Fiscal incentives are indispensable prerequisites for the development of employee share ownership

Manifesto 2014

European Federation of Employee Share Ownership

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Abstract

Worldwide practical evidence and a wide range of academic research credibly and authentically support the view that a proper legal environment and the provision of suitable fiscal incentives are indispensable prerequisites for any policy truly aiming the development of employee share ownership. Moreover, such evidence and research also show that fiscal incentives always pay off medium/long term and in many ways. Organizations promoting employee ownership around the world have demanded persistently and consistently supportive legislations including fiscal incentives for the common good (evidenced in additional growth and profitability, the spread of wealth, contribution to economic and social stability). New fiscal incentives pave the way to new encouraging development, while political decisions reducing or cutting such incentives always lead to regression.

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Worldwide practical evidence and a wide range of academic research credibly and authentically support the view that a proper legal environment and the provision of suitable fiscal incentives are indispensable prerequisites for any policy truly aiming the development of employee share ownership. Moreover, such evidence and research also show that fiscal incentives always pay off medium/long term and in many ways. Organizations promoting employee ownership around the world – among them EFES since its foundation in 1998 - have demanded persistently and consistently supportive legislations including fiscal incentives for the common good (evidenced in additional growth and profitability, the spread of wealth, contribution to economic and social stability). New fiscal incentives pave the way to new encouraging development, while political decisions reducing or cutting such incentives always lead to regression.

From this perspective it is very unfortunate and damaging that Professor Jens Lowitzsch in his study prepared for the European Parliament under the title "Employee Financial Participation in Companies' Proceeds" (September 2012) attempted to cast doubt, even to deny the well founded and widely shared view. In the study, Jens Lowitzsch superficially and - as we shall demonstrate below - unfoundedly stated that "fiscal incentives are not a prerequisite for employee financial participation schemes"[1] and that there wouldn't be any urgency to promote fiscal incentives.

This is why the EFES regards the well-founded response to the question: “Prerequisite or not?” as essential for all who regard employee share ownership and employee financial participation an important issue for the European and global economic and social future.

In the subsequent pages we will argue that fiscal incentives are indispensable prerequisites for the development of employee ownership.

Then, we will demonstrate how biased Lowitzsch chose the cases for his study: He chose very specific cases (basically exceptions) for supporting his statements instead of presenting "typical" cases and putting the employee share ownership experience in large European companies into a worthy place in the analysis, the way how an honest scientific approach should have done.

1 Relevant quotes: "Fiscal incentives are not a prerequisite for EFP schemes but do promote the spread of these schemes" (Study for the European Parliament, p 1), and "…tax incentives are not to be considered a prerequisite (p 53)". "Fiscal incentives are not a prerequisite to financial participation" (p 64), and "Tax incentives are not a pre-requisite but are an effective instrument of support for employee financial participation" (p 69), and "Tax incentives are not a pre-requisite, but effectively support EFP, when properly introduced" (p 79), and "Fiscal incentives — while not a prerequisite — do promote EFP schemes" (p 83). Additional quotes can be found in Appendix 3 of this document.

Fiscal incentives are indispensable prerequisites

What arguments support the statement that fiscal incentives are prerequisites for any policy intending to promote substantially employee share ownership and employee financial participation?

1. Theory

Fiscal incentives are **essentially** a prerequisite for a wide development of employee share ownership. Why? Typically an employee being offered a reward from his company, he will choose for cash rather than shares, pension benefits or others. This is an aspect of the liquidity preference (or in other words: risk aversion), a well known factor in economics. This is why fiscal incentives are an essential element. Fiscal incentives are a prerequisite to compensate the liquidity preference, to convince employees to choose "risky" shares (or pension savings as well) in place of money. The development of employee share ownership or pension savings are political choices. The prerequisite for successful policies in such matters are fiscal incentives. With regards to employee share ownership, the usual financial calculation is that a 20% discount, free of tax and social contribution, is the right compensation for the fact that employees buy shares with a usual lock-up period of 2 to 5 years (these are the basic features of the Employee Share Purchase Plan, the basic employee share plan in large companies).

2. The EFES mission statement

"Employee share ownership brings better economic performance. This is the reason why it has to be promoted and this is why we ask for supportive legislations. This would be good for all."

This equation was the basis of the EFES mission statement in 1999. Here is how the EFES positioned itself in this matter in its mission statement:

> "Employee ownership and participation make a significant contribution to economic and social progress. They combine excellence in labour productivity and business performance with a broad, constructive social contribution. They are growing all over the world…
>
> Employee owners, as neither just employees nor just shareholders but co-entrepreneurs, are taking on a new voice and seeking to make it heard at its rightful level: They are new social partners.
>
> They have a new and important contribution to make to the debate and policy on the objectives of growth, competitiveness and employment in Europe.
>
> Employee ownership is not a matter for employee owners alone. It is also a way of achieving better results for everybody: Employee owners and others,

> employees and self-employed staff, managers, businesses and the population generally.
>
> All major studies show that employee ownership provides competitive advantage to companies in terms of growth, profitability, productivity, efficiency…
>
> EFES seeks to make it easier for employees and their employer companies to establish sustainable employee ownership and participation, by promoting throughout Europe developments in legislation and in financial and organizational structures."

This mission statement was not about "social" ideas, it was about the economy. It was about "economic and social" progress, about a conjunction of economic and social policies. Such conjunction couldn't be considered as a novelty fifteen years ago. It can certainly not be seen as a novelty fifteen years further on.

