Exploring Employee Share Ownership as a Potential Investment Strategy in Opportunity Zones

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On October 9, the Aspen Institute Economic Opportunities Program, together with the Rockefeller Foundation, brought together a set of financial, legal, academic, and policy experts, along with individuals leading work in states and communities, to discuss ways in which Opportunity Fund investments could finance employee share ownership program (ESOP) conversion opportunities specifically and develop ideas to include employee share ownership within a Qualified Opportunity Zone's inclusive economic development strategy in general. This document, based on the day's discussion, offers the authors' views as to why employee share ownership is an important strategy that could meaningfully contribute to the expansion of high-quality economic opportunity within Qualified Opportunity Zones and summarizes key issues discussed with respect to how to align the mechanics of investing in ESOP conversions with the regulatory framework governing Opportunity Fund investments. The authors are grateful to the participants in the conversation for their time, expertise, and commitment to advancing quality economic opportunity in communities of need, and to the Rockefeller Foundation for its thought partnership and support for this work. The document is the work of the authors, and they alone are responsible for the content and opinions expressed.

For 40 years, economic prospects stagnated or declined for most working people despite great advances in economic growth and the nation's wealth. Real wages have been stagnant for decades, even during periods of substantial productivity growth, and in recent years even the most highly educated workers have experienced little real wage growth. While earlier generations might have expected to grow up and do better than their parents, recent research indicates this trend is reversing. Growth in profits and returns to capital, however, have increased, thereby deepening the chasm between Wall Street and Main Street.

Today, the United States economy is at a crossroads. Despite a decade of growth since the Great Recession, millions in America experience economic hardship and millions more feel economically insecure and marginalized. Gender, ethnicity, race, and place are intertwined in inequitable ways with the fortunes of working people, families, and communities, exacerbating the divisions in our economy and society. But it does not have to be this way. We have choices, and our choices will have great implications for an equitable and just future for working people. Creating systems with appropriate incentives, rules, and norms could create opportunities for millions more of our neighbors to earn and own.

The Qualified Opportunity Zone provisions included in the Tax Cuts and Jobs Act of 2017 are expected to spark significant new investments in communities that face some of the highest rates of poverty in the country. These provisions were designed to directly address place-based economic inequality. Focused on investors with significant capital gains, the legislation allows for deferring and reducing capital gains tax liabilities if gains are put toward qualifying investments in low-income, high-poverty census tracts. These investments have the potential to not only provide a new spark to high-poverty communities and struggling places, but also to address our society's deepening economic inequities across ethnic and racial groups, as designated Opportunity Zones are disproportionately communities of color. These communities need better opportunities for work, for business ownership, and for residents to have a better chance at fully participating in and benefiting from a flourishing US economy.

While the Qualified Opportunity Zones incentives could unleash needed capital in communities in ways that create much-needed work and wealth-building opportunities, this is not a foregone conclusion. Qualified Opportunity Zones could have a modest or even negative effect if the investments support businesses that create primarily low-wage jobs, residents are displaced by rising property values, and the ownership of business assets remains or becomes further concentrated outside the community. For the Opportunity Zone incentives to fulfill their potential for impact, it is essential that strategies that both encourage the development of high-quality jobs and offer working people a stake in the success of their local economy are supported. Employee share ownership is one such strategy.

What Are Opportunity Zones & Funds?

"An *Opportunity Zone* is an economically distressed community where new investments, under certain conditions, may be eligible for preferential tax treatment. Localities qualify as Opportunity Zones if they have been nominated for that designation by the state and that nomination has been certified by the Secretary of the U.S. Treasury via his delegation of authority to the Internal Revenue Service."

"A Qualified Opportunity Fund is an investment vehicle that is set up as either a partnership or corporation for investing in eligible property that is located in a Qualified Opportunity Zone."

From "Opportunity Zones Frequently Asked Questions"

https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions

Employee share ownership can take many forms, ranging from ESOPs, to worker cooperatives, to various types of equity grants and stock purchase plans, to a variety of profit-sharing opportunities. All forms of employee capital shares are worthy of encouragement in the context of strategies to revitalize communities and expand economic opportunity. In the context of retiring baby boomer business owners – what some have termed a "silver tsunami" – the ESOP conversion has been generating interest as an approach to retaining businesses, jobs, and wealth in communities and to increasing opportunities for employee capital share ownership. Investing in ESOP conversions within Qualified Opportunity Zones is a promising approach to expanding employee share ownership within those communities. Encouraging this kind of investment will be critical to ensuring that qualified investments provide not only tax benefits to the investor, but meaningfully improve lives and livelihoods within Opportunity Zone communities. With this goal in mind, the Aspen Institute Economic Opportunities Program, in partnership with the Rockefeller Foundation, hosted a meeting to explore the potential for investments in Opportunity Zones to support employee share ownership.

