DISCUSSION PAPER

Building an employee ownership economy

Social Capital Partners

Social Capital Partners

366 Adelaide St West, Suite 606
Toronto, Ontario, Canada M5V 1R9
socialcapitalpartners.ca
info@socialcapitalpartners.ca
(416) 646-1871

When employees have a chance to participate financially in the growth of their companies, everyone benefits. It leads to better company performance, stronger local economies, and higher wealth and income for workers.

Social Capital Partners is working to build a more resilient economy through broad-based ownership and quality employment. This discussion paper highlights an opportunity to create a public policy framework that supports employee ownership in Canada.

Date published:
October 2020

> *"EllisDon owes a lot of its success to employee ownership – we are 100% committed to it. There should be much more of this in Canada."*
>
> GEOFF SMITH,
> CEO OF ELLISDON

Introduction

After two significant economic crises in the last dozen years, the word on everyone's lips is "resilience." How do you create a resilient economy, capable of weathering storms and meeting the challenges and opportunities posed by globalization, urbanization, and technological change? One tool that has been proven over several decades to build more economic resilience is employee ownership. In fact, the benefits are so strong that in the United States bi-partisan political support for employee ownership has led to 14 million American workers at 6,600 companies sharing in $1.4 trillion USD in wealth.[1]

When employees have a chance to participate financially in the growth of their companies, everyone benefits. Employee-owned companies — where a broad base of employees own a significant stake in their employer[2] — are associated with better company performance, stronger local economies, and higher wealth and income for workers.[3] Research shows employee-owned companies also have a greater focus on the long-term[4] and are better at weathering recessions.[5]

Despite these advantages, Canada has a low rate of employee ownership. Canada does have businesses, especially technology start-ups, that include shares or stock options in their compensation for employees, and others like EllisDon and Beau's Brewery that have programs to help their employees buy shares. But these add up to far fewer employees at far fewer companies than in the US or Europe.[6]

The lower rate of employee ownership in Canada is not explained by culture or economic conditions, but by public policy. The most common form of employee ownership elsewhere — employee ownership trusts[7] — is missing in Canada. These trusts, which include Employee Stock Ownership Plans in the US (or US-ESOPs) and Employee Ownership Trusts in the UK (UK-EOTs) provide a purpose-built vehicle to transition ownership of successful businesses to their employees. The US and UK models have some differences in features and design, but what they have in common is public policy, designed to make them viable and promote their use, by providing a clear legal structure and targeted incentives.

1 "ESOP (Employee Stock Ownership Plan) Facts," accessed June 23, 2020, https://www.esop.org/.
2 "Sharing Success: The Nuttall Review of Employee Ownership," 2012.
3 Jared Bernstein, "Employee Ownership , ESOPs , Wealth , And Wages," no. January (2016).
4 Joseph Lampel, Ajay Bhalla and Pushkar Jha, "The Employee Ownership Advantage - Benefits and Consequences," City University London, July 2012. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/31668/12-929-employee-ownership-advantage-benefits-and-consequences.pdf.
5 Fidan Ana Kurtulus and Douglas L Kruse, How Did Employee Ownership Firms Weather the Last Two Recessions?: Employee Ownership, Employment Stability, and Firm Survival in the United States: 1999-2011 (Kalamazoo, MI: Upjohn Press Upjohn Press Collection, 2017), https://research.upjohn.org/up_press.
6 Canadian Worker Cooperative Federation, "How Worker Co-Operatives Can Contribute to Improving Canada's Productivity, Competitiveness and Resilience," 2017, www.canadianworker.coop.
7 For the purposes of this report "employee ownership trusts" are used to refer to any form of employee ownership that uses a trust structure. US Employee Ownership Trusts and Perpetual Trusts are other examples of trusts used for employee ownership.

Where other countries provide incentives for employee ownership, Canada has numerous road blocks. Even if a Canadian company spent hundreds of thousands of dollars for a custom-designed trust to hold shares for employees, current tax policy significantly reduces the value for both employees and owners. In fact, the limited employee ownership that exists in Canada today does so in *spite* of the disincentives in place.

Not all “ESOPs” are trusts

In the US, employee ownership trusts are known as “ESOPs.” But the term “ESOP” in Canada generally refers to a wide range of employee stock ownership plans, most often stock options targeted at management or senior employees. These do not offer the same features – or benefits – of broad-based employee ownership trusts. For clarity, in this paper we use the term “employee ownership trusts” generally and US-ESOP to refer to the American trusts.

Increased employee ownership in Canada could support more inclusive growth and wealth creation, address looming business succession challenges, and promote resilience across the Canadian economy. This discussion paper explores the potential of employee ownership trust models to promote employee ownership in Canada and the public policy decisions needed to make them possible.

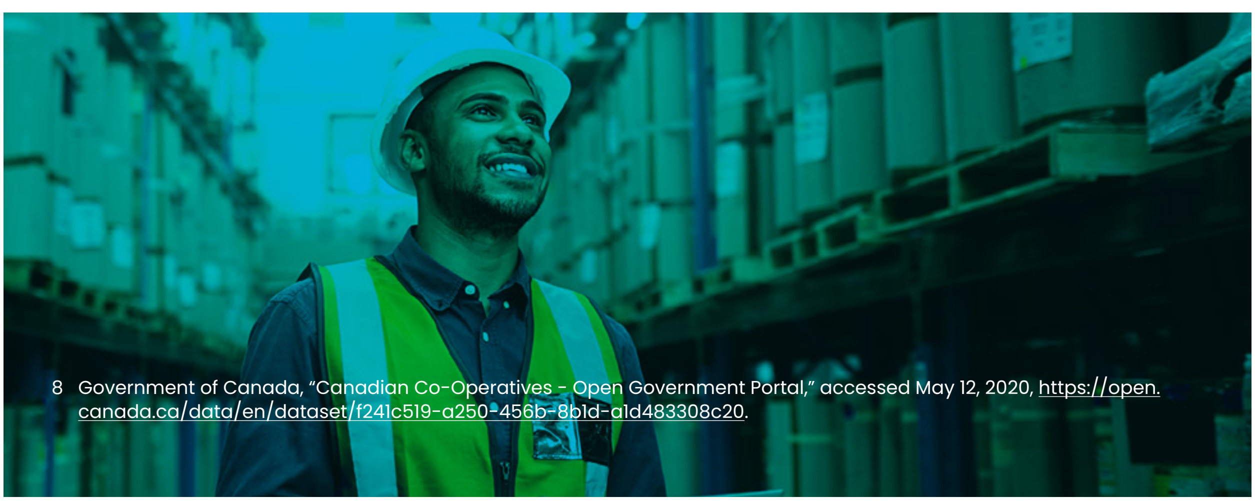
> “Implementing an employee ownership program in Canada at this time is incredibly difficult. I would greatly appreciate a structure that allows companies and their employees to benefit financially in the success of their business.”
>
> STEVE BEAUCHESNE, CEO & CO-FOUNDER OF BEAU'S ALL NATURAL BREWING COMPANY