3. Political choices

The fact that performance can be increased through employee share ownership is of interest for shareholders owning companies and for the population as a whole.

For shareholders, the fact that it leads to better economic and social performance is a good reason to promote employee share ownership through capital offers reserved for employees (the typical case in large companies) or through business transfers to employees (the typical case in SMEs, the best example being the American ESOP model). Capital offers reserved for employees are usually promoted through price discounts. Price discounts are taken in charge by shareholders through share dilution. For employees, this benefit is not coming from the company as a wage but from other shareholders as an extra. This is why it shouldn't be taxed as a salary.

For policy makers, the fact that employee share ownership leads to better performance is a good reason to promote it through economic and social policies. The usual ways are tax exemptions or other fiscal incentives. In the most typical case, price discounts on capital offers reserved for employees are free of tax and social contribution, up to a defined limit.

4. Observation of facts

Higher fiscal benefits lead to higher development of employee share ownership, while lower tax benefits lead to lower development or disappearance. The highest fiscal benefits in Europe are in France and in the UK, - and France and the UK are on top of Europe regarding employee ownership. At the contrary, fiscal benefits are very low in Germany, - and employee share ownership as well.

This is self-evident, as can be seen in the EFES Annual Surveys of Employee Ownership in European countries. Just one single number here: The number of employee shareholders in 2013 was 3.7 million in France, 2.5 million in the UK and only 0.9 million in Germany.

It was recently announced in the UK that "Amounts of money employees can save in Government approved SAYE employee share plans will be doubled from £250 a month to £500 a month and for the SIP employee share plan it has increased from £1,500 a year to £1,800 a year." This was celebrated by all employee ownership organizations and experts as an historical decision in the UK. However, even doing so, the limits for tax exemptions in the UK are still lower than they were in France. Anyway, they are much higher than the annual limit of 360 Euro which applies in Germany.

The key information here is that these higher or lower limits applying to fiscal incentives in various Member States of the EU are much more important for the promotion of employee share ownership than the differences in tax rates.

Other typical case: Since January 1, 2012, fiscal incentives disappeared in Denmark. Here are comments from some Danish companies:

> William Demant : "Employee share ownership plans and incentive programmes - Due to changed legislation, we will, as of 2012, no longer be able to offer salary sacrifice arrangements to our employees." (AR 2012)
>
> D/S Norden : "In January 2012, Norden again granted employee shares. All employees with at least one year's seniority received 161 shares each. As the new government has abolished this scheme, this was unfortunately the last time that Norden can make use of this opportunity to make employees co-owners of the Company." (Annual Report 2012)

5. Employee ownership organizations

The common view and experience from most organizations promoting employee share ownership in Europe and in the rest of the world point out the fact that fiscal incentives are the key element. Here are some examples:

> This is the head of the NCEO webpage about "ESOP Tax Incentives and Contribution Limits" (USA): "Congress has enacted tax incentives for employee stock ownership plans (ESOPs) that provide advantages for not only the sponsoring company but also the employees, the lender to an ESOP, and selling shareholders in closely held companies. Many states have laws that automatically track these provisions, thus magnifying the tax incentives."
>
> From the OEOC website (USA): "Advantages of ESOP. On top of improving their performance, ESOP companies enjoy significant tax advantages. The tax incentives make ESOPs an excellent mechanism for low cost financing, as well as another form of tax deferred income for employees."
>
> From the ESOP Association website (USA): "In order to broaden the ownership of capital to provide employees with a stake in the ownership of their employing corporation and to provide a unique means of financing to

corporations, Congress has granted a number of specific incentives meant to promote increased use of the ESOP concept. This is especially true for leveraged ESOPs, which through the use of borrowed funds provide a more accelerated transfer of stock to employees. These ESOP incentives provide numerous advantages to the sponsoring employer and can significantly improve corporate financial transactions."

From the SNPI website (The Netherlands): "Fiscal incentives. With the disappearance of the employee savings regulation, The Netherlands does not have any more tax incentive for financial participation. SNPI urges the politics to come to alternatives, so that Dutch companies could be able to compete in this field." 2

From the IPSA website (Ireland): "Taxation matters have an impact on employee ownership! IPSA recommends that Government adopt a more proactive policy, similar to the approach adopted in the United States regarding employee ownership taxation by creating meaningful incentives in the tax regime to encourage increases in employee ownership. This has happened in the United States because Federal and State authorities recognise that employee ownership helps to grow GDP and can increase tax revenues. Measures to reduce the tax burden on employee ownership should be implemented here for the same reasons."

From ifsProShare website (UK): "Employee share ownership provides employees with a tax efficient savings and investment vehicle… Earlier today ifs ProShare submitted their annual Budget submission to HM Treasury. The submission consists of four recommendations to improve the operational effectiveness of tax-advantaged share plans in the UK and in turn to boost the number of employees benefitting from the schemes."

From the EOA website (UK): "EOA celebrates new Government measures to stimulate growth of employee ownership… The EOA and its Members have campaigned long and hard for all of the employee ownership tax incentives outlined in the Finance Bill. The agreed measures signify real tangible support from Government…"

From the EOA website (Australia and New Zealand): "Since its incorporation in July 2011 the EOA's core objectives have been… to encourage Governments at all levels to develop taxation and other incentives to promote broad based employee ownership".

2 "Fiscaal stimuleren. Met het verdwijnen van de spaarloonregeling kent Nederland geen eigen fiscale regeling meer die ingezet kan worden voor financiële participatie. SNPI dringt er bij de politiek op aan om te komen tot alternatieven, zodat Nederlandse ondernemingen op dit gebied kunnen concurreren."

