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Report to the Chairman, Subcommittee on Federal Services, Post Office and Civil Service, Committee on Governmental Affairs, U.S. Senate

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FEDERAL PERSONNEL

Status of the Federal Employee Direct Corporate Ownership Opportunity Plan

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The Honorable David Pryor
Chairman, Subcommittee on
Federal Services, Post Office
and Civil Service
Committee on Governmental Affairs
United States Senate

Dear Mr. Chairman:

This report is in response to your March 22, 1988, request for information concerning the Federal Employee Direct Corporate Ownership Opportunity Plan (FED CO-OP). FED CO-OP is a plan being implemented by the Offices of Management and Budget (OMB) and Personnel Management (OPM) to increase contracting out efforts. The FED CO-OP method of contracting out offers affected employees stock in private companies that take ownership of activities previously administered by the federal government. The stock is paid for by the government from a portion of the savings achieved through contracting out. (For a detailed example, see app. I.) Specifically, we were asked to determine (1) how the plan evolved, (2) the plan's status, and (3) OMB's future plans for FED CO-OP. Additionally, you asked us to determine who would receive the stock remaining in the employees' stock-ownership plan (ESOP) if all the former federal employees participating are terminated before the plan expires.

Results in Brief

FED CO-OP evolved through the efforts of OPM and OMB to increase the contracting out of the government's commercial-like activities by providing affected employees incentives to join those companies that receive the contracts. The plan was developed by OPM and then transferred to OMB for implementation in November 1987.

The Department of Agriculture's National Finance Center (NFC), has been considering contracting out under FED CO-OP. Agriculture has hired an accounting firm to determine its cost of operations but the agency believes that the activity would not be privately operated before mid-1990. No other examples of the plan's usage were known to OMB. As of February 1989, OMB was identifying potential future participants but had put further contracting out efforts on hold until it is clear what direction the new administration wants to pursue.

FED CO-OP involves several unanswered questions, including whether employees who had never previously worked for that federal activity could be excluded from receiving federally funded ESOP stock bonuses, and whether FED CO-OP ESOPs qualify under the Internal Revenue Code for certain tax benefits. The current law applicable to qualified ESOPs may prevent exclusive participation by former federal employees.

We believe that the federally funded portion of ESOP stock bonuses should benefit only former federal workers employed by the contractor. Accordingly, OMB needs to explore ways to achieve this, including either restructuring FED CO-OP or possibly seeking legislative changes. Also, questions on the tax status of ESOPs under FED CO-OP need to be answered.

OMB officials concurred that these questions are valid. They also agreed with our recommendations to explore ways to limit the federally funded portion of ESOP bonuses to former federal employees and to look into the income tax issues involved in the ESOP proposal.

Objectives, Scope, and Methodology

To determine the evolution and status of and the future plans for FED CO-OP, we obtained information primarily from interviews with officials at OMB, OPM, NFC—which is the only agency currently considering FED CO-OP—and the former OPM consultant involved with developing FED CO-OP. Although these sources generally confirmed each other's information, we did not independently verify all the information to assess its accuracy nor did we make a comprehensive assessment of the merits of the FED CO-OP concept. We reviewed a May 1988 study for the National Commission for Employment Policy entitled Privatization and Public Employees: The Impact of City and County Contracting Out on Government Workers; OMB Circular No. A-76, "Performance of Commercial Activities;"[1] and other relevant documents, such as the tax laws governing ESOPs. Our work, done between July 1988 and February 1989, was in accordance with generally accepted government auditing standards. Responsible officials at OPM, OMB, and Agriculture provided informal comments on this report, and these comments are presented on page 9.

Evolution of FED CO-OP

OPM, the President's Council on Management Improvement, and OMB believed they needed to develop a process that would substantially increase the rate at which the government's commercial activities are

[1] The government has traditionally followed OMB Circular No. A-76's procedures for contracting out.

contracted out to private firms. OPM believed that the 6,678 and 6,524 federal jobs contracted out in fiscal years 1984 and 1985, respectively, were insufficient.

While in England, the Director of OPM met with British officials and saw media accounts of England's successful contracting out efforts accomplished through the use of ESOPs. These plans allowed those civil servants who transferred to private firms to acquire stock in those firms. Upon her return in February 1986, the Director asked her Associate Director for Administration to explore the use of ESOPs to encourage contracting out in the federal government.

