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EMPLOYEE OWNERSHIP, AND BABY BOOMER BUSINESS RETIREMENTS

By Pete Shuler, Michael Palmieri, and Chris Cooper

INTRODUCTION

We all hear and read about economic development all the time. Whether it's the fight to attract the next e-commerce distribution facility; the construction of a new waterfront shopping and entertainment center; or the latest expansion of a regional health care provider, these stories make the news, and rightfully so. Large scale projects such as these bring much needed capital into our communities, create jobs and other economic activity, and attract our attention.

Less well-known are the smaller economic development success stories – Company X grows its workforce by a third; Company Y secures a loan that allows them to expand their manufacturing capacity and build a second facility; the owner of company Z successfully transitions his or her company to the next generation of ownership and keeps the doors open.

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TAKEAWAYS

1. Two of the biggest economic challenges of our time are the impending wave of baby boomer business owners and the growing wealth inequality between those at the top and everyone else.
2. Employee ownership is an effective and viable option for business owners as they plan for exiting their business – creating a buyer for a business that may have a lack of other options while providing a fair price for the seller; and preventing business shutdown due to the same lack of options or poor/non-existent planning.
3. Employee owned businesses compete well in the marketplace (especially during a downturn) and provide employee owners with an opportunity to build real wealth and opportunity for themselves and their families. This stabilizes our communities and mitigates wealth inequality.
4. Taking advantage of the tool of employee ownership depends on a proactive strategy of educating business owners of this option and assisting with the transfer.

It's easy to see why the second set of examples doesn't attract the same level of attention as the first type. They represent a smaller, quieter, and everyday type of economic development that might be less newsworthy, but no less important to the economic vitality of our communities. Small businesses still provide nearly half of all private employment.[1] Moreover, studies have shown that small businesses circulate dollars from purchases in their communities at a rate three times higher than large big box or chain stores.[2]

Another and somewhat more uncomfortable truth is that not all economic development is equal. The movement of traditional high-paying manufacturing jobs to offshore markets, to be replaced by service sector jobs with generally lower pay and benefits, has manifested a growing disparity of eco-

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AN IMPORTANT TOOL FOR ECONOMIC DEVELOPMENT

Employee ownership, specifically as an under-utilized option in business succession, can address two major issues of our time – the current baby boomer business owner retirement wave and growing wealth inequality among all but those at the top. We analyze trends and data for both issues, discussing how business transfers to employees can mitigate business (and job) loss due to poor or non-existent succession planning and can build wealth for those at lower ends of the economic ladder. Addressing these two issues is an important task for economic development in the coming years; the impact of which ensures a strong base of economic activity, and community resilience.

Low wages, precarious work, and wealth and income inequality have negative effects on retirement security, health and well-being, education, and housing. In this context, local economic development strategies must focus not only on the number of jobs but the quality of those jobs and how they contribute to increasing incomes and provide wealth-building opportunities for individuals and families.

nomic opportunity. Increasingly, working people find themselves with fewer pathways to economic security, which gradually saps the economic vitality of our communities in ways large and small.

This article examines two specific trends from those outlined here – the impending wave of baby boomer business owner retirements (the so-called "Silver Tsunami") that if not confronted may lead to large scale business loss (along with the jobs they support); and a specific option for the transfer of ownership of these businesses that closes the wealth gap, provides a succession option for owners, and anchors jobs and capital in our communities.

TWO BROAD TRENDS

Inequality, precarious work, wealth creation

Decent jobs and wealth creation are a core mission of economic development efforts. Thus, trends in the labor market and the structure of wealth inequality are major concerns. Despite recent wage growth, wage stagnation has characterized the past four decades for many workers, with a disproportionate amount of wage gains going to the highest earners.[3] Moreover, with the decline of manufacturing and production sectors, low wage industries are growing and precarious work (defined as non-standard employment that is poorly paid, insecure, unprotected, and cannot support a household) is becoming more common. Recent research finds that half of all workers ages 18-64 work jobs that pay median hourly earnings of just over ten dollars.[4]

Trends in inequality are equally stark. Regarding income, the top one percent of earners receive 13 percent of all income. Wealth is even more concentrated with the top one percent holding nearly forty percent of all wealth in the US.[5] Low wages, precarious work, and wealth and income inequality have negative effects on retirement security, health and well-being, education, and housing. In this context, local economic development strategies must focus not only on the number of jobs but the quality of those jobs and how they contribute to increasing incomes and provide wealth-building opportunities for individuals and families.