6. The ESOP Association

The ESOP Association is the organization of ESOP companies in the USA. The ESOP Association is a supporting member of the EFES. In this context, the EFES got the strong indication from Michael Keeling, President of the ESOP Association, that fiscal benefits are the key element for success of ESOPs in the USA. This is from a recent interview of Michael Keeling in the OEOC Newsletter (Winter 2014):

> "Q: What's top on your wish list from a governmental/ legislative/regulatory standpoint?
> A: Number one, that when Congress reforms the current tax laws, positive laws encouraging the creation and operation of ESOPs continue…
>
> Q: What new initiatives are on the agenda for the ESOP Association over the next year or so?
> A: We will continue to push for moderate expansion of the ESOP tax benefits…"

7. The ESOP model

In short, the American ESOP model is a pension plan by which a business owner sets up a dedicated legal person (the ESOP, - the Employee Stock Ownership Plan) to buy shares in the name of employees, thanks to a bank loan. The bank loan will later be reimbursed thanks to the company's profits, and the shares will finally go to employees.

The key point here is: A bank loan to buy shares. Loans or bank loans to buy shares. Such operations are usually considered as "particularly high risks".

The ESOP model was promoted by Jens Lowitzsch in his Study for the European Parliament. In addition, Lowitzsch published a video entitled "Capital at work" to promote the idea that the world could be rescued through bank loans, allowing employees (or consumers, or others) to buy all shares of companies.

This is how Lowitzsch describes his work: "Capital at work: Professor Jens Lowitzsch explains why our modern economies need broadened ownership of productive assets and how to turn this analysis into public policy".

The video can be seen on:

https://www.youtube.com/watch?v=yxzwxOcbsHM&feature=youtu.be&a

In fact, these are very old ideas, the most famous initiators being Ferdinand Lassalle in Germany and Pierre-Joseph Proudhon in early nineteenth century, neither having much credence in current economic debates. Maybe the most appropriate qualifier about such demonstration would be "Kindergarten economics".

It is strange to see Jens Lowitzsch using European Commission funds to promote such questionable scheme, at the same time as the idea of a new Glass Steagall Act is promoted in Europe to limit commercial bank securities activities.

Bank loans cannot finance share investments on a large scale (even by employees). The risk would be much too high for banks and for the financial system.

It may only work if fiscal benefits intervene, leading to lower financial risk for the lender. **Fiscal incentives are the reason why American ESOPs may reasonably be based on bank loans.**

Fiscal benefits are a major condition of the ESOP model, - a prerequisite in fact.

It is astonishing to see that Jens Lowitzsch didn't devote one single word about the fact that ESOPs are based on tax incentives neither in the Study for the European Parliament nor in his video for the European Commission.

8. Experts of the ESOP model

How experts of the ESOP model tell about fiscal incentives?

Appendix 1 shows how all most famous American experts answer the question "what is an ESOP".

It is obvious that "tax" is the first word for all of them. In short, ESOPs are "unique tax-advantaged solutions". This is the key-point for all experts.

This is in total contrast with Jens Lowitzsch' presentation which didn't devote one single word about the fact that ESOPs are based on tax incentives, neither in the Study for the European Parliament nor in the video for the European Commission.

The EFES promotes the idea that the American ESOP model should be introduced in Europe. This proposal is a main piece of the "Political Roadmap for Employee Ownership in Europe" which the EFES defined in 2008.

However, fiscal incentives to promote transfers of businesses from family owners to employees are the key-element of the ESOP model.

Europe tells about 1 million employee owners in SMEs, compared to 10 million in the USA. This major difference is essentially due to the fact that strong fiscal incentives support the ESOP model in the USA, while they don't exist in Europe.

In the Study for the European Parliament, Jens Lowitzsch mentions the existence of "the French cousin" of the ESOP model (known as the "*FCPE de reprise*"). It is one of the eight cases Lowitzsch describes as best practices in Europe (case 5.2.3). "The case of *FCPE de reprise* is particularly interesting as it is the example of the relatively recent introduction of a new employee-buyout model for SMEs" (Study, p 73). However, in Annex 6 on page 147 he has to admit that "As of May 2012, no "*FCPE de reprise*" has yet been approved by the AMF (*Autorité des Marchés Financiers*), the French securities regulator. The fact that this model first conceived in 2006 has not been implemented yet, despite the enormous need for corporate business succession, is probably due to the ignorance of market operators." This French legislation was introduced in 2006 and still now it does exist only on paper. Of course, this is not due to ignorance. It is due to the fact that it is not supported through fiscal incentives as it is for the ESOP model in the USA.

Still in the Study, Jens Lowitzsch mentions the existence of a German version of the ESOP model. He was the author of this German version. Again, it is one of the eight cases he describes for the European Parliament as "best practices" (case 5.2.4, see Study, Annex 6, pp 154-156). However, here again, Jens Lowitzsch doesn't mention the fact that this German model exists only on paper. Not a single real case. And here again, Jens Lowitzsch doesn't mention the fact that the difference between the USA and Germany is that fiscal incentives are strong there but inexistent here.

The fact that Jens Lowitzsch systematically hides the key-element of fiscal incentives is seriously misleading in the information and the policy recommendations he had to provide to the European Parliament and to the Commission.

9. Press articles

Thousands of articles in the world press point out the fact that fiscal incentives are the key element for the development of employee ownership.

Such demonstration can easily be made through the EFES monthly press review which offers systematic information from the world press since 2006.

A number of typical cases can be seen in Appendix 2.