The OPM Associate Director for Administration became the director of a task group on contracting out commissioned by the President's Council. The President's Council believed federal employees were concerned about the impact of contracting out on job security, pay, and benefits. The task group met with several management and industrial associations and other private groups. They developed five potential approaches for minimizing pay reductions and providing employee incentives for participation and issued a report in July 1986. One of these approaches was similar to FED CO-OP in that it provided for the contractor to purchase the government's commercial activity and considered stock ownership for the employees.

According to the Special Assistant to the Chief of Staff for the Director of OPM, OPM used some preliminary data from the Council's study and its own research to develop and issue a concept paper outlining FED CO-OP in July 1986. This paper said that FED CO-OP needed to meet three basic criteria critical to gaining the support of the main participants. These criteria were to (1) address federal employee interests and concerns, (2) address business concerns, and (3) be fiscally sound. One of the benefits identified in the paper involved partial ownership of the private firm by the former federal employees.

OPM issued the concept paper and on the basis of comments from the public and the private sector decided that an ESOP should be included in the approach as the mechanism for employee ownership. According to an OPM official, OPM needed expertise concerning ESOP laws and regulations, so it hired a consultant with legal experience in the establishment of ESOPs in state and private organizations. While working for OPM, the consultant developed a technical paper explaining how ESOPs function under different scenarios and some of the laws governing ESOPs. This technical paper was used by OPM staff in developing the initial FED CO-OP plan issued in April 1987.

The plan differed from the July 1986 concept paper. For example, the concept paper provided for federal employees to own a share (up to 49 percent) of the newly formed subsidiary.[2] The April 1987 plan used an ESOP to give the employees a share in the parent company. The plan also included several suggestions for legislative changes to remove limits from employees' bonuses to allow employees terminated by the subsidiary after 180 days to still receive a substantial ESOP bonus. The April 1987 plan included three employee benefits not previously found in the government's contracting out procedures. This plan:

- offered partial ownership of the company via an ESOP to the activity's former federal employees who accept employment with the contractor,
- guaranteed employment with the company's subsidiary for a minimum 6-month period, and
- ensured an outplacement service for those employees whose employment was terminated by the FED CO-OP firm during the first 365 days of the contract.

It also indicated that pilot projects were being sought whose progress could lead to additional revisions to the program.

In November 1987, OPM published a more technical version of the plan entitled FED CO-OP, Blue Print for Implementation. The plan stated that it was based on the policy guidelines of OMB Circular A-76. This version of the plan cited the criteria an agency must meet before it can consider FED CO-OP for an activity. They were: (1) the service must be obtainable from a commercial source, (2) the activity must have at least 50 full-time employees, and (3) the agency must be authorized to contract for commercial services.

The version also contained provisions similar to the April 1987 version. It (1) required a private accounting firm to determine objective and current actual costs of an activity's operations; (2) set requirements for the Request for Proposals (invitations to bid); (3) explained the requirements for establishing an ESOP, including how to set up individual stock accounts for employees and the types of securities that were acceptable; (4) guaranteed 6 months of employment; (5) stated outplacement service

[2]To obtain a government contract, FED CO-OP requires the contractor or parent company to form a subsidiary to do the activity's work.

requirements; and (6) provided an example of a FED CO-OP model. The document concluded that additional revisions to the plan were likely as pilot cases are established and implemented.

OPM and OMB officials agreed that FED CO-OP should be administered by OMB. OMB established the Office of Privatization in October 1987 and assigned responsibility for FED CO-OP to this office in November 1987. The Office adopted OPM's November 1987 plan, which provided guidance for agencies seeking to participate.

FED CO-OP's Current Status

OMB has been contacted by agencies concerning FED CO-OP. It has also identified agency activities as potential candidates for contracting out through a review of some agencies' inventories of activities that could be contracted out. None of these agencies have decided to contract out using FED CO-OP. However, Agriculture is studying the possibility of contracting out via FED CO-OP.

NFC's Director said that when Agriculture officials told NFC they were considering contracting out its commercial activities, NFC suggested using FED CO-OP rather than the government's traditional procedures because it appeared to have more benefits for the employees. Agriculture's Office of Financial Management let a contract on September 14, 1988, to an independent accounting firm to determine NFC's current operating costs. The cost information developed will be provided to prospective contractors during the FED CO-OP solicitation period if the process advances that far. An Agriculture official responsible for coordinating the FED CO-OP process said that if contracting out is deemed beneficial, solicitation of contractors' bids would probably occur in mid-1990.

