[JOINT COMMITTEE PRINT]

TAX REFORM PROPOSALS: TAX TREATMENT OF EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs)

FOR THE USE

OF THE

COMMITTEE ON WAYS AND MEANS

AND THE

COMMITTEE ON FINANCE

PREPARED BY THE STAFF

OF THE

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INTRODUCTION

This pamphlet[1] is prepared by the staff of the Joint Committee on Taxation for the House Committee on Ways and Means and Senate Committee on Finance in connection with the respective committee review of tax reform proposals. This pamphlet is one of a series of tax reform proposal pamphlets, and it describes and analyzes tax provisions and proposals relating to the tax treatment of employee stock ownership plans (ESOPs).

The pamphlet describes present-law tax provisions and the various tax reform proposals made by President Reagan ("The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity," May 1985, referred to as the "Administration Proposal"), the 1984 Treasury Department recommendations to the President ("Tax Reform for Fairness, Simplicity, and Economic Growth," November 1984, referred to as the "1984 Treasury Report"), Congressional proposals (identified by the primary sponsors), and other related proposals.

The pamphlet contains a discussion of the rules relating to employee stock ownership plans (ESOPs).

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Tax Reform Proposals: Tax Treatment of Employee Stock Ownership Plans (ESOPs)* (JCS–42–85), September 20, 1985.

EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs)

A. Present Law and Background

1. Overview of Qualified Plans and ESOPs

General background

Under the Federal income tax system, individuals generally are taxed on income as it is received. This principle has been applied to tax income that is made available (constructively received) in addition to income actually received. If there is a transfer of property in exchange for services, the individual performing the services generally is required to include the value of the property in gross income when the right to the property is not subject to a substantial risk of forfeiture. In addition, the gross income of a taxpayer generally includes noncash items that are equivalent to cash. An employer's deduction for deferred compensation paid to employees generally is postponed until the employee includes the amount in income.

Historically, exceptions to the principles of constructive receipt have been adopted by Congress to encourage certain savings by taxpayers. In particular, taxpayers have been encouraged by the tax law to set a part of their compensation aside under current programs that generally are designed to replace compensation upon retirement. Present law provides incentives by permitting taxpayers to postpone income tax on current compensation set aside for retirement, and on investment earnings on those savings, under special plans of deferred compensation. Under these plans, income tax is generally postponed until the time benefits are paid, even though the benefits (if funded and nonforfeitable) would otherwise be considered constructively received or equivalent to cash. Also, employers are allowed deductions (within limits) when contributions are made to these plans.

Since 1921, the Internal Revenue Code has provided that certain employee trusts are exempt from Federal income tax. The 1921 Code provided an exemption for a trust forming part of a qualified profit-sharing or stock bonus plan.[2] The 1926 Code provided a similar exemption for qualified pension trusts and established deduction limits designed to set appropriate limits on the extent to which tax-favored treatment would be available under qualified plans.[3]

The standards for plan qualification have been revised and expanded since 1921 to reflect Congressional interest in the expansion of pension, profit-sharing, and stock bonus plans and concern over tax abuses. The rules relating to qualified plans were substan-

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[2] Sec. 219(f) of the Revenue Act of 1921.
[3] Sec. 219(f), sec. 23(p) of the Revenue Act of 1921.

tially revised by the Employee Retirement Income Security Act of 1974 (ERISA), which added (1) minimum coverage, vesting, benefit accrual, and funding requirements, and (2) overall limits on contributions and benefits.

In addition to the deferral of income tax on amounts contributed to a qualified pension, profit-sharing, or stock bonus plan (qualified plan), present law provides an exclusion from employment taxes (FICA and FUTA) for the amounts deferred under, and the benefits paid from, a qualified plan.[4] Effective for years beginning after December 31, 1981, amounts held in a trust forming part of a qualified plan are taxable to the employee or beneficiary only when actually paid or distributed under the plan. In addition, if the distribution is made in the form of a lump sum, present law provides relief from the effect of graduated tax rates by providing special income averaging rules. Present law also provides special treatment for net unrealized appreciation in employer securities distributed under a qualified plan. Moreover, certain distributions may be rolled over, tax free, to an individual retirement account or annuity (IRA) or to another qualified plan.

A money purchase pension plan is a defined contribution plan[5] under which the amount of employer contributions allocated to the account of an employee must be fixed or determinable. In addition, employer contributions are subject to minimum funding standards. Benefits generally may be paid under a money purchase pension plan only in the event of death, disability, separation from service, or attainment of the normal retirement age specified in the plan (e.g., age 65).

A stock bonus plan is also a type of defined contribution plan. Under a stock bonus plan, employer contributions may be made under a fixed formula or they may be related to profits of the employer. The rules for stock bonus plans generally require that benefits be available for distribution in the form of employer stock. Benefits can be distributed to an employee who has not separated from service.

An employee stock ownership plan ("ESOP") is a tax-qualified plan[6] designed to invest primarily[7] in qualifying employer securities. The securities, which are held by one or more tax-exempt trusts under the plan, may be acquired through direct employer contributions or with the proceeds of a loan to the trust (or trusts).

Although pre-1974 administrative rulings permitted an employer to establish a qualified plan designed to borrow money based on an employer's guarantee and to invest primarily in employer securities,[8] it was the Employee Retirement Income Security Act of 1974

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[4] This employment tax exclusion does not apply to elective deferrals under a qualified cash or deferred arrangement (sec. 401(k) or a tax-sheltered annuity (sec. 403(b)).

[5] A defined contribution plan is one under which each participant's benefit is based solely on the balance of the participant's account, consisting of contributions, income gain, expenses, losses, and forfeitures allocated from the accounts of other participants.

[6] The plan may consist of a stock bonus plan or a combination of a stock bonus plan and a money purchase pension plan.

[7] Although the ESOP must invest "primarily" in employer securities, it is permissible to hold other assets sufficient to cover administrative expenses and to enable the ESOP to repurchase employer securities and make cash distributions, if necessary (Treas. Reg. sec. 54.4975-11(b)).

[8] Rev. Rul. 46, 1953-1 C.B. 287, updated by Rev. Rul. 71-311, 1971-2 C.B. 184.

(ERISA) that first established the ESOP as a separately described form of qualified defined contribution plan. In addition, ESOPs are accorded special treatment under the rules of ERISA and the Code proscribing certain conflicts in interest and self dealing (prohibited transaction rules).

Leveraged ESOP

An ESOP that borrows to acquire employer stock is referred to as a "leveraged ESOP." Generally, an employer will establish an ESOP in order to to borrow funds. Then, the employer or a holder of employer securities generally enters into a contract with the ESOP to sell the ESOP a specified amount of those employer securities at fair market value. In some cases, the ESOP borrows from a financial institution the funds needed to purchase the stock and uses the proceeds to purchase the stock. Typically, the loan is guaranteed by the employer. The employer stock may be pledged as collateral.[9] In subsequent years, the employer makes tax-deductible contributions to the ESOP in amounts necessary to pay principal and interest payments on the loan.

Alternatively, the employer may borrow from a financial institution or other lender and sell its stock to the ESOP in exchange for the ESOP's installment note. Under this arrangement the employer makes deductible contributions to the ESOP. The ESOP uses these contributions to pay off the note to the employer who will, in turn, use those payments to repay its lender.

In either case, as the loan is retired, stock is allocated to the employees, increasing their beneficial interest although the stock may not actually be distributed until retirement or some other subsequent event.

From the standpoint of the ESOP participants, a leveraged ESOP may be preferable to an ordinary ESOP because it can acquire a large equity interest in the employer corporation more quickly than if shares were purchased only with annual contributions from the employer. Employers also may prefer a leveraged ESOP for this reason and because of the value of the ESOP as a financing vehicle. Leveraged ESOPs are designed as an alternative corporate financing technique which, because of the special tax benefits (described more fully below) available to the employer, the ESOP, and certain institutions making loans to ESOPs, can produce a lower cost of borrowing than if conventional debt or equity financing were used.[10] The employer corporation may use the proceeds of the sale of its stock to the ESOP as general working capital, to finance plant expansion, or for other corporate purposes.

Leveraged ESOPs have been used to create a market for employer securities, to finance acquisitions of the stock or assets of other companies and to defend against attempted takeovers. A leveraged ESOP acquisition of another company might be structured in the following manner. An ESOP maintained by the acquiring corpora-

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[9] The loan must be nonrecourse to the ESOP, and the only assets of the ESOP that may be pledged are the shares purchased with the loan proceeds.

[10] Among other benefits, a 50-percent interest exclusion available to certain ESOP lenders may enable the lender to lend to the ESOP at a lower rate than it lends to customers utilizing more traditional financing techniques. This rate may lower than 80 percent of the prevailing prime rate.

tion or its subsidiary borrows funds in an amount equal to the amount needed to acquire the target corporation. The proceeds of the loan are used to purchase employer securities. The employer (or the subsidiary) in turn uses the monies to purchase the stock or assets of the target company. The employer's contributions to the leveraged ESOP to enable it to amortize the loan will, within statutory limits, be deductible. Because of the interest exclusion available to the lending institution, the loan will carry a favorable interest rate, which reduces the amount required to amortize the loan. In this manner, the corporation can reduce its after-tax cost of financing the acquisition.

One variation of this leveraged-ESOP financing technique is for the employer to purchase target stock, either directly or through a subsidiary, using funds borrowed from a financial institution or other lender. Once the acquisition is complete, the newly acquired subsidiary establishes a leveraged ESOP. The ESOP borrows money and purchases stock in the subsidiary from the subsidiary (or from the acquiring corporation). The acquiring corporation then uses the proceeds of this sale to pay off the original acquisition loan. The subsidiary thereafter makes annual, deductible contributions sufficient to amortize the principal and pay interest on the ESOP's loan.

Leveraged ESOPs are used in some cases to thwart corporate takeover attempts. By selling stock to an ESOP, a company may make it difficult for a bidder to acquire control, since stock held by an ESOP generally might by some be expected to be voted to keep the company independent. In any event, a sale of stock to the ESOP will not necessarily dilute control of the company to the same degree as a sale to outside parties. The stock purchased by a leveraged ESOP is not immediately credited to employees' individual accounts but is held in a suspense account and released for allocation to employees' accounts as the acquisition loan is repaid. During this period, the shares may be voted by plan trustees subject to the fiduciary rules of ERISA.

