ESOP Association - Advocacy Update

President's Budget Says ESOPs Too Risky and Bad for Employees!

Reverses 39 Years of Executive Branch Support of ESOPs

In justifying a repeal of a tax incentive Congress enacted in 1984 permitting C corporations to have a tax deduction for dividends on ESOP stock paid to employee accounts, the President's budget says that ESOPs are too risky and employees working in corporations with more than $5 million in gross revenue a year cannot understand how their work "impacts" the company where they work.

Such a statement is ridiculous.

The pages and pages of research that prove ESOP companies are more profitable, more productive, provide more sustainable jobs, with better retirement benefits, in the vast majority of instances, were never based on little companies with less than $5 million annual revenue. (For evidence, click here: http://www.esopassociation.org/explore/employee-ownership-news/resources-for-reporters.)

99.5% of The ESOP Association's corporate members have more than $5 million in revenue.

While the ESOP community has had debates over tax law details promoting ESOPs with the Administrations of Presidents Ford, Carter, Reagan, Bush I, Clinton, and Bush II, never ever has an Administration said ESOPs were no good. (See the following pages from the Department of Treasury's Green Book which provides an explanation for President Obama's Administration's justification for repeal of the dividend deduction provision. Note the highlighted text under the Reasons for Change section.)

The ESOP community cannot sit by and let this characterization stand. It is wrong; it is dangerous to the future of your ESOP, and your clients ESOPs.

Please be alert to suggested communications to Congress as the work on tax reform proceeds.

Or just send a message NOW to your Senators and Representatives that you are dismayed, shocked, and flabbergasted with the Administration's view of ESOPs being bad for employees.

ELIMINATE SECTION 404(k) EMPLOYEE STOCK OWNERSHIP PLAN (ESOP) DIVIDEND DEDUCTION FOR LARGE C CORPORATIONS

Current Law

Generally, corporations do not receive a corporate income tax deduction for dividends paid to their shareholders. However, C corporations are allowed a deduction for dividends paid with respect to employer stock held in an ESOP if certain conditions are met. To be eligible for this treatment, the dividend must be an "applicable dividend." For this purpose, a dividend qualifies as an applicable dividend only if the provisions of the ESOP provide that the dividend is paid or used in accordance with one of four available alternatives. Specifically, a dividend qualifies as an applicable dividend if the provisions of the ESOP provide that the dividend is paid directly to the plan's participants or their beneficiaries, paid to the plan and distributed to participants or their beneficiaries not later than 90 days after the end of the plan year, or, at the election of the participants or their beneficiaries, is either paid directly to the participants or their beneficiaries or paid to the plan and distributed to the participants or their beneficiaries not later than 90 days after the end of the plan year. Alternatively, a dividend qualifies as an applicable dividend if the plan terms provide that it may be used to repay a loan originally used to purchase the stock with respect to which the dividend is paid. For this purpose, the dividend qualifies as an applicable dividend only to the extent that employer securities with a fair market value of not less than the amount of the dividend are allocated to the accounts to which the dividend would have been allocated. The limitation of deductibility of dividends used to repay loans to those paid with respect to stock acquired with those loans does not apply to employer securities acquired by an ESOP prior to August 4, 1989 (if the plan was an ESOP prior to that date).

A deduction for a dividend that otherwise qualifies as an applicable dividend may be disallowed if the Secretary determines that the dividend is, in substance, an "avoidance or evasion" of taxation. This includes authority to disallow a deduction of unreasonable dividends, which has been used to recharacterize excess dividends as contributions subject to the limit on annual additions under section 415. Thus, the authority to disallow a deduction for a dividend serves not only to disallow the deduction but also to constrain any dividend that, in substance, constitutes an employer contribution to the ESOP in excess of the otherwise applicable limit on annual additions.

When distributed to participants or their beneficiaries, either directly or from the plan, applicable dividends constitute taxable plan distributions (ordinary income) but are not subject to the 10% early distribution tax. Applicable dividends are not treated as wages for purposes of income tax withholding or federal employment taxes.

Reasons for Change

Current law extends several tax benefits to ESOPs that are in addition to those applicable to other tax-qualified retirement plans. The ESOP dividend deduction is one of these benefits. Thus, while current law does not allow a paying corporation a deduction for dividends paid with respect to its stock, including stock that is held in a retirement plan, the deduction for dividends on employer stock held in an ESOP constitutes an exception to this rule. The difference in treatment creates an additional incentive for employers to encourage investment in employer stock through ESOPs. Concentration of employees' retirement savings in the stock of the company for which they work, however, subjects employees' retirement benefits to increased risk (potentially the same risk that could affect their job security) without necessarily offering a commensurate return. To the extent that current payments of dividends to ESOP participants may be viewed as having a productivity incentive effect, the effect may be more likely in small firms, where each employee's efforts could more directly affect overall company performance and where there may be a greater possibility that the benefits of any such incentives could justify the risks associated with concentration of retirement savings in employer stock. By providing an exception from elimination of the ESOP dividend deduction for smaller corporations, the proposal seeks to strike a balance between these competing considerations.

Proposal

The proposal would repeal the deduction for dividends paid with respect to stock held by an ESOP that is sponsored by a C corporation (subject to an exception for C corporations with annual receipts of $5 million or less). The current law rules allowing for immediate payment or use of an applicable dividend would remain intact, without a deduction, and be moved to section 4975(f)(7), which currently provides corresponding rules for distributions (as described in section 1368(a)) with respect to S corporation stock held in an ESOP maintained by a S corporation that is used to repay the loan or loans with which the stock with respect to which the distribution is paid was originally purchased. The Secretary would continue to have authority to disallow an unreasonable dividend or distribution (as described in section 1368(a)) for this purpose.

The proposal would apply to dividends and distributions that are paid after the date of enactment.