The study for the European Parliament was biased

Chapter 5 of the Study for the European Parliament is the key chapter.

Jens Lowitzsch has first affirmed that fiscal incentives are not a prerequisite, they can be considered in a later stage. He is now going to tell that question number one is "a stable legal framework", hence "a legal framework", hence "models", hence "the 29th regime".

This assertion is based on eight case studies which are the matter of Chapter 5 of the Study for the Parliament.

These are the eight cases:

1. Sociedades Laborales
2. Childbase UK
3. French "*FCPE de reprise*"
4. Recognition of the French FCPE in Germany triggers national ESOP model for SMEs
5. Strategic employee shareholding via an intermediary entity (Voestalpine)
6. SME employee buyouts in privatisation (*Spolki Pracownicze*, Poland)
7. Decline of Hungary's employee-owned firms
8. Failing sustainable support to employee shareholding in Lithuania

This is how Jens Lowitzsch defines the eight cases he chose: "Chapter 5 contains eight cases identifying best practice and obstacles to spreading best practice" (p 20). They are "typical cases". "All best practice cases show…" (p 69). "In this study, high profile and, to some extent, typical cases were selected and analysed in order to identify best practice and obstacles to spreading best practice" (p 79).

Typical cases? This is not exact. Most of these cases are NOT typical cases. We already know that cases 3 and 4 (French "*FCPE de reprise*" and German ESOP) exist only on paper. They don't have any realization (see above). On the other hand, case 1 (*Sociedades Laborales*) is an interesting but unique (thus untypical) case in the world, while cases 6, 7, 8 are all failures: Employee-owned firms after privatizations declined and disappeared in Hungary and in Poland as well. About Poland, Jens Lowitzsch affirms that "A positive example of utilization of employee ownership plans in the course of privatization is the case of "*Spolki Pracownicze*" (p 76). He describes the decline from 1.563 to 852 companies as "a slow but steady decline". The truth is that numbers are dramatically declining, and the lists of surviving firms show that most of them are in liquidation.

Best practice cases? Jens Lowitzsch says: "Most individual cases – despite their difference – represent best practice". Again, this is not exact. Most of these cases are NOT best practice cases. It is obvious that cases 3, 4, 6, 7, 8 are all failures. They are by far not "all best practice cases".

In fact, Jens Lowitzsch makes a strict selection of cases as to justify his personal policy recommendations. "The case studies selected and conducted according to pre-defined criteria are relevant in so far as they help to determine principles of and instruments for best practice for a future European framework on EFP, and to identify obstacles to the spread of best practice" (p 70). It is remarkable that these "pre-defined criteria" are not described.

What should have been done for an honest and scientific approach? Which "typical cases", which "best practice cases" should have been used here?

We know that Europe counts 10 million employee shareholders, on which 9 million are in listed companies and only 1 million in non-listed ones. Large companies should have been represented in the eight cases. Some large French and UK companies should have been here as well as some other large companies. However, the only large company in Lowitzsch' set is Voestalpine. On eight cases, seven are about SMEs, which are by far not the most typical cases in Europe. Not a single large French or UK company within the eight cases which means, following Lowitzsch, that no best practices could be observed there.

For an honest and scientific approach, the choice of cases should have been strongly different, giving its right place to employee share ownership in large European companies.

A number of such typical best practice cases in large European companies were presented during the Public Hearing in the European Parliament on March 22, 2012 and other conferences, for instance by the Belgian Presidency of the EU on November 26, 2010. Saint-Gobain, Vivendi, Steria, Siemens, Svenska Handelsbanken, British Telecom, Prysmian, Tesco, Essilor are some typical best practice cases beside Voestalpine and many others (the EFES' Annual European Survey of Employee Ownership lists the 130 most remarkable European companies regarding employee ownership).

An honest choice of eight typical and best practice cases in Europe could be: *Sociedades Laborales*, Tullis Russell (one of the few emblematic cases in the UK), Voestalpine, Saint-Gobain, Essilor, Svenska Handelsbanken, Tesco, Mondragon. Not much to do with the selection of Professor Lowitzsch. By the way: Mondragon is probably the most emblematic case in the world. It is difficult to understand why Professor Lowitzsch decided to ignore Mondragon, as well as any other workers co-operatives.

The fact is that in place of choosing typical cases, Jens Lowitzsch chose very specific ones, for the needs of his personal assertions.

On the other hand, through the Public Hearing of March 22, 2012 in the European Parliament and through other conferences, a real demand was expressed from large European companies and from the European employee ownership organizations. This real demand aimed to face the real obstacles that large companies have to face for the implementation of their real multinational employee share plans.

This real demand was:

> The need for legislation with a basic fiscal incentive supporting a simple robust employee share plan model in each Member State of the EU.

This demand was first expressed by the EFES in the "Political Roadmap for Employee Ownership in Europe" in the framework of the French Presidency of the EU in 2008. The Roadmap was supported by the Belgian Presidency of the EU in 2010 through the conference "Ten years of public policies for employee ownership in Europe – past, present, future" on 26 November 2010, Belgian Minister of Finance Didier Reynders calling for the implementation in each Member State of what he called "*un modèle supplétif*".

This was based on the idea of a "building block approach" of the legislation for employee share ownership. Legislations in France and the UK contain many additional building blocks developed over fifty years. The first block, the common base for any supportive legislation, was defined as:

> An Employee Share Purchase Plan (ESPP), with a 20% discount free of tax and social contribution, up to 5.000 Euro annually.

