



# Expanding ESOPs or Experimenting with ESOPs?

## Lawmakers should not confuse Short Term Equity Plans with actual ESOPs.

### Summary

Employee ownership, broadly defined, has several forms – employee stock ownership plans (ESOPs), employee ownership trusts, cooperatives, and other models. Currently, in America and around the world, ESOPs represent the most significant and truly broad-based form of employee ownership, by a large magnitude. An ESOP is a qualified retirement plan that is clearly and specifically defined by the Employee Retirement Income Security Act of 1974 (ERISA), including significant protections and safeguards for the interests of employee beneficiaries and their accounts. Importantly, Congress also provided tax incentives for ESOP companies and their founders which, combined with employee retirement savings, creates a powerful economic engine that helps achieve several well-documented public policy goals.

ESOPs, therefore, are very specific things within the law and are very special successes in public policy. Because of their popularity among lawmakers and their constituents, it has recently become attractive to try to associate all kinds of ideas and experiments with the “ESOP” concept. However, simply labeling something as an “ESOP” does not make it so.

### Private Equity’s Experiments With Ownership

Recently, private equity (PE) firms, private investors, and investment banks have experimented with granting equity to the employees of companies they purchase. “Ownership Works”, a group that Pete Stavros (Co-Head of Private Equity for KKR) funded and launched in 2021, focuses on incubating and testing these shared equity arrangements within private equity firms. The ESOP Association is not criticizing any investment firm that makes the decision to use what are essentially stock bonuses to better align employee interests with the company, reduce turnover, and achieve larger and faster profit. However, these bonuses are not ESOPs, and investors’ existing activity shows that implementing them requires no change in law.

### Expanding ESOPs’ Agenda: Tax Breaks and Immunity from Oversight

“Expanding ESOPs”, a group also founded by Pete Stavros in 2024, has the stated intention of changing government ESOP policy. It is vitally important to understand that despite its name, *Expanding ESOPs* is not seeking to “expand ESOPs” as they have been known and existed for the last five decades. *Expanding ESOPs’* agenda is to create an entirely new entity, one they want to call an ESOP under ERISA. These new entities would come with an entirely new structure of tax deductions and deferrals, reserved exclusively for the private equity firms sponsoring the plans. The Budget Lab at Yale University found that these incentives would cost taxpayers nearly \$100 billion over the first 10 years of implementation and over \$524 billion over the next 10 years.

Additionally, private equity firms would receive significant exemptions from ERISA and protections that completely shield their valuation of shares and plan administration from oversight and litigation. Initially, the group posted detailed policy proposals and shared them directly with The ESOP Association. But when their effort was formally launched, they removed those details from their website. The group’s leadership replaced

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the content with a significantly abbreviated version, presented to the public as merely 'principles.' The major tenets of their detailed policy agenda are subsumed in these principles and remain intact, even when filtered through their public principles. These new entities are more accurately termed Short Term Equity Plans (STEPS).

## What Are STEPs?

According to *Expanding ESOPs'* policy proposal, a STEP would work like this:

- When a private equity firm buys a company, 10% of the company's equity would be granted to employees.
- The grant is funded based on the amount of tax savings the private equity firm receives by doubling its payroll tax deduction (not through the profits of the company, like an ESOP does).
- The private equity firm would receive legal immunity pertaining to valuing the price of shares to be bought or sold.
- Employee shares would have little to no value - and employees cannot sell them - unless they are employed when the private equity firm sells the company for a pre-determined profit margin.
- Employees receive nothing if they are fired, retire, pass away, or the private equity firm fails to meet its profit target.

To finance these arrangements and increase their acceptance as a management practice, *Expanding ESOPs* would like to introduce this STEP structure under existing federal ESOP policy, capitalizing on the positive reputation of ESOPs. Plainly, they would like to associate their new proposal with the proven good of ESOPs in order to obtain tax incentives for these experiments without facing the same accountability to the employees or taxpayers currently required of actual ESOPs.

If adopted, it is hard to imagine why an investment company would **not** incorporate this model into a transaction, especially since the cost would be fully borne by the taxpayer. Why wouldn't every investment firm use a tax provision so generous? The investors would get the benefit of lower voluntary turnover, higher productivity, and likely a higher return, all realized over a shorter period through a massive taxpayer subsidy with no government oversight. The employees **might** get a potential windfall when the company is sold – **if** they are still with the company and the investors achieve their pre-determined ROI first – while the taxpayer gets the bill.

**STEPS are simply not ESOPs.** Elected officials should not be confused by STEPs, and they should not be categorized as ESOPs. They are very different structures with unproven public benefit for the cost associated with the significant tax incentives being sought.

## What Are An ESOP's Obligations Under ERISA?

ESOPs have specific requirements under ERISA. Those obligations mean transparency, ownership that comes with irrevocable rights, and significant legal and fiduciary protections for employee owners. For example, an ESOP:

- Is required to have individual accounts for each plan participant and is required to tell plan participants their account value and allocations annually.
- Must disclose how those allocations are made, tell employees how the company performed, and how much their account is worth every year.
- Must have a trustee serving as a fiduciary to the ESOP participants who is accountable to the employee owners with authority to act on their behalf.
- Is required to pay employees the value of the stock allocation they hold in their accounts if they leave the company for any reason, including their termination, not just at retirement.