Baby Boomer Retirements and Business Closures

In addition to trends in the labor market and wealth distribution there is another significant economic development challenge that will affect nearly 20 percent of the nation's labor force – baby boomer retirements. Baby boomers, defined as individuals born between 1946-1964, are retiring at the staggering rate of 10,000 a day. In addition, this group owns nearly half of all privately held businesses in the United States which employ 25 million people, and account for over $5 trillion in sales. Cities and states across the nation, that rely on these businesses staying open to provide good paying jobs and the needed tax base to keep communities thriving, must be serious and proactive in response.

The need is profound. Between 60 and 80 percent of business owners do not have a written succession plan in place, meaning there is no plan for what to do after the current owner retires, becomes incapacitated, or dies "on the job".[6] For some of these businesses, retirement of the owner can result in the business being packaged for a quick sale, a quiet liquidation, or other catastrophic event that can leave the owner's family, the employees, and the broader community suffering as a result.

In addition, small businesses' owners who are actively planning a succession strategy are finding it more difficult to sell their businesses. Very few family-owned businesses will pass to the next generation and less than 50 percent will find a buyer outside the family. For companies operating for more than 25 years with 20-100 employees in key service sectors including grocery stores, food manufacturing, home care agencies, residential care facilities, and child care centers the numbers are even starker. A recent report by Citi Community Development and Capital Impact Partners states that the ratio of business closures to sales of businesses among firms with these characteristics is 9 to 1.[7]

Estimating the Impacts

The enormity of this shift to the business landscape is daunting. For example, in the state of Ohio baby boomer retirements (if they follow established national estimates) will likely affect an estimated 72,000 businesses, which generate $190 billion in sales and employ 950,000 people. While all communities will be impacted, the magnitude and types of sectors affected changes according to the local context (Table 1).

TABLE 1: POTENTIAL ECONOMIC IMPACTS OF BABY BOOMER BUSINESS CLOSURES IN FRANKLIN COUNTY (COLUMBUS), OHIO

	Firms with at Least 1 Employee	Baby Boomer Owned Firms with at Least 1 Employee	Potential Average Loss Assuming 25 Percent Closure Rate
# of Firms	19,031	8,732	2,183
# of Jobs	615,914	251,339	62,835
Payroll ($US Billions)	$28.1	$13.2	$3.3*
Sales ($US Billions)	$162.2	$77.6	$19.4*

Source: Census Bureau, 2012 Survey of Business Owners. * These numbers are based on the strong assumption that payroll and sales are equally distributed across all companies. We know this is an assumption that likely will not hold.

A 25 percent shutdown rate is conservative, assuming national averages for shutdowns due to a lack of succession planning. However, it is important to show that, even under a conservative estimate, the potential economic impacts can be large. Knowing that owners of smaller companies face more difficulties when selling their companies, Table 2 looks at a narrower segment of businesses that have fewer than 100 employees. The economic impacts are still large, 4.6 percent of firms and 4.5 percent of jobs would be lost in this scenario.

TABLE 2: POTENTIAL ECONOMIC IMPACTS OF BABY BOOMER BUSINESS CLOSURES WITH 5-99 EMPLOYEES IN FRANKLIN COUNTY (COLUMBUS), OHIO

	Total	Baby Boomer Businesses 5-99 Employees	Potential Average Loss Assuming 25 Percent Closure Rate
# of Firms	19,031	3,530	883
# of Jobs	615,914	112,853	4.5