Why do we need employee ownership trusts?

Employee ownership benefits employees, owners, and communities. It's a powerful tool to build wealth for workers at all income levels, improve business performance, and help companies better weather economic shocks. Given the benefits, promoting broad-based employee ownership should be a priority for policymakers that are looking to strengthen Canada's economic recovery and increase the well-being of Canadians over the long-term.

> The lower rate of employee ownership in Canada is not explained by culture or economic conditions, but by public policy.

There are a range of different approaches to employee ownership, including worker co-operatives, stock options, employee share purchase plans, and employee ownership trusts. But most of these options have limited potential to reach a broad range of workers at scale. For example, while Canada has a long history of co-operative businesses, very few are employee-owned. Most Canadian co-operatives are consumer co-ops, credit co-ops, or buying group co-ops. Worker co-ops represent only seven percent of Canadian co-ops, employing just over 5,000 people.[8] Globally, employee ownership trusts are the most successful tool to allow existing businesses to transition to employee ownership and they are the only model with the potential to create broad-based employee ownership at scale in Canada.



8 Government of Canada, "Canadian Co-Operatives - Open Government Portal," accessed May 12, 2020, https://open.canada.ca/data/en/dataset/f241c519-a250-456b-8b1d-a1d483308c20.

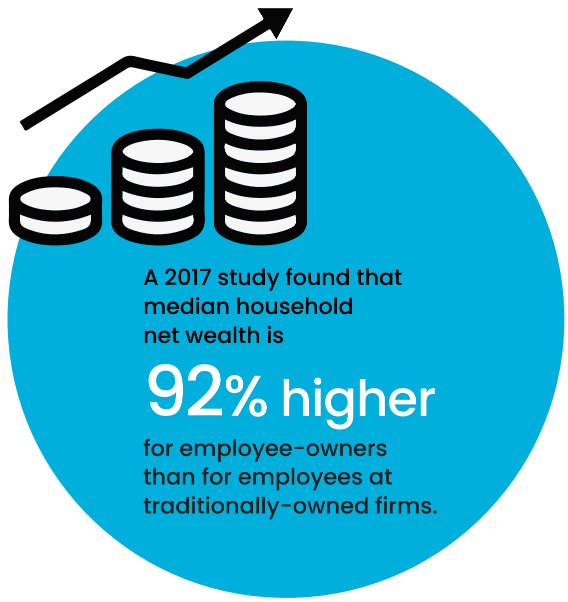
Types of employee ownership at a glance

Type of employee ownership	Overview	Most Common Application
Worker co-operatives	In a worker co-operative, employees typically purchase a share and become a member. The business is owned and democratically controlled by the employee-members.	• Social-purpose organizations built as co-ops from startup • Small collectives of professionals (e.g. tattoo parlours) • Transition of small companies (<10 employees)
Employee stock options plans	Stock option plans provide employees the right to purchase shares at a future date for a predetermined price. Typically, employees exercise options and immediately sell the shares back to the company, and as a result are not required to make a cash investment.	• Compensating employees at growing startups (e.g. tech firms) • Incentives for management at established companies
Employee ownership trusts	Employee ownership trusts provide employees indirect ownership as beneficiaries of a trust. Typically, the trust borrows to purchase shares so that there is no cash investment required by employees.	• Transition of established companies (>10 employees) • Broad-based employee compensation plans for public companies
Employee share purchase plans	Share purchase plans allow employees to purchase shares in their employer, typically through a payroll deduction and at a discounted price. Employees hold these shares directly.	• Encouraging employee investment at mature public companies • Employee share ownership in some private companies

There is a large body of research from around the world that points to employee ownership trusts as a powerful tool to 1) reduce wealth inequality, 2) support business succession, 3) protect local jobs, and 4) promote economic resilience.

Increased wealth for employees

Employee ownership trusts put wealth into the hands of employees that might not otherwise have access to ownership and profit-sharing opportunities, helping to grow the middle class. A 2017 study, drawing on data from the US Bureau of Labour Statistics, found that median household net wealth is 92 percent higher for employee-owners than foremployees at traditionally-owned firms.[9] A 2019 report found that low- and moderate- income workers in a US-ESOP had significantly more wealth than similar workers without US-ESOP plans.[10]



This research also found that the wealth benefits were even more pronounced for women and people of colour.[11] The study found that median wealth of Latinx US-ESOP employees was nearly 12 times the median wealth of Latinx households nationally. Likewise, Black employee-owners had approximately three times the median wealth of Black households nationally.

As leading economists have noted, these results come against an economic backdrop where workers have been receiving a declining share of corporate income since the late 1970s.[12] In the UK, the Institute for Public Policy Research's (IPPR) Commission on Economic Justice identified the expansion of incentives for Employee ownership trusts as one of their key policy pillars to address wealth inequality.[13]

In Canada, new data places greater urgency on the need for solutions to address growing wealth inequality. Data from the Parliamentary Budget Office shows that wealth disparities amongst Canadians are much worse than previously estimated, with the top 1% of Canadians holding one quarter of total wealth, double previous estimates of 13% (while the bottom 40% of Canadians hold only 1.2% of wealth).[14] These findings place Canada one of the most unequal countries in the OECD.

