

**The ESOP Association's Statement to the Small Business
Subcommittees on Rural Enterprises, Agriculture and Technology
and Tax, Finance and Exports Hearing on "Transforming the Tax
Code: An Examination of the President's Tax Reform Panel
Recommendation"**

February 1, 2006
2360 Rayburn House Office Building

The ESOP Association is a national 501(c)(6) business trade association representing over 1,400 U.S. corporations that are partially, or wholly owned by an employee stock ownership plan (ESOP), and over 900 professionals who provide services to corporations with ESOPs.

We are pleased that the Small Business Subcommittees on Rural Enterprises, Agriculture and Technology and Tax, Finance and Exports have joined to examine the recommendations put forth by the President's Advisory Panel on Federal Tax Reform [the Panel].

As the trade association representing companies with ESOPs and their employee owners, we find the recommendations to be shocking, and contra to the Administration's previous posture towards employee ownership. The recommendations fly in the face of over thirty years of Presidential and Congressional support of broadened ownership, of both Republican and Democratic Administrations.

Since there is some confusion over the specific recommendations of the Panel that would eliminate ESOPs, it is important to explain how the Panel's recommendations would eliminate **all** ESOPs. Specifically on pages 61, 93, 108, 115, and 157, the Panel recommends that all ERISA defined contribution plans in current law be eliminated from the tax code, and in lieu thereof, there be **one** type of plan named by the Panel as a "Save at Work," plan which resembles a 401(k) plan. An ESOP is a defined contribution plan, and the description of the new "Save at Work" plan does not describe an ESOP – ergo the Panel's "Save at Work" recommendation eliminates ESOPs.

Top members of the Panel state that there was "no intent" to eliminate ESOPs and it is now obvious that leaders of the Panel were not aware of the impact in ESOPs. Senior staff of the Panel say that "the Panel did not get into details, and so did not address ESOPs." Thus, intentional, or unintentional, the impact of the Panel's defined contribution proposal is the same—if adopted, no ESOPs.

In meetings with senior Treasury Department tax policy officials, who are reviewing the Panel's recommendations, elected leaders of the Association were told it was "irrelevant" as to why the Panel recommended a policy that would mean no more ESOPs, as the Treasury Department personnel are taking the Panel's recommendations at face value, and not trying to be psychics in discerning the Panel's hidden reasons behind certain recommendations.

The Small Business Subcommittees should seriously consider the ramifications of the Panel's recommendations and the impact on the millions of Americans who own and work for small businesses. ESOPs encourage entrepreneurship, productivity, and American competitiveness on both a corporate and individual scale and promote an ownership society, where many average income citizens are owners.

Furthermore, small businesses dominate the ESOP world. In fact, 82% of ESOP Association members have less than 250 employees and 92% have less than 500 employees. These demographics can also be applied to non-member companies as economic figures show that the majority of companies in the U.S. are small businesses.

The ESOP Association recognizes that current Federal tax law encourages and promotes employee ownership through ESOPs, and that in the 30 plus years these laws have existed, employee ownership through ESOPs has in the overwhelming majority of instances provided significant wealth to employee owners, and has in the overwhelming majority of instances made the employee-owned companies high performing companies in comparison to their non-employee-owned competitors.

Here's why ESOPs should have been considered by the Panel; with a desire to increase employee ownership:

- Since 1974, ESOPs have been the primary tool to broaden ownership of American business among employees.
- There are approximately 11,000 ESOPs in place in the U.S., covering 10 million employees (10% of the private sector workforce).
- An estimated 8 to 11 million Americans have accounts in ESOPs.
- Total assets owned by U.S. ESOPs were estimated to be \$600 billion at the end of 2004.
- In 2005, the Employee Ownership Foundation, conducting its 14th Annual Economic Performance Survey (EPS), found that a very high percentage of companies, 87.5%, declared that creating employee ownership through an ESOP (employee stockownership plan) was "a good decision that has helped the company." In addition, the EPS asked companies to indicate their performance in 2004, relative to 2003. Approximately 74% of respondents indicated a better performance in 2004 than 2003, 9% indicated a nearly identical performance, and 17% indicated a worse performance. Approximately 84% indicated that revenue increased while 16% indicated revenue did not increase. In terms of profitability, 74% indicated that profitability did increase and 26% indicated that profitability did not increase in 2004.