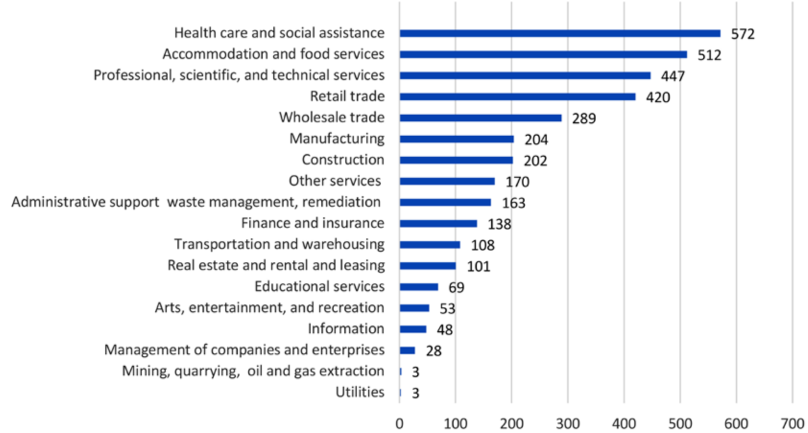
Source: Census Bureau, 2012 Survey of Business Owners. Due to the nature of the Census data we could not provide estimates for payroll and sales for this narrower segment.

Baby-boomer retirements will not affect all industries in the same way. To demonstrate in the state of Ohio, Figure 1 provides estimates for potential impacts on number of firms by industry, while Figure 2 does the same for jobs. When considering what industries have the most businesses at risk, health care and social assistance; accommodation and food services; professional, scientific, and technical services; and retail trade are among the potentially most affected industries. Combined, these four industries represent over half of the total number of at-risk businesses. Looking at jobs, a similar picture of unevenness emerges. Health care; accommodation and food services; and retail trade, when combined, account for two thirds of at-risk jobs. This isn't surprising as all three industries are labor intensive.

Some industries that rank high in the total number of at-risk firms rank lower for the total number of at-risk jobs (or vice versa). This is a function of businesses within an industry employing, on average, more employees per business because that industry is more labor intensive. Hence, while the manufacturing and construction industries have a similar number of at-risk businesses, the construction industry has four times the amount of at-risk jobs. This underscores the importance of understanding the local context, especially if you want to know the impact on tax revenues.

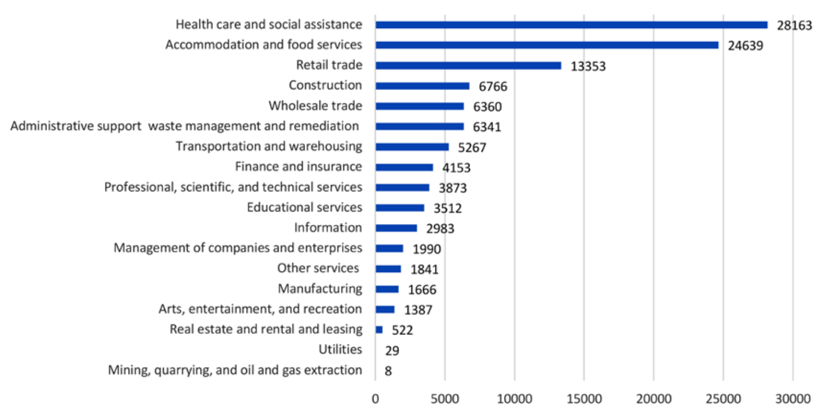
One final point: the most at-risk industries are also those that pay the lowest wages and have the least amount of wealth-building potential for marginal workers. This can increase demands and expenditures on already squeezed government services and social safety net programs. Economic development strategies should not be solely based on retaining these jobs, but doing so in a way that provides pathways to real wealth creation.

FIGURE 1: AT-RISK BUSINESSES BY INDUSTRY, TOTAL (3,530)



Source: Census Bureau, 2012 Survey of Business Owners

FIGURE 2: AT-RISK JOBS BY INDUSTRY, TOTAL (112,853)



Source: Census Bureau, 2012 Survey of Business Owners

EMPLOYEE OWNERSHIP AS A BUSINESS SUCCESSION STRATEGY

Proactive Outreach Succession Planning

Nearly all business owners intuitively understand the need to plan for what happens when they leave their company. Yet, one of the biggest impediments to successful ownership succession is often the business owner him/herself. A typical business owner often spends much more time working *in* the business than *on* the business. Their entire life (and often their sense of self-worth) can be so closely tied to the business and their role in it, that it can be hard to step back or out. The difference between the expectations and reality of business value can delay succession planning on the hope that next year will bring the windfall. Or they just don't want to quit what they love doing.