Leveraged ESOPs also have been used in conjunction with so-called "leveraged buy-outs" of companies by managers seeking to remove such companies from being publicly traded.[11]

Tax credit ESOP

An ESOP under which an employer contributes securities or cash with which to acquire securities in order to qualify for a credit against income tax liability is referred to as a tax credit ESOP. A tax credit ESOP must satisfy additional special requirements relating to vesting, allocation of employer contributions, and certain distribution rules.

The tax credit ESOP was created by the Tax Reduction Act of 1975, modified by the Tax Reform Act of 1976, renamed by the Revenue Act of 1978, converted from an investment-based tax credit to a payroll-based tax credit by the Economic Recovery Tax Act of 1981, and further modified by the Deficit Reduction Act of 1984.

[11] This is sometimes referred to as "taking the company private."

2. ESOPs as Employee Benefit Plans

a. Qualification requirements

In general

Under present law, a funded plan (including an ESOP) is a qualified plan if it meets certain requirements of the Internal Revenue Code. A trust forming part of a qualified plan is exempt from tax as a qualified trust if (1) employer contributions to the trust are made for the purpose of distributing the corpus and income to employees and their beneficiaries, and (2) under the trust instruments it is impossible for any part of the trust corpus or income to be used for, or diverted to, purposes other than the exclusive benefit of employees before the liabilities to employees and their beneficiaries are satisfied. Benefits or contributions under a qualified plan are subject to standards designed to prohibit discrimination in favor of employees who are officers, shareholders, or highly compensated.

In addition, qualified plans are required to meet minimum standards relating to coverage (the class of employees eligible to participate in the plan) (sec. 410), vesting (the time at which an employee's benefit becomes nonforfeitable) (sec. 411(a)), and benefit accrual (the rate at which an employee earns a benefit) (sec. 411(b)). Also, minimum funding standards apply to the rate at which employer contributions are required to be made in order to ensure the solvency of pension plans (sec. 412). Further, contributions or benefits must not exceed specified limits (sec. 415).[12]

Special ESOP qualification rules

In addition to satisfying the general requirements, applicable to all qualified plans (sec. 401), ESOPs generally must satisfy certain qualification requirements (sec. 409).[13] The scope of the special qualification rules differs depending on whether the plan is structured as a tax-credit ESOP.

An ESOP will not be a qualified plan unless, in addition to satisfying the overall qualification requirements, it provides that (1) participants have the right to demand that benefits be distributed in the form of employer stock; (2) with respect to employer securities that are not readily tradeable, participants have a right to require that the employer repurchase the securities under a fair valuation formula (i.e., a "put option"); and (3) participants have the right to direct the trustee to vote certain employer securities. If

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[12] For a more complete discussion of the qualification requirements, see Joint Committee on Taxation, *Tax Reform Proposals: Pensions and Deferred Compensation*, (JCS-33-85), August 5, 1985.

[13] Certain tax-credit ESOPs established pursuant to section 301(d) of the Tax Reduction Act of 1975 (TRASOPs) could, but were not required to, meet the general plan qualification requirements. However, TRASOPs had to meet certain statutory requirements. An employee who participated in a TRASOP at any time during the year for which an employer contribution was made was entitled to have a share of the employer contribution credited to an account under the plan based upon the amount of the employee's compensation from the employer. Also, a plan participant was entitled to direct the voting of employer stock allocated to his or her account under a TRASOP, whether or not such stock was registered under Federal securities laws. In addition, even if a TRASOP was not a tax-qualified plan, it had to satisfy special rules with respect to employee participation and limitations on contributions and benefits that were the same as those for tax-qualified plans.

the employer has registration-type securities,[14] participants must have the right to direct the trustee on how to vote allocated securities. If the employer does not have registration-type securities, participants must have the right to direct the trustee how to vote allocated securities with respect to any corporate matter that, by law or charter, must be decided by more than a majority vote.

In general, distributions under a stock bonus plan or an ESOP are required to be made in the form of employer securities. A participant in a leveraged ESOP or a tax credit ESOP who is entitled to a distribution under the plan must be provided the right to demand that the distribution be made in the form of employer securities rather than in cash. Alternatively, subject to a participant's right to demand a distribution of employer securities, the plan may elect to distribute the participant's interest in cash, in employer securities, or partially in cash and partially in employer securities.

In addition, a participant who receives a distribution of employer securities from a tax credit ESOP or a leveraged ESOP must be given a put option with respect to distributed employer securities that are not readily tradable.[15]

The distributee must be given at least sixty days after receipt of the securities to require the employer to repurchase the securities at their fair market value. If the distributee does not exercise the initial put option, the option will temporarily lapse. After the close of the employer's taxable year in which the temporary lapse of a distributee's option occurs and following a determination of the value of the employer securities (in accordance with Treasury regulations) as of the end of that taxable year, the employer is required to notify each distributee who did not exercise the initial put option in the preceding year of the value of the employer securities as of the close of the taxable year. The distributee must then be given at least sixty days to require that the employer repurchase the employer securities. If the distributee does not exercise this put option, the option permanently lapses.

Tax credit ESOP.—In addition, a tax credit ESOP must satisfy additional special requirements relating to vesting, allocation of employer contributions, and certain distribution rules. Under the vesting rules, a participant's right to stock allocated to an account under a tax credit ESOP must be nonforfeitable. Under the special allocation rules, any employee participating in the plan and entitled to share in the allocation of employer securities must receive

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[14] Registration-type securities are defined as (1) those required to be registered under section 12 of the Securities Exchange Act of 1934, and (2) those that would be required to be registered but for the exemption provided by section 12(9)(2)(H) (relating to securities issued in connection with a qualified stock bonus, pension, profit-sharing, or annuity plan).

[15] Present law provides certain exceptions to these rules requiring distributions of employer securities. First, an ESOP may preclude a participant from demanding a distribution in the form of employer securities if the employer's corporate charter (or bylaws) restricts the ownership of substantially all outstanding employer securities to employees or to a trust under a qualified plan. The ESOP must, however, provide that participants entitled to a distribution have a right to receive the distribution in cash.In addition, in the case of a tax credit ESOP or a leveraged ESOP established and maintained by a bank or similar financial institution which is prohibited by law from redeeming or purchasing its own securities, an exception is made to the rule generally requiring that a participant who receives a distribution of employer securities must be given a put option if the securities are not readily tradable. No put option is required if the ESOP provides that participants entitled to a distribution from the plan have a right to receive the distribution in cash.

an allocation of securities based upon the ratio of that participant's compensation to all compensation paid to all participants. However, only the first $100,000 of compensation may be taken into account in determining this allocation.

For a discussion of the special distribution restrictions, see 2.d., below.

b. Investment in employer securities and voting rights

ERISA limitations

ERISA generally provides a limit on the proportion of plan assets that may be invested in securities or real property of a related employer. Under ERISA, in the case of a defined benefit pension plan[16] or a money purchase pension plan,[17] holdings of qualifying employer securities and qualifying employer real property generally may not exceed 10 percent of plan assets (ERISA sec. 407(a)). Certain defined contribution plans may hold up to 100 percent of plan assets in qualifying employer securities and qualifying employer real property provided the plan specifies the extent of such investments. In addition, an ESOP must be designed to invest primarily in qualifying securities of the employer.

Under ERISA, for qualified plans generally, qualifying employer securities include any stock or marketable obligation of an employer of employees covered by the plan, or by an affiliate of the employer (ERISA sec. 407(c)(1)). Thus, employer stock or certain employer debt obligations[18] are considered qualifying employer securities for purposes of applying the 10 percent limit.

ESOP definition

In the case of an ESOP, the class of employer securities is further limited. Employer securities are defined as common stock or certain convertible preferred stock[19] issued by the employer maintaining the ESOP (or by a corporation that is a member of the same controlled group)[20] that is readily tradeable on an established securities market (sec. 409(h)(1)).

If there is no readily tradeable common stock issued by the employer (or any member of a controlled group including the employer) employer securities are qualifying employer securities only if they consist of that common stock issued by the employer (or any member of a controlled group including the employer) having (1) voting power at least equal to that class of common stock having the greatest voting power, and (2) dividend rights at least equal to

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[16] A defined benefit pension plan specifies a participant's benefit independently of an account for contributions, etc. (e.g., an annual benefit of two percent of average pay for each year of employee service).

[17] A money purchase pension plan is a defined contribution plan under which contributions allocated to an employee's account must be fixed or determinable.

[18] Under ERISA, debt obligations will be considered qualifying employer securities only if (1) those obligations are traded on a national securities exchange or have a price otherwise established by independent persons, (2) the plan holds no more than 25 percent of the issue, and (3) independent persons hold at least one-half of the issue (ERISA sec. 407(e)).

[19] Noncallable preferred stock that is convertible at any time into otherwise qualifying employer securities may be treated as qualifying employer securities.

[20] Although a group of corporations that is a controlled group within the meaning of section 1563 generally will be considered a controlled group for purposes of identifying which securities are qualifying employer securities. A series of special rules also applies with respect to certain tiered subsidiaries.

that class of common stock having the greatest dividend rights (sec. 409(h)(2)).

An ESOP maintained by an employer that has registration-type[21] securities must provide that each participant in the plan is entitled to direct the trustee in the exercise of voting rights with respect to securities allocated to the participant's account (sec. 409(e)(2)).

In addition, a tax-qualified defined contribution plan (other than a profit-sharing plan) that is established by an employer whose securities are not publicly traded and that, following any acquisition of employer securities after 1979, holds more than 10 percent of its assets in employer securities, must provide that a plan participant is entitled to direct the trustee in the exercise of voting rights with respect to employer securities allocated to the participant's account on any corporate issue that must, by law or charter, be decided by more than a majority vote of outstanding common shares voted on the issue (sec. 409(e)(3)).

c. Special ESOP limits

Deduction limits

In general.—The contributions of an employer to a qualified plan are deductible in the year for which the contributions are paid, within limits (sec. 404). No deduction is allowed, however, for a contribution that is not an ordinary and necessary business expense or an expense for the production of income. The deduction limits applicable to an employer's contribution depend on the type of plan to which the contribution is made and may depend on whether an employee covered by the plan is also covered by another plan of the employer. Under the Code, if a contribution for a year exceeds the deduction limits, then the excess generally may be deducted in succeeding years as a carryover. Deductions are not allowed with respect to contributions or benefits in excess of the overall limits on contributions or benefits (sec. 404(j)).