The discussion yielded four key insights about how ESOPs could be used to broaden ownership in Qualified Opportunity Zones:

- Real estate investment corporations created to manage real property in the Opportunity Zones can use existing ESOP legislation to create ESOPs that they would contribute to over time as part of their employees' retirement plans, thereby enabling them to have an ownership stake in those real estate investments.

- Similarly, existing corporations in Opportunity Zones could be encouraged to create ESOPs to allow their employees to benefit from the growth that added capital investment might enable in those corporations.

- Changes to or clarifications of the Qualified Opportunity Zone regulations could enable Opportunity Funds to invest in some types of ESOP transactions that transfer ownership of businesses whose owners are seeking to retire to the firm's employees and managers. The extent to which ESOP transactions may be feasible will depend in part on to what degree Opportunity Funds can be used to invest in businesses in existence prior to January 1, 2018.

- Statutory changes to the original Qualified Opportunity Zone legislation would be needed to allow a broader range of ESOP conversions to be financed within Opportunity Zones, keeping businesses, their jobs, and their economic growth within neighborhoods to benefit local employees with ownership stakes.

Employee share ownership in Opportunity Zone businesses has the potential to meaningfully contribute to the goals of the Opportunity Zone initiative by broadening opportunities for residents to both earn and own. Employee stock ownership plans (ESOPs) allow employees to own a share of the business they work for, giving them a greater stake in a company's success and helping them to build wealth. In many cases, ESOPs help retiring business owners to sell their businesses to employees, enabling the owner to retire while rewarding employees and keeping jobs in communities. Real estate investments in Opportunity Zones could also use ESOPs in real estate management companies to include employees in the gains those companies might experience.

What is an ESOP?

An Employee Stock Ownership Plan (ESOP) is an ERISA-qualified defined contribution benefit plan, like a 401(k), that can buy equity of the company sponsoring the plan for the benefit of its employees. An ESOP is the only ERISA-qualified plan permitted to borrow money to purchase employer stock; and is not required to be diversified. Shares can be purchased either from selling shareholders directly, or from the company (as newly issued shares). Congress created the legal framework for ESOPs in 1974 to provide a way for employees to participate in their company's equity appreciation through legislation that provides significant tax benefits to selling shareholders and sponsoring corporations.

Most ESOPs are created when owners of closely held firms (organized as either S or C corporations) are seeking to retire and sell their ownership interest in their firms. An ESOP trust is established that receives a loan, based on a business plan, and uses the proceeds of the loan to purchase an existing firm and holds the equity shares of the firm in trust for the employees. Importantly, the employees of the firm do not provide any cash or any collateral. The trust repays the loan out of the business' operating cash flows. The level of ownership held by the ESOP can vary. Some closely held firms allow employees to own a minority stake in a firm, while in other closely held firms the ESOP holds 100 percent of the stock. The management of the ESOP company is selected by a board of directors that typically includes management and outside experts; in some cases, the board also includes worker representatives. Federal law also mandates that workers vote on several major corporate issues.

The benefits of employee share ownership are well-documented. Research has shown that companies with employee shares, such as through an ESOP, have shown greater resilience in economic downturns and have performed better than peer companies (Blasi, Kruse, and Freeman, 2018). For example, one study showed that in the most recent recession, companies with employee share ownership were less likely to lay off employees or close altogether than were companies without employee share ownership. (Kurtulus and Kruse, 2017) Research has also shown that employee share ownership, combined with a supportive corporate culture, is associated with higher quality jobs, as measured by compensation, benefits, employee retention and satisfaction. (Blasi, Freeman, and Kruse, 2013, 2016; Kruse, 2016; Kruse, Freeman, and Blasi, 2010; Wiefek, 2017).