We have attached a copy of the written statement submitted by The ESOP Association to the President's Advisory Panel on Federal Tax Reform that outlines the Association's position and why ESOPs should be considered within the context of a more fair, simple, and efficient Federal tax system.

Also, we note that 850 of the Association's 1,400 members are S corporations. As the Committee has probably heard from the millions of small businesses that are so called "pass through" entities for Federal tax purposes, the Panel's recommendations for a corporate level tax on all businesses with receipts over \$10.5 million per annum does not sit well with these 850 ESOP companies, as under current law, passed in 1997, and heavily debated in 1999 and 2000, income of an S corporation sponsoring an ESOP pro rated to the ESOP's share of the corporation's annual taxable income is not taxed at the corporate level, but at the individual level only when the individual receives a distribution from the ESOP in accordance with ERISA law. On behalf of our S corporation members, not only do we urge a total rejection of any proposal to eliminate ESOPs, we urge maintaining current tax law treatment of S corporation ESOPs and rejection of any wrongheaded plan to snuff out employee ownership through ESOPs.

We thank you for holding this hearing and ask you in your deliberations to look closely at the impact these recommendations will have on the millions of small business owners and their employees in the U.S.

Attachments

Summary Sheet of Written Statement
To President's Advisory Panel
on Federal Tax Reform
Submitted Friday, March 4, 2005

Statement on Behalf Of: The ESOP Association, a national 501(c)(6) business trade association representing over 1,300 U.S. corporations that are partially, or wholly owned by an employee stock ownership plan (ESOP), and over 900 professionals who provide services to corporations with ESOPs.

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Summary:

1. The Advisory Panel should make recommendations that are consistent with President Bush's policy goal to encourage and promote an "Ownership Society".
2. If the Advisory Panel does not make recommendations for major changes in the current tax systems, there are several changes in current tax laws to encourage more employee ownership through ESOPs.
3. In studying the current tax laws encouraging employee ownership through ESOPs, the legislative history of ESOP law leads to conclusion that ESOP law may be reviewed in context of tax favored employer provided benefits, or in the context of tax laws encouraging entrepreneurship, productivity, and American competitiveness on both a corporate, and individual scale.

The ESOP Association's Position Towards
Statement to the President's Advisory Panel on Federal Tax Reform

"To give every American a stake in the promise and future...we will...build an ownership society. We will widen the ownership of homes and businesses, retirement savings, and health insurance—preparing our people for the challenges of life in a free society.

By making every citizen an agenda of his or her own destiny, we will give our fellow Americans greater freedom from want and fear and make our society more prosperous and just and equal."
President George W. Bush, January 20, 2005.

Part I
General and Primary Position

The ESOP Association, on behalf of the employee ownership community, respectfully asks that the President's Advisory Panel on Federal Tax Reform (Advisory Panel) make it a goal of its work that the Federal tax system encourages and promotes an ownership society, where many average income citizens are owners, in addition to the goals of a more fair, simple, and efficient Federal tax system.

The ESOP Association recognizes that current Federal tax law encourages and promotes employee ownership through ESOPs, and that in the 30 plus years these laws have existed, employee ownership through ESOPs has in the overwhelming majority of instances provided significant wealth to employee owners, and has in the overwhelming majority of instances made the employee-owned companies high performing companies in comparison to their non-employee-owned competitors. (Summary of research data attached.)

The ESOP Association recognizes the Advisory Panel may recommend major overhaul of the current Federal tax system, moving the current income tax based system to a so-called "flat-rate" system with few exceptions to the general rule that all income of whatever source and form is subject to tax, or to a consumption tax such as a national sales tax or value added tax, or to a hybrid system of both.

The ESOP Association notes to the Advisory Panel that no matter what the major structure of the Federal tax system may be, consumption or income, or both, there are many methods to be sure it contains provisions that encourages and promotes ownership by average income citizens.

Based on real world experience, a system that enables average income citizens to be "financed" into an ownership state is more effective in creating significant ownership than voluntary savings plans, which are most utilized by citizens with ample income.

Theories of how to expand ownership through finance were put to Congress by Senator Russell B. Long from 1974 through 1986, and resulted in the current laws for ESOPs, which do finance average pay employees into ownership positions.