In the case of a qualified profit-sharing or stock bonus plan, employer contributions for a year not in excess of 15 percent of the aggregate compensation of covered employees generally are deductible for the year paid.

Employer deductions for contributions to a money purchase pension plan are deductible to the extent necessary to meet the minimum funding standard for plan years ending with or within the taxable year (sec. 404(a)). Under a qualified money purchase pension plan, the contribution rate specified by the plan is required to be made under the minimum funding standard unless that standard is waived.

If an employer maintains a pension plan (defined benefit or money purchase) and either a profit-sharing or a stock bonus plan for the same employee for the same year, then the employer's deduction for contributions for that year is limited to the greater of the contribution necessary to meet the minimum funding requirements of the pension plan for the year, or 25 percent of the aggre-

[21] See definition at n. 14 *supra*.

gate compensation of employees covered by the plans for the year. Deduction and limitation carryovers are provided (sec. 404(a)(7)).

Deductible contributions to leveraged ESOPs.—As a result of the separate plan deduction limits, the deduction allowed an employer for contributions to a profit-sharing or stock bonus plan (including a leveraged ESOP stock bonus plan) for years beginning before 1982 generally was limited to 15 percent of the aggregate compensation of all employees under the plan. However, in the case of a leveraged ESOP consisting of a stock bonus plan and a money purchase pension plan, the deduction for contributions to qualified plans for a year was limited to 25 percent of the aggregate compensation of employees covered by the plans. Employer contributions used to repay interest on ESOP acquisition indebtedness were included in this limitation.

However, effective for years beginning after 1981, the Economic Recovery Tax Act (ERTA) expanded the deduction rules to provide that amounts contributed by an employer to a leveraged ESOP and applied by the plan to the payment of interest on a loan incurred to purchase employer securities are allowed as a deduction to the employer without regard to an annual percent-of-compensation limit. The deduction allowed the employer for contributions applied to the payment of loan principal (but not interest) is limited to 25 percent of the compensation of all employees under the plan.

Deduction for dividends paid on ESOP stock.—Effective for dividends paid in taxable years beginning after December 31, 1984, present law permits an employer to deduct the amount of certain dividends paid with respect to stock of the employer that is held by an ESOP. (See discussion in 3.a., below.)

Limits on tax credits

Special tax credits are provided for employers maintaining qualifying tax credit ESOPs. These credits were initially investment based (and the plans were called TRASOPs) but generally effective, after 1982, are payroll based (and the plans are called PAYSOPs).

TRASOPs.—Prior to the Economic Recovery Tax Act of 1981 (ERTA), an employer was entitled to an additional percentage point of investment tax credit (i.e., 11 percent rather than 10 percent) if it contributed an amount equal to the full additional credit to a tax credit ESOP. The contribution could be made in cash or employer securities. If cash was contributed, the ESOP was required to apply the cash to purchase employer securities within 30 days after the contribution. The employer's contribution to the ESOP could be made for the taxable year for which the investment tax credit is earned or as late as the taxable year for which the credit is claimed. In addition to the one-percent credit, up to one-half percent of extra investment tax credit was allowed where an employer contributed the extra amount to the tax credit ESOP and the employer's extra contribution was matched by employee contributions.

The Economic Recovery Tax Act of 1981 (ERTA) repealed the additional investment tax credit with respect to qualifying investments made after December 31, 1982, and added a payroll-based tax credit. With respect to qualifying investments made after December 31, 1981, and before January 1, 1983, an employer was allowed a partial additional investment tax credit (i.e., an additional credit not in excess of one percent), if the employer contributed an amount equal to the additional credit to a tax credit ESOP.

PAYSOPs.—For taxable years ending after December 31, 1982, in lieu of the additional investment tax credit, an electing employer is allowed an income tax credit for contributions to a tax credit ESOP limited to a prescribed percentage of the aggregate compensation of all employees under the plan. For compensation paid or accrued in calendar years 1983 and 1984, the tax credit was limited to one-half of one percent of compensation. With respect to compensation paid or accrued in 1985, 1986, and 1987, ERTA provided that the limit was scheduled to increase to three-quarters of one percent. However, the Deficit Reduction Act of 1984 (DEFRA) repealed that scheduled increase. No credit is available with respect to compensation paid or accrued after December 31, 1987.

No payroll-based tax credit is allowed for contributions to a plan if more than one-third of the employer's contribution for the year is allocated to the group of employees consisting of officers, shareholders directly or indirectly owning more than ten percent of the employer's stock (other than stock held by qualified plans), or individuals whose compensation exceeds a specified limit (for 1985, $60,000) (sec. 41(c)(1)(A)).

The amount of the employer's income tax liability that can be offset by the payroll-based tax credit for contributions to a tax credit ESOP generally is limited to the first $25,000 of tax liability, plus 85 percent of the excess over $25,000 (sec. 38(c)).[22] If the tax credit exceeds the amount of tax liability against which the credit may be applied for a taxable year, certain carrybacks and carryforwards are provided.[23]

Limits on annual additions

In general.—The Employee Retirement Income Security Act of 1974 (ERISA) amended the Code to provide overall limits on contributions and benefits under qualified plans and tax-sheltered annuities (sec. 415). The overall limits apply to contributions and benefits provided to an individual under all qualified plans, tax-sheltered annuities, and simplified employee plans (SEPs) maintained by any private or public employer or by certain related employers. The limits were automatically adjusted for inflation. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) reduced the limits and suspended cost-of-living increases.

Defined contribution plans.—Under a defined contribution plan (including an ESOP), the qualification rules generally provide an overall limit on annual additions[24] with respect to each plan par-

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[22] If the employer is a member of a controlled group of corporations, the $25,000 amount against which the tax credit may be fully applied is reduced by apportioning such amount (pursuant to Treasury regulations) among the member corporations (sec. 38(c)(3)(B)).

[23] The unused tax credit may be carried back to each of the three preceding taxable years and carried forward to each of the 15 succeeding taxable years (sec. 39(a)). The amount of any unused credit that expires at the close of the last taxable year to which it may be carried is allowed as a deduction to the employer for such taxable year without regard to the usual limits on deductions for employer contributions to qualified plans (sec. 404 (i)).

[24] Annual additions include employer contributions, certain employee contributions, and forfeitures allocated from the accounts of other participants (sec. 415(c)(2)).

ticipant (sec. 415(c)). As originally enacted in 1974, the annual addition generally was limited to the lesser of (1) 25 percent of an employee's compensation for the year, or (2) $25,000, adjusted for cost-of-living increases, as measured by the changes in the consumer price index (CPI) since 1974. By 1982, the dollar limit, as increased to reflect cost-of-living adjustments, was $45,475. In 1982, TEFRA reduced the dollar limit from $45,475 to $30,000.

Special ESOP limits.—In addition, an employer's deductible ESOP contributions that are applied by the plan to the payment of interest on a loan to acquire employer securities, as well as any forfeitures of employer securities purchased with loan proceeds,[25] generally are not taken into account under the rules providing overall limits on contributions and benefits under qualified plans. However, such contributions and forfeitures are disregarded for purposes of the overall limitations only if no more than one-third of the employer's contributions for the year is allocated to the group of employees consisting of officers, shareholders directly or indirectly owning more than ten percent of the employer's stock (other than stock held by qualified plans), or individuals whose compensation exceeds a specified limit ($60,000 for 1985).

d. Special ESOP distribution restrictions

Stock bonus plans.—In general, a qualified stock bonus plan may distribute amounts attributable to employer contributions only after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of an event such as a layoff, illness, disability, retirement, death, or separation from service. Amounts that are to be distributed after a fixed number of years must be held in trust for at least two years. Special rules further restrict distributions from a stock bonus plan that contains a cash or deferred arrangement. An ESOP that is structured as a stock bonus plan is subject to these restrictions.[26]

Qualified money purchase plans.—A qualified money purchase pension plan may not distribute benefits before (1) the employee retires or otherwise separates from service, (2) the employee becomes disabled or dies, or (3) the plan terminates. The money purchase plan portion of an ESOP that is structured as a combination stock bonus plan and money purchase pension plan is subject to these restrictions.

Tax credit ESOPs.—In addition to satisfying these separate plan distribution restrictions, a tax credit ESOP must further restrict distributions. In general, employer securities allocated to an employee's account under a tax credit ESOP may not be distributed before the end of the 84th month after the month in which the securities are allocated. This limitation does not apply to distribu-

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[25] A forfeiture of an employer security is disregarded for purposes of the overall limitations on contributions and benefits only if the security's entire purchase price was paid with the proceeds of a loan to the ESOP. For this purpose, if a unit of employer securities is purchased by an ESOP partly with the proceeds of a loan and partly with other amounts, those securities having an aggregate value not in excess of the applied loan proceeds are treated as having been purchased only with the loan proceeds.

[26] For a discussion of those rules, see JCS-33-85 referenced in n. 12, *supra*.

tions of securities in the case of the employee's separation from service, death, disability, or certain acquisitions.[27]

Dividend distributions.—Certain ESOP distributions of dividends payable with respect to qualifying employer securities are permitted prior to the time the plan otherwise would be permitted to make distributions. Thus, dividends paid with respect to qualifying employer securities allocated to a participant's account under a stock bonus ESOP may be distributed immediately in cash. Similarly, dividends paid with respect to qualifying employer securities allocated to a participant's account under a combination stock bonus and money purchase plan ESOP may be distributed immediately in cash. These ESOP distributions of dividends are treated as plan distributions, and are not eligible for the dividends received deduction of section 116.

3. Incentives for ESOP Financing

a. Deduction for dividends paid on ESOP stock

As amended by the Deficit Reduction Act of 1984 (DEFRA), effective for dividends paid in taxable years beginning after December 31, 1984, present law permits an employer to deduct the amount of any dividends paid in cash during the employer's taxable year with respect to stock of the employer that is held by an ESOP (including a tax credit ESOP), but only to the extent the dividends are actually paid out currently to participants or beneficiaries (sec. 404(k)).

An employer is allowed a deduction for its taxable year in which the dividends are paid. The deduction is allowed with respect to dividends that (1) are, in accordance with the plan provisions, paid in cash directly to the participants, or (2) are paid to the plan and subsequently distributed to the participants in cash no later than 90 days after the close of the plan year in which paid.