9 Nancy Wiefek, "Employee Ownership & Economic Well-Being," 2017, 1–24, https://www.ownershipeconomy.org/wp-content/uploads/2017/05/employee_ownership_and_economic_wellbeing_2017.pdf.
10 Janet Boguslaw and Lisa Schur, "Building the Assets of Low and Moderate Income Workers and Their Families," 2019.
11 Boguslaw and Schur.
12 Bernstein, "Employee Ownership , ESOPs , Wealth , And Wages."
13 IPPR Commission on Economic Justice, "Prosperity and Justice: A Plan for the New Economy," 2018
14 Office of the Parliamentary Budget Officer, "Estimating the Top Tail of Family Wealth Distribution in Canada," 2020, www.tcpdf.org

Business succession

While it does not often make headlines, the Canadian economy faces an urgent challenge of business succession for small and medium-sized (SME) businesses. The vast majority of SME business owners in Canada are over the age of 50.[15] Approximately 70% of private business owners are planning to sell or pass on their businesses in the next decade — businesses that account for the majority of jobs in Canada and almost two-thirds of the country's GDP.[16]

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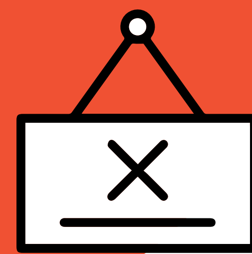

Canadian business owners often struggle to find local buyers, even for successful businesses. For many, keeping business in the family is not a viable option, so they are left with selling their business either to predominantly American private equity firms or to competitors (often international as well).[17] This can lead to greater industry consolidation, exacerbate growing wealth disparities, and contribute to the hollowing out of local economies.[18]

> Today, founders looking to sell face a choice between investors and competitors – often with negative effects for local economies. Why not a third options that rewards employees and allows the business to stay local?

For business owners choosing between financial investors or competitors, employee ownership trusts can be a third option that keeps their business running with ownership that is aligned with maintaining jobs in their community. Because employee ownership trusts are able to borrow money to purchase shares, owners can receive fair market value for their businesses, while all employees receive an ownership stake without having to buy in with their personal savings. Employee ownership allows for continuity — owners often remain involved and management stays in place. For retiring business owners, many of whom care deeply about the legacy of their businesses and have a strong connection to their employees and communities, employee ownership trusts are a compelling succession option.

15 "Key Small Business Statistics - June 2016 - SME Research and Statistics," accessed May 20, 2020, https://www.ic.gc.ca/eic/site/061.nsf/eng/h_03018.html#point8-2.

16 PwC, "Retirement Pushes Canadian Private Company Owners to Keep, Sell or Transfer Their Business," 2019, https://www.pwc.com/ca/en/media/release/retirement-pushes-canadian-private-company-owners-to-keep-sell-transfer-their-business.html; Canadian Federation of Independent Business, "Nearly Three Quarters of Small Business Owners Plan to Exit Their Business within the next 10 Years," 2018, https://www.cfib-fcei.ca/en/media/nearly-three-quarters-small-business-owners-plan-exit-their-business-within-next-10-years.

17 PwC, "Retirement Pushes Canadian Private Company Owners to Keep, Sell or Transfer Their Business."

18 Jason Furman et al., "A Firm-Level Perspective on the Role of Rents in the Rise in Inequality for Us," 2015; Technology and Innovation OECD Directorate for Science, "The Great Divergence(s): The Link between Growing Productivity Dispersion and Wage Inequality," 2017, www.oecd.org/sti; Ray Bawania and Yelena Larkin, "Are Industries Becoming More Concentrated? The Canadian Perspective," SSRN Electronic Journal, May 13, 2019, https://doi.org/10.2139/ssrn.3357041.

ESOP trusts in action:
BOB'S RED MILL

"It's the only business decision that I could make…I don't think there's anybody worthy to run this company but the people who built it." – Bob Moore, Bob's Red Mill[19]

Bob's Red Mill is an Oregon-based whole grain flours and cereals company, founded by Bob Moore and his late wife Charlee in 1978.[20] When it came to succession planning, Bob fielded a lot of buy-out offers from large corporations, but wanted to have more control over the future of his brand, reward the employees who helped build it, and ensure workers had a vested interest in the company's success.[21] In 2010, Bob and his partners began transitioning ownership to an ESOP, which paid out around $6 million USD to 45 employee retirees as of April 2016.[22] Recently, the company completed the transition and is now 100 percent owned by its employees.[23]

19 Christine Brozyna, "Owner of Multi-Million Dollar Company Hands Over Business to Employees," ABC News, 2010, https://abcnews.go.com/WN/owner-multi-million-dollar-company-hands-business-employees/story?id=9875038.
20 Jeanne Sahadi, "Bob's Red Mill Founder Is Still Working in His 90s and Loving It," CNN Business, February 14, 2020, https://www.cnn.com/2020/02/14/success/bobs-red-mill-founder-profit-sharing/index.html.
21 Bob's Red Mill, "Proudly Employee Owned for 10 Years," accessed July 16, 2020, https://www.bobsredmill.com/employee-owned; Aaron Juckett, "National ESOP Coverage: Bob's Red Mill Natural Foods," ESOP Partners, February 19, 2010, https://www.esoppartners.com/blog/bid/88969/National-ESOP-Coverage-Bob-s-Red-Mill-Natural-Foods.
22 Singapore Management University, "Bob's Red Mill: For the Employees by the Employees," 2016, https://ink.library.smu.edu.sg/pers/15
23 Bob's Red Mill, "Proudly Employee Owned for 10 Years"; Singapore Management University, "Bob's Red Mill: For the Employees by the Employees."

Protecting local jobs

Employee ownership trusts strengthen the roots of businesses in communities. Employee-owners are much less likely to move a business than external purchasers who will often live and have businesses in other locations.

