

Frequently Asked Questions About ESOP Promotion and Improvement Act of 2007 S. 1322

1. How much will the proposed ESOP Promotion and Improvement Act of 2007 Cost the Federal Treasury?

The proposed ESOP bill is not going to lower federal revenues by any significant amount; in fact, it is submitted that one provision may actually raise revenues, and might do so in a manner offsetting any other provisions of the proposed ESOP bill that might lower revenues. To explain briefly: By repealing the 10% excise tax on S corporation dividends paid in cash to ESOP participants, federal tax revenue will increase as these employees will pay regular tax on the dividends. Currently, companies are not passing through the dividends, or if they are, the dividends are being rolled over tax free into an IRA. Thus, the 10% penalty is stopping the payment of regular taxes, as no dividends are being paid subject to regular tax payment. There is solid precedent in Congress for the position that, when repealing a penalty tax that prevents persons from engaging in an activity that results in regular tax payments, such a repeal increases federal revenues.

To give an example, in the 90s, leaders of the House tax committee made proposals to repeal the very high penalty tax on the surpluses of a terminated defined benefit (db) plan that reverted back to the employer sponsor. The Congressional tax experts would “score” these proposals to repeal the penalty tax as a revenue raiser, because if corporations did terminate over funded db plans and reclaim the surplus, the surplus would be included in the corporation’s regular taxable income.

But even if the revenue raised from the repeal of the 10% penalty tax on S dividends paid to ESOP participants in cash is discounted, the other provisions of the proposed ESOP bill have small, or even de minimus revenue impact.

Clarification that the corporate AMT does not apply to dividends paid by a C corporation on ESOP stock should be less than \$25 million, probably very much so; but the caution is to estimate high.

Permitting sellers of S stock to an ESOP to take advantage of the tax deferred rollover rule of Code Section 1042 should be less than \$100 million as since 1986, the revenue loss from utilization of 1042 by sellers of C stock has never exceeded \$100 million in official tax expenditure estimates. Keep in mind, 1042 is a tax deferral, not a tax deduction or tax credit. Because S stock has a higher basis than C stock, any deferral on gain from S stock sale should be less than on C stock.

Permitting 1042 deferrals to be invested in mutual funds would have a de minimus revenue impact, as currently deferral is permitted for investments in a tailored basket of stocks, or bonds.

Defining who is 25% owner ineligible for participation in an ESOP with shares acquired in a 1042 transaction would have de minimus impact as the rule, going from measuring from voting stock, or all stock value, from any class of stock, is of limited impact.

Updating from 1984 law the de minimus amount eligible for diversifications from \$500 to \$2,500 has no revenue impact.

Not knowing the revenue offset of the repeal of the 10% penalty tax, and taking the most cautious position that it might be \$0, the revenue loss from the proposed ESOP bill might be as much as \$130 million, but as little as \$25 million per year. Both amounts are frequently “paid-off” when other revenue raiser items are in a multi-provision tax bill.

Furthermore, The ESOP Association, and the ESOP community, stand ready to work with appropriate Congressional committees should provisions of the proposed ESOP bill receive serious review during work on a tax bill, to tailor any provision of the proposed ESOP bill to lower revenue impact, or to abandon any provision that proves too costly in the context of the legislation under consideration.

Thus, supporting the proposed ESOP bill as introduced does not commit a Senator to push for enactment of provisions that significantly add to the federal budget deficit.

2. Why should S Corporation ESOPs be exempt from the 10% early withdrawal penalty tax when the purpose of ERISA plans such as an ESOP is to hold money for retirement, not to have it passed through and spent before retirement?

The primary reason is the same reason why Congress in 1984 exempted ESOPs from the early penalty tax if the dividends are paid by a C corporation. This reason is that ESOPs are ownership plans, and an important point of ownership of equity of a business entity is being able to share in the surplus earnings of the business. The Congress, in a series of laws, intend ESOPs to be ownership plans, and there are certain aspects of ESOPs that are designed to make them good ownership plans, as well as, plans for retirement savings.

Note, the proposed ESOP bill does not repeal the 10% penalty tax if an ESOP participant takes money, or stock, from the ESOP that is part of the annual ESOP contribution, which is the overwhelming bulk of a participant’s assets in the ESOP. The proposal only deals with dividends, which for many would be no more than a hundred or less dollars per year, if the S corporation declares a dividend and has a plan that passes the dividend through to employees. (To be clear, dividends paid by an S corporation are more commonly referred to as the S corporation distributions from current earnings.)

Since the pass through of dividends in C corporations became law in 1984, over and over ESOP company leaders have reported that the dividends check has significantly added to the employees’ understanding of what ownership of stock means, and led to the attitudes needed to maximize the human resources in the context of shared ownership.

