Employee Ownership Concepts in Nonprofits and Government

Corey Rosen

This PDF file includes the table of contents, the introduction, and a sample chapter (chapter 4, "Participating in Commercial Partnerships"). To order the book, go to *www.nceo.org* or call the NCEO at 510-208-1300.

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The National Center for Employee Ownership
Oakland, California

Contents

Introduction **vii**

1. Why Is Ownership Important? **1**

2. Spinning Off an Enterprise Through an ESOP **13**

3 Spinning Off Through a Worker Cooperative **29**

4. Participating in Commercial Partnerships **33**

5. Creating Equity Equivalent Plans in Nonprofits **37**

6. Ownership Culture **53**

Appendix A: Case Studies **79**

Appendix B: Participative Management **97**

Appendix C: Research on Participation **105**

Appendix D: Stock Options and the New Section 457 Rules **113**

About the Author **121**

About the NCEO **123**

Introduction

Over the past 30 years, employee ownership has become a mainstay of the U.S. economy. About 25% of U.S. workers have an equity stake in their companies through an employee stock ownership plan (ESOP), a 401(k) plan, an employee stock purchase plan (ESPP), or stock options. Once reserved for senior executives, ownership has now spread through the ranks of everyday employees. Aside from well-publicized disasters and scandals such as Enron and United Airlines, the overall experience of employee ownership has been exceptionally positive. Research demonstrates that companies in which most or all employees own stock perform substantially better than would have been otherwise expected, with employees enjoying higher wages and more retirement assets. Furthermore, companies that share ownership are more likely to remain in business and motivate their employees to participate in various decision-making steps. The success of employee ownership in the U.S. has spawned curiosity worldwide, as the phenomenon is growing in many other countries.

The concept of employee ownership, however, might not seem to be a reality to workers in the nonprofit and government sectors. After all, employees cannot truly earn shares in these organizations because there is nothing to own. This book provides ideas on how, in fact, employee ownership can be relevant in these situations. In some cases, nonprofit and government agencies transform their employees into owners, literally, by spinning off potentially for-profit aspects of their work. In others, employees may be rewarded with

ownership stakes, or something parallel, in commercial endeavors that involve their organizations. Here, employees can be offered incentive compensation geared toward long-term, overall organizational performance. Simultaneously, principles of "ownership culture," such as open-book management (OBM), team-based decision-making, and devolution of responsibilities can all be used within nonprofits and government agencies.

This book begins by reviewing the for-profit sector's experience with employee ownership and briefly describing the principal mechanisms by which employees can become owners. These may be valuable cases where a new for-profit company is created out of a government agency or nonprofit, or as models for similar concepts when privatization is not used. The following chapters examine using employee ownership to spin off new companies, as well as how concepts of employee ownership can be used in nonprofit and government organizations. Finally, the book discusses ownership culture, its mechanics, and its potential for application outside the for-profit world. Please note that some chapters repeat material; it is assumed our audience will read only those sections that are of interest to them, so we have tried to make each chapter self-sufficient.

This book is not intended to be a comprehensive primer on incentive compensation practices in the nonprofit world or government sector; ample resources on this already exist (although most focus on executive pay). Instead, this book focuses on the concept of sharing ownership, in one way or another, with most or all employees. It uses specific case studies to illustrate these points.

We welcome feedback and ideas for making this book better, and we especially welcome learning more about other cases of employee ownership concepts being applied in the government and nonprofit worlds.

Chapter 4

Participating in Commercial Partnerships

The second way nonprofit or (less probably) government agency employees can become owners is through commercial partnerships. Here, equity in the partnership is shared using phantom stock, stock appreciation rights (SARs), or restricted stock. (Until recently, stock options were the most familiar approach used by nonprofits. However, a 2003 IRS ruling on the application of Internal Revenue Code Section 457, referred to here as the "new Section 457 rules," casts doubt on their use in these contexts. Appendix D discusses the 2003 ruling and stock options.)

Phantom stock, SARs, and restricted stock are subject, like options, to rules under Internal Revenue Code Section 457, but, if properly structured, their tax treatment should be acceptable to employees. The key is that Section 457 requires an employee to pay tax on a deferred benefit (such as an option or phantom stock) once the benefit has no significant risk of forfeiture. If a plan is set up to pay out the award (in stock with restricted stock or cash with stock appreciation rights, phantom stock, or similar plans) as soon as vesting occurs, then the employee will have the same tax issues under all interpretations of the tax code. Vesting should occur on the day the actual payout is made. The employee then would either have shares (with restricted stock) that could be sold to pay the taxes or cash (phantom stock and stock appreciation rights).