Many business owners in the US, such as Shawn Burcham of Missouri-based restaurant chain PFS Brands, Robert Ryberg of Minnesota-based manufacturer Windings, and the Buehler family of Ohio-based Buehler's Supermarkets, cite loyalty to the towns in which they operate as the reason they chose an ESOP for their business succession.[24]

Canadian policymakers are currently trying to balance an economy operating at "two speeds."[25] In the past two decades, many smaller communities have seen the loss of key manufacturing employers while service-driven economies grew in larger cities.[26] A recent study by Sean Speer and Weseem Ahmed suggests that rural communities in Canada are also at greater risk of job loss from automation

24 National Center for Employee Ownership, "Why Thousands of Business Owners Sell to Their Employees," accessed August 6, 2020, https://www.nceo.org/assets/pdf/public/WhoShouldOwn.pdf. ; Buehler's Fresh Foods, "E&H Family Group Announces Sale of Buehler Supermarkets to Its Employees," October 17, 2017, https://www.buehlers.com/eh-family-group-announces-sale-buehler-supermarkets-employees.
25 Jason Kirby, "Goods and Services: Canada's Other Two-Speed Economy," Maclean's, 2017, https://www.macleans.ca/economy/economicanalysis/canadas-other-two-speed-economy/.
26 Mike Moffatt, "Manufacturing Employment in the Great Lakes Region — A Story in 6 Acts," May 24, 2019, https://medium.com/@MikePMoffatt/manufacturing-employment-in-the-great-lakes-region-a-story-in-6-acts-d0dfd75c9f8b.

going forward.[27] At a time when it is crucial for place-based economic development initiatives to show results, employee ownership trusts may be a tool to maintain anchor employers that are critical to the economy of small and mid-sized Canadian cities. They can also help to keep talent in communities who might otherwise leave to bigger cities by providing an ownership stake in their employers.[28]

Economic resilience

Employee-owned companies are more resilient in the face of economic shocks and downturns. US data from the 2001 and 2008 recessions showed that employee-owned firms were much more stable in the face of economy-wide crises, showing stronger employment and lower likelihood of bankruptcy or merger in recessions.[29]

There are countless examples of employee-owned companies like Recology (see Box 2) that have managed to avoid laying off workers during a recession. Because they lay off fewer employees, employee-owned companies maintain their productivity advantages through downturns and are better prepared to bounce back when the economy begins to improve.[30]These actions also have benefits for public spending. One study estimates that between 2002-2010, the US federal government saved $13.7 billion USD annually in tax revenues and unemployment compensation because of lower layoff rates among employee-owned companies.[31]

> **"As an investor, I've seen how successful employee ownership has been in a great company like Chobani. There's alignment throughout the company that improves performance. I think Canadian companies, employees and investors would all benefit from more employee ownership."**
>
> JIM WALKER, SENIOR VICE PRESIDENT OF PRIVATE MARKETS AT HEALTHCARE OF ONTARIO PENSION PLAN

27 Sean Speer and Weseem Ahmed, "A Place-Based Lens on the Future of Work in Canada," June 2020, https://ppforum.ca/wp-content/uploads/2020/06/PlaceBasedLensToTheFutureOfWork-PPF-June2020-EN.pdf.
28 David Ellerman and Tej Gonza, "A Generic ESOP Employee Share Plan for Europe," May 2020, http://www.efesonline.org/LIBRARY/2020/A Generic ESOP Employee Share Plan for Europe.pdf.
29 Ana Kurtulus and Kruse, How Did Employee Ownership Firms Weather the Last Two Recessions?: Employee Ownership, Employment Stability, and Firm Survival in the United States: 1999-2011 .
30 Ana Kurtulus and Kruse, How Did Employee Ownership Firms Weather the Last Two Recessions?: Employee Ownership, Employment Stability, and Firm Survival in the United States: 1999-2011 , 138.
31 Corey Rosen and Michael Keeling, "The Impact of Employee Ownership and ESOPs on Layoffs and the Costs of Unemployment to the Federal Government," 2013.

More generally, having a diverse mix of organizational forms and ownership structures is good for economic performance. The UK's expert Ownership Commission warned that a "monoculture" in private sector ownership form leads to short-termism and makes companies more prone to foreign takeovers.[32] The UK Employee Ownership Index, which tracks the performance of companies with employee ownership initiatives, has seen publicly-traded companies with at least three percent employee ownership outperform the market consistently and substantially.[33]

RECOLOGY

In business for over 100 years, Recology is a San Francisco-based waste management company that serves more than 889,000 residential and 112,000 commercial customers across California, Oregon, and Washington.[34] Recology is 100% employee-owned through an ESOP trust that was established in 1986 as part of a merger between two waste management companies.[35] Today, Recology has over 3,600 employee-owners who view their employee-owned status a key strength of their business.[36] The company has grown drastically since becoming an ESOP trust and its gains have been widespread amongst employees. With over $1 billion USD in revenue in 2018, no employee — from the CEO to new hires — owns more than one percent of the company.[37]

Recology believes that their employee-ownership culture makes them respond to crises differently than other companies. For example, Recology introduced its Recology Recovers policy in response to the COVID-19 pandemic, which ensured that all employees continued to be paid and have health coverage through temporary service disruptions.[38] "Our employees embrace an employee ownership mentality and recognize that this is a difficult time. As owners of the business, we're going to work together to be successful."[39]

34 Warren Cassell Jr., "6 Successful Companies That Are Employee-Owned," Investopedia, November 29, 2019, https://www.investopedia.com/articles/insights/051316/6-successful-companies-are-employeeowned.asp; Recology, "Our History & Team," accessed July 16, 2020, https://www.recology.com/about-us/#mission-vision.
35 Recology, "Our History & Team."
36 Henry A.J. Ramos and Katie Taylor, "How to Make Wealth Building and Job Opportunities More Equitable," Stanford Social Innovation Review, accessed July 16, 2020, https://ssir.org/articles/entry/how_to_make_wealth_building_and_job_opportunities_more_equitable#; Recology, "Our History & Team."
37 "Recology | Crunchbase," accessed July 19, 2020, https://www.crunchbase.com/organization/recology#section-overview.
38 "Recology | Project Equity," accessed August 25, 2020, https://www.project-equity.org/learn-from-others/conversation-series-recology/.
39 "Recology | Project Equity."