For income tax purposes, dividends distributed under an ESOP, whether paid directly to participants pursuant to plan provisions or paid to the plan and redistributed to participants, generally are treated as plan distributions. Such dividends do not qualify for the partial exclusion from income otherwise permitted under Code section 116.

b. Partial exclusion of interest earned on ESOP loans

A bank (within the meaning of sec. 581), an insurance company, or a corporation actively engaged in the business of lending money may exclude from gross income 50 percent of the interest received with respect to a securities acquisition loan (sec. 133) made after July 18, 1984 and used to acquire employer securities after such date.

[27] The 84-month rule does not apply in the case of the direct or indirect transfer of a participant from the employment of a selling corporation to the employment of an acquiring employer where all (or substantially all) of the assets used by the selling corporation in a trade or business are sold to the acquiring employer. The 84-month rule is also waived for an employee of a subsidiary of the selling corporation, with respect to securities of the selling corporation, where the selling corporation disposes of its interest in the subsidiary and the employee continues in the employ of the subsidiary.

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A securities acquisition loan is defined as a loan to a corporation or to an ESOP to the extent that the proceeds are used to acquire employer securities (within the meaning of sec. 409(1)) for the plan.

c. Tax deferred rollover on gain derived from sales of stock to an ESOP

In general

As amended by DEFRA, effective for sales in taxable years of the seller beginning after July 18, 1984, present law permits a taxpayer to elect to defer recognition of gain on the sale of certain qualified securities to an employee stock ownership plan (ESOP) or eligible worker-owned cooperative to the extent that the taxpayer reinvests the proceeds in qualified replacement property within a replacement period (sec. 1042). To be eligible for nonrecognition treatment, (1) the qualified securities must be sold to an ESOP; (2) the ESOP or cooperative must own, immediately after the sale, at least 30 percent of the total value of the employer securities then outstanding; (3) the ESOP or cooperative must preclude allocation of assets attributable to qualified securities to certain individuals; and (4) the taxpayer must provide certain information to the Secretary of the Treasury.

Qualified securities; qualified replacement property

For purposes of this provision, qualified securities are defined as employer securities that (1) are issued by a domestic operating corporation that has no readily tradable securities outstanding, (2) have been held by the seller for more than one year, and (3) have not been received by the seller as a distribution from a qualified plan or as a transfer pursuant to an option or similar right to acquire stock granted to an employee by an employer (other than stock acquired for full consideration).

Qualified replacement property (which includes debt and equity instruments, as defined in sec. 165(g)(2)) consists of securities issued by another domestic corporation that does not, for the corporation's taxable year preceding the year in which such securities are acquired by the taxpayer seeking nonrecognition treatment, have passive investment income (within the meaning of sec. 1362(d)(3)(D)) exceeding 25 percent of such corporation's gross receipts for that taxable year.

Disposition of qualified replacement property

In general, the basis of the taxpayer in qualified replacement property is reduced by an amount not greater than the amount of gain realized on the sale of qualified securities to the ESOP that was not recognized pursuant to the election provided by this provision. The gain is to be recognized upon disposition of the qualified replacement property.

d. Payment of estate tax liability by an ESOP

As amended by DEFRA, effective for the estates of decedents required to file estate tax returns on a date after July 18, 1984, present law provides special rules permitting an ESOP to assume certain estate tax liabilities. If qualified employer securities are (1) acquired from a decedent by an ESOP or an eligible worker-owned cooperative, (2) pass from a decedent to an ESOP or worker-owned cooperative, or (3) are transferred by the decedent's executor to an ESOP or worker-owned cooperative, then the executor of the decedent's estate generally is relieved of estate tax liability to the extent the ESOP or cooperative is required to pay the liability (sec. 2210).

No executor is relieved of estate tax liability under this provision with respect to securities transferred to an ESOP unless the employer whose employees participate in the ESOP guarantees, by surety bond or other means as required by the Secretary of the Treasury, the payment of any estate tax or interest.

To the extent that (1) the decedent's estate otherwise is eligible to make deferred payments of estate taxes pursuant to section 6166[28] with respect to the decedent's interest in qualified employer securities; and (2) the executor elects to make payments pursuant to that section, the plan administrator of the ESOP or an authorized officer of the worker-owned cooperative also may elect to pay any estate taxes attributable to the qualified employer securities transferred to the ESOP or cooperative in installments pursuant to that section. The usual rules (sec. 6166) apply to determine ongoing eligibility for deferral.

B. Administration Proposal

Overview

In general, the Administration proposal would let the special employee benefit provisions affecting tax credit ESOPs expire as scheduled (i.e., with respect to compensation paid or accrued after December 31, 1987), and repeal the special qualified plan rules for leveraged ESOPs, replacing those provisions with other tax incentives for employee stock ownership. Thus, under the proposal, the rules for qualified plans would no longer specify higher limits on deductions or annual additions for ESOPs, and qualified plans could no longer be designed to invest primarily in employer securities.

Under the proposal, separate tax incentives would be provided to encourage employee stock ownership. The new Employee Stock Ownership Trust (ESOT), a nonaccumulating trust, would provide employees with beneficial ownership of employer securities, including all traditional incidents of ownership.

Other benefits would apply to the ESOT but not to a qualified plan or eligible worker-owned cooperative. Eligible lenders would be permitted to exclude 50 percent of the interest income earned on securities acquisition loans to the ESOT (but not to a qualified plan or cooperative). Individuals selling employer securities to the ESOT (but not a qualified plan or cooperative) may be eligible to defer recognition of the gain realized on the sale. In addition, employers would be permitted to deduct certain dividends paid with

[28] An election under section 6166 permits a qualifying estate to pay estate taxes in installments for up to 14 years (annual interest payments for four years, followed by up to ten annual installments of principal and interest. In addition, a special four-percent interest rate applies to estate taxes on the first $1 million of value of an interest in a closely held business.

respect to qualifying employer securities held by the ESOT (but not a qualified plan or cooperative).

ESOPs as employee benefit plans

Under the proposal, (1) the tax credits for ESOPs would expire as scheduled (after December 31, 1987), (2) the special limits on employer deductions and annual additions with respect to qualified plans would be repealed, (3) the special ESOP exception to the conflict of interest and self-dealing rules would be repealed, (4) qualified plans would be prohibited from investing primarily in qualifying employer securities, and (5) qualified plans would be ineligible for other tax incentives, including dividends-paid deductions, interest exclusions on securities acquisition loans, tax-deferred rollovers, and the special estate tax provisions.

Employee stock ownership trust (ESOT)

In general

Under the proposal, any employer with 15 or more employees would be eligible to create a qualified ESOT. If the ESOT qualifies, then (1) the trust would be exempt from income tax, (2) employers would be allowed deductions (within limits) for principal payments made on a securities acquisition loan, or amounts contributed to an ESOT, and participants would not be currently taxed on such contributions, and (3) participants would not be taxed until the employer securities were sold or exchanged.

ESOT loan

An employer that borrows funds from an unrelated lender to purchase outstanding employer securities with a fair market value equal to the principal amount of the loan would be permitted to deduct principal payments made either to the lender or to the ESOT with respect to the indebtedness, provided that (1) the employer contributes the securities to an "employee stock ownership trust," and (2) the loan agreement requires either (a) annual principal payments not greater than 20 percent or less than 8.3 percent of the original principal balance, or (b) equal annual payments and a term of ten years or less. In addition, an employer could not deduct principal payments for any year in excess of 25 percent of eligible employees' aggregate compensation for such year. Nondeductible payments would be deductible in a subsequent year, subject to the same 25 percent limit. Parallel rules would be provided for nonleveraged ESOTs to which the sponsoring employer committed to making a stream of contributions.

Qualified ESOT trust

The ESOT would be required to satisfy special rules with respect to the allocation and distribution of employer securities as well as the control of voting rights. The ESOT trust agreement would be required to provide that (1) the securities distributed or allocated during a year, and (2) dividends on undistributed and unallocated securities, be apportioned among all employees (or, those employees with 1000 hours of service) on the basis of each employee's compensation for the year not in excess of $50,000.

Under the proposal, employees would be entitled to direct the trustee to vote allocated securities. In addition, employees must be able to vote unallocated securities with respect to any corporate matter requiring more than a majority vote of outstanding employer securities. The trustee could grant the right to vote unallocated securities in such cases to employees eligible to receive distributions from the trust in any reasonable manner.

The ESOT generally would be required to distribute annually a portion of the securities equal in value to the sum of (1) the scheduled principal payments on the loan, plus (2) dividends paid on allocated and unallocated stock held by the ESOT. Alternatively, the trust agreement could provide that the trust would retain nominal ownership of the employer securities allocated to employees. However, if the trust retained nominal ownership, it would be required to provide employees with all rights of direct ownership in the securities, including the right to dividends paid with respect to the securities, the right to direct the vote (either individually or through a voting trust) and the right to direct the ESOT to transfer the securities (either directly or pursuant to a buy-sell agreement).

In addition, the employer would be required to grant employees the right to put distributed or allocated securities to the employer at their fair market value within three years after receipt or allocation of the securities. The put would be required to be available during a specified period every year thereafter (through the year following separation from service).

Taxation of participants

Employees would recognize no income on account of the distribution or allocation of securities under an ESOT. Upon sale or disposition of securities, employees would recognize income equal to the full amount of the proceeds from the sale or disposition. The portion not in excess of the employer's principal payments with respect to the stock would be characterized as ordinary income, and the excess would be characterized as capital gain.

Other tax benefits

Under the proposal, the present-law rules relating to the exclusion of certain interest on a securities acquisition loan and the deferral of gain on certain sales of employer stock would apply only with respect to transactions involving the new ESOT. In addition, the special employer deduction for payments of certain dividends would be revised to apply only to ESOTs, and would apply only if the employer makes an additional nondeductible payment to the employees receiving the dividends. Under the proposal, the present law provision permitting an ESOP to assume certain estate tax liabilities would be repealed.

Net unrealized appreciation

The Administration proposal would repeal the special tax treatment afforded to certain distributions of employer securities from qualified plans.

C. Other Proposals

1984 Treasury Report

The 1984 Treasury Report would have repealed the tax credit for ESOPs and the special limits on employer deductions and annual additions for the repayment of principal and interest on ESOP plans. Thus, the deductibility of contributions to an ESOP would have been governed by the generally applicable deduction limits.

In addition, the proposal would have repealed the deduction for dividends paid on ESOP stock, the partial exclusion of interest on ESOP loans, the nonrecognition of gain on certain sales of stock to an ESOP, and the assumption of estate tax liability by an ESOP. No new ESOT incentives were provided.