A final point is that the one time that Congress made a major overhaul of the Federal tax system, coming very close to a pure flat tax system, was in 1986 under the leadership of President Ronald Reagan. He and Senator Long made sure the Tax Reform Act of 1986 not only maintained the tax laws favoring employee ownership through ESOPs, but enhanced those laws. A similar result is possible with the recommendations of the Advisory Panel if it is agreed that promoting an ownership society is an important goal of any Federal tax system.

In summary, the ESOP community's general position towards the Advisory Panel's work is in alignment with the words spoken by President Bush in his Inaugural Address that an ownership society will build a more prosperous, more just, and more equal society. Therefore, the ESOP community urges the Advisory Panel to have as a goal whatever tax system it endorses, income or consumption, the recommended Federal tax system should encourage and promote an ownership society where ownership is widespread, among average income Americans.

To reach this goal in the context of the system that the Advisory Panel recommends, The ESOP Association stands ready to provide input on any of the details of any tax system in order to be sure it promotes a true ownership society.

Part II

Specific Ideas to Promote Employee Ownership If Advisory Panel Does Not Recommend Major Changes in Current Federal Tax System

Assuming the Advisory Panel does not recommend significant, major restructuring of the current Federal income tax system, The ESOP Association recommends modest, but significant steps to create more employee owners through ESOP arrangements, and to permit better operation of existing ESOPs. The recommendations are particularly pointed to two areas: One, situations where an S corporation is partially owned by an ESOP, and two, in the universe of publicly-traded companies. Many may be characterized as "simplification" proposals of certain current ESOP related tax provisions.

Brief summary history is in order to understand these recommended positions. Under current law, Congress has established significant tax incentives for small to mid-sized privately owned businesses to establish employee ownership through ESOPs, primarily by encouraging the current shareholder[s] who are exiting the business to sell shares to the ESOP, if the business is a C corporation. For S corporations Congress has established a method of taxing the ESOPs share of an S corporations' income that encourages the creation of S corporations owned 100% by the ESOP. Current law does not necessarily encourage S corporations to establish employee ownership through ESOPs where the ESOP owns a minority of the S corporation, and even has somewhat of a barrier to the continued operation of an ESOP that owns a minority of an S corporation. Current law also does not directly encourage publicly-traded companies to expand ownership to employees through an ESOP.

In essence, The ESOP Association would want to see an expansion of ownership through ESOPs with specific provisions of law that addresses the barriers to ESOP creation and operation, in both C and S corporations, and both private and public companies.

Here are some ideas for new law, but certainly not exhaustive, that assumes no major change in Federal tax law, as all ideas were developed in the context of current law. Many of these legislative ideas were included in HR 4796 and S 2298, introduced in the 108th Congress.

1. Repeal the punitive 10% penalty tax on S corporations' distributions from current earnings, also referred to as dividends, paid on ESOP stock that are passed through to ESOP participants in cash. (Participants will pay regular income tax on the cash received. Based on prior Joint Committee on Taxation revenue estimates of repeal of excise taxes, this revision should raise revenue.) Such a change would equalize treatment of cash dividends distributed between C corporations and S corporations as the treatment for C corporation dividends has no penalty tax imposed.
2. Permit sellers of stock to the ESOP on an S corporation to utilize the ESOP tax benefit referred to as the tax deferred rollover, or the 1042 treatment.
3. Clarify that dividends paid by C corporations on ESOP stock are not a preference item in calculating the corporate alternative minimum tax.
4. Permit proceeds received from a 1042 transaction to be invested in mutual funds consisting of operating US corporation's securities.
5. Redefine what is a 25% owner for purposes of IRC 1042 to be 25% or more owner of voting stock, or 25% or more owner of all stock of the corporation, not 25% of any class of stock. IRC 1042 imposes restrictions on 25% owners' participation in a 1042 ESOP.
6. Permit early withdrawals from ESOP for first time home purchases, and college tuition under limited circumstances.
7. Increase de minimus amount in an ESOP account not subject to mandated diversification from \$500 per account to \$5,000 per account. There should be no revenue impact from this change. In 1986, Congress passed a law mandating that an ESOP participant be permitted to diversify his or her account from employer securities over a five year period up to 50% of the account balance if the account was over \$500. The \$500 level has never been altered in the past 20 years, whereas nearly all other de minimus amounts cited in ERISA law have increased either under a standard inflation adjuster, or by specific law. It is not reasonable to require the administrative headaches of diversifying accounts under \$5,000 as that amount is not enough to ensure a secure retirement.
8. Allow a corporation selling a division or subsidiary to an ESOP company to utilize 1042 to defer the corporate capital gains tax.
9. Permit a tax deduction for transfer of stock at less than fair market value that equals the difference between the transfer price and the fair market value price. Under certain circumstances, transferring stock at less than fair market value triggers a favorable gift tax deduction. The contemplated provision would provide for an income tax deduction.