32 The Ownership Commission, Plurality, Stewardship and Engagement, 2012
33 FTSE, "UK Employee Ownership Index ," accessed June 8, 2020, http://www.employeeownershipindex.co.uk/wiki/index.php5?title=Welcome_to_the_UK_Employee_Ownership_Index.

Because they lay off fewer employees, employee-owned companies maintain their productivity advantages through downturns and are better prepared to bounce back when the economy begins to improve.

In the US, industries with the most employee ownership include:

- manufacturing
- construction
- professional services
- grocery

US-ESOPs are also common in specialty businesses like craft breweries and garden centers.

How employee ownership trusts work

While a number of countries have their own approaches to promote employee ownership, the two most prominent models of employee ownership trusts — and the most relevant to the Canadian context — are US-ESOPs and UK-EOTs.

The fundamental difference between the UK-EOT and US-ESOP is how employees receive value for their shares. In the US model, employees typically receive shares or cash in a lump sum when they leave or retire. Employee owners of a UK-EOT are paid annual bonuses out of the company's profits, some of which they can receive tax-free.

US Employee Stock Ownership Plans (US-ESOPs)

US-ESOPs are a form of employee ownership where some or all of a company's shares are held in an employee-owned trust. To create a US-ESOP, a company sets up a trust and the trust typically borrows money from a bank and/or the owner themselves to buy shares.[40] The loan is repaid out of the company's ongoing earnings.

Being able to borrow to buy shares is a key feature of US-ESOPs. It allows owners to "exit" at fair market value, which is very hard to accomplish with other forms of employee ownership. US-ESOPs also allow for the gradual accumulation of shares by the ESOP trust, often occurring over many years. Both of these features have made US-ESOPs an attractive succession plan for private company owners and a mechanism for large public companies to provide employees with minority stakes. The illustration on the next page shows how US-ESOP trusts can work as a business succession plan.

History of Employee Ownership in the US

Before the US-ESOP trust was introduced, employee-owned companies in the US were rare, just as they are in Canada today. That changed when Louis Kelso, a lawyer who helped set up some of the pioneering employee ownership trusts, convinced the then-Chair of the US Senate Finance Committee, Russell Long, to clear some of these hurdles. With Long's support, a new set of rules for US ESOPs were created as part of the 1974 *Employee Retirement Income Security Act*. This new structure, combined with targeted incentives first introduced in the 1980s, have allowed ESOPS to grow significantly. US-ESOPs have had consistent support from both Republicans and Democrats, including a recent bi-partisan proposal to encourage ESOP growth as part of COVID-19 economic recovery. As a result of the US-ESOP's success, a robust enabling environment for employee ownership professionals has developed to support further growth of US-ESOPs — a key factor in its ongoing success.

40 National Center for Employee Ownership, "How an Employee Stock Ownership Plan (ESOP) Works," 2018, https://www.nceo.org/articles/esop-employee-stock-ownership-plan.

Transitioning to employee ownership

Employee ownership trusts allow successful businesses to transition ownership to their employees.[41] This approach allows all employees to receive an ownership stake without having to invest their own cash, while still allowing owners to sell at a fair market price. Here's how it works:

1 Set up an employee ownership trust

The first step is to set up an employee ownership trust. The trust is a legal entity that will hold the shares of the company on behalf of the employees.

2 Secure financing

The trust then secures a loan from banks and/or the current owners to purchase shares. This loan is ultimately repaid using company profits once the trust owns the shares.

3 Purchase shares

Using the proceeds from the loan, the trust buys some or all of the company's shares from the current owners. The price for these shares is determined by an independent appraiser. Afterward, the owner may leave and retire, or stay involved with the company.

4 Distribute benefits to employees

Employees now receive the benefits of the shares purchased on their behalf by the trust. In US-ESOPs, each employee earns shares that they can sell back to the company at retirement. In UK-EOTs, employees receive regular profit sharing as bonuses. In both cases, strict rules ensure that these benefits are distributed equitably to all employees.

41 Description adapted from National Center for Employee Ownership, "ESOP Nuts and Bolts", https://www.esopinfo.org/how-esops-work/

For employees, the key feature of US-ESOPs is that they receive shares over time in addition to their regular compensation (without having to pay for them). Unlike stock options or share purchase plans, there are strict requirements that all employees benefit from the trust, generally based on a formula tied to earnings or tenure. Because US-ESOPs are part of the US retirement income system (see sidebar on page 11), employees typically receive the cash value of their shares when they leave the company for another job or to retire.

Companies and (former) owners that provide these benefits to their employees in the US can benefit from tax incentives. Depending on the corporate structure, US-ESOPs can either deduct contributions to the trust from their taxable income or are exempt from corporate tax altogether. Owners selling to an employee-owned trust can defer and potentially eliminate their capital gains tax.

ESOP trusts in Action: **PUBLIX**

One of the prominent examples of an ESOP-trust owned company is Publix, a supermarket chain in the Southeastern US with over 1,200 locations, primarily in Florida.[44] The company is majority-owned by its current and former employees, with a minority stake held by the family of founder George Jenkins.[45] Employees who work at least 24 hours per week receive stock equivalent to approximately eight percent of pay. Long-time front-line workers have built retirement payouts of over $1 million USD.[46]

44 Publix Supermarkets, "Facts & Figures - Company Overview," accessed June 25, 2020, https://www.publixstockholder.com/corporate/about-publix/company-overview/facts-figures.
45 Barry Berman, Competing in Tough Times: Business Lessons from L.L. Bean, Trader Joe's, Costco, and Other World-Class Retailers, 2011.
46 Elberta McKnight, "Retire as a Millionaire, College Degree Not Required," Atlanta Journal-Constitution, March 25, 2016, https://www.ajc.com/business/employment/retire-millionaire-from-this-company-college-degree-not-required/PWg5SAhU4jRy78tCnwdLIN/.