The fact is that the imposition of the 10% penalty tax was an oversight by the ESOP community in 1997 when the ESOP S law was drafted to ensure that an S corporation did not get an illogical corporate tax deduction for paying dividends on ESOP stock, when unlike a C corporation, which does get a tax deduction for the dividends on ESOP stock, S corporations pay no corporate level tax. But the law written in 1997 should have made clear that the deduction was being denied, but not the traditional uses of dividends in the case of an S corporation ESOP.

3. Would employees of an S corporation pay the regular federal tax rate on their dividends?

Yes, since the corporation did not pay a tax on the value of the dividends, the employee receiving the dividends would pay tax at her or his regular tax rate.

4. What purpose is served by exempting C corporations with ESOPs from the corporate AMT?

The proposed ESOP bill does not exempt C corporations with ESOPs from the corporate AMT; the proposed ESOP bill clarifies that Congress, in 1989, when it created an AMT preference item known as “adjusted current earnings,” or ACE, did not intend ESOP dividends benefiting employees in an ESOP to be part of the ACE calculations. It was IRS regulations in 1990 that deemed ESOP dividends paid by a C corporation, to be part of the ACE calculation. It is a long standing principle of promoting employee ownership that using dividends to benefit the ESOP participants is a key element in building employee wealth, and most important, employee understanding of ownership in a free enterprise economy. There is no direct evidence that in 1989 in enacting the ACE preference that Congress intended to limit the use of ESOP dividends to benefit employees.

5. Why is it necessary to have the tax deferred rollover treatment, or 1042, for sales of S corporation stock to an ESOP, when the gain on sale of S stock is usually not as great as the gain on sales of C corporations?

Since 1985, evidence indicates that nearly 75% of the employee ownership through ESOPs in America was created by a seller of private company stock to an ESOP, and then utilizing the tax deferred rollover, or Code Section 1042. In 1998, when for the first time Congress extended to S corporations the opportunity to sponsor employee ownership through an ESOP, it felt that the deferred rollover incentive was not needed for S corporation owners to sell to an ESOP because data indicated that the gain from the sale of S stock would not be as great as the gain of the sale of C stock, and that the deferral of tax on the income of an S corporation’s ESOP pro rata share of its income was enough of an incentive, to encourage owners of S corporate stock to sell to an ESOP.

Two points: The gain for many sellers of S stock is significant, but absent the tax deferred rollover treatment, there is little evidence since 1997 that there is any significant number of large sales of S stock to ESOPs, so common among private C corporations, are taking place; and therefore, the expansion of employee ownership among employees of S corporations existing before 1998 is not as significant as anticipated in 1997.

By its action in 1997, Congress clearly signaled intent that S corporations can establish employee ownership through ESOPs. It is believed that until the current owners of S stock are given an incentive to sell significant blocs of stock to an ESOP, the growth of employee ownership among S corporations will not be as great as Congress intended in 1997.

6. Why should certain 25% owners of stock in an ESOP also acquire stock acquired in a 1042 transaction participate in the ESOP?

Current law is an anomaly in the way it was drafted. It prohibits the 25% owner of any class of stock from getting stock in an ESOP if the stock was acquired in a 1042, or tax deferred rollover transaction. There are examples where a class of stock might be owned 100% by a senior or junior executive, but the stock is not voting stock, and its value as measured against the total value of the corporation might be 5%. The stock was created and granted to the employee as an incentive, but carries much less than 25% value, or 25% voting power. The proper measure should be someone who owns at least 25% of the voting power stock, or owns stock that represents at least 25% of the corporation's value.

7. Since the Enron and other corporate collapses, experts, and many in Congress have urged more diversification of company stock in ERISA plans, not less; so why would Congress wish to raise the de minimus rule for the opportunity of ESOP participants to diversify from company stock as they near retirement?

The proposed ESOP bill would not make a major change in the current law mandating that sponsors of ESOPs permit ESOP participants nearing retirement to diversify their accounts. It is common sense that amounts less than \$2,500 are not going to be significant retirement income security, whether diversified or not. Plus, when a retired employee receives less than \$2,500 in cash from an ESOP company she or he can diversify it in an IRA. The change from the current \$500 de minimus rule to a proposed \$2,500 de minimus rule is an administrative relief. It costs the ESOP sponsor administrative fees to offer diversification, and if the amount offered for diversification is not significant, what is purpose of extra costs? Fact is experts know of no situation where an employee demanded diversification for amounts less than \$5,000 in an ESOP account.

Creating and operating an ESOP requires more costs to a plan sponsor than other ERISA plans. The ESOP community accepts these costs when justifiable, such as, the costs to insure the ESOP stock is valued independently, to pay extra lawyers to be sure prohibited transactions rules are honored, or to ensure ESOP tax benefits go to a broad base of employees, not just the top paid executives, to name a few examples. But the ESOP community believes costs associated with a rule that has not been adjusted for inflation the past near 20 years is not benefiting anyone.