According to the Policy Analyst responsible for FED CO-OP in OMB's Office of Privatization, other agencies that initially targeted potential candidates have decided not to contract out these functions for several reasons. These reasons include employee resistance, an insufficient number of full-time employees to qualify for establishing an ESOP, and the realization that FED CO-OP would not give the activity's employees full ownership of the private subsidiary.

FED CO-OP's Future Is Uncertain, and Several Questions Remain Unanswered

The OMB Policy Analyst said that the new administration will most likely address further implementation of the FED CO-OP program in early 1989. Meanwhile, OMB is identifying some additional activities as possible candidates and is aware of several questions concerning FED CO-OP's current policies.

The Policy Analyst said that OMB did not intend to initiate contracting out efforts under FED CO-OP before the change in administration, explaining that a new administration will want to establish its own policies for contracting out. OMB will continue to review agencies' inventories of commercial-like activities to identify potential candidates that will be presented to the new administration in early 1989. In the meantime, several unanswered questions remain about the program. For example:

- Can federally funded ESOP stock bonuses be restricted to only the former federal employees?
- Will a sufficient portion of the firm's employees participate to meet federal tax code requirements?
- Does the FED CO-OP approach for establishing ESOPs meet the Internal Revenue Service's (IRS) requirements of a permanent and continuing arrangement?

ESOP Participation

FED CO-OP requires the contractor to create an ESOP and pre-fund it, generally at a value equal to 50 percent of the government's savings for the length of the contract. The contractor also is required to purchase its own stock, which it puts into the ESOP. The contractor then receives periodic federal payments for its expenses, including the cost of the stock. The contractor is to set up the ESOP with an account for each participating employee. A share (stock bonuses) of the ESOP is released to eligible employees in increments. For example, if the contract was for 3 years, one-third of the ESOP stock would transfer annually to the employees' accounts.

Although ESOPs would basically be funded by federal payments, nonformer federal employees would also apparently receive ESOP stock bonuses during a contract's life. ESOPs are governed by the Employee Retirement Income Security Act of 1974, which requires an ESOP to meet the qualification requirements of the Internal Revenue Code. From our reading of the Code, it appears that current law may prevent exclusive participation by former federal employees. We also believe that nonfederal employees would apparently receive all remaining stock bonuses if all of the former federal employees were terminated before contract completion.

To qualify for certain tax benefits, ESOPs must satisfy certain rules applicable to all qualified employee benefit plans, including minimum participation standards designed to prevent discrimination in favor of officers, shareholders, or highly compensated employees. Additionally, the plan may not qualify if it discriminates in eligibility requirements, contributions, or benefits in favor of these individuals.

The Acting Deputy Director and the Policy Analyst, Office of Privatization, said that while they wanted to limit ESOP stock bonuses to former federal employees, the former OPM consultant told them that current Internal Revenue Code requirements restrict OMB from excluding a subsidiary's nonformer federal employees from receiving ESOP stock bonuses. The Acting Deputy Director and the Policy Analyst said that all of the subsidiary's employees will receive ESOP stock bonuses. They believe that enough federal employees required to operate the activity will transfer to the subsidiary, so that the subsidiary would need to employ only a minimum number of nonfederal employees who would receive ESOP stock bonuses. However, they are considering either having the contractor fund all nonfederal employees' bonuses or reducing the portion of the federal payments for the ESOP when former federal employees are terminated. This would be done to eliminate or minimize the extent to which nonformer federal employees receive federally funded ESOP stock bonuses.

ESOP Duration

Income tax regulations require that a pension plan be established with the intent that it will be a permanent and continuing arrangement. The regulations state that if a plan is terminated within a few years after establishment for reasons other than business necessity, such an action would be construed as evidence that such a plan, from its inception, was not a bona fide program for the exclusive benefit of the employees. If an ESOP does not qualify as a permanent or continuing arrangement, the participating employer and employees are not eligible for tax benefits.

ESOPs established under FED CO-OP provide for the full disbursement of stock to the employees' accounts in a specified period of time (the life of the contract), which can be for a brief period, such as 1 year. As long as at least one of these employees remains with the subsidiary and the subsidiary remains in business, stock will remain in the ESOP's employee account. If the firm went bankrupt or all the employees in the ESOP left and withdrew their stock, depending upon when this occurred, the ESOP might not meet IRS' definition of a permanent arrangement.