UK Employee Ownership Trusts (UK-EOTs)

The UK has a long history of employee ownership. The John Lewis Partnership (a department store and grocery store chain with nearly 90,000 employees) has been owned in trust on behalf of its employees since 1929.[42] Until recently, employee benefit trusts were legal in the UK but faced tax hurdles and had few direct incentives to encourage their uptake. Early in the 2010s, the coalition government commissioned an outside review led by tax lawyer Graeme Nuttall on how to promote greater employee ownership, with a focus on improving business performance, innovation, and economic resilience.[43]

42 Christopher Michael, "The British Are Coming — ESOPs and Perpetual Trusts," Employee-Owned America, 2018, https://medium.com/fifty-by-fifty/the-british-are-coming-esops-and-perpetual-trusts-c1d4cf45ba61.
43 "Sharing Success: The Nuttall Review of Employee Ownership," 2012.

Drawing on the Nuttall review, the UK government introduced a package of reforms in 2014 to promote employee ownership. The reforms included a new streamlined structure called an Employee Ownership Trust (referred throughout this document as the UK-EOT) and new tax incentives. To be eligible for these benefits, employees must hold a controlling interest in the company and the trust must benefit all of a company's employees.[47]

For companies transitioning to employee ownership, the process for a UK-EOTs looks similar to a US-ESOP. The company creates a trust to benefit its employees and the current shareholders enter into an agreement to sell their shares to the trust. In the case of a UK-EOT, agreements must be for at least 51 percent of the company's shares, making it less conducive to a gradual transition than a US-ESOP. The transaction is either financed by a bank loan or by the owners themselves, with the loan repaid from company revenues.[48] Employees do not get allocated individual shares, instead they get profits distributed among them as bonuses.

While it remains early days, the combination of policy changes appears to be driving strong growth in employee ownership in the UK. Of the 370 firms owned by employee ownership trusts in the UK as of June 2019, over 60 percent had converted to employee ownership since 2014.[49] Most of these new transactions were related to business succession, featuring founders and existing shareholders selling to employees at fair market value.[50]

Comparing US-ESOPs and UK-EOTs

Key Features	US-ESOPs	UK-EOTs
How employee-owners are paid	Annual allocation of shares	Annual allocation of profits
Minimum threshold of employee ownership	None – tax incentives vary depending on level of employee ownership	51%
Tax incentives	• Corporate tax (company) • Capital gains tax (owner) • Personal income (employees)	• Capital gains tax (owner) • Personal income (employees)

47 "New Tax Exemptions for Companies Owned by Employee Ownership Trusts | Fieldfisher," accessed May 12, 2020, https://www.fieldfisher.com/en/insights/new-tax-exemptions-for-companies-owned-by-employee-ownership-trusts#sthash.dtm8G990.dpbs.
48 Harper James Solicitors, "A Guide To Employee Ownership Trusts ," November 28, 2019, https://hjsolicitors.co.uk/article/employee-ownership-trusts/#section-4.
49 Andrew Robinson and Andrew Pendleton, "Employee Ownership In Britain: Size and Character," n.d.
50 Presenters Nigel Mason and Andrew Pendleton, "Employee Ownership Sector Update," n.d.

Europe

In Europe, the role of employee share ownership varies, with much better results in countries like France, Sweden, and Finland where there are stronger incentives in place.[51] Overall, broad-based share ownership in Europe is on the rise; 52 percent of large European companies provided some form of broad-based share plan to their employees in 2019, up from 34 percent in 2006.[52] However most of this growth has been in more modest plans — the number of companies in Europe where employees hold more than 20 percent of the company has stayed stable since 2006.[53]

Lessons for Canada

- **A clear employee ownership structure matters:**
  Employee ownership in both the US and UK only began to grow when clear and specific rules were developed by governments and an "off the shelf" corporate form was introduced. Having a clear structure is important for creating awareness among business owners and promoting uptake.
- **Employee ownership trusts are the most successful model for business succession to employee ownership:**
  Trusts that can borrow money allow for owners to receive fair market value for their companies in a transition to employee ownership. This has been critical to widespread adoption among privately-owned small and medium-sized businesses, where the succession crisis in Canada looms. In Europe, where trusts are less common, employee ownership is heavily-weighted towards public companies, rather than privately-owned businesses.
- **No existing model is a perfect fit for Canada:**
  The US-ESOP has been a powerful wealth-building tool, especially for front-line workers, but is complicated to administer and the main benefits only flow to employees on retirement. However, these issues are solvable – they're more a product of the US-ESOP's history than anything inherent to the model. The UK-EOT provides benefits throughout a worker's career, but isn't as good for long-term wealth-building. It can also disadvantage employees who are at the company at the time of transition to employee ownership, since the first few years of EOT debt repayments will significantly reduce dividend distribution. A Canadian approach to employee ownership would want to take the best parts of each: creating meaningful wealth, allowing for different types of successions, providing more benefits during an employee's working life, and creating as simple a structure as possible.

51 European Federation of Employee Share Ownership, "Employee Share Ownership: The European Policy," May 2019, http://www.efesonline.org/LIBRARY/2018/Employee Share Ownership -- The European Policy.pdf.
52 Marc Mathieu, "Annual Economic Survey of Employee Share Ownership in European Countries 2019," 2020.
53 Marc Mathieu.

A "Made-in-Canada" approach to employee ownership

Paving the way for employee ownership trusts in Canada depends on supportive public policy. The distinct success of US-ESOPs, evident in the $1.4 trillion USD of assets in the hands of participating employees, is a result of deliberate public policy to put legislation and tax incentives in place.

Building on the experiences of other countries can allow Canada to act quickly. The generational business succession challenge, accelerated by COVID-19, calls for an urgent policy response to guard against increased geographic and demographic inequality. Learning from the successes and limitations of international experiences there are three key pillars that need to be in place for a successful made-in-Canada approach to employee ownership:

- **a clear structure** and rulebook for employee ownership trusts;
- **targeted incentives** that put employee ownership on an equitable playing field with alternatives and recognize the benefits to the economy of employee-owned companies;
- **effective oversight** that ensures the interests of employees, shareholders, and the public are protected.

