[COMMITTEE PRINT]

DESCRIPTION OF S. 3241, S. 3291 AND S. 3223

RELATING TO

TAX INCENTIVES FOR STOCK OWNERSHIP PLANS

LISTED FOR A HEARING

BY THE

COMMITTEE ON FINANCE

ON JULY 19 AND 20, 1978

PREPARED FOR THE USE OF THE

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BY THE STAFFS OF THE

COMMITTEE ON FINANCE AND THE JOINT COMMITTEE ON TAXATION

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I. INTRODUCTION

The bills discussed in this pamphlet, S. 3241 (introduced by Senator Robert C. Byrd for Senator Russell B. Long), S. 3291 (introduced by Senator Mike Gravel), and S. 3223 (introduced by Senator Mike Gravel) have been scheduled for a hearing on July 19 and 20, 1978, by the Senate Committee on Finance. S. 3241 and S. 3291 relate to employee stock ownership plans and S. 3223 relates to proposed general stock ownership trusts.

In connection with the hearing, the staffs of the Committee on Finance and the Joint Committee on Taxation have prepared a description of the bills. With respect to each bill, the description indicates the present law, an explanation of the provisions of the bill, its effective date, and its possible revenue effect.

II. EMPLOYEE STOCK OWNERSHIP PLANS—S. 3241 AND S. 3291

Present law

Under present law, a corporate employer is entitled to an additional percentage point of investment credit (11 percent rather than 10 percent) if it contributes an amount equal to the additional credit to an employee stock ownership plan (ESOP) which satisfies the requirements of the Tax Reduction Act of 1975 (a Tax Reduction Act ESOP, or TRASOP). Up to ½ percent of extra investment credit is allowed where an employer contributes the extra credit to the TRASOP and the employer's extra contribution is matched by employee contributions. The present law provision for TRASOP contributions expires after December 31, 1980.

The employer's contribution to a TRASOP must be in the form of employer stock or cash (if the cash is used by the TRASOP to acquire employer stock). The employer stock may be stock of an affiliated employer and may be newly issued or previously outstanding.

No income tax deduction is allowed to an employer for contributions of investment tax credit to a TRASOP. Additional employer contributions to a TRASOP are deductible under the usual rules applicable to employee plans. Under the usual deduction rules, if an employer maintains a pension plan on the one hand and a profit-sharing or stock bonus plan on the other hand, deductions for aggregate employer contributions are generally limited to 25 percent of the compensation of employees covered by the plans. Deductions for contributions to a pension plan may exceed the 25-percent limit if the contributions are required by the minimum funding standard applicable to pension plans. Deductions are not allowed for estate tax or gift tax purposes, on account of a contribution to a qualified plan or TRASOP. Also, no deduction is ordinarily allowed to an employer for dividends paid on corporate employer stock.

To be a TRASOP, a plan need not be a tax-qualified plan, but the plan must satisfy special rules as to vesting,[1] employee participation,[2] and allocation of employer contributions.[3]

Generally, an ESOP (including a TRASOP) is subject to the same overall limits on benefits and contributions that apply with respect to tax-qualified employee plans. Under these limitations in the case of an ESOP-type plan, the allocation of a combination of employer contributions, reallocated forfeitures, and employee contributions [4] by or on behalf of a plan participant may not exceed the lesser of $30,050 [5] or 25 percent of the participant's compensation. In the case of an ESOP under which at least two-thirds of the employer's plan contributions are allocated to rank-and-file employees, the $30,050 limit is doubled. In addition, under the TRASOP, employees must be permitted to direct the voting of employer stock allocated to their accounts. The plan need not permit employees to direct the voting of unallocated employer stock. The vesting, allocation, and voting rules are generally considered to be more favorable to rank-and-file employees than those which are required under qualified plans.

An employer may make up recaptured investment credit contributed to a TRASOP by withdrawing assets from the TRASOPS, by withholding future TRASOP contributions, or by taking an income tax deduction for the recaptured credit. Where an employer plans to withdraw recaptured investment credit from a TRASOP, the employer may wish to limit benefit distributions from the TRASOP to amounts with respect to which the time for recapture has expired. If such amounts are withheld from a distribution, the distribution cannot qualify as a lump sum distribution for which special 10-year income averaging or rollovers to an individual retirement account (IRA) is provided. Where a distribution of benefits is made from a qualified plan (including a tax-qualified TRASOP) and the distribution meets the requirements of a lump sum distribution, the estate tax exclusion provided for benefits under qualified plans is denied whether or not the distributee actually elects to treat the distribution as a lump sum distribution and applies 10-year income averaging. In addition, where the TRASOP is not also a qualified plan, benefit distributions may not be rolled over to an IRA and are not eligible for 10-year income averaging.

Present law does not permit an active participant in a tax-qualified plan to make a deductible contribution to an IRA. Consequently, a participant in a tax-qualified TRASOP, which is not designed as a retirement plan, cannot provide for retirement through deductible IRA contributions. With respect to the tax-free rollover of a lump sum

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[1] Each participant's right to shares credited to this account must be nonforfeitable at all times.