Despite all these factors, every business owner will eventually exit their company, one way or another. This truth should reinforce to all who care about the economic well-being of our local economies that inaction is not a viable path forward for businesses or local economies. So what's the solution? The key is to connect proactively with business owners to convince them that inaction is costing them money when it comes time to exit the business. There are options that allow a business owner to begin cashing out of the business while staying involved, if that is their wish. The possibility exists to create a plan that provides value for the business owner while addressing their goals and objectives for the business, and for their life after leaving the business. It can be a win-win situation.

The Employee Ownership Option

Traditionally, there were two common methods for transferring a smaller, closely held business – passing on the business to one or more of their children, and selling to an outside buyer. (A lucky few see enough growth to have a third option – going public).

Forty or 50 years ago, it was not uncommon for a business to be in its 3rd or 4th generation of family ownership, it was an important part of the family legacy. But we tend to see fewer of these today, for a number of reasons. For example, a typical business owner has likely been successful enough to send their children to college, providing an opportunity to find their own path, and perhaps a profession. Having witnessed the amount of effort and time away from the family that mom and dad spent to build the business, or merely finding a preferred profession of their own, children are increasingly choosing a career path rather than taking over the family business.

Conversely, selling to an outsider is often an appealing option for a business owner. There are a number of reasons for this, and primary among them is, absent a distressed or liquidation type situation, it will likely provide the selling owner with the best price for the business. On the other hand, after the transaction and the check has been cashed, owners may be unprepared for the changes implemented in, and on, the company, including name changes, layoffs, dismantling of the business, and more. Finally, (as mentioned above) a viable external buyer is not always easy to find. Buyers have choices in where they invest their money and no matter how financially successful, a particular business is not always of interest to investors.

So, what is an owner to do in situations where neither a financial investor or children are prepared to purchase and run the business? There is a third option for the business owner and that is selling to most or all of their employees – as a group. In the United States, there are two major types of employee-owned business models in general use – Employee Stock Ownership Plans (ESOPs) and employee-owned cooperatives. Both are intended to be broad-based structures that include most (if not all) employees as owners (this differentiates them from management or key-person buyouts).

ESOPs are tax-qualified retirement plans similar in many ways to 401(k) plans and profit-sharing plans. Like these other plans, ESOPs offer tax advantages to the companies sponsoring them and to employees participating in them. In exchange for these tax advantages, ESOPs and these other retirement plans must follow certain rules capping the tax advantages and promoting the fair treatment of all employees. The Internal Revenue

THE TWO EMPLOYEE OWNERSHIP MODELS – IN BRIEF

Employee Stock Ownership Plan (ESOP)

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ESOPs are the only retirement plan permitted to borrow money to acquire assets. Unlike other retirement plans, they are not subject to fiduciary concerns regarding diversified investments and must invest primarily in the sponsoring company's stock.

Owners of stock in a C-Corp can completely avoid capital gains taxes, if they sell their shares to an ESOP and follow certain rules.

ESOPs sponsored by C-Corps receive tax deductions for the contributions they make to the ESOP, and those contributions can flow back to the company as payments on the ESOP loan. Thus, these companies receive tax deductions without losing cash.

S-Corps are taxed at the shareholder level, and an ESOP is a tax-exempt shareholder, so income attributable to shares in an ESOP is not taxed at the federal level nor by most states.

As with any retirement plan, employee accounts in the ESOP grow tax free until they eventually receive payouts of benefits from the plan. Unlike any other retirement plan, that growth can be fueled by the employee's own efforts in the business.

Employee-Owned Cooperative

A type of corporate entity (not a retirement plan) that has similarities with Partnerships, LLCs, S-Corps, and C-Corps but differs in its internal structure and tax implications.

Employees are member-owners of the business (similar to LLCs), and each member has one share and one vote for major corporate decisions, including voting for the Board of Directors. Most states require at least a majority of board members also be member owners of the company.

Corporate profits are distributed not based on membership share but on employee contribution (i.e. amount of labor hours) provided to the company on an annual basis. This distribution is called patronage or a patronage refund and is taxable as income on an annual basis (similar to S-Corp distributions).

As a type of corporate entity, cooperatives do not have the regulatory burden of ESOPs, thus they are less costly to set-up and maintain.