As a matter of fact, the Employee Share Purchase Plan is the most usual employee share plan in all large companies all over the world.

This same demand was also expressed by the European Economic & Social Committee in its Own-Initiative Opinion of October 10, 2010, asking that each country should firstly made available "an optional simple, uniform incentive model, with the same tax arrangements and incentives throughout the EU".

It is obvious that Jens Lowitzsch ignored this whole side of the European background in its study for the European Parliament.

It is equally obvious that Jens Lowitzsch ignored the real demand from large European companies and from employee ownership organization. In place of that, he chose for focusing on the personal vision he has about what employee share ownership should be in European SMEs.

This is deflecting the attention from the real demand which large European companies and employee ownership organizations expressed.

As a conclusion

For economic and social policy reasons, employee share ownership should be promoted for the common good (evidenced in additional growth and profitability, the spread of wealth, contribution to economic and social stability). Fiscal incentives are indispensable prerequisites in this way. Of course, fiscal incentives are a means to an end, not an end in themselves. They are a necessary, but not sufficient condition for the development of employee share ownership and for the creation of better performing, employee owned enterprises. But this is another story.

Appendix 1

How American ESOP experts tell about fiscal incentives

Hereafter the most famous experts regarding ESOPs, answering the question "what is an ESOP". It is flagrant that "tax" is the first word for all of them.

The Menke Group (America's largest ESOP administration firm)

"An ESOP uses the tax advantages afforded to qualified employee benefit plans in order to maximize the tax savings to the sellers, to the company and to the employees (…)

What is an ESOP?

ESOP Definition: “ESOP” is an acronym that stands for Employee Stock Ownership Plan. Technically, the Plan is operated or administered pursuant to a tax-exempt Trust, referred to as ESOT, Employee Stock Ownership Trust. Accordingly, the Plan is alternatively referred to as the ESOP or the ESOT.

The purpose of an ESOP is to enable employees to acquire beneficial ownership in their Company without having to invest their own money.

The Plan is also a tax-exempt entity for Federal and state corporate income tax purposes. This enables the Company to make cash and/or Company stock contributions to the Trust, which are used to acquire stock of the Company on behalf of its employees. The advantage of the ESOP is that employees are able to acquire this stock without paying a current income tax on the stock. Again, this results from the fact that the contribution is made entirely by the Company and is not taxed to employees personally as it is allocated. The advantage to the Company is that the ESOP makes pre-tax dollars available to finance Company growth and/or to create ownership liquidity at the time of retirement.

Because employees are not taxed currently on the stock which is acquired for their benefit, they are able to acquire up to twice the amount of stock which they could acquire if a Trust arrangement were not used. That is, if shares of stock were issued to an employee by the Company, that employee would be taxed currently on the value of those shares. Also, if an employee buys stock directly from the Company or other shareholders, that employee is using “after-tax” funds rather than pre-tax dollars. The use of a Trust eliminates this tax problem since the Trust is not taxable and frees employees from income tax liability until the shares are distributed.

What are the Tax and Financial Advantages of an ESOP?

The ESOP enjoys a number of tax and financial advantages not enjoyed by other types of buyout alternatives, including the following:

1. Under Section 1042 of the Internal Revenue Code, if the ESOP acquires 30% or more of the outstanding stock of a privately-held company, any capital

gains tax on the transaction is deferred indefinitely, provided that the seller reinvests the proceeds in "qualified replacement property" within 12 months of the date of sale.

2. Unlike a sale or merger, the ESOP enables the seller to sell any portion of his or her stock. A sale or merger usually requires the seller to sell 100% control.
3. The ESOP enables the company to repay principal with tax-deductible dollars.
4. Dividends paid on stock held by an ESOP are fully tax-deductible, provided that such dividends are either passed through to participants or are used to make principal or interest payments on an ESOP loan.
5. In the case of an S corporation, the ESOP's share of S corporation earnings is not subject to federal or state corporate taxation or to taxation as "unrelated business income tax," unless the ESOP runs afoul of certain "anti-abuse" provisions. Thus, in the case of an S corporation that is 100% owned by its ESOP, the company's earnings will be entirely tax-exempt.
6. An ESOP enables an owner to keep control until he is ready to fully retire. When the owner does retire, the ESOP enables the owner to pass control to his key employees.
7. An ESOP enables an owner to provide for business continuity for the business that he has grown and nurtured over many years. Unlike a sale or merger, an ESOP enables a company to retain its separate identity rather than become a branch or division of a larger company.
8. An ESOP enables a company to attract, retain and motivate key employees.
9. Studies have shown that ESOP-owned companies become more productive and profitable than comparable firms in the same industry that are not ESOP-owned.
10. An ESOP can be used to enable a company to make acquisitions of other companies with tax-deductible dollars. In addition, by using an ESOP the sellers can receive their proceeds tax-free under the provisions of Section 1042 of the Code."

The National Center for Employee Ownership (NCEO)

"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."

ESOP Services, Inc.

"Definition of an ESOP

Technically an ESOP is a tax qualified defined contribution benefit plan. Functionally ESOPs are a very flexible financial and equity incentive instrument that uses corporate tax-deductible or “tax-free” dollars to achieve a variety of individual and corporate objectives, including shareholder liquidity, perpetuation, raising working capital, and charitable giving."

The ESOP Association

"In order to broaden the ownership of capital to provide employees with a stake in the ownership of their employing corporation and to provide a unique means of financing to corporations, Congress has granted a number of specific incentives meant to promote increased use of the ESOP concept. This is especially true for leveraged ESOPs, which through the use of borrowed funds provide a more accelerated transfer of stock to employees. These ESOP incentives provide numerous advantages to the sponsoring employer and can significantly improve corporate financial transactions. The leadership of a corporation setting up an ESOP will need to understand the different tax advantages available to a C corporation compared to an S corporation and vice versa."

