How ESOPs and EOTs Work

Corey Rosen, Founder, National Center for Employee Ownership

Washington law requires that cannabis businesses in the state be organized as a qualifying business entity. Companies owned by Employee Stock Ownership Plans (ESOPs) do not qualify because the legal owner of the company is the employee ownership trust that holds the shares for the benefit of employee participants in the plan. Presumably this same logic would apply to a simpler form of employee ownership, the employee ownership trust (EOT).

This paper looks at how ESOPs and EOTs work and what is means for these companies to have the trustee as the legal owner.

How an ESOP Works

An ESOP is a kind of employee benefit plan, similar in some ways to a profit-sharing plan. In an ESOP, a company sets up a trust fund, into which it contributes new shares of its own stock or cash to buy existing shares. Alternatively, the ESOP can borrow money to buy new or existing shares, with the company making cash contributions to the plan to enable it to repay the loan. Regardless of how the plan acquires stock, company contributions to the trust are tax-deductible, within certain limits. In the cannabis business, it seems likely that most of these plans will be financed with seller notes because of the legal difficulties in acquiring senior debt from outside lenders

Shares in the trust are allocated to individual employee accounts. Although there are some exceptions, generally all full-time employees over 21 participate in the plan. Allocations are made either on the basis of relative pay or some more equal formula. As employees accumulate seniority with the company, they acquire an increasing right to the shares in their account, a process known as vesting. Employees must be 100% vested within three to six years, depending on whether vesting is all at once (cliff vesting) or gradual.

When employees leave the company, they receive their stock, which the company must buy back from them at its fair market value (unless there is a public market for the shares). Private companies must have an annual outside valuation to determine the price of their shares. In private companies, employees must be able to vote their allocated shares on major issues, such as closing or relocating, but the company can choose whether to pass through voting rights (such as for the board of directors) on other issues. In public companies, employees must be able to vote all issues.

Major Tax Benefits

ESOPs have a number of significant tax benefits, the most important of which are:

1. 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.
2. 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.

3. 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.
4. 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.
5. In S corporations, the percentage of 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.
6. 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.
7. 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.

Shares in the ESOP are held in an employee stock ownership trust. A trustee acts as the legal shareholder. The trustee can be an outside individual or institution or can be one or more insiders from the company. The Department of Labor and the ESOP professional community strongly recommend that there be an independent trustee for any transaction between the plan and a shareholder to make sure that the ESOP pays an appropriate price for the shares. On an ongoing basis, smaller companies most often have one or more employees act as plan trustees.

The value of ESOP shares, including for any transactions, is determined by independent outside appraisal. The trustee's primary legal responsibility is to make sure that this appraisal is done properly and protects the interests of plan participants. The trustee elects the board of directors, but the board appoints the trustee. In practice, outside trustees do not become involved in normal corporate governance or operational issues because they lack the business expertise to do so. Only in extremely rare cases do trustees step in, usually when there are egregious actions by management, such as violating the terms of the plan or paying very excessive executive compensation. This means that the management of the company in an ESOP will normally not change because it is an ESOP.

Costs and Complexity Issues

Because ESOPs are subject to federal retirement plan law and provide substantial tax benefits to sellers, companies and employees, they are subject to a number of statutory and regulatory requirements. Compliance with these requirements makes these plans more expensive than other retirement plans. To set up an ESOP generally costs $150,000 to $500,000 depending on the size and complexity of the company and the financing arrangements for the transaction. Most cannabis companies would find costs in the lower range. On an ongoing basis, companies hire third party administrators and other expert advisors to provide for compliance. In smaller companies, these costs typically come to about $20,000 to $30,000 per year.

While these costs are substantial, selling to an ESOP is usually substantially less expensive than selling to another buyer. Such sales typically involve a success fee between 2 % and 5% of the total transaction plus significant legal and accounting fees. The real cost issue for a company considering an ESOP is whether it has sufficient profits both to pay the set-up costs and have enough money left over both to purchase the shares from a selling shareholder and run the business profitably. In general, this means that companies need to have roughly 20 to 30 employees or more and expect ongoing profits.

How Employee Ownership Trusts (EOTs) Work

EOTs are far less common than ESOPs, but there is some growing interest. In an EOT their company sets up a trust to hold the shares. The trust is typically structured as a purpose trust with the purpose being to hold the shares indefinitely for the benefit of employees. Unlike an ESOP, the employees have no claim on the equity value of the company, leading some to argue this is not truly ownership. Proponents say employees receive either a profit share or dividend based on the company's performance and the company cannot be sold. The Washington employee ownership law passed in 2023 does include EOTs as employee owned companies.

There are no tax benefits associated with the EOT and there are also no rules or regulations about how they are structured. Typical establishment costs for an EOT are between $50,000 and $100,000. The company can set its own rules about participation and other issues. If the state were to allow EOT's to qualify as cannabis businesses it would need to define minimum ownership requirements for the trust and possibly minimum rules for who is eligible to participate in it. EOT's are financed in the same way that ESOPs are.

Because of their lower costs, EOTs may be suitable for cannabis businesses too small for ESOPs.

Impact of ESOPs on employee financial well-being

ESOPs have been in existence under ERISA since 1974 and there is now a very substantial body of research on the performance of companies with ESOPs:

Research indicates ESOP companies grow about 2-3% per year faster after setting up an ESOP than would have been expected otherwise. The default rate on loans from outside lenders is close to zero. ESOP plan participants have about twice the assets in their accounts ($132,000) as comparable employees in comparable companies have in their 401(k) accounts ($64,000), and 77% of ESOPs also have an additional 401(k) plan. Of course, in the cannabis industry, employees have no qualified retirement plans, so an ESOP could be a major improvement for their wealth security.

ESOP companies also have dramatically lower turnover than non-ESOP companies. ESOPs companies also lay people off at one-third or less the rate of non-ESOP companies. EOTs are too new to have any performance data.

Examples of ESOPs in Washington

There are about 6,000 privately held company ESOPs in the US and just over 100 in Washington. They include some very large companies, such as Schweizer Engineering and Yoke's Food, but most employ 200 or fewer people. They include such companies as Nussbaum Group (landscaping, Redmond), Meier Enterprises (engineering, Kennewick), Red Dot (manufacturing, Seattle), and Seattle Gymnastics Academy (Seattle). ESOPs can be found in every industry.

We are not aware of any EOTs currently in Washington.

ESOPs and EOTs in the Cannabis Industry

The limitations in the law on ownership are understandable as ways to have cannabis companies be local Washington small businesses benefiting local citizens. The legislature will have to decide if ESOPs and EOTs, given their trust ownership structure, meet this definition and purpose.

One possible issue is whether employees should be required to reside in Washington. Doing that, however, would violate ERISA, which has precedence over state law. Companies could require employees to reside in the state, but if they left the state after employment, they could not be excluded from the plan (ESOPs typically pay out over time after people leave). Because the trustee plays a limited governance role, requiring them to live in state would have essentially no impact on the company, albeit their fees would be collected in state. Appraisers are simply outside experts with a very defined and limited task and have no governance role.

Corey Rosen is the founder of the NCEO. He co-authored, along with John Case, Ownership: Reinventing Companies, Capitalism, and Who Owns What *(Berrett Kohler, 2023). Over the years, he has written, edited, or contributed to dozens of books, articles and research papers on employee ownership. He has been called the leading expert on employee ownership in the world. He has been interviewed widely by major media and spoken around the world.*

The National Center for Employee Ownership is a 501(c)(3) not profit organization. It does not take positions on legislative issues and is not taking a position on this issue.