Cooperatives do not have the tax breaks for the operating company and member owners that ESOPs have.

Selling owners can utilize the 1042 Rollover on Capital Gains on the proceeds of a sale, and the cooperative will pay a negotiated price for the stock.

Service and Department of Labor oversee compliance with and enforcement of these rules.

Unlike an ESOP, an employee-owned cooperative (or co-op) is a type of corporate entity – other types of corporate entities include C- and S-corps, LLCs, and Partnerships – and not a Qualified Employee Retirement Plan. And also unlike with an ESOP, the employers are generally required to consent to take over the business and will be required to pay a membership fee to join the new cooperative business (which is generally not prohibitively expensive). Cooperatives also institute a new governance structure of one member one vote on major corporate decisions.

Both models usually finance the sale by leveraging the cash flow of the business to generate financing. This financing usually is obtained from traditional sources, like banks, but can also include seller financing for some or all of the purchase price. Because of this, good candidates must be generally financially solvent without a current debt load that would preclude additional financing. Another important pre-requisite is the presence of a current strong management team, or a plan for the company to either build one from within or from outside. This ensures business continuity when the selling owner(s) fully exit the company.

Both models can benefit the company on an ongoing basis, providing a motivated workforce when participation is encouraged enabling employee-owned companies to outperform non-employee-owned firms on a number of important indicators.

Why Employee Ownership?

Selling Owners – We've mentioned above the impact of not having another viable buyer for the business. In fact, selling to employees can in many ways allow the seller to create a buyer, that pays a fair price, for the company where none previously existed. In most cases, selling to an ESOP or cooperative also allows the owner to defer or even eliminate capital gains taxes on the proceeds (the "1042 Rollover"). Finally, for those business owners interested in maintaining the legacy of the business – for the employees and the community – this type of sale may be the next best thing to a family member taking over the business. Finally, if the selling owner wishes to continue to be involved in the new employee-owned business, that can happen as well.

Company – Both models can benefit the company on an ongoing basis, providing a motivated workforce when participation is encouraged enabling employee-owned companies to outperform non-employee-owned firms on a number of important indicators. This includes productivity, profitability, employee turnover, and a lower closure rate during economic crises.[8] Ongoing income tax breaks for S-Corp ESOPs provide for a competitive advantage in the market. Consumers/customers also like employee-owned companies.[9]

Employees – Employees stand to benefit greatly from this type of sale. The selling owner has chosen an option that keeps the business, and the jobs it supports, viable for the future. Employees also stand to benefit financially, allowing them to build real wealth beyond just a wage or salary.[10] Research has shown that employee-owned firms, on average, pay higher wages, provide better levels of benefits, provide 401k retirement plans at higher rates than conventionally owned companies, provide higher levels of employee retirement savings, and more.[11] For example, research conducted by the Ohio Employee Ownership Center (OEOC) finds that in Ohio the average ESOP participant's balance in their ESOP account is more than $109,276, with some averaging over $500,000 or more.[12]

Communities – The benefits to our communities are numerous. Retaining companies and jobs that might otherwise be lost to a lack of succession planning is important by itself, and if a company is sold to an outside buyer, layoffs and/or the movement of the company to another location (perhaps out of the country) are certainly possible and often occur. Employee-owned companies, on the other hand, almost always continue operating in the same location and with the same employees they had before the transaction.

AN OUTREACH APPROACH

It's clear from our experience that employee ownership will not be a fit for every company, every business owner, or every ownership succession situation. What cannot be denied is that every business owner will benefit from timely and effective succession planning. Transferring a business to children, key management, a competitor, all of the employees, or even a financial buyer will benefit the community more than if an owner's lack of planning causes the business to shut down. What's needed is a proactive, community-based strategy that includes a variety of stakeholders.

An example of one strategy was developed in the mid-90s in Northeast Ohio by the OEOC, local economic development partner The Greater Cleveland Partnership's Council on Smaller Enterprises, and local service providers (attorneys, accountants, financial planners, etc.) The program's goal was to engage with business owners with a comprehensive set of seminars on issues related to succession and post-succession planning, including highlighting the employee ownership option. In addition, the program provided a short manual on succession planning (that outlines an easy to implement and manage process and worksheets that helped jump start planning) and a Service Provider Directory of local practitioners in relevant fields needed to complete the planning process.