These design choices matter. The right structure, incentives, and oversight can attract business owners, capital providers, and advisors. They can also provide effective protections for Canadian employees and taxpayers. This discussion paper highlights key considerations for a "made-in-Canada" approach that lays a strong foundation for employee ownership trusts in Canada.

Clear structures

In both the US and the UK, governments created dedicated legal structures for employee ownership trusts, making the process of creating a trust easier and more attractive to business owners. No comparable structure exists in Canada. While it is legally possible under Canadian trust law to replicate an employee ownership trust, doing so results in significant tax, legal, and administrative issues (see box).

A clear structure and operating environment are key to getting this right. Even though US-ESOP trusts were officially "created" in the 1974 Employee Retirement Income Security Act, their use did not take off until nearly a decade later when clear IRS regulations were issued.[54] In the UK, the transition to employee-owned businesses has accelerated since the creation of the new streamlined UK-EOTs in 2014.[55] A cross-EU study found that in all cases, clearer legislation for employee financial participation helps to spread the practice.[56]

> A clear structure and operating environment are key to getting this right.

The other major advantage of a dedicated legal structure is the ability to target incentives. Without a clear definition of employee ownership (like those spelled out in the rules for employee ownership trusts), it can be challenging to target tax incentives effectively to companies that truly offer the broad-based employee ownership that benefits communities. In the UK, incentives are offered only to trusts that own at least 51 percent of a company, where in the US there is not a minimum threshold but the value of incentives are scaled to the degree to which a company is employee-owned.[57]

Any dedicated legal structure must be tailored to how employees are rewarded and create an appropriate governance model. The decision to focus on shares paid out at retirement like the US-ESOP or profit-sharing through annual bonuses like the UK-EOT has implications for how a trust would be structured and governed, and for rules around independent valuations. It is also possible to design a model that blends long-term share ownership and regular cash distributions.[58]

54 John Menke and Dixton C. Buxton, "The Origin and History of the ESOP and Its Future Role as a Business Succession Tool," Journal of Financial Services Professionals, 2010, https://cleo.rutgers.edu/articles/the-origin-and-history-of-the-esop-and-its-future-role-as-a-business-succession-tool/.

55 Robinson and Pendleton, "Employee Ownership In Britain: Size and Character."

56 Jens Lowitzsch and Iraj Hashi, "European Commission Study: The Promotion of Employee Ownership and Participation," 2014, https://doi.org/10.2780/15951.

57 BDO, "Employee Ownership Trusts ," July 19, 2019, https://www.bdo.co.uk/en-gb/insights/tax/global-employer-services/employee-ownership-trusts.

58 Ellerman and Gonza, "A Generic ESOP Employee Share Plan for Europe."

A made-in-Canada approach that offers this simplicity and clarity would mean adding a new form of business trust to facilitate a transition to employee ownership. A new Canada Employee Share Ownership Trust with requirements spelled out in legislation would provide an "off-the-shelf" option for companies to consider, make it easier to target incentives, and provide standard arrangements that make lenders more comfortable with financing transitions to employee ownership.

Barriers in Canadian trust law

Under the Income Tax Act in Canada, there are many different kinds of trusts, each with its own rules and requirements. On the surface, it is possible to create an employee ownership trust using some of these forms. However, based on a detailed legal review commissioned by Social Capital Partners, each of the existing forms of trusts include barriers that make it impossible or commercially unworkable as a pathway for employee ownership trusts.

For example, Express Trusts (the most basic form of trust) are fairly flexible, but employees would have to pay capital gains tax every 21 years on shares the trust had not sold. Other trusts are restricted from borrowing, from investing primarily in one company, or from holding shares long-term.

Even aside from these barriers, these trust options do not offer the clarity that has been key to success in the US and UK. Each Canadian employee ownership trust would need to be "custom-created" with lawyers and accountants in the documents spelling out the design of that trust. That burden alone would discourage many businesses from pursuing this route.

Creating appropriate incentives

Increased employee ownership produces higher-performing and more resilient firms, wealth for workers, and benefits for the broader economy. But the wide range of incentives and support for businesses in Canada (including federal and provincial tax incentives, grants, low-interest loans) do nothing to encourage broad-based employee ownership. Canada's tax system puts employee ownership transitions at a disadvantage compared to other forms of ownership.

For Canada to reach the levels of employee ownership, seen in the US and increasingly in the UK, and achieve the benefits for our economy and communities, the policy framework must ensure that owners are aware of and able to choose employee ownership, investors and lenders are encouraged to finance the transactions, and companies choose to remain employee-owned over the long-term.

Efforts to encourage employee ownership in other countries are generally targeted at four specific challenges for employee ownership:

- **Encouraging owners to choose employee ownership:**
  To level the playing field, jurisdictions have introduced modest incentives to encourage owners to sell to their employees and keep the company local instead of selling to outside buyers (often competitors or private equity). In the UK and in the US, owners can get deferrals and/or exemptions from some or all of their capital gains taxes if they sell to a qualifying employee ownership trust. This can increase the value of a sale to an employee ownership trust by 30-40 percent.
- **Supporting long-term sustainability:**
  Governments have also introduced incentives for employee-owned companies to help them pay back the debt associated with acquisition and to support the long-term sustainability of the company. In the US, all company contributions to a US-ESOP are tax deductible, and small businesses are fully exempt from income tax if they are 100 percent employee owned. The UK does not use corporate income tax incentives to encourage UK-EOTs.
- **Enabling a viable financial market:**
  In the early years of the US-ESOP trust, access to financing was a major barrier to encouraging more employee-owned firms, as it was a new structure that wasn't well understood. Incentives for lenders changed this dynamic and helped support a boom in the creation of new US-ESOP trusts. Starting in the mid 1980s, the US allowed lenders to deduct 50 per cent of the interest income they earned on loans to ESOPs from federal tax. By the time the incentive was removed in the mid 1990s, a more mature marketplace had developed and the incentive was no longer necessary.
- **Protecting employees from negative tax implications:**
  Importantly, most jurisdictions have made changes to ensure employees do not owe tax on the shares they receive until those shares are sold for cash. Because US-ESOPs are set up as retirement plans, they allow employees to defer tax for the long-term. In the UK, where the focus is on profit sharing, employees can receive up to £3,600 ($6,200 CAD) in bonuses from a UK-EOT tax-free each year. Canada lets employees who receive stock options and share grants from private companies defer tax, but it is unclear if employee ownership trusts would benefit from the same treatment.[59]

59 "Income Tax Act - Section 7," accessed June 23, 2020, https://laws-lois.justice.gc.ca/eng/acts/i-3.3/page-2.html.