These, and other, legally mandated requirements of ESOPs constitute real employee ownership, with enforceable protections and transparency. Any version of employee ownership that lacks these important criteria must not be called, treated like, or incentivized as an ESOP.

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## ESOPs Provide Public Good in Return

Why do ESOPs deserve their current tax and regulatory treatment? Because the **public** derives extensive benefits in exchange for the favorable tax status provided to ESOPs. Specifically, Congress envisioned a public good via ESOPs by which average employees would enjoy more financially secure retirements. Employees achieve this by receiving a growing financial interest in the company they help build, which in turn reduces the public exposure to the harm and costs of financially insecure retirees.

This was the main goal of ERISA – to create more retirement security for American workers – and ESOPs have been more effective than any other plan envisioned within ERISA in producing retirement savings. ESOP participants have more than twice the average retirement savings compared to other workers. ESOPs receive modest tax incentives compared to the public good they create. Those tax incentives are largely, if not entirely, recovered when employees receive their distributions as ordinary income in retirement (which is taxed between 10%-37% and more often at higher rates than the corporation would have paid in a much lower effective corporate tax). From the public standpoint, over the last 50 years ESOPs have also resulted in:

- Significantly more financial security in retirement for employee owners.
- Local job retention – especially in manufacturing, construction, and engineering, which are top economic sectors for ESOPs.
- Local wealth retention and the associated local economic multiplier, especially in rural communities.
- Greater company productivity.
- Lower employee turnover.
- Better employee benefits and a higher quality work environment.

As an economic and policy idea, ESOPs are uncommon. Politicians on the left, right, and center have long supported ESOPs as good public policy. But simply labelling something an ESOP does not guarantee these benefits or outcomes, nor does it promote the public good.

## ESOPs Are Designed for Longevity, Not Quick Turnarounds

Traditionally ESOPs are designed for an enduring legacy or even permanence when a founder sells their company to its employees. The transaction unleashes the true potential of employee ownership when it offers employees a real ownership stake in the business and the opportunity to build lasting wealth and retirement security. ESOPs are designed to be “evergreen”, meaning: a well-run ESOP with a proper sustainability plan can survive multiple generations of employee owners, while the ongoing enterprise survives and continues to grow. These incentives and alignment are the real drivers of ownership culture and mindset for ESOP employees. In contrast, STEPs are based on a far shorter investment horizon, typically a five-to-seven-year window for resale following the initial equity investment. The stock incentives in this shorter turnaround time are functionally a modest amount of profit sharing to reduce voluntary turnover. If the employee is still with the company when it is sold, a modest pay day does not mean a more secure retirement.

## What's Missing from the *Expanding ESOPs* Proposal?

A lot. In fact, the investment firm proposals lack nearly all the principles ESOPs are founded upon that make them successful public policy.

- **Ownership** – Short Term Equity Plans (STEPS) don't provide a contract that tells employees what they do (or don't) own, nor payment when employees retire, pass away, leave the company, or get terminated ahead of its sale.
- **Transparency** – STEPs don't provide annual valuations that disclose to employees what their equity interest is worth. They also don't specify terms and conditions under which employees would be paid, or if the investors must meet certain benchmarks or returns before any of the retention bonuses are triggered at the company's sale.

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- **Protection** – STEPs don't provide a fiduciary responsible for protecting employees' interests.
- **Longevity** – A PE firm's entire goal is to sell the company – the opposite of permanence. Employees *MAY* get paid after the investors and only when the PE firm sells the company.

The proposal by *Expanding ESOPs* cannot promote its own namesake goal – it isn't expanding *actual* ESOPs. At best, it's a misnamed attempt intended to secure taxpayer-funded benefits for private equity's business model with limited benefit to employees or the public.

## Conclusion

The ESOP Association does not oppose employees at PE portfolio companies receiving equity or a payout. In fact, the recognition of employee ownership's benefits – its power to improve companies, increase competitiveness, and support worker satisfaction and engagement – is an encouraging development from past behavior of private equity firms. To be absolutely clear – no current laws must change to allow for this practice. But any proposals, like *Expanding ESOPs'* STEP proposal, seeking legislative and regulatory changes that water down ERISA's employee protections and effectively force American taxpayers to subsidize PE's small equity grants to employees must be viewed with a high degree of suspicion. Any legislative attempt by private equity to create an entity that would increase burdens on taxpayers without government oversight or worker protections is *not an ESOP in any sense of the term*.

Effects on Employees, Businesses, and Communities	STEP	ESOP
<b>Employee Protections and Benefits</b>		
Greater retirement savings	?	✓
Employees hold an irrevocable right to the known value in their individual capital account and its appreciation	✗	✓
Annual ownership allocation	✗	✓
Annual company valuation that is transparent and shared	✗	✓
Require a trustee to ensure that fair market value is paid for shares bought OR sold	✗	✓
Specific vesting schedules and requirements under law	✗	✓
Required payout regardless of reason for employee departure/separation	✗	✓
Trustee with governance authority (can over-rule management) and a fiduciary duty of loyalty and prudence to the plan beneficiaries	✗	✓
Transparency on the terms and conditions of payout	✗	✓
<b>Company and Community Benefits</b>		
Company profits contribute to employee's ownership stake	✗	✓
Employee/employer alignment	?	✓
Lower turnover	✓	✓
Local wealth retention	✗	✓
Creates local job security	✗	✓
Goal is to sell company	✓	✗
Maximum employee ownership	10%	100%

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