Phantom stock is a reward paid to an individual for the value of a defined number of shares. The award is made not in shares but in a promise to pay the employee the value of the shares at some point

in the future. The award is usually paid in cash, but it could be paid in shares. For instance, a company might provide that an employee will have the right to the dollar value of 100 shares of stock if the employee continues to work for the organization for five years. At the end of the five years, the employee would receive a cash payment equal to the value of the shares. Provided there is, in fact, a significant risk of forfeiture until that five years is up, the employee would not pay tax until the payment is made, at which time the payment would be taxed just as if it were wages. If the shares were worth $50 each at the beginning of the period and $80 at the end, the employee would get $80 times 100 shares, or $8,000. If the shares declined to $30, the employee would get $30 times 100 shares, or $3,000. The company providing the benefit (the commercial partner) would get a tax deduction for these amounts, while the employee would be taxed as if these were wages.

A stock appreciation right (SAR) is the right to the monetary equivalent of the increase in the value of a specified number of shares over a specified period of time. As with phantom stock, this is normally paid out in cash, but it could be paid in shares. The tax treatment on the amount received is the same as for phantom stock. For instance, an employee might be granted the right to the increase in the value of 100 shares initially valued at $50 per share. If, after five years, the shares are worth $80, the employee would receive $30 ($80 minus $50) times 100, for a benefit of $3,000. If the stock declined below $50, however, the employee would receive nothing.

Restricted stock refers to any shares whose sale or acquisition is subject to restrictions. In nonprofits, this typically would mean that an employee would be given shares or the right to buy shares (perhaps at a discount) but could not take possession of them until some time later when certain requirements have been met (or, to put it differently, restrictions have been lifted), such as working for a certain number of years or the company reaching a certain size. While the restrictions are in place, the employee could, if the plan allows it, still be eligible for any dividends paid on the shares and could be allowed to vote them as well. If the employee does not fulfill the terms of restrictions, the shares are forfeited. Some plans allow the restrictions to lapse gradually (for instance, an employee could buy

30% of the stock when the shares are 30% vested); others provide the restrictions lapse all at once. Because of Section 457, however, it would be better for employees of nonprofits to vest all at once. In that case, the employee would pay tax only at the date of vesting.

Restricted stock is the most complicated of the three alternatives described here. Three scenarios would be typical with this form of ownership. In the first, the employee would actually purchase the shares at the time they are offered for their fair market value. The employee would not, however, have the right to take ownership of these shares until vesting occurs some years later. If the employee worked for a for-profit company, the employee would file what is called an 83(b) election (named for the section of the tax code where it is found). This is an election made by the employee to be taxed at the time of grant award, rather than when the award vests. This would be advantageous here because the tax when an 83(b) election is made is based on the difference between the amount paid and the current fair market value. In this case, that is zero, so there is no tax. Any subsequent increase in stock price would be taxed as a capital gain. If the employee never becomes fully vested, however, the employee would not be able to get the shares, even though they were paid for (this is true for all three scenarios). If the company offering the shares is public, there is no reason to accept a restricted stock grant requiring the shares be bought at current fair market value—the employee could just go buy the shares, with no restrictions, for the same price. But if the company is closely held, this may be the only way to acquire the stock. While the restrictions are in effect, the employee may still get dividends, if any are paid. In a nonprofit, however, the award is subject to taxation when it vests for any value received by the employee (the gain on the shares). It appears that the new Section 457 rules, even in this case, would override the capital gains treatment and impose ordinary income tax treatment on the gain (but this issue is not entirely clear, as the rules were designed more with options in mind).

In the second scenario, the employee buys the stock at less than fair market value. Now, in a for-profit company, if the employee makes an 83(b) election, the employee pays ordinary income tax on the difference between the price paid and the fair market value at grant,

then capital gains tax on any subsequent gain. So if the employee receives a grant allowing $20 shares to be bought for $10, the employee pays ordinary income tax on $10 per share. If they go to $30 five years later and are sold, the employee would pay capital gains tax on the additional $10 gain. Alternatively, the employee could not make an 83(b) election and only pay tax at the time the award vests, in which case the employee would pay ordinary income tax on the entire $20. In the nonprofit case, this would make more sense, because it appears that the new Section 457 rules would require the employee to pay tax at vesting on the present value of the benefit received ($20 per share, the difference between the sale price and market value at vesting) in addition to the capital gains tax.

The third scenario is essentially the same, except the employee pays nothing for the shares. Again, it would probably not make sense for the employee to make an 83(b) election because upon vesting, all the increase in value (here the entire value of the shares) would be taxable as ordinary income anyway.

In all of these cases, because tax is due on vesting (rather than on sale, as would be the case in a for-profit company) on any gains made after purchase of the stock, the employee will probably need a way at least to sell enough shares to cover the tax obligation.