Deborah Groban Olson

"What are ESOPs?

Summary Overview

- An ESOP is a highly tax-favored way for employees to share ownership in their company through a trust fund.
- Companies make tax-deductible contributions to the ESOP, and those contributions are either allocated to participant accounts or used to repay the ESOP loan. (…)

Advantages of ESOPs:

- Tax-advantaged (to seller, company, employee)
- Company makes tax-deductible contributions of stock or cash to buy stock."

ESOP Plus

"Some benefits of an ESOP

- An ESOP creates a tax-sheltered private market for all or part of the shares in a closely held company when entrepreneurs and family business owners want to reduce the risk of having “all their eggs in one basket.”
- The selling shareholders can usually retain substantial control over the company and maintain their business and personal philosophy even after a company is partially or wholly owned by an ESOP.
- The selling shareholders can protect the legacy of the business they have built and nurtured by selling to an ESOP instead of to an absentee buyer.
- An ESOP can protect valued employees from potential layoffs that usually result when third parties purchase closely held companies.
- The shareholders may be able to postpone or eliminate any capital gains tax on the sale after selling to an ESOP.
- Repayment of principal on loans used to purchase ESOP shares may be made wholly or in part with pre-tax dollars to reduce the cost of borrowing for both the ESOP purchase of shareholder’s interest and general borrowing.
- Employees of the ESOP-owned company will have a substantial, tax sheltered retirement benefit that will grow with the company."

Van Olson Law Firm

"What Are ESOPs?

Unique tax-advantaged solutions for difficult business issues

An employee stock ownership plan ("ESOP") is a tax-qualified retirement plan that also is an extraordinary corporate financial and tax-advantaged tool for the closely held company. An ESOP is authorized by law and design to invest in the shares of the company sponsoring the ESOP. The ESOP can pay shareholders fair market value for all or part of their company shares, raise capital by engaging in tax-favored company share transactions, and increase cash flow. ESOPs also permit employees to take an ownership interest and share in the company's success. Both C corporations and S corporations may sponsor ESOPs, and the S corporation's "pass through" income is not taxable at the S corporation or ESOP level.

ESOPs offer unique tax-advantaged solutions for difficult corporate, financial, shareholder, and community issues."

Appendix 2

Thousands articles in the world press point out the fact that fiscal incentives are the key element. Some examples about ESOPs.

Dubuque Telegraph Herald, 27.4.2014: "As retirement nears, some entrepreneurs opt for ESOPs. Experts say that the strategy can help save jobs and provide 'overwhelming' tax advantages."

Pittsburgh Gazette, 13.4.2014: "ESOPs attractive to baby-boomer business owners…" "The tax advantages are pretty overwhelming," said Corey Rosen, co-founder of the National Center for Employee Ownership, an Oakland, Calif., nonprofit that provides assistance to business owners. "From a financial standpoint, it's pretty hard to beat an ESOP; and from a legacy standpoint, it's impossible," Mr. Rosen adds.

EFES press review, February 2014: "ESOPs are a tax-efficient way to reward employees and provide liquidity for shareholders. The difference between an ESOP and a human being shareholder is that the ESOP pays no taxes. The 1974 ESOP law and later amendments were designed to encourage employee ownership thanks to high tax benefits."

EFES press review, December 2013: "A major boost to employee-ownership came from passage in 1974 of federal legislation providing special tax benefits to ESOPs, - the legal structure which most firms now use for worker ownership."

LifeHealthPro, 19.11.2013: "ESOPs are afforded preferential tax treatment and work for both C and S Corporations. Lexington Clipper Herald, 21.11.2013: "When it comes to encouraging the formation of employee-owned companies, Iowa leads the nation, with a package of tax and other incentives that has begun to attract attention from Nebraska lawmakers. In Iowa, businesses owners who sell their companies to their workers through an employee stock ownership plan, or ESOP, get a 50 percent tax deduction on capital gains earned from the transaction. The state also offers cash grants to companies facing accounting, tax and legal bills during the exploratory phase of starting an ESOP, upfront costs that can sometimes daunt and deter."

Real Business, 31.10.2013: "Why you should consider employee-ownership. Switching to an employee-owned business model should be considered more readily at times of succession and the proposed tax incentives could make such transitions even more attractive. The tax incentives and other measures outlined in a recent Treasury consultation on employee ownership, which closed at the end of September 2013, are expected to be translated into draft legislation in the Finance Bill 2014. Among the measures included in the latest consultation is a proposal to introduce capital gains tax relief on the sale of a controlling interest in a business into an employee ownership structure."

Construction Today, 21.9.2013: "There are *substantial tax incentives* to owners who sell to ESOPs and companies that operate as ESOPs. Usually, the owner can avoid payment of capital gains tax otherwise payable upon the sale of the business. In addition, both principal and interest on the loan to purchase the company are repaid with *pre-tax dollars*. More importantly, once the ESOP acquires 100 percent of the firm, it can elect Subchapter S status, allowing it to pass through profits to its tax-exempt ESOP shareholder and *operate as a tax-free company*."

Fox Business, 25.2.2013: "Why Employee Ownership Matters… Corey Rosen, founder of the National Center for Employee Ownership (NCEO), says ESOPs have been viewed very favorably by the government and offer great tax benefits to an organization."