10. Clarify impact of 25%/5% ownership rule for allocations in a post-1042 transaction. Current law has a quirk that eliminates an exception to the 5% rule for lineal descendants but in the 25% ownership rule covers the same lineal descendants nullifying the 5% rule exception.
11. Permitting holders of “Section 83” stock to sell that stock, if not-publicly traded, to an ESOP and utilize the ESOP tax deferred rollover provision (Code Section 1042) if employees acquired stock at fair-market value. This provision arises from both a current law provision in 1042 that does not permit stock held by an employee because of the exercise of a stock option to utilize 1042, and from a series of IRS letter rulings in the late 80’s that expanded the limit on 1042 utilization to all stock held by an employee because of his/her receiving it because of a program of the employer, even if the employee bought the stock at fair market value. The current law is not fair as employees who obtained stock paying fair market value because of employment do not have the same treatment as an owner-founder, or outside investor, who can sell stock to the ESOP and defer the cap gains tax under Section 1042.
12. In the estate and gift tax is maintained, and not totally repealed, consider these ideas:
 - A. Restoration of the shifting of the estate tax liability from an estate to the ESOP sponsor if estate transfers stock to the ESOP. This provision would be a restoration of a 1984 pro-ESOP law that was repealed in 1989 during a series of cutbacks in ESOP tax incentives. It was Code Section 2210. At no time from 1984 to 1989 did the provision lose more than \$5 million per year in revenue, and estimates made for a variety of pro-ESOP bills containing the provision since 1990 have always been less than \$5million.
 - B. Treat non-corporate donations of company stock to ESOP as a charitable contribution for purposes of income, estate, and gift taxes.

Part III

Proper Input from Employee Ownership Community to Advisory Panel

Given the hybrid nature of employee ownership in all of its various forms, it is possible for the Advisory Panel to slot a review of how employee ownership fits into any tax system in two different general areas.

One, it is clear, particularly for ESOP discussions, that employee ownership is tied to the compensation decisions of the employer, either current, or deferred. Two, nearly all employee ownership plans arise from deferred compensation schemes. Three, nearly all therefore fall into the generally accepted category of employer provided benefits. And four, within the general area of employer provided benefits, the major employee stock compensation schemes are part of the retirement income security law, or ERISA.

Thus, there is no doubt that any review of how our tax system might impact, or should impact the encouragement of broad ownership in our society, could be done in the context of how current law, and proposed law, might impact employers' actions to compensate employees as part of an employer provided benefits package.

On the other hand, most of the social research, and the justification for broad based employee ownership revolves not just around employee income security, but also on how ownership increases citizen responsibility, citizen entrepreneurship attitudes, self-esteem, community involvement, and the performance of companies with broad based ownership among its employees. These concepts are in sync with the views of President Bush, as expressed in his Inaugural Address cited above, and certainly are in sync with his expressions of why wide spread home ownership is important.

Thus, any review of employee ownership by the Advisory Panel could focus on whether the tax system of the United States should encourage employee ownership, in order to increase not just personal wealth, but also whether to encourage the ownership behavior that leads to high performing companies, better and more involved citizens, and employees who are more likely to approach their work in an entrepreneurial manner.

Or, of course, the Advisory Panel could measure the effectiveness of broad based employee ownership in the review of both areas of the tax laws—both as employer provided benefits, and as a way to make American companies and their employees more productive, entrepreneurial, and connected to the community.

In any manner, The ESOP Association stands ready to dig into both the macro and micro evidence of why the Advisory Panel should endorse a tax system that helps create the Ownership Society called for by President Bush.

