this organization. <https://txceo.org/>
- **Missouri.** The Missouri Center for Employee Ownership (MOCEO) is operated by the Employee Ownership Expansion Network (EOX) and seems to have no separate funding or existence from this organization. <https://moceo.org/>
- **Tennessee.** The Tennessee Center for Employee Ownership (TNCEO) is partnered with the Employee Ownership Expansion Network (EOX). The organization filed an IRS Form 990-N in 2020, meaning that its expenses for that year were under \$50,000. Employment numbers are unreported. <https://tnceo.org/>
- **North Carolina.** The North Carolina Employee Ownership Center (NCEOC) is operated by the Employee Ownership Expansion Network (EOX). It has its own Executive Director and Board of Directors. It files an IRS Form 990-N, meaning it has revenues of less than \$50,000. Employment is unreported. <https://nceoc.org/>
- **Georgia.** The Georgia Center for Employee Ownership (GACEO) received a favorable IRS tax-exempt determination ruling in 2021 and seems to be operated by the Employee Ownership Expansion Network (EOX). No other information is available. <https://gaceo.org/>
- **Florida.** The Florida Center for Employee Ownership (FLCEO) received a favorable IRS tax-exempt determination ruling in 2021 and seems to be operated by the Employee Ownership Expansion Network (EOX). No other information is available. <https://flceo.org/>

National Organizations.

- **The Employee Ownership Expansion Network (EOX).** The creation of many of the above State-level offices is being supported by the Employee Ownership Expansion Network (EOX), a national nonprofit focused on “establishing and supporting a network of independent nonprofit State Centers for Employee Ownership.”⁴⁵ It had reported expenditures totaling \$323,674 and reported having two employees and 10 volunteers on its 2020 IRS Form 990. <https://eoxnetwork.org/>
- **Fifty by Fifty.** Fifty by Fifty is a project of the Democracy Collaborative, whose reported goal is to “catalyze a movement with the knowledge, resources, and skills to grow the

⁴⁵ Employee Ownership Expansion Network: Our Mission. <https://eoxnetwork.org/>

number of employee owners in the U.S. to 50 million Americans by 2050.”⁴⁶
<https://www.fiftybyfifty.org/>

ESOPs and Small Business Development Centers (SBDCs).

- The Main Street Employee Ownership Act was signed into law in 2018. The legislation “directs the Small Business Administration to support employee ownership in a variety of ways including loans, loan guarantees, and technical assistance. The bill was passed with an eye toward the large number of retiring “baby boomer” business owners who, over the next decade, may be interested in selling their companies to their employees”⁴⁷ The requirements in this legislation also included Small Business Development Centers (SBDCs) across the nation, who are now starting to implement strategies to assist business in transitioning to employee ownership.

What Funding Sources are Used in Other States to Fund Employee Ownership Offices?

As mentioned in the previous section the majority of all State-level employee ownership organizations are non-profit entities, and are funded through donations from businesses, government, and other entities. Four entities are housed in (or will be housed in), and partially funded by, institutes of higher education. Finally, two organizations are either a part of a State agency (Colorado) or are contractors that are funded through State budget appropriations (Massachusetts).

What Incentives Exist to Incentify the Creation of ESOPs?

The only incentive that exists to support the creation of ESOPs in the United States is IRS Section 1042, which makes ESOPs a legal type of retirement plan and grants those plans significant tax advantages. According to the National Center for Employee Ownership, the major tax benefits are these:

“Contributions of stock are tax-deductible: That means companies can get a current cash flow advantage by issuing new shares or treasury shares to the ESOP, albeit this means existing owners will be diluted.

Cash contributions are deductible: A company can contribute cash on a discretionary basis year-to-year and take a tax deduction for it, whether the contribution is used to buy shares from current owners or to build up a cash reserve in the ESOP for future use.

Contributions used to repay a loan the ESOP takes out to buy company shares are tax-deductible: The ESOP can borrow money to buy existing shares, new shares, or treasury shares. Regardless of the use, the contributions are deductible, meaning ESOP financing is done in pretax dollars.