[2] A TRASOP (or two or more of an employer's TRASOPS) must separately satisfy the same employee participation requirements applicable to qualified plans.

[3] An employee who participates in the TRASOP at any time during the year for which an employer contribution is made is entitled to a share of the employer contribution based upon the amount of the employee's compensation from the employer. Only the first $100,000 of an employee's compensation is considered for this purpose. New ESOPs (including TRASOPs) are not permitted to be integrated with social security benefits.

[4] The portion of employee contributions considered for this purpose is limited to the lesser of (1) one-half of the employee contributions, or (2) employee contributions in excess of 6 percent of the employee's compensation.

[5] This limitation is adjusted for inflation.

distribution from a qualified plan to an IRA or to another qualified plan, present law requires that the same property received in the distribution be rolled over. Accordingly, employer stock received in a lump sum distribution from an ESOP (including a TRASOP) cannot be rolled over to an IRA or another plan unless the IRA or plan is permitted to hold stock (many IRAs and plans cannot hold stock, e.g., a savings account IRA or a plan not funded exclusively with insurance contracts).

Under present law, all ESOPs must be designed to invest primarily in employer stock, and any ESOP which is established as a stock bonus plan is required to distribute benefits in the form of employer stock. The ESOP rules provide that if benefits are distributed in the form of employer stock, the distributee must also receive an option to sell the stock to the employer (a put option).

If a qualified plan distributes benefits in the form of appreciated employer securities, present law provides that although the amount distributed is generally taxed in the year received, the unrealized appreciation on the employer securities is not taxed until the securities are subsequently sold or exchanged, at which time appreciation is taxed as a capital gain.

Under present law, for purposes of the corporate minimum tax on tax preferences, a deduction is allowed for regular income tax paid by the corporation, but the deduction is reduced by the amount of allowable investment tax credit. Consequently, a corporate employer that makes investment tax credit contributions to a TRASOP may incur additional minimum tax on its preference income.

S. 3241

Description of the bill

General

S. 3241 would make the additional investment tax credit for TRASOP contributions permanent and would raise the credit from one percent to 2 percent. The requirement for matching employee contributions as a prerequisite for the additional one-half percent credit would be repealed. Also, the bill would allow a corporate employer a credit of one percent of the compensation of employees covered by a TRASOP if an amount equal to the credit is contributed to the TRASOP by the employer. Under the bill, an employer could choose the greater of the 2-percent additional investment tax credit or the one-percent compensation credit. The bill provides that the credit would be allowed only if at least one-half of the employer stock acquired by the TRASOP with employer contributions is newly issued stock. (As under present law, the credit for TRASOP contributions would not be refundable.)

Deductions

Under the bill, a deduction would be allowed to an employer for dividends paid on employer stock held by an ESOP (including a TRASOP), if the dividends are passed through to the participants currently. In addition, taxpayers in general would be allowed an income tax, gift tax, or estate tax deduction for a contribution (or bequest) made to an ESOP if (1) the contribution is allocated to ESOP participants in a manner which does not discriminate in favor of employees who are officers, shareholders, or highly compensated, and (2) no part of the contribution is allocated to the donor, a relative of the donor, or any person who owns more than 25 percent of the stock of the employer. The dividend deduction and the contribution deduction would be allowed in addition to the usual limits on deductions for contributions to tax-qualified employee plans.

Voting rights

The bill would modify the operating rules for TRASOPs by providing that TRASOP participants would be entitled to direct the voting of employer stock allocated to them under a TRASOP only if an issue of the employer's securities is registered under the Securities Exchange Act of 1934.

Lump sum distributions

Under the bill, a benefit distribution to an employee from a TRASOP could be treated as a lump sum distribution even though a portion of the stock allocated to the employee's account is held in a separate TRASOP account and is withheld by the plan until expiration of the time for recapture of the related investment tax credit. Also, when benefits under a qualified plan (including an ESOP or TRASOP) are payable as a lump sum distribution, the bill would not deny the estate tax exclusion for the benefits unless the recipient actually elects 10-year income averaging.

The bill would continue present law under which a recipient of a lump sum distribution which includes appreciated employer securities defers tax on the appreciation until the securities are sold or exchanged, but the bill would permit the recipient to elect to have the unrealized appreciation taxed as part of the lump sum distribution (to which 10-year income averaging would apply).

Individual retirement accounts (IRAs)

The bill would permit a participant in a TRASOP to make deductible contributions to an IRA (if the participant is not also covered by another qualified plan, a tax-sheltered annuity arrangement, or a governmental plan). Also, the bill would permit a tax-free rollover of the proceeds of the sale of employer stock distributed by a qualified plan to an IRA or another plan if the stock is sold back to the distributing plan. Under the bill, gain on the sale of the stock would not be taxed in the year of sale if a rollover is completed.