Attachment



Employee Ownership and Corporate Performance

1. In 2004, the Employee Ownership Foundation, conducting its 13th Annual Economic Performance Survey, found that a very high percentage of companies, 88%, declared that creating employee ownership through an ESOP (employee stockownership plan) was “a good decision that has helped the company.” In addition, the EPS asked companies to indicate their performance in 2003, relative to 2002. Approximately 65% of respondents indicated a better performance in 2003 than 2002, 12% indicated a nearly identical performance, and 23% indicated a worse performance. Around 70% indicated that revenue increased while 30% indicated revenue did not increase. In terms of profitability, 64% indicated that profitability did increase and 36% indicated that profitability did not increase in 2003. This survey was conducted in the summer of 2004 among corporate members of The ESOP Association.
2. The most comprehensive and significant study to date of ESOP performance in closely held companies was conducted by Dr. Joseph R. Blasi and Dr. Douglas L. Kruse, professors at the School of Management and Labor Relations at Rutgers University, and funded in part by the Employee Ownership Foundation. The study, which paired *1,100 ESOP companies* with *1,100 comparable non-ESOP companies* and followed the businesses for *over a decade*, reported overwhelmingly positive and remarkable results indicating that ESOPs appear to increase sales, employment, and sales/employee by about 2.3% to 2.4% over what would have been anticipated, absent an ESOP. In addition, Drs. Blasi and Kruse examined whether ESOP companies stayed in business longer than non-ESOP companies and found that 77.9% of the ESOP companies followed as part of the survey survived as compared to 62.3% of the comparable non-ESOP companies. According to Drs. Blasi and Kruse, ESOP companies are also more likely to continue operating as independent companies over the course of several years. Also, it is substantially more probable that ESOP companies have other retirement-oriented benefit plans than comparable non-ESOP companies, such as defined benefit plans, 401(k) plans, and profit sharing plans.
3. Research done by the Washington State Department of Community, Trade and Economic Development of over 100 Washington not publicly-traded ESOP companies compared to 500 not publicly-traded non-ESOP companies showed that the ESOP companies paid better benefits, had twice the retirement income for employees, and paid higher wages than their non-ESOP counterparts. *Wealth and Income Consequences of Employee Ownership: A Comparative Study from Washington State*, Kardas, Peter A., Scharf, Adria L., Keogh, Jim, November, 1998.
4. Research conducted by Professor Hamid Mehran, while he served on the faculty of the J.L. Kellogg Graduate School of Management, Northwestern University, of nearly 400 publicly traded companies with significant ESOPs both before and after the adoption of the ESOP, compared to non-ESOP companies in similar lines of businesses, showed that the rate of return for the ESOP companies was 2.7% higher, 60% of the ESOP companies experienced share price increases upon announcement of the ESOP program, and 82% indicated that the ESOP had a positive impact on

business results.

5. In 1995, Douglas Kruse of Rutgers University examined several different studies between ESOPs and productivity growth. Kruse found through an analysis of all studies that "positive and significant coefficients [are found] much more often than would be expected if there were no true relation between ESOPs and productivity." Kruse concludes that "the average estimated productivity difference between ESOP and non-ESOP firms is 5.3%, while the average estimated pre/post-adoption difference is 4.4% and the post-adoption growth rate is 0.6% higher in ESOP firms. Kruse cites two studies as part of his research: Kumbhakar and Dunbar's 1993 study of 123 public firms and Mitchell's 1990 study of 495 U.S. business units in public firms. Both reports found significant positive effects of greater productivity and profitability in the first few years after a company adopted an ESOP.
6. In 1995, the U.S. Department of Labor released a study entitled "The Financial and Non-Financial Returns to Innovative Workplace Practices: A Critical Review." This study found that companies that seek employee participation, give employees company stock, and train employees, can positively affect American corporations' bottom lines. In addition, the report cited three studies that analyzed "the market reaction to announcements of ESOPs which found significant positive returns to firms which implemented ESOPs as part of a broader employee benefit or wage concession plan." The three studies are: Chang's 1990 "Employee Stock Ownership Plans and Shareholder Wealth: An Empirical Investigation"; Dhillon and Ramirez' 1994 "Employee Stock Ownership and Corporate Control"; and Gordon and Pound's 1990 "ESOPs and Corporate Control." citation at (202) 293-2971 or E-mail: esop@esopassociation.org.

For additional information about ESOP or The ESOP Association, visit the website at www.esopassociation.org, call 1-866-366-3832, or email esop@esopassociation.org.