The Employee Ownership Trust (an alternative to an ESOP)

The employee ownership trust ("EOT") is a form of employee ownership with historical roots in the United Kingdom. In the United States, businesses are more familiar with the Employee Stock Ownership Plan ("ESOP") than the EOT. The popularity of ESOPs in the United States is closely tied to the special tax advantages an ESOP can provide to companies and their owners. EOTs are relatively common in the United Kingdom for similar reasons. However, the origin of EOTs predates the tax advantages the United Kingdom affords them today and EOTs are gaining popularity in the United States.

History and Purpose of EOTs

The most well-known example of an early EOT in the United Kingdom is the John Lewis Partnership. The John Lewis Partnership is a retail chain that began using a trust to facilitate employee ownership in 1929. The John Lewis Partnership gives its employee-members governance power through the elections of its Partnership Council, a governing authority of the company. The John Lewis Partnership also pays its employee members a "Partnership Bonus" each year which is a share of the company's profit. This general structure has persisted with and without tax advantages and the company intends this structure to promote employee loyalty and productivity.

Historically, like the John Lewis Partnership, EOTs operate to facilitate profit-sharing with a company's employees. Owners create EOTs with the express purpose of running the company for the benefit of the employees. In the United States, the EOT is the sole owner of the company but any profit-sharing plan is not part of the trust. Rather, the company establishes a profit-sharing plan that compensates employees with taxable bonuses. Additionally, companies may have a 401(k) plan with a generous match and employer contributions that employees may participate in.

Formation of EOTs

Like ESOPs, EOTs facilitate employee ownership and succession planning for owners. To create an EOT and achieve these goals, the company buys all but one share of the company's stock in a redemption transaction. Then the owner gifts the remaining share to the EOT. Generally, the one share gifted to the EOT would have di minimis value to avoid gift tax rules (i.e. a few hundred dollars) so it may be necessary to issue additional company shares to the owner prior to the transaction. The company can buy out the owner all at once or in installments. Importantly, the company must be a C corporation because an EOT is not a qualified S corporation shareholder. Once the company has transferred ownership to the EOT, as mentioned above, the EOT and the company are managed for the benefit of the employees. The company can allocate profits, or a portion of profits, to employees as taxable bonuses and/or set up a qualified profit-sharing plan.

The EOT structure may appeal to owners who want to create a legacy business that continues to operate for the benefit of the employees or the community. First, EOTs traditionally are perpetual trusts and hence can last indefinitely. Note that this requires the company to establish the EOT in a jurisdiction that has abolished the rule against perpetuities or otherwise modified it

to permit perpetual trusts. Second, unlike an ESOP, an EOT is not a qualified retirement plan. The purpose of an ESOP is to maximize employee retirement benefits, whereas the purpose of an EOT is to benefit both current and future employees. As such, the fiduciary duties of an EOT trustee do not require the trustee to consider offers to buy the company when the financial return may be too good to pass on. This gives the owner more assurances that the company will persist.

Benefits of EOTs

While an ESOP is a qualified retirement plan that is heavily regulated by the Internal Revenue Code and Department of Labor regulations, an EOT is not subject to such rules. Owners may find this attractive because the different regulatory scheme, or lack thereof, for an EOT makes EOTs simpler and less costly than an ESOP. First, unlike an ESOP, an EOT does not require annual valuations. Second, EOTs do not have individual employee accounts. Instead the EOT trustee holds the ownership of the company for and on behalf of all employees. Relatedly, EOTs do not have repurchase obligations when an employee leaves or retires from the company. This eliminates a cash flow issue common to ESOPs. The other side of this is that EOTs do not inherently give former or retired employees a stake in growth in the firm's value. Companies that like this feature of ESOPs can create other employee benefits aimed at similar goals.

Finally, EOTs cost significantly less than ESOPs. One tradeoff for these reduced costs is the lack of special tax advantages afforded to ESOPs but not EOTs. For larger companies the tax advantages of an ESOP may outweigh the simplicity and lower costs offered by an EOT. For smaller companies or those with different priorities, an EOT may be more appealing.

Whether an EOT or an ESOP is appropriate for a company will depend on the owner's circumstances and goals. Both offer a form of employee ownership, but the benefits to the owner and the employees can be different. ESOPs provide special tax advantages and directly offer retirement benefits. EOTs offer simplicity and potentially a longer business legacy. The experience and expertise of MNCEO can help guide companies and their owners to which arrangement makes the most sense for their goals.

The Minnesota Center for Employee Ownership serves as a free unbiased source for education and resources around all forms of employee ownership. With 52,000 business owners over the age of 55 in Minnesota exiting their business in the next 3-5 years, there is a crisis looming. https://www.mnceo.org/the-silver-tsunami *What will happen to their legacy, employees, community? Business owners will look to their advisors on how best to exit. Contact us for more information on how we can be a resource for you www.mnceo.org - Sue Crockett, Executive Director, MNCEO scrockett@mnceo.org*

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