S. 409 and H.R. 800 (Bradley-Gephardt)

The bill would repeal the special tax credit provisions for ESOPs.

In addition, the bill would indirectly affect ESOPs by reducing the overall limits for qualified plans. Under the bill, the overall dollar limit on annual additions to defined contribution plans (profit-sharing or stock bonus plans, and money purchase pension plans) would be reduced. The dollar limit on the annual addition under a defined contribution plan (including an ESOP) would be reduced from $30,000 to $20,000. In addition, the cost-of-living adjustment to that limit would generally be repealed.

H.R. 1377 (Stark)

Although the bill contains no specific provisions directly affecting ESOPs, it indirectly would affect ESOPs by prescribing reductions in the level of tax credits and the overall limits on contributions and benefits. The bill would reduce the tax credit provided for certain ESOPs as well as the amount of tax liability that can be offset by the tax credit by 20 percent in the case of any "revenue enhancement year." A revenue enhancement year is any taxable year a portion of which falls within the period beginning January 1, 1986, and ending December 31, 1989.

For any such year, the allowable credit would be reduced from one-half of one percent of the aggregate compensation paid or accrued in a taxable year to four-tenths of one percent of compensation. In addition, the amount of an employee's income tax liability that could be offset by the payroll-based tax credit generally would be reduced.

The bill also would reduce the dollar limit on contributions and benefits by 20 percent in the case of any revenue enhancement year. For any such years, the dollar limit on annual additions to a defined contribution plan (including an ESOP) would be reduced from $30,000 to $24,000. Conforming changes would be made to the special limits provided for leveraged ESOPs.

S. 556 (Chafee)

Although the bill contains no specific provisions directly affecting ESOPs, it would indirectly affect ESOPs by prescribing reductions in the level of tax credits and the overall limits on contributions and benefits. The bill would reduce the tax credit provided to certain ESOPs as well as the amount of tax liability that can be offset by the tax credit by 15 percent in the case of any "revenue enhancement year." A revenue enhancement year is any taxable year a portion of which falls within the period beginning January 1, 1986, and ending December 31, 1989.

For any such year, the allowable credit would be reduced from one-half of the aggregate compensation paid or accrued in a taxable year to approximately three-sevenths of one percent of compensation. In addition, the amount of an employer's income tax liability that could be offset by the payroll-based tax credit generally would be reduced.

The bill also would reduce the dollar limit on benefits and contributions in any revenue enhancement year. For any such year, the dollar limit on annual additions to a defined contribution plan (including an ESOP) would be reduced from $30,000 to $25,000. Conforming changes would be made to the special limits provided for leveraged ESOPs.

Tax-credit ESOPs

Some have suggested that it is appropriate to repeal or reduce the payroll-based tax credit afforded ESOPs.

Others have suggested that it is appropriate to extend and increase the tax credits afforded ESOPs. For example, it is suggested that all or a portion of the investment tax credit be conditioned on the tax benefit being funded through an ESOP or requiring that corporations claiming the research and experimentation credit ("R&D" credit) be required to fund all or a portion of the tax benefit through an ESOP.

Corporate tax benefits for ESOP sponsors

Some who favor expanding the tax incentives designed to encourage employee stock ownership argue that it is appropriate to re-examine other corporate tax preferences. For example, some suggest that a lower capital gains tax be allowed on proceeds from the sale of investments in corporations meeting a specified threshold of employee stock ownership. Others suggest that a corporation be permitted to deduct all or a portion of its dividends paid to stockholders provided the corporation meets a specified threshold of employee stock ownership.

Others suggest that the corporate tax rate be reduced for corporations meeting a specified threshold of employee stock ownership.

Still others suggest that it may be appropriate to require that all or a portion of (1) depreciation tax benefits in excess of useful life depreciation, and (2) net operating loss deductions be funded through an ESOP. It is also suggested that interest on capital formation and ownership transfer indebtedness be partially disallowed if not funded through an ESOP.

Others suggest it may be appropriate to repeal the existing corporate tax benefits rather than extend them to employers maintaining an ESOT.

Certain qualified plan limits and pension plan revisions

It is suggested that a higher limit be permitted on contributions to 401(K) plans provided the extra amount is invested in employer securities for a period of time. It is suggested that defined benefit pension plan sponsors be provided relief from the Administration's proposed recapture excise tax on pension plan reversions provided such recaptured funds are recovered through an ESOP.

Estate tax exclusion for sales to ESOPs

Some have suggested that it is appropriate to provide an estate tax exclusion for 50 percent of the proceeds realized on the sale of employer securities to an ESOP.

ESOP treated as charitable organization

It is suggested that ESOPs be treated as charitable organizations for income, gift and estate tax purposes.

It is also suggested that Treasury be required to report on the extent to which tax benefits for capital formation operate to expand the base of capital ownership. Others suggest that tax policy be coordinated with monetary policy and that the Federal Reserve discounting policy be adapted to encourage the use of capital-ownership financing techniques.

D. Analysis

Overview

In evaluating the various ESOP related proposals, it has been suggested that it is necessary to determine (1) whether it is appropriate to provide employee stock ownership incentives through qualified plans, (2) the extent to which employees should receive the traditional benefits of stock ownership, and (3) whether or to what extent, non-ESOP qualified plans should be permitted to invest in employer securities. In addition, several specific issues have been raised with respect to the Administration's ESOT proposal.

Retirement income security vs. employee stock ownership

If employee stock ownership is an appropriate tax policy objective, some suggest that it may not be necessary or appropriate to provide that incentive through qualified plans. Although stock bonus plans and profit sharing have been permitted to invest in certain employer securities since 1921, Congress has, from time to time, expressed concern that encouraging employee stock ownership may not be the best means of securing employees retirement income, which is one of several reasons for which Congress sanctioned tax benefits for qualified plans.

The concern is caused by fears that if an employer experiences financial difficulty, employees with retirement savings concentrated primarily in employer stock may be subject to a double risk of loss. Not only would employees lose their jobs (and employer contributions to their retirement plan possibly be reduced or eliminated), but they also may suffer from decreases in the value of the securities and the amount of dividends paid thereon. Moreover, if a plan is permitted to invest substantially in employer securities, a plan fiduciary could be subject to great pressure to time purchases and sales to improve the market in those securities, whether or not the interests of plan participants were adversely affected.

Because of these concerns, ERISA generally limits the extent to which qualified plans may invest in qualifying employer securities. In general, no qualified plan may invest more than 10 percent of the assets in employer securities. However, ERISA permits certain defined contribution plans (e.g., profit-sharing and stock bonus plans) to invest up to 100 percent of plan assets in employer securities if the plan so provides.

Under the Administration proposal, the employee stock ownership incentives are separated from the qualified plan incentives. Thus, the retirement income security incentives provided through broadly diversified plan assets would be provided through qualified plans, and employee stock ownership incentives would be provided through the new ESOT.

Proponents of the Administration proposal argue that it is appropriate to separate employee stock ownership incentives from retirement income security incentives. Noting the magnitude of the tax expenditures presently afforded qualified plans,[29] some argue that the expenditure is justified only if qualified plans are designed solely for the purpose of providing retirement income security and only if employees' retirement income security is underwritten by plan assets being invested in a broadly diversified portfolio. They question whether plans that permit pre-retirement withdrawals and investment in employer securities achieve these goals. They argue that encouraging employee stock ownership may well be desirable social policy. However, they believe government support of employee stock ownership should be addressed separately, so as not to provide a mechanism whereby employers can utilize a qualified plan to invest in any assets other than a broadly diversified portfolio designed to achieve the retirement income security goal of qualified plans. They believe that the fact that retirement is so distant in time and of such uncertain duration makes it a unique problem, which should be treated separately under the tax laws.

Still others suggest that the application of qualified plan rules such as vesting rules, distribution restrictions, etc., unnecessarily restricts the employer's ability to provide traditional benefits of ownership to employees. Accordingly, they conclude it is more appropriate to provide tax incentives to achieve these goals outside the qualified plan area.

Opponents of the Administration proposal argue that profit-sharing and stock bonus plans were established to ensure that employees could share in profits through dividends on, and appreciation in the value of, employer securities. They oppose the proposal to subject these capital accumulation plans to retirement plan rules more appropriate for pension plans.

Some suggest that the tax incentives historically afforded employee stock ownership plans represent an attempt to balance tax policy goals encouraging employee stock ownership with those encouraging employer-provided retirement benefits. Others suggest

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[29] The tax expenditure for qualified plans is the largest single item of tax expenditures. For fiscal year 1986, the tax expenditure for employer maintained qualified plans (including Keogh plans) is estimated to be $56.8 billion and this expenditure is projected to increase to $88.9 billion for fiscal year 1990. For fiscal years 1986 through 1990, the total expenditure is estimated to be $359.8 billion. (See Joint Committee on Taxation, *Estimated Tax Expenditures, Fiscal Years 1986-1990*, (JCS-8-85), April 12, 1985.

that the tax benefits for employee stock ownership plans are designed to encourage the use of a technique of finance structured to expand the ownership of capital.

Incidents of ownership

Some have suggested that it is necessary to consider whether tax incentives should be provided only if employees receive direct stock ownership.

Proponents of the Administration proposal argue that if employee stock ownership is a valid tax policy goal, it is more appropriate to provide incentives for direct ownership. They believe that providing employee stock ownership under a qualified plan (including an ESOP) defers significant traditional incidents of ownership for employees and beneficiaries (i.e., transferability, the right to receive dividends and the right to vote) until the securities are distributed from the plan. They suggest, for example, that in most ESOPs employees generally must wait until they separate from service before they receive a distribution.

Those supporting the Administration proposal also argue that, because an ESOP may pass through dividends only with respect to allocated securities, ESOP participants may receive currently less than all of the dividends paid on the employer securities that are eventually distributed to them.

Similarly, voting rights with respect to employer securities in ESOPs maintained by employers with non-publicly traded securities are required to be passed through to participants only on major corporate issues and only with respect to shares allocated to participants' accounts. Proponents of the Administration's proposal argue that the failure to pass through voting rights immediately upon the acquisition of employer securities is inconsistent with the goal of employee stock ownership.

Proponents also support elimination of the distinction between the voting rights required with respect to registration-type securities and those required with respect to closely held securities.[30] They argue that additional restrictions on voting rights are inconsistent with the concept of employee ownership, and that there is no clear policy justification for permitting different treatment based upon whether the exployer is publicly traded or closely held.