OMB's Acting Deputy Director and the Policy Analyst, Office of Privatization, said that OMB plans to involve only the types of government activities that can sustain operations in the private market even if the government contract expires. These officials believe it is unlikely that all the participating employees would leave the subsidiary and withdraw their stock, thus the ESOPs would continue to exist. If the firm does fail after the government contract expires, OMB believes IRS would allow the tax benefits. The Acting Deputy Director said OMB has not requested an opinion from IRS on this issue.

Conclusions

FED CO-OP is an evolving program and, as such, will require revisions as unforeseen situations arise. Potential problems that can be addressed at this time are the distribution of ESOP bonuses and the ability of these ESOPs to qualify for tax benefits.

We believe that the federally funded portions of ESOP stock bonuses should not be paid to nonformer federal employees and that OMB needs to explore ways to achieve this, including either restructuring FED CO-OP or possibly seeking legislative changes. If OMB chooses to make all subsidiary employees eligible for ESOP stock bonuses by requiring contractors to fund the nonformer federal employee portion, it appears OMB will have sufficient employee participation in each ESOP to comply with some of the Internal Revenue Code participation requirements. The ESOPs as currently planned, however, may not meet other requirements for participation or for a permanent and continuing arrangement. If the ESOPs do not qualify, the participating employers and employees cannot obtain certain tax benefits under the Internal Revenue Code. OMB may need to request an advance ruling from IRS on whether the FED CO-OP ESOPs would comply with the Code requirements and if not, what modifications would be necessary. If the ESOPs are not in compliance, OMB may need to restructure FED CO-OP or seek changes in legislation or regulations.

Recommendations to the Director, OMB

We recommend that the Director require OMB's Office of Privatization to explore ways to ensure that (1) the federally funded portion of ESOP stock bonuses are paid only to the former federal employees who were initially employed with the subsidiary, even if all of the former federal employees have been terminated; and (2) the ESOPs meet IRS' requirements. To accomplish these objectives the Office of Privatization may need to restructure FED CO-OP or seek changes in legislation or regulations.

Agency Comments

We discussed our report with officials at OMB, OPM, and Agriculture. They generally concurred with the information in the report and offered a number of technical suggestions that have been incorporated in the report as appropriate. In addition, OMB officials agreed to explore options for preventing the distribution of federally funded ESOP stock bonuses to nonformer federal employees and for addressing the tax implications of FED CO-OP ESOPS.

As arranged with the Subcommittee, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after its issue date. At that time we will make copies available to OMB, OPM, the Department of Agriculture, and other parties upon request.

This report was prepared under the direction of Bernard L. Ungar, Director, Federal Human Resource Management Issues. Other major contributors to this report are listed in appendix II.

Sincerely yours,

Richard L. Fogel

Richard L. Fogel
Assistant Comptroller General

Example of FED CO-OP Based on November 1987 Plan

The following is a general example of how the FED CO-OP plan is intended to work:

- A federal agency decides to contract out a commercial activity it administers that employs a minimum of 50 people.
- The agency contracts with a private accounting firm to determine the actual cost of the activity.
- The accounting firm finds that the activity costs the government $1 million per year to run.
- The agency then sends out a Request for Proposals.
- Parent Corporation determines that it could make an acceptable profit running the same operation for $700,000 per year.
- It makes plans for the creation of a 100-percent-owned subsidiary company, Newco, to run the activity. Plans are also made for Newco to create an employee stock-ownership plan.
- Parent Corporation submits a bid in response to the government's Request for Proposals for $850,000 per year, because the $300,000 the government could save ($1 million government operating cost versus $700,000 for contractor) if it selects Parent Corporation must be equally shared by the government and the employees for whom the ESOP is created. ($700,000 plus half of the $300,000 savings, or $150,000, for total bid of $850,000.)
- Parent Corporation wins the government contract and establishes Newco with sufficient working capital to operate the activity.
- The activity's federal employees make their decisions on whether to transfer to Newco or pursue another course of action. All employees in the affected activity will have the rights and options available under reduction-in-force procedures. These include severance pay and involuntary retirement rights.
- Newco must create and pre-fund the ESOP for the length of the contract, in this case 3 years. To do so, it borrows $450,000 from a bank ($150,000 per year times the 3-year length of the contract) on a 3-year loan and uses the money to buy Parent Corporation stock for the ESOP.
- After the first contract year, one-third of the ESOP stock is released from a suspense account to the employee accounts. The same is done for the following 2 contract years. As the suspense account is depleted, all stock is allocated to the remaining employee accounts in the ESOP.

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