CLIF BAR & COMPANY

Clif Bar & Company, headquartered in Emeryville, California, makes CLIF Bar and LUNA Bar energy bars. They were founded in 1992 by Gary Erickson and Lisa Thomas. After significant growth throughout their first decade, they received a $120 million USD acquisition offer in 2000 from Quaker Oats. Erickson decided he did not want to give up the company he founded and turned down the offer, buying out his partner. In 2010, Erickson and his wife/co-CEO Kit Crawford created an ESOP to sell 20 percent of the company to employees. The company has grown significantly since that time, from over 200 to over 1,200 employees and from over $200 million to an estimated $500 million to $1 billion USD in annual revenue. Employee ownership has been extended to newly-acquired operations in Indianapolis, Indiana and Twin Falls, Idaho. In addition to the ESOP shares, employees have access to a number of other benefits including a 401(k) retirement plan, paid time to volunteer, and cash towards bicycles or low-emission vehicles.

> ***Increased employee ownership produces higher-performing and more resilient firms, wealth for workers, and benefits for the broader economy.***

Effective oversight

With the use of incentives to encourage employee ownership trusts, it is important to ensure effective regulatory oversight to protect employees and the public interest. There are five key components of oversight should be considered for a made-in-Canada approach to employee ownership trusts:

- **Fair corporate valuations:**
  When owners arrange the sale of their shares to their employees, it is important to ensure that the price paid is fair and does not saddle the company with too much debt. Retiring employees in US-ESOPs also need guarantees of a fair price paid for their shares. In the US, trusts must get independent valuations at the outset and on an annual basis, and US-ESOPs are overseen by the federal Department of Labor. In the UK transitions are overseen by the tax department.
- **Equitable benefits for employees:**
  A key advantage of employee-ownership trusts is that, unlike stock options or share purchase plans, they benefit the full range of a company's employees. Both the US and the UK have clear rules that all employees participate in the plan on the same terms; employees can still receive different amounts based on hours worked, seniority, and compensation.
- **Effective corporate governance:**
  Employee ownership trusts generally rely on the same type of well-designed boards as other companies. Most lenders and advisors prefer supporting companies with a traditional board of directors and management team. A made-in Canada approach also provides an opportunity to create a governance model that remains attractive to outside capital providers while also enhancing employee voice, for example with employee representation. A UK study found that the employee board representation in employee owned companies was associated with greater productivity and a more engaged workforce.[60]
- **Management by trustees:**
  In employee ownership trusts, trustees are appointed to manage the operations of the trust (rather than the company itself) and make decisions on behalf of employees. A made-in-Canada approach needs to be thoughtful about the role and responsibilities of trustees, including what factors they take into account in making decisions and which issues are put to a vote of employee-owners.
- **Harmonized federal-provincial approaches:**
  In Canada, rules around fair treatment of employees and rules around securities and the operation of trusts touch on both federal and provincial responsibilities. A clear operating environment and effective protections in a made-in-Canada approach will depend on harmonization and alignment between Canadian governments.

60 Lampel, "The Employee Ownership Advantage - Benefits and Consequences."

Conclusion

Employee ownership trusts are smart public policy. They are a proven model, with over 40 years of real-world outcomes and significant amounts of research to demonstrate their value. Now is the time for Canadian policymakers to get serious about enabling them.

The COVID-19 crisis has laid bare that we may all be in the same storm, but we are not in the same boat. While many workers across Canada remain unemployed and small businesses are shutting their doors for good, wealthier Canadians have already seen stock portfolios rebound to pre-pandemic levels. There is a real risk that the crisis will accelerate unequal divisions like these across the Canadian economy — between urban and rural communities, between high- and low-income households, and between large and small businesses.

As policymakers look for ways to build Canada's economy back better than ever, no vision of prosperity can succeed without addressing the fact that seven in ten private business owners in Canada are looking to sell their businesses in the next decade — businesses that account for the majority of jobs in Canada and almost two-thirds of the country's GDP.[61] Given that this is the second major economic crisis in recent memory, even owners of successful businesses may accelerate plans to retire and sell. How these businesses are sold, and to whom, will have a profound effect on the future resilience of the Canadian economy.

As Canada looks to its recovery, employee ownership can be a tool to help build a more inclusive economy for all Canadians. We have good models to follow. In the United States, proactive and bi-partisan public policy has enabled millions of Americans to build wealth and has created a new form of ownership better able to weather economic downturns. The US example drove the UK to create their own approach to employee ownership that is showing early signs of success. A "made-in-Canada" policy framework for employee ownership could improve on these models and create a new pathway to build middle-class wealth, keep businesses local and increase economic resilience.

> **We have a chance today to make policy choices that will better prepare our economy for the next storm and help employees build real wealth.**

61 PwC, "Retirement Pushes Canadian Private Company Owners to Keep, Sell or Transfer Their Business," 2019, https://www.pwc.com/ca/en/media/release/retirement-pushes-canadian-private-company-owners-to-keep-sell-transfer-their-business.html; Canadian Federation of Independent Business, "Nearly Three Quarters of Small Business Owners Plan to Exit Their Business within the next 10 Years," 2018, https://www.cfib-fcei.ca/en/media/nearly-three-quarters-small-business-owners-plan-exit-their-business-within-next-10-years.


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