Across the country, including in Opportunity Zones, there are 2.34 million small-to-medium-sized businesses owned by baby boomers who can be expected to retire in the next 10 years. This so-called "silver tsunami" could involve as many as 24.7 million jobs, almost a billion in payroll annually, and $5 trillion in sales. Retiring business owners without a succession plan or a family successor can, through an ESOP, sell the business to employees rather than to a competitor or an outside investor, who may choose to relocate, close the business, or lay off workers. For well-managed and viable businesses, conversion to employee share ownership has a number of advantages for a community, primarily retaining jobs, business ownership, and anchoring wealth within the community as the local employees gain asset wealth on top of their wages. (Project Equity, 2018)

Establishment of an ESOP trust is a proven method of conversion to employee share ownership, with a history of success in the US. Using an ESOP or other plan, employees and managers can typically purchase a successful firm with loans or loan guarantees to an employee trust that does not require the use of savings by individual employees. Using 2014 US Department of Labor data, researchers at the Institute for the Study of Employee Ownership and Profit Sharing at Rutgers University find there are about 6,000 closely held ESOPs with about 2 million employees, with the total employee share ownership of about $255 billion. In most cases, the business owners converted their equity to ESOPs at the time of their retirement. Among these firms the average asset wealth in shares per employee is $134,000, and it is closer to a quarter of a million dollars for those employees who have been with the firm for more than 20 years (Blasi and Kruse, 2018)[1]. In smaller firms in which the cost and complexity of creating an ESOP does not make sense, retiring business owners have used conversions to worker cooperatives to transition ownership to their employees.

Experts gathered in New York at the Rockefeller Foundation to discuss the role ESOP conversions can play in advancing the important goals of the Opportunity Zone incentive. The meeting on October 8 included legal and finance experts with expertise in ESOPs and other employee share ownership mechanisms, legal and policy experts knowledgeable of the Opportunity Zone legislation and existing guidelines, leading researchers on employee share ownership and capital shares, and representatives of states and local communities working to advance the goals of Opportunity Zones in their regions.

The meeting included a detailed discussion of whether and how existing models for financing ESOP conversions might be applied within the context of Opportunity Funds, as well as other approaches that Opportunity Funds might take to invest in and support such conversions. At the time of the meeting, the US Department of Treasury had not yet released regulations for implementation of Opportunity Zones. The discussion addressed the following issues and questions:

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[1] Analysis of ESOP Data from 2001-2014 by Douglas Kruse and Joseph Blasi, Rutgers University Institute for the Study of Employee Ownership and Profit Sharing, 2017. Available at: **https://smlr.rutgers.edu/content/shared-capitalism**.

- *What types of regulatory or statutory changes would be needed to enable Opportunity Funds to provide the types of capital used in ESOP conversions?* The Opportunity Zone program is designed to incentivize the flow of equity into low-income communities. While some ESOP transactions include equity (which would qualify), many involve debt, and some use preferred equity, or structured equity in the form of notes and warrants. The group generally agreed that regulatory guidance or changes could enable Opportunity Funds to use structured or preferred equity for ESOP transactions, but that statutory change would likely be required to enable investments that use more standard forms of debt.

- *What is the threshold for a "substantial improvement" in a Qualified Opportunity Zone business?* Because Opportunity Fund investments are intended to drive new economic activity in designated Opportunity Zones, the simple transfer of ownership that takes place via ESOP transactions may not be sufficient for an investment to qualify. Any investment must be accompanied by a tangible improvement in the value of the business or property. The specific methodology by which "substantial improvement" will be assessed had not yet been released at the time of the meeting[2]. This provision will likely limit the types of ESOP transactions that will qualify as Opportunity Fund transactions.

- *What is the process by which property will be determined to be located in an Opportunity Zone?* To be considered as qualified opportunity zone property, the asset in question must be located in an Opportunity Zone[3].

- *How quickly must Opportunity Funds deploy investments?* At the time of the meeting there was not yet regulatory clarity regarding how quickly any funds invested in an Opportunity Fund must be deployed into an initial qualified investment[4]. However, experts consulted in the preparation for our convening noted that the length of the time frame will directly affect the extent to which ESOP transactions will receive financing from Opportunity Funds. Business investments typically take longer to develop and complete than real estate investments; ESOP transactions typically take even more time given the required changes in management.

Most believed the concerns could be addressed with clarifying regulatory guidance, while some believed that a statutory change that positively encouraged and affirmed support for conversions to employee share ownership within Opportunity Zones was also needed to provide further clarity and confidence for investors. Since the meeting, on October 19, 2018 the US Department of Treasury released its first proposed regulations on the Opportunity Zone program (see 26 CFR Part I [REG-115420-18] RIN 1545-BP03). Review of the guidance reveals that many of the above areas of uncertainty for ESOPs remain, while some of the details regarding Opportunity Fund investments in general and Opportunity Fund investments in existing businesses were clarified.