Over the intervening years, the above model has been adjusted and altered, as local circumstances have required in communities around Ohio, to reach out to business owners – where they are – and get them the assistance they need. The keys have remained the same – a partnership of a variety of community stakeholders all geared to one purpose of proactively engaging with business owners.

The outline here is not the only way to do things. Local problems require local solutions, and there are numerous organizations and groups, public and private, that are working in communities across the country to reach out to business owners and get them the planning help they need. The OEOC is currently developing additional programs for communities around Ohio that build on previous iterations, but that also adapt, in strategy, to the present.

CONCLUSION

The broad canvas of business sizes and types are all important for maintaining a strong economic ecosystem. Such a system supports jobs, economic opportunity, and the overall health of our communities. No region can survive on only large, or small businesses. Everyone is needed if we are to thrive and remain resilient. As we reach the wave of baby boomer business owner retirements, and the potential for business and job loss if succession planning needs are not met, are we ready to accept the consequences? The question is ours to answer.

THE IMPACT OF COVID-19 BUSINESS SUCCESSION PLANNING

Note: this article was originally written prior to the COVID-19 Virus impact on the economy.

It's hard to know at this point what the full impact of COVID-19 will be for business owners, business succession planning, and future trends with both. Clearly, some businesses (including those facing an ownership succession event) will not make it through the crisis or have closed already. Some business owners close to retirement will choose to ride it out for a few years more, maybe a few years more than they would like. Others will decide enough is enough and seek a way to sell or otherwise exit the business as soon as they can – to whoever they can – getting what they can for the business. This may accelerate the rate of business closure or dislocation.

Depending on who you ask, third-party sales (to private equity, strategic buyers, or sales through brokers) have slowed considerably or have ground to a halt. We expect third-party sale activity to slowly increase, but the already low odds (around 25 percent) of an outside sale will be even lower for some time. Since the seller is essentially creating its own buyer with a sale to an ESOP or Worker Cooperative, the attractiveness of this option will likely increase for business owners looking to exit the business right now. Anecdotal information from the employee ownership advisory community is corroborating this assumption – and the related tax breaks with such sales create additional incentives.

For the economic development community, the intense dislocation of the past six months, and the resultant loss of businesses and jobs, makes it even more imperative that a proactive strategy be developed without delay not only to help business owners and their exit planning but to educate and inform them of the employee ownership option. The benefits of employee ownership, for individuals, companies, and surrounding communities is well documented. The data is clear, employee-owned businesses on average survive recessions at a higher rate than conventionally owned counterparts – shedding fewer workers, and coming out onto the other side in better financial shape.

With so much lost already, can we afford to lose even more due to incomplete planning or lack of knowledge? We believe allowing this to happen will be a mistake of lasting consequence for our communities and the people we serve.

FURTHER RESOURCES

1. **Ohio Employee Ownership Center**
   - Owners Guide to Succession Planning (https://uploads-ssl.webflow.com/5cdc97dbfcbd7455a5788315/5e5400b7a6be493a177d08a5_OEOCOwnersGuideBusinessSuccessionPlanning.pdf)
   - Selling Your Company to Your Employees: Employee Stock Ownership Plans and Worker Owned Cooperatives (https://uploads-ssl.webflow.com/5cdc97dbfcbd7455a5788315/5e5402bf64688e7af861b247_SellingToEmployees.pdf)
2. **Crowe**
   - A Comprehensive Guide to ESOPs (https://www.crowe.com/insights/asset/a/a-comprehensive-guide-to-esops)

OTHER MATERIALS AND ORGANIZATIONS

1. **National Center for Employee Ownership** – How an Employee Stock Ownership Plan Works (https://www.nceo.org/articles/esop-employee-stock-ownership-plan)
2. **Democracy at Work Institute** – A Guide to Cooperative Conversions (https://institute.coop/resources/legacy-business-our-opportunity-build-wealth-economy-and-culture)
3. **Project Equity** – Business Conversions to Worker Cooperatives (https://www.project-equity.org/wp-content/uploads/2017/02/Case-Studies_Business-Conversions-to-Worker-Cooperatives_ProjectEquity.pdf)

ENDNOTES

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