Proponents also argue that, to the extent that the traditional rights of ownership are deferred (or never realized) for ESOP participants, some argue that the motivational aspect of employee stock ownership plans is diminished. If a significant tax subsidy is to be provided to encourage employee stock ownership, they argue that it is appropriate to require that employees receive traditional ownership rights. If the employees are not given the full incidents of ownership, they argue, the tax benefits are essentially being provided for what amounts to a stock appreciation right plan (where the employer retains the earnings and grants employees some measure of the subsequent appreciation in the value of employer

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[30] Under present law, if an employee has registration-type securities, a participant is entitled to direct the trustee in voting on all issues on all securities allocated to the participant's account; if the employee has no registration-type securities, the participant is entitled to direct the vote on allocated securities only with respect to issues requiring more than a majority vote.

securities) or a stock purchase plan (where employees are permitted to purchase employer securities). Thus, some who support employee stock ownership argue that the Administration proposal, by encouraging direct employee ownership including traditional rights, more effectively encourages employee productivity.

Some opponents argue, however, that the Administration proposal over emphasizes the importance of achieving traditional ownership rights. They argue that ESOPs were never intended to provide employees immediately the traditional incidents of actual stock ownership. They believe that leveraged ESOPs in particular, were intended not to facilitate direct transfer of employer securities to employees, but to create a capital accumulation device designed to achieve three objectives: (1) to facilitate corporate financing on favorable terms, (2) to provide a market for employer securities, especially in the case of a closely held corporation, and (3) to enable employees to accumulate a capital estate sufficient to generate an additional income stream unrelated to compensation. Accordingly, they oppose the Administration proposal to require that employees receive at the outset all the traditional incidents of ownership. Some argue further that if direct ownership is required and the corporate finance incentives are weakened, the ESOP goals would be undermined because few employers will maintain ESOTs.

Opponents of the Administration proposal argue that Congress has already defined the extent to which traditional ownership rights accompany these nontraditional capital accumulation spendthrift trust financing techniques by mandating different pass-through voting requirements according to whether the sponsoring company is or is not publicly traded and by encouraging all ESOP companies to pass through dividends to employees on a current basis.

Opponents argue that the Congress has addressed this issue and has concluded that full traditional ownership rights are inappropriate and, in fact, may operate to deny employees an opportunity to begin to accumulate a capital estate because expanding mandatory voting rights will slow or halt employers' willingness to establish or maintain an ESOT. They also argue that employees are now protected by the existing pass-through voting provisions and the fiduciary standards of both general trust law and ERISA (which require the trustees to vote stock in the best interest of plan participants).

Opponents also suggest that full pass-through voting is not a necessary element of the primary goals of expanding capital ownership, individual capital accumulation and capital-income generation. Some argue further that the Administration proposal fails to recognize that lenders are reluctant to provide ESOP financing unless there is assurance that the entity to whom they are lending (i.e., including the management team) will remain intact during the term of the loan, an assurance that could not be provided if the ESOT was required to pass through the voting rights on all allocated and unallocated securities. Those favoring full pass through argue, however that it may be inappropriate to protect management. They argue that employees should have an immediate right to direct the vote.

Others argue that it is not boardroom, but job-site related, decision making that is of most interest to employees. Thus, they argue that voting rights are not related to improved productivity.

Other opponents suggest that it may be appropriate to define those issues on which the trust beneficiaries should have some input, differentiating, for example, between substantive changes and other issues (e.g., a change in corporate name) which may not directly affect the employees and thus, not justify the expense of a proxy solicitation. Others argue that it may be inappropriate to mandate a pass through of the vote on issues where the ESOP-held stock could not possibly affect the outcome.

Others seeking to limit the scope of the required pass through of voting rights argue that pass-through voting should be required only for publicly-traded companies.

Others suggest that voting be linked to the vesting schedule. Some contend that the tax benefits should be reduced or eliminated until full pass-through voting is provided. Others argue that voting should be required only for leveraged ESOPs and only for years after the securities acquisition loan is repaid. Some argue that voting should be required only for employees who have attained a specified age.

Those favoring the full pass through of voting rights suggest that it may be appropriate to require pass-through voting in all defined contribution plans which invest in employer securities or in all qualified plans which invest in employer securities.

Some opponents also suggest that the Administration proposal contains conflicting incentives. For example, though suggesting that employee ownership can contribute to motivation and profitability, the proposal requires immediate distribution and unlimited transferability. Some question whether employees will dispose of the securities, undermining the productivity objectives.

Others opposing the Administration proposal argue that, although employee stock ownership (with the attendant benefits of increased productivity and improved employee-management relations) is one important goal, a second, equally important objective is securing of capital funds for growth. Thus, a number of tax incentives historically developed to ensure that ESOPs became valuable tools to aid in corporate financing. Some opponents of the Administration proposal question whether the corporate finance objectives of ESOPs can be achieved through use of the new ESOT. In particular, they question why ESOT acquisitions should be limited to outstanding shares of employer securities, why an unrelated lender should be required, and why ESOT loans should be limited to those with a 5–12 year term. They contend that, unless employee stock ownership incentives are attractive to both sponsoring corporations and employees, corporations will be unwilling to establish ESOPs or ESOTs.

Some opposing the Administration proposal believe that the corporate finance objectives can only be achieved by the accumulation of capital in a trust, from which distributions are deferred. They suggest that the proposal to require current distribution of employer securities and the provision of an extended put option may preclude or significantly deter ESOP transactions because of the ESOT's inability to comply with typical lender restrictions. They suggest that this would be the result because lending covenants typically restrict share repurchases until loans are fully repaid, thereby impeding companies' ability to borrow, either through the ESOP or in a more traditional manner. They also suggest that the proposed extended put option would operate as an unpredictable liability that would significantly impede the corporation in planning its capital budgeting requirements.

For example, they point out that many lenders restrict cash dividends or share repurchases until the loan has been fully amortized. Without this ability, they argue, lenders may be unwilling to make loans to the ESOT.

Accordingly, some suggest that it may be more appropriate to preclude distributions for an initial period (e.g., in the case of a leveraged ESOT the 5-12 year maturity period of the securities acquisition loan), requiring that the ESOT provide a put option only after the loan is repaid. Others suggest that partial distributions should be required, subject to a put, after an initial period (e.g., 84 months). Still others suggest that participants be permitted to receive partial in-service distributions of account balances after a specified period of participation, thereby enabling employees to realize some of the benefits under the plan while leaving the bulk of the capital accumulation in trust for distribution upon termination of employment. It is suggested that this would reduce the incentive for employees to terminate employment in order to receive a distribution.

Other concerns with the immediate distribution requirement include a concern that this may require SEC registration, (e.g., because such distributions may cause the employer to go public) providing a substantial deterrent to privately held companies considering ESOPs. This group contends that employers will be unwilling to establish ESOTs because, if shares must be distributed, they will be reluctant to deal with potentially large numbers of minority shareholders.

Still others argue that allowing free transferability, particularly if enacted in conjunction with repeal of the employer's right of first refusal, will erode the goal of accumulating a capital estate for employees. Some suggest that in closely held companies a right of first refusal continue to be permitted for distributed stock so that an employer is not inadvertently taken public through ESOP distributions of stock to participants.

Some argue that these concerns are critical to the success of any ESOP or ESOT proposal. They also question the value of a proposal for direct employee stock ownership if its effect, in operation, results in no ESOPs or ESOTs. Proponents of the Administration proposal respond that it may be inappropriate to provide ESOT incentives to encourage employee stock ownership if their success requires a denial or limitation of all traditional ownership rights.

Others opposing the Administration proposal argue that ESOPs historically have been designed to ensure that employees share in the appreciation in value of employer securities, not to facilitate direct transfers of the stock and all indicia of ownership. Accordingly, they argue that it is inappropriate to require complete pass-through of voting rights in closely held companies or free transferability.

Moreover, opponents suggest that the ownership rights available through ESOP financing can justifiably differ from more traditional stock ownership rights. They argue that differences may be justified because traditionally stock owners pay cash for their ownership whereas ESOP participants generally receive employer stock without personal investment of capital. They argue that the tax benefits for leveraged ESOPs encourage shareholders to put their assets at risk to borrow funds for the acquisition of employer securities in trust for employees. They suggest that it is the employer's willingness to provide collateral for such financing that replaces the usual requirement for personal savings with which traditional stock owners acquire stock along with the traditional indices of ownership that accompany cash purchase of stock.

Proponents of the Administration proposal respond that the social goal is not worth the tax benefit if the only benefit provided to employees is a right to appreciation in the value of employer securities or a benefit in some way limited to the sponsoring employer's tax savings. Moreover, some argue that the use of leveraged ESOPs as corporate financing devices may, in fact, be undesirable, both from the standpoint of the corporation's financial health and that of its shareholders and employees. The tax benefits derived from using leveraged ESOPs as a financing tool, they contend, may induce companies to incur excessive debt burdens. Such companies may run a greater risk of bankruptcy if a temporary economic downturn or other factors reduce their cash flow and render them unable to meet the increased debt service requirements. Thus, leveraging may jeopardize the security of the employees' jobs as well as the shareholders' investment in the company.

Proponents of the Administration proposal also point to the increasing use of leveraged ESOPs both offensively and defensively in corporate mergers and acquisitions as an undesirable development. They argue the tax code should neither encourage nor discourage corporate mergers and acquisitions, which are matters of economic and antitrust, not tax, policy and should be addressed directly under antitrust or securities laws. It is argued that additional requirements on ESOTs would make the tax code more neutral towards such transactions.

Opponents of this view contend that ESOP financing enables companies to service debt at lesser levels of revenues and suggest that if leveraged buyouts are to be permitted under the tax law, ways should be found to limit such transactions to techniques of finance that enable debt service requirements to be met with less cash flow while simultaneously expanding the base of those taxpayers who benefit from such tax-favored financing.

Opponents also argue that restrictions on the use of ESOP financing in such transactions would limit the extent to which employees have an opportunity to accumulate a capital estate through such mergers and acquisitions. They also argue that without ESOP incentives, the tax code would continue to encourage such transactions but without encouraging such transactions to be structured to benefit those who are most endangered by the increased debt service (i.e., the employees). This group argues that only with ESOP financing do employees have an opportunity to share in the potential gain that their efforts help make possible.