Truth-Out, 23.1.2013: "Ownership, Full Employment and Community Economic Stability… A large part of this recent boom in worker ownership is due to federal policy; specifically, legislation that created substantial tax advantages for business owners who sell their ownership stake to their workers." CFO Magazine, 28.1.2013: "The Pros and Cons of ESOPs… ESOPS are commonly used to create a market for closely held stock of departing shareholders, to motivate and reward employees by giving them a piece of the action, and to take advantage of tax incentives. CFOs are likely to consider the tax-deductible benefits of ESOPs even more valuable in 2013."

An Analysis of the Benefits S ESOPs Provide the U.S. Economy and Workforce, Alex Brill, Matrix Global Advisors, Washington DC, 26.7.2012: "…this paper examines the economic impact of the preferential tax treatment of employee stock ownership plans (ESOPs). An ESOP is a tax-exempt defined contribution retirement plan comprising shares of a company's stock held on behalf of the company's employees. (…) ESOPs represent the most prevalent form of employee ownership in the United States (NCEO 2012a). The structure was originally established to promote employee ownership and retirement savings in the Employee Retirement Income Security Act of 1974. In the late 1990s, Congress decided to begin allowing S corporations, which are taxed only at the shareholder level like other pass-through entities, to sponsor ESOPs. Since that time, S ESOPs have become the most popular form of ESOP. (...) Like 401(k) contributions, contributions to an ESOP are tax exempt. In addition, loans ESOP firms take out to purchase company stock, as well as interest on the loans, are exempt from taxation (Ivanov and Zaima 2011). (…) The value of a tax preference must be assessed based on the positive economic returns of the activities or behavior the preference targets. S ESOPs, for example, enjoy an important tax benefit. But S ESOPs are a proven way to cultivate employee loyalty, and worker commitment appears to enhance economic prosperity. In fact, as the analysis presented above indicates, S ESOPs have seen an increase in employment and active participants compared to the overall economy both when the economy was adding jobs and when it was in recession. These results strongly suggest that, in the context of the current tax reform debate that seeks to curtail existing tax expenditures in favor of lower statutory tax rates, policymakers should recognize the evidence in support of S ESOPs and their positive economic contribution…"

The Hill, 31.7.2012: "A model for saving for a sound retirement. As members of the House Ways and Means Committee, we are deeply involved in conversations on tax policy and its impact on small businesses. As we consider the different facets of tax reform, we must look out for the business entities that are not only increasing productivity, but are also creating sustainable jobs in this tough economy, showing signs of high employee retention and providing stable retirement savings options for their employees. The ESOP (Employee Stock Ownership Plan) model, commonly used by S corporations to provide a retirement savings alternative to the traditional pension plan, highlights these qualities. It's easy to see why our nation's S-ESOPs are just the type of businesses we should promote and incent as part of comprehensive tax reform."

PR Newswire, 22.2.2012: President Obama's Corporate Tax Reform Proposal Negative Towards ESOPs, Especially S ESOPs, Report The ESOP Association. The ESOP Association's President, J. Michael Keeling, released the following statement concerning President Obama's corporate tax reform proposal. The S corporation proposal would be particularly harmful to S ESOPs which Congress authorized in 1998. Furthermore, the proposal references two commissioned tax reform reports that recommended repeal of all ESOP tax benefits. "I find it incredulous that President Obama travels the country talking jobs, jobs, jobs, yet his corporate tax reform policy will stifle the best jobs sustaining program in the U.S. --- the ESOP (employee stock ownership plan). Why does the Administration want to cut back on a program that creates companies that are more productive, more profitable, in the vast majority of instances, and provide sustainable jobs that are locally-controlled? For example, the 2010 General Social Survey found that less than 3% of employees of companies with employee stock ownership, which include the ESOP model and other forms of employee stock ownership, were laid off in 2009-2010 compared to a 12% rate for employees without employee stock ownership. Our national leaders of both parties, need to understand that national policies to encourage employee stock ownership, and new policies to increase ownership among more working Americans, need to be considered as an effective way to ensure our national employment rate is where we all want it to be," stated Keeling.

Bizjournals, 11.10.2011: "For those who wish to turn their businesses over to employee ownership, ESOPs provide several advantages. In most cases, company profits are not taxed, because they flow to the employee retirement plan. "Depending on which state you're in, that's maybe 45 percent of cash flow that is not going out for taxes that you can use to start investing in other businesses," said Spencer Coates, president of Houchens Industries Inc."

Staffing Industry Analysts, 28.10.2011: "There has been a lot of talk about Employee Stock Ownership Programs. The benefits are almost unreal. A three-year tax credit, a discounted cash flow valuation that will typically pencil out to six times EBITDA (earnings before interest, taxes, depreciation, and amortization), potential deferment of capital gains taxes, employees that are excited and engaged, the ability to save some stock for key hires, the ability to make acquisitions without bank financing, on and on."

New York Times, 30.5.2011: "Shares Capitalism (…) How could public policies promote and expand this shared capitalism? Public policies already offer companies tax benefits for setting up employee stock-ownership plans, and these could be increased."