Sellers in a C corporation can get a tax deferral: In C corporations, once the ESOP owns 30% of all the shares in the company, the seller can reinvest the proceeds of the sale in other securities and defer any tax on the gain. In S corporations, the percentage of

⁴⁶ <https://www.fiftybyfifty.org/>

⁴⁷ [Building the Assets of Low and Moderate Income Workers and their Families: The Role of Employee Ownership.](#) Joseph Blasi and Douglas Kruse. 2019. Institute for the Study of Employee Ownership and Profit Sharing, Rutgers University.

ownership held by the ESOP is not subject to income tax at the federal level (and usually the state level as well): That means, for instance, that there is no income tax on 30% of the profits of an S corporation with an ESOP holding 30% of the stock, and no income tax at all on the profits of an S corporation wholly owned by its ESOP. Note, however, that the ESOP still must get a pro-rata share of any distributions the company makes to owners.

Dividends are tax-deductible: Reasonable dividends used to repay an ESOP loan, passed through to employees, or reinvested by employees in company stock are tax-deductible. Employees pay no tax on the contributions to the ESOP, only the distribution of their accounts, and then at potentially favorable rates. The employees can roll over their distributions in an IRA or other retirement plan or pay current tax on the distribution, with any gains accumulated over time taxed as capital gains. The income tax portion of the distributions, however, is subject to a 10% penalty if made before normal retirement age. Note that all contribution limits are subject to certain limitations, although these rarely pose a problem for companies.”⁴⁸

The State of Maryland also grants preferential treatment to ESOPs. “The Maryland Securities Act exempts certain transactions related to ESOPs from registration and filing requirements, including the sale of securities to an ESOP, the accrual of interests of participants in ESOP, and any distribution made under ESOP to participants or beneficiaries.”⁴⁹

As of the writing of this report, there are no state or local incentives that assist in the creation of ESOPs or any other type of employee ownership structure outside of the technical assistance offered by the various organizations mentioned previously.

Conclusions.

Employee Stock Ownership Plans (ESOPs) have the potential to encourage economic growth and improve business performance. The vast majority of these were founded before the existence of state- or local-level non-profit assistance organizations. In the past few years, there have been efforts on the national level to found state-level organizations to support the concept of ESOPs and other forms of employee ownership, the majority (14 out of 19) of which are operated by independent non-profit entities. As of 2021, Colorado is the only state with an Office of Employee Ownership that is both funded by State funds and is a part of a State agency. Massachusetts funds these activities through their State budget, but the actual work is done by an outside contractor. The remainder of these state-level organizations are operated by institutes of higher education.

In Maryland, Salisbury University is a USM campus that currently has academic staff that are researching questions around employee ownership. In addition, the Maryland Small Business Development Center is examining how best to implement the new requirements put forth by the 2018 Main Street Employee Ownership Act.

⁴⁸ <https://www.nceo.org/articles/esop-employee-stock-ownership-plan>

⁴⁹ Fiscal Note, SB 409 of 2019, p. 3.

As the majority of these assistance organizations are successfully operated by non-profits funded by private donations and (occasionally) through State or local government grants, it is the recommendation of this report that any such office in Maryland also be operated by an independent non-profit organization, unless a particular school or institute at one of Maryland's institutes of higher education would like to take on the task.

As ESOPs are federally-regulated retirement accounts, their administration is complex. There is already a robust ecosystem of law firms and non-profits that exist to service ESOPs, one that the Department of Commerce is unlikely to be able to emulate. In addition, it is unlikely that the Department would be in a position to give useful advice to companies who wish to create their own ESOP without hiring specialized, highly skilled staff who would then be in competition with private firms.

As an ESOP is a retirement plan that is funded by the retirement accounts of individual workers, the level of risk to those workers is higher than in a traditional retirement plan. The Department should not place itself in a situation where it is taking a position on how worker's retirement accounts should be funded or structured, and should not give preferential treatment to one type of retirement account structure over another.

Finally, the incentives needed to create and support ESOPs have already been created in the Federal tax code. As the tax incentives for creating and maintaining ESOPs are both unique and powerful, there is no need to create any State-level tax or grant incentive programs to support the creation of ESOPs in Maryland.