Opponents of the Administration proposal also argue that leveraged ESOPs have a legitimate function as corporate financing devices. The corporation is able to obtain low-cost financing for plant expansion and other purposes, enabling it to become more productive, with the corporation's employees rather than outside investors reapplying the benefits. By making the ESOT unattractive as a financing mechanism, it is argued that the Administration's proposal would deny the corporation and the employees these benefits.

Qualified plan investment in employer securities

Proponents of the Administration proposal also argue that if ESOTs are accorded separate tax benefits, it is appropriate to further restrict qualified plan investments in employer securities. Some argue, for example, that no qualified plan should be permitted to invest more than 10 percent of assets in employer securities.

Others argue that employer securities are an inappropriate investment for retirement programs. They point out that qualified retirement plans generally are required to invest in a diversified portfolio to ensure that anticipated benefits will be available when a participant retires. Some suggest, accordingly, that a retirement benefit entirely dependent on market fluctuations in a single, often unmarketable asset provides an employee little certainty that adequate retirement security will be provided. If retirement benefits are invested primarily in employer securities, the employee faces a double risk of loss. Not only would the employees lose their jobs (and employer contributions to their retirement plan be reduced) but they also may suffer from decreases in the value of the securities and the amount of dividends paid thereon.

Some point out that ERISA imposed minimum funding requirements to enhance retirement income security. They believe that permitting investment in employer securities undermines that policy goal. If Congress, by requiring minimum funding, has concluded that an unfunded employer liability provides inadequate retirement income protection, this group questions whether investment in employer stock, which further subordinates employees' interests, should be considered to provide adequate protection.

Those opposed to the Administration ESOT proposal question whether it is appropriate to preclude qualified plans from being used to encourage employee ownership. They point out that the original tax incentives provided for qualified plans were enacted to encourage profit-sharing and stock bonus plans that were originally designed to attract and retain qualified employees and to improve employee productivity through stock ownership and profit sharing. Opponents also argue that the Congress has traditionally provided employers and employees with a variety of deferred compensation arrangements to reflect a variety of compensation philosophies and circumstances. For example, by precluding plan investment in employer securities in the interest of ensuring a retirement income stream in the future, the Administration approach may undermine the ability of companies to tap their employees' entrepreneurial spirit and deny them the means by which they can share in the success they help to create.

Opponents also question the appropriateness of severely limiting plan investments to assets the value of which employees' efforts cannot influence (i.e., securities other than employer securities). They question the wisdom of requiring that 90 percent of all qualified plan assets be invested in a diversified portfolio of assets the value of which is totally outside the influence or control of employees.

Others argue that if the goal is to ensure that a participant's retirement benefits be invested in a diversified portfolio of assets, the trust could be required to diversify assets sufficient to provide retirement benefits for any particular employee as that employee approaches retirement age. Others suggest that participants should be permitted to receive partial in-service distributions after a specified minimum period of participation, while leaving the bulk of the capital accumulation in trust for distribution upon termination of employment. This approach, it is argued, would reduce the incentive for employees to terminate employment to receive a distribution.

Some opponents suggest these plans have been demonstrably good productivity motivators despite their requirements for deferred distribution, indirect ownership and limited transferability. Accordingly, they argue that it is inappropriate to subject these arrangements to restrictions more appropriate for defined benefit pension plans. They believe it is appropriate to retain the historic distinction between pension and profit-sharing plans, and continue qualified plan tax incentives for stock bonus plans and ESOPs.

Some also argue that ESOPs can, and currently do, serve as adequate, and in some cases quite substantial, retirement plans. Some argue that although ESOPs are not primarily retirement plans, ESOP financing can be used by employers who would not otherwise have provided a deferred compensation plan.

In addition, some believe that further restrictions on investment in employer securities would deny retirees the opportunity to benefit from growth in the value of employer securities. They argue that existing fiduciary standards and prohibitions against self-dealing and conflict of interest under the ERISA and the Code are adequate to deal with appropriate investments in employer securities.

Some opponents argue that employees should have the individual choice to invest their accounts under qualified plans in employer securities. Accordingly, they argue that even if trustees are precluded from investing more than 10 percent of discretionary plan assets in employer securities, it is appropriate to permit the investment of additional amounts of individually directed amounts in employer securities. Proponents of this proposal argue that if employees are permitted to choose among at least four bona fide investment options, one of which is employer securities, it is appropriate to permit additional employee-directed amounts to be invested in employer securities.

ESOT issues

Coordination with ERISA

A number of ERISA issues are raised by the proposed separation of the ESOT from qualified plans. The extent to which ERISA's employee benefit protections, preemption, and fiduciary rules would apply is uncertain.

Employee benefit protections

Under the Administration proposal, the new ESOT will be required to provide benefits for all employees with at least 1,000 hours of service during the year.

Proponents of the Administration proposal argue that it is inappropriate to permit any tax expenditures for employee stock ownership unless that ownership is provided for rank-and-file employees. Without coverage and nondiscrimination requirements, for example, they argue that an employer would be permitted to establish an ESOT covering only highly compensated employees. To preclude this result, this group argues that it is appropriate to require the ESOT to provide benefits for all employees with 1,000 hours of service. Some argue, however, that it may be appropriate to exclude certain employees. (e.g. those under a certain age or those with less than a stated period fo service.) Others suggest that the qualified plan rules under which ESOPs currently operate are designed for this purpose and should be retained. Opponents suggest that other qualified plan rules should be retained as well, including the ability of employers to require a reasonable period of service with the company before vesting in the benefit being provided.

Similarly, the Code requires that a qualified plan satisfy certain benefit accrual requirements and that a top-heavy plan (including an ESOP) provide minimum contributions or benefits for non-key employees. Absent the application of these rules or the development of similar, new rules specifically for ESOTs, they argue that an employer could provide an ESOT only to highly compensated or key employees without providing benefits for rank and file (non-key) employees.

Those favoring the Administration proposal to require the annual allocation of employer securities based upon the first $50,000 of compensation also argue that the limit would limit allocations benefiting only highly compensated employees.

They argue that the ESOT tax expenditure intended to encourage employee stock ownership is appropriate only if adequate benefit levels are ensured for nonhighly compensated employees. Consistent with that goal, some question whether it is appropriate to permit allocations to vary based on compensation. They argue that compensation-related variations necessarily provide proportionately more benefits to highly compensated employees. However, if some variation by compensation is permitted, it is appropriate to limit the resultant difference in benefits provided by capping the compensation taken into account.

Opponents of the proposal argue that although it may be appropriate to require that allocations be a uniform percentage of compensation, it is inappropriate to limit includible compensation. In addition, they question the decision to use a $50,000 threshold for ESOTs that qualify for tax deductions when, historically, tax credit ESOPs have been permitted to take $100,000 into account and top-heavy plans are permitted to consider the first $200,000 of compensation.

Some proponents of the Administration proposal question whether it is appropriate to coordinate the level of benefits provided through the ESOT with those provided under qualified plans.

Under present law, they argue that ESOP allocations are considered under the overall limits on contributions and benefits and, similarly, employer deductions to ESOPs and other qualified plans are subject to an aggregate limit. Some question whether the proposal should require that ESOT allocations be taken into account in applying these limits.

Those favoring the Administration proposal to separate ESOT allocations from the limits on qualified plan benefits argue that coordination of the two limits is inappropriate. This group argues that separate tax benefits should be provided to encourage retirement income security and employee stock ownership. If the limits are coordinated, they argue, an employee's retirement income security may be reduced or eliminated by virtue of ESOT allocations designed to broaden employee stock ownership.

Still others suggest that ESOPs should be treated as welfare benefit plans or that they should have a separate classification and a separate title under ERISA with rules tailored to reflect the special hybrid purposes for which they are intended.

Preemption

Under the proposal, some argue that the ESOT may not be an employee benefit plan under ERISA. Accordingly, they question whether the ESOT would be entitled to ERISA preemption. Arguably, if the ESOT were not considered a qualified plan under the Code and not subject to ERISA preemption, the new ESOT may be subject to State tax and securities laws. Thus, favorable tax treatment provided by the Internal Revenue Code may not ensure favorable tax treatment under local laws. Similarly, State securities laws could be applicable. They argue this would inappropriately complicate and make more costly the administration of an ESOT particularly for ESOTs maintained by an employer with operations in several different jurisdictions. Accordingly, they suggest that the ESOT must be provided similar tax benefits and preemption.

Self-dealing

Others question the impact of the decision to separate ESOTs from qualified plans on the traditional oversight role. Because investments in employer securities are, arguably, a form of self-dealing, ERISA requires both the IRS and the Department of Labor to give ESOP transactions special scrutiny to preclude abuse. Some argue that this special scrutiny is needed to protect employees' interests, even if the ESOT is not a retirement vehicle. Others argue that it may be appropriate to protect employee interests through other means, e.g., by requiring that employees be permitted representation in employer decision to establish an ESOT or by requiring employee approval as a prerequisite to establishing the ESOT.

Fiduciary rules

Under the proposal, the new ESOT would be subject to ERISA fiduciary rules. Some question how the proposed fiduciary restrictions are intended to apply. They question whether the specific proposal to apply ERISA, Title I fiduciary restrictions makes ERISA amendment necessary. Others argue that the decision to acquire and hold employer securities should not be a fiduciary decision.

Eligible employers

Those supporting the Administration proposal argue that it is appropriate to restrict the tax benefits afforded through the proposed ESOT to employers with at least 15 employees and to make eligible workers owned cooperatives ineligible for the ESOT tax benefits. They believe that tax expenditures to encourage employee stock ownership are justified only if a significant number of employees receive the stated benefits.

In addition, they argue that small employers are more likely to be closely held entities. Historically, it has been very difficult to value the stock of closely held entities. If employer securities are not readily tradeable, for example, they may be difficult to value. Many question whether appraisals of the value of closely held securities lack independence. In particular, some express concerns that valuations may not properly consider relevant factors, such as earning capacity, book value, comparability with similar companies, and marketability. They point out that these valuation difficulties may adversely affect ESOP participants. If the transactions in company stock are for more than fair market value, they (1) are prohibited transactions under ERISA and subject to an excise tax, (2) mislead participants about the value of their plan account, and (3) increase the amount on which participants would ultimately pay income tax.

In addition, it is argued that participants may not be permitted to vote or direct the voting of closely held employer securities allocated to their ESOP accounts.