Hawaii Business Magazine, 4.4.2011: There are multiple costs to employee ownership, but benefits include lower taxes and motivated workers. (…) Morrison, CFO of Pacific AquaScapes Inc., says money was available for the acquisitions because of the company's Employee Stock Ownership Plan, which shields the company from federal and state income taxes. It allows the company to reinvest more of its profits. "That makes the ESOP attractive," says Morrison…"

Financier Worldwide, 1.3.2011: "Understanding ESOPs. (…) A number of benefits make ESOPs a compelling choice when structuring a leveraged buyout. Those benefits cited most often by financial advisers are the tax advantages that the plan allows, which serve to increase cash flow. "ESOPs are attractive in leverage buyouts because of the ability of the corporation to repay acquisition debt from pre-tax company profits," says Jim Steiker, chairman and CEO of SES Advisors Inc. "This works particularly well where there is both a high degree of anticipated profitability and a high degree of leverage." If an ESOP is used to finance a buyout, not only will interest on the loan be deductible but so will principal repayments, explains David Ackerman, a partner at Morgan, Lewis & Bockius LLP. "This substantially reduces the cost of ESOP financing as compared to other available types of financing. In addition, if an ESOP is used, and if the company makes the S election under US federal income tax laws, the company's income will be shielded from tax on that percentage of its income equal to the ESOP's stock ownership percentage." Furthermore, ESOP companies where the ESOP owns 100 percent of the stock of an S corporation avoid all current Federal income tax at both a corporate and shareholder level. Those companies that do not meet the requirements of an S corporation still benefit, says J. Michael Keeling, president of The ESOP Association. "In a C corporation, dividends used to pay ESOP debt are tax deductable, and if the leveraged buyout involved a privately held company, sellers may be able to defer capital gains taxes. But setting aside these tax advantages, the evidence is overwhelming that a well-managed ESOP company is a very profitable business," he adds."

Appendix 3

"Fiscal incentives are not a prerequisite" – All assertions by Jens Lowitzsch in the study "Employee Financial Participation in Companies' Proceeds"

"Fiscal incentives are not a prerequisite for EFP schemes but do promote the spread of these schemes". (Abstract, p 1)

"…fiscal incentives are not a prerequisite to EFP but do promote the spread of schemes. Thus, harmonisation of taxation is not a necessary condition for further development. However, transparency is needed to avoid double taxation and discrimination." (p 14)

"Chapter 4. Policy measures to encourage EFP at national level. Key findings

- Establishing EFP schemes through legislation is of primary importance

- Fiscal incentives are not a prerequisite to financial participation

Financial participation schemes without tax incentives sometimes have a higher incidence than those with tax incentives. Many factors influence a firms' decision to engage in EFP, but tax incentives are not to be considered a prerequisite.

- When properly designed, fiscal incentives promote the spread of EFP

- Tax incentives in most countries target those taxes, which constitute the heaviest burden in the national taxation system" (p 53)

"4.1. Overview of measures: Tax, fiscal and other incentives for EFP

Of the measures in place to promote EFP the legal framework—being a premise to the implementation of schemes—is the most fundamental." (p 54)

"4.5 Conclusions…

4.5.1 General principles

Establishing EFP schemes through legislation is of primary importance. (…)

Fiscal incentives are not a prerequisite to financial participation. (…) When properly designed, fiscal incentives promote the spread of EFP. (p 64)"

"Chapter 5. Significance of the national best practice for the further development of EFP at EU level Key findings

- All best practice cases show that a stable legal framework for EFP induces individual firms to offer these schemes…

- Tax incentives are not a pre-requisite but are an effective instrument of support for EFP if properly designed and maintained…" (p 69)

5.3. Conclusions

In this study, high profile and, to some extent, typical cases were selected and analysed in order to identify best practice and obstacles to spreading best practice. Due to the great variety of EFP schemes in different EU Member States, a qualitative analysis of each case was conducted not only to determine best practice instruments, but also to achieve comparability of individual cases. Despite the fact that comparability is limited, the following common principles could be identified:

- EFP needs sustainable political support to realise its potential, especially a stable legal framework.

All best practice cases, but especially those from France and the UK, show that a stable legal framework of measures in support of EFP enables individual enterprises to achieve their goals relative to employee share schemes as vehicles for strategic employee ownership. By contrast, the less successful cases from Lithuania and Hungary clearly show that discontinuation of political support leads to a rapid decline in employee share ownership, even if the level of employee share ownership was previously high. The less successful cases also indicate that the stability of political support is more important than the number and extent of incentives.

- Tax incentives are not a pre-requisite, but effectively support EFP, when properly introduced.

The case studies from France and the UK, where tax incentives were introduced more than 30 years ago, and also from Austria, illustrate that progress of EFP schemes towards their goals (here transfer of ownership) was accelerated by the substantial tax incentives already existing." (p 79)

"6.1.4. Rationale to promote fiscal incentives

Despite the difficulty of implementation at the European level—due to exclusive jurisdiction of national legislation over tax laws—, tax incentives remain powerful tools for promoting, enhancing and broadening financial participation. Fiscal incentives—while not a prerequisite—do promote EFP schemes. The experience of countries with a long tradition of EFP, as well as those in which tax incentives are more recent, confirm their positive impact. However, although harmonisation of taxation is not a necessary condition for further development transparency is needed to avoid double taxation and discrimination. Tax incentives in most countries target those taxes, which constitute the heaviest burden taxes in the national taxation system. (…)The ultimate conclusion is that to realize its potential, EFP needs sustainable political support, especially a stable legal framework. This also indicates that sustained support—even modest support—is more important than the extent of the support, e.g., fiscal incentives." (p 83).

Finally, it is good to know that fiscal incentives are considered here in the wide sense:

"**Fiscal incentives**… embrace not just tax incentives but also measures such as subsidies for training or consulting on EFP, authorisation to use public unemployment benefits to set up a worker-owned company (and thus become a shareholder) or reduction of registration fees" (p 54).