The group identified steps that need to be taken to ensure that employee share ownership models make it into Opportunity Zone investment considerations. Beyond clarifying and potentially expanding the regulatory and statutory framework, more work is needed to raise awareness of and build capacity to

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[2] Pending regulations released on October 19, 2018 clarify that "substantial improvement" is defined as 90 percent of value added.
[3] The pending regulations also clarified that 70 percent of tangible assets must be located in an Opportunity Zone.
[4] The pending regulations released on October 19, 2018 note that 90 percent of funds must be deployed within 180 days, and that funds are considered deployed if a written plan for expenses over a 31-month period is adopted and substantially followed.

support the use of employee share ownership models in Opportunity Zones. Many business owners are not aware of the option of converting their business to an ESOP at retirement and are more likely to consider selling to an investor, competitor, or other buyer. The management transition needed to make an ESOP work can take time too, so planning should begin a few years before the business owner expects to retire. Work needs to be done to raise awareness among businesses and to build capacity among business advising organizations and lenders and investors so that they are comfortable working with clients on this approach. Local and state economic development organizations should also understand more about the benefits of employee share ownership and how ESOP conversions can help retain jobs and improve economic opportunities in the areas where they work.

The group also agreed that communities within Qualified Opportunity Zones, investors in Opportunity Zones, and professionals advising them should be encouraged to incorporate ESOP conversions into their broader Opportunity Zone strategies, even if they are initially financed separately from Opportunity Fund investments. Communities have other tools at their disposal that they can use to encourage and support employee share ownership; doing so can help to ensure that the developments that take place in Opportunity Zones benefit the low-income residents who live and work there. For example, local governments can use economic development tools, such as tax increment financing districts, to create incentives for ESOP conversions, or they can use procurement preferences to promote employee share ownership more broadly. Firms in Opportunity Zones could be encouraged to set up ESOPs under existing tax incentives for any companies that are involved in Opportunity Zone investments.

Since the meeting in October, the Economic Opportunities Program has continued to explore whether and how Qualified Opportunity Zones might invest in or support ESOP transactions, consulting with additional experts with knowledge of ESOPs and Opportunity Zones. We are continuing to hear creative approaches being raised, such as:

- ***Can Opportunity Funds be used to finance the acquisition and improvement of land owned by retiring business owners who sell to their employees?*** Business owners often own the land on which their firms operate. In some cases, as employees acquire the firm, it makes sense to separate the land from the operating business, relocating the business to another site. Opportunity Fund capital might be used to support purchase and improvement of the land, making acquisition of the firm by the workers more feasible.

- ***Can ESOPs be an inclusive and responsible way for investors to exit from their investments in Qualified Opportunity Zones at the end of the 10-year investment period?*** Social and impact investors are currently considering whether there are ways to exit from Opportunity Funds that benefit community residents rather than external investors. Creating an ESOP could be one means to this end.

- ***Can the Opportunity Zone regulations be clarified to include the structured equity used by ESOP-owned S corporations under the definition of "qualified opportunity zone stock"?*** The City of Newark has submitted a comment to the Treasury Department recommending this regulatory change.

Opportunity Zones could unleash substantial investment in some of the most investment-starved communities in the US. For these investments to realize their aim of improving opportunity for the members of these communities, however, the investments must lead to improvements in opportunities to work and in opportunities to start businesses and to own business assets. Investments that include employee capital share strategies can fulfill these aims and make a meaningful difference in people's ability to build livelihoods and to own assets that offer a measure of economic stability and security. Employee capital share strategies in general, and ESOPs in particular, can contribute to business retention, job growth, improved quality of employment, and broader and more inclusive opportunities for ownership of business assets. But including employee capital share strategies in Opportunity Zones will take creativity and hard work among a range of actors to navigate regulations, build awareness and understanding of the strategy, and develop needed capacities across a range of institutions. The Aspen Institute Economic Opportunities Program looks forward to continued work with the Rockefeller Foundation, the Institute for the Study of Employee Ownership and Profit Sharing at Rutgers University, the experts who joined this meeting, and others to advance this work. We're grateful to all for their contributions to this important conversation about a very promising approach to achieving this end and look forward to continued work to bring these ideas to actions that make a difference in communities.

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