Put options

Under the bill, an ESOP which provides for the payment of a cash benefit in lieu of employer stock would not be required to provide a put option with respect to any stock it actually distributes. Also, the bill provides that this arrangement will not be considered the offering of a security to a participant for purposes of Federal or State securities laws.

Minimum tax

Under the bill, beginning with 1975, an employer will not incur the minimum tax on account of a contribution of investment tax credit to a TRASOP.

Effective date

The bill would apply for taxable years beginning after December 31, 1977.

Revenue effect

It is estimated that the portion of the bill which increases the investment credit from one to two percent for employers with TRASOP's would result in a reduction of budget receipts of $0.6 billion in fiscal year 1979.

The revenue effect of the portion of the bill which allows a corporate employer a credit of one percent of the compensation of TRASOP covered employees could vary greatly depending on the timing of the election by employers. If approximately one-third of eventual electors participated in calendar years 1978 and 1979, the reduction of budget receipts in fiscal 1979 would be $1.3 billion. If, however, all eventual electors participated in those years then the reduction in fiscal 1979 budget receipts would be $3.8 billion.

S. 3291

Description of the bill

S. 3291 would increase to 50 percent the present 25-percent limit on deductions for employer contributions to qualified plans, where an employer maintains a pension plan and either a profit-sharing or stock bonus plan if one of the plans is an ESOP and the additional contribution is made to the ESOP. Also, the bill would increase to 50 percent the present 25-percent limit on amounts which may be allocated to the account of an employee who participates in an ESOP.

Effective date

The bill would apply for years beginning after December 31, 1978.

Revenue effect

The adoption of the proposal is not expected to have a significant effect on 1979 budget receipts.

III. GENERAL STOCK OWNERSHIP TRUSTS—S. 3223

Present law

Under present law, there are no special provisions relating to the establishment of a trust to acquire stock in private corporations for the benefit of the residents of the United States or of a State or local government.

Description of the bill

General

The bill would allow the United States, a State or the political subdivision of a State to establish a general stock ownership trust ("GSOT"). A GSOT would be maintained for the benefit of residents of the jurisdiction which establishes it. The trust would be authorized to borrow money to acquire stock in business corporations.[1] The GSOT would hold this stock for such residents. It is anticipated that institutional loans would be available to such a trust because the jurisdiction which establishes the GSOT would be permitted to guarantee

[1] Under the bill, only common stock issued by a corporation with voting power and dividend rights no less favorable than the voting power and dividend rights of other common stock issued by the corporation could be acquired by a GSOT.

these loans. Amounts of corporate income received by the GSOT on stock held by it would be used to pay the obligations incurred by the trust to acquire such stock or to make distributions to participants.

Participating in the GSOT

Under the bill, any resident of the jurisdiction sponsoring the GSOT would be eligible to participate, provided he or she had satisfied a 12-month residency requirement.

Corporate deduction for payment to a GSOT

Under the bill, a corporation would be allowed a deduction (within certain limits) for amounts of corporate income paid on its stock a GSOT. This deduction would be allowed for a taxable year so long as the amount was paid to the trust not later than the due date of the corporation's Federal income tax return for such taxable year (including any extension).

Tax treatment of the GSOT

Under the bill, a GSOT would be exempt from Federal income taxation (including the tax on unrelated business income).

The bill would require a GSOT to "distribute" all amounts of corporate income received on shares of corporate stock it holds. These distributions would be required to be made no later than the due date for the filing of the trust's information return for its taxable year. The GSOT would have satisfied this requirement to distribute amounts of corporate income received by it so long as all such dividends were (1) actually paid to participants of the trust; (2) paid as ordinary and necessary expenses of trust operation, or (3) paid in retirement of debt principal and interest incurred in furtherance of the trust's purpose.

Under the bill, the failure of a GSOT to make a required distribution would be a prohibited transaction. In such event, an excise tax equal to 5 percent of the amount involved would be imposed on the "responsible person". If the prohibited transaction were not corrected, a tax equal to 100 percent of the amount involved would be imposed.

Tax treatment of participants

The bill would provide that amounts paid by a GSOT with respect to amounts received on stock held in a participant's account would be income to the participant only when actually distributed to the participant; and at such time, would be treated as a dividend for tax purposes.

Shares of stock transferred either to a participant from a GSOT or to a participant's account in a GSOT would not be considered taxable income to the participant. A participant would not be taxable on such distributed stock until such time as the participant sold or exchanged the stock.

Eligibility for industrial development bonds

The bill would permit a sponsoring State or local government to issue industrial development bonds to finance stock acquisitions made by its GSOT.

Effective date

The provisions of the bill would apply to taxable years beginning after December 31, 1978.

Revenue effect

The revenue effect of this provision on budget receipts depends on the extent to which various governmental units elect to sponsor general stock ownership plans and the timing of setting up such plans. There is not enough information now to predict what the responses of the many governmental units will be with respect to this bill. However, adoption of the proposal is not expected to have a significant effect on 1979 budget receipts.