Many of the valuation problems are caused by the difficulty of determining the fair market value of closely held stock and are not observed in the publicly traded companies. Some concerned about the valuation problems favor the proposal to restrict ESOTs to those employers with at least 15 employees. Others argue that it may be appropriate to preclude any closely held employer from establishing an ESOT.

Opponents argue, however, that the proposal to limit ESOTs to employers with more than 15 employees inappropriately and unfairly discriminates against small and start-up businesses and against eligible worker-owned cooperatives. Some question why small or start-up companies should be precluded from participating in ESOPs. Still others question how the provision would operate in practice (e.g., if employment levels fall below the prescribed minimum).

Others suggest that if the concern is that rank-and-file employees will not benefit in smaller companies or cooperatives that a nondiscrimination test or concentration test could be required. Under a concentration test, for example, the ESOT could be denied tax benefits if more than one-third of employer contributions for a year are allocated to officers, certain shareholders, or highly compensated employees.

Opponents also argue that if the limitation is intended to minimize valuation problems, it is more appropriate to directly address the valuation issues. Some suggest that independence in valuation can be achieved without the Administration proposal for making the appraiser a fiduciary. Concern is expressed that such fiduciary status would substantially raise the costs of an already costly undertaking. Given the Department of Labor's failure issue regulations under ERISA, it is suggested that the Congress direct Treasury to issue valuation regulations. Some suggest a requirement that the valuation be filed with the Internal Revenue Service.

Others suggest the desirability of requiring the use of an "enrolled appraiser" similar to the "enrolled actuary" concept of pension law. Others suggest that requiring that assumptions be "reasonable in the aggregate" (as is now the case with actuarial assumptions) would add little to a process that (like the actuarial area) ultimately relies on expert opinion.

Put options

Those favoring the Administration proposal to require the employer to grant extended put options argue that it is necessary to protect the employees. They argue that, without the put option, employees may not have a market for closely held employer stock.

In addition, some argue that if employees have no voice in the employer's decision to establish an ESOT, the accelerated put option is an appropriate mechanism for the employee to effectively opt out. ly opt out.

Others suggest that it may be more appropriate to grant employees representation or the right to vote on whether an ESOT should be established. If employees had input in the employer decision to create the ESOT, it is argued, it may be possible to delay the grant of the put option for some longer period, perhaps tied to the securities acquisition loan maturity period.

Those opposing the Administration proposal argue that this requirement would make ESOT financing operationally impracticable since employers would not adopt (nor would lenders lend to employers who would adopt) a plan under which substantial company cash flow is committed to repay a stock acquisition loan, if, in mid-loan, the law imposes a potential liability to repurchase the stock being acquired. Opponents also suggest that the extended put option period may make corporate capital budgeting difficult because the outstanding put options would represent a potential liability that may need to be paid at a time outside the control of the corporation.

In addition, some argue that providing a deferred put option is inconsistent with the Administration's stated goal of providing employees the traditional rights of ownership. They argue that such a put option places ESOT participants in a much better position than normally is accorded even to traditional shareholders—who generally enter into buy-sell agreements that require the company to buy back stock based on some future event such as death, disability, or separation from service, thereby enabling the company to plan for and fund its repurchase liability over a period of years.

Others argue that the extended put option is also inconsistent with the stated goal of encouraging productivity through employee ownership. They believe that the put option would jeopardize the incentive aspect of the plan because employees would put the stock back to the company and would thereafter have no further interest in the success or profitability of the company. They also point out that, because it may take many years for contributions and stock appreciation to reach significant levels, employees who have exercised the put option will have sold their stock before gaining the benefits of the appreciation.

Proponents of the Administration proposal also argue that providing a put at an early date helps lessen problems with the valuation of employer securities.

Dividend distributions

Proponents of the Administration proposal argue that, consistent with their goal of providing traditional ownership rights, it is appropriate to require the full annual distribution of dividends paid with respect to ESOT stock. They argue that employee productivity is enhanced only if they receive all traditional benefits of stock ownership. Paying current dividends, based on the employer's performance, it is argued, is a more effective incentive than merely telling an employee that he eventually may receive employer stock.

However, opponents question why the employer should also be required to pass through the tax benefit of the employer's deduction. They argue that the tax savings generated by deducting dividends paid on ESOT stock are not incidents of the employee's ownership and should not be provided to the employees. It also is argued that the dividends deduction was intended as an incentive for ESOP companies to pay such dividends, and that this incentive would be ineffective under the Administration proposal.

Others question whether it is appropriate to require the payout of dividends on unallocated ESOT stock. They argue that the payout of stock on unallocated stock disadvantages employees who become plan participants in later years *vis a vis* those who become participants in earlier years. Accordingly, some suggest that only dividends on allocated stock be paid out currently. Others argue that the use of dividends to accelerate repayment of the securities acquisition loan would, in turn, accelerate the allocation of employer securities, also to the disadvantage of employees who become participants in later years.

Some suggest, alternatively, that it may be appropriate to permit the dividends (or at least those dividends paid on unallocated stock) to be applied to reduce the securities acquisition loan. Others suggest that a deduction should be permitted for all dividends paid on ESOT stock whether paid on allocated or unallocated stock and whether paid out currently to employees or used to retire ESOP debt. Some suggest that dividends on unallocated stock be limited to debt repayment and that dividends on unallocated stock be paid out currently. Some argue further that the required pay out of dividends actually erodes the ESOT's ability to acquire stock more rapidly for employees. They believe that all dividends should be applied to retire ESOT debt. They argue that some lenders would hesitate to make securities acquisition loans unless dividends were applied to reduce the debt.

Net unrealized appreciation

Those favoring the elimination of the special treatment of net unrealized appreciation (NUA) in employer securities argue that the present law rules are inconsistent with the tax policy goal of encouraging the use of retirement savings for retirement purposes.

They suggest that NUA treatment provides a mechanism for using retirement funds as a nonretirement investment. Taxpayers who can best afford to avoid income tax on qualified plan benefits by holding employer securities, it is argued, may not be the class of taxpayers for whom such special tax treatment is justified.

Some argue, however, that permitting an exclusion of NUA may be appropriate for certain types of capital accumulation plans. Accordingly, they support the Administration ESOT proposal which, by deferring any recognition of income until the participant disposes of the securities, provides tax treatment more favorable than the NUA historically provided under qualified plans.

In addition, those who support the proposal to repeal the special treatment of net unrealized appreciation in employer securities distributed from qualified plans point out that, under present law, an exemption from tax is provided if the securities have not been sold before the employee's death. The NUA is excluded, not merely deferred, because heirs take the securities with a stepped up basis. They note that this exclusion is available even though there is no longer any general estate tax exclusion for qualified plan benefits. They argue that the provision of additional tax benefits for employer securities is inappropriate.

However, some suggest that providing preferred tax treatment of NUA for distributions under qualified plans may be necessary for individuals whose sole or primary retirement benefits are employer securities. They assert that such an individual should not be forced to bear the administrative expense of maintaining an IRA in order to continue the deferral of income tax on the benefits. They also point out that individuals who receive employer securities would be taxed on the appreciation at capital gains rates when the securities are sold.

In addition, some question whether the elimination of the NUA treatment is appropriate for a capital accumulation plan designed to facilitate employees in accumulating a capital estate if, in fact, employees may then be forced to sell the securities in order to pay taxes.

On the other hand, those who favor the Administration proposal have pointed out that plans distributing securities or property other than employer securities have the same problem and that similar relief is not provided for them. They argue that the tax benefit of NUA treatment should not depend on whether the property distributed is employer securities.

Tax credits

Those favoring the proposal to reduce or eliminate the ESOP tax credits argue that the credit is, in effect, totally government-provided. The employer is given a credit not only for the full value of employer securities transferred to the ESOP, but also for administration costs. Thus, the employer bears no expense and the government, in effect, is granting employer securities to plan participants. Those favoring reduction of the credit argue that it is more appropriate to require that the employer share the cost. Some suggest that the tax benefit provided by any credit should approximate the tax benefit accorded employer deductions.

Opponents of the proposal to reduce or eliminate ESOP tax credits suggest that it is appropriate to extend and increase the tax credits afforded ESOPs by allowing corporations to claim all or a portion of the current investment tax credit provided all or a portion of the tax benefit is used to acquire stock for employees through an ESOP. It is suggested that with this approach to the investment tax credit, the taxpayer-provided cash flow would continue to be available to reduce the cost of corporate investments provided the corporation uses the funds to buy newly issued or treasury stock for employees. To the extent that the corporation instead uses the funds to buy outstanding shares, it is argued, the corporation loses the benefit of the cash flow, but both the employees and the corporation would still benefit from the stock ownership acquired on the employees' behalf. Some argue that an investment-based ESOP tax credit discriminates in favor of employees in capital-intensive companies, and that such employees tend to be better paid than those in labor-intensive companies. Therefore, it is argued, an alternative ESOP tax credit should be available whereby companies annually can choose between either an investment-based or a payroll-based ESOP tax credit. For similar reasons, still others argue that it may be appropriate to condition the research and experimentation credit on all or a portion of the tax benefit being used to acquire employer securities for employees through an ESOP.

Corporate tax benefits for ESOP or ESOT sponsors

Some who favor expanding the tax incentives designed to encourage employee stock ownership argue that it is appropriate to re-examine other corporate tax preferences. This group suggests that, because the bulk of the nation's productive capital is financed through corporations, the corporate entity is the appropriate vehicle through which expanded capital ownership should be encouraged. It is argued that corporations which finance their capital requirements in such a way as to expand capital ownership among their employees serve a more useful economic and social purpose than those which do not and that corporate taxation should favor the former. It is also argued that such corporations are generally more productive and more competitive and that tax policy should favor corporations that use capital financing techniques that promote these socially desirable goals.

This group argues, for example, that it may be appropriate to provide additional corporate tax benefits for corporations sponsoring ESOPs or ESOTs. Such benefits could include preferred corporate tax rates, increased dividend deductibility, and lower capital gains tax on investment in such corporations as well as the more traditional employee stock ownership tax credits.

Some suggest that a lower capital gain tax be permitted on proceeds from the sale of investments in companies that meet a certain threshold of employee stock ownership. For example, it is suggested that the capital gains exclusion be increased to 80 percent for investments in companies in which at least 50 percent of the stock is owned by at least 50 percent of non-management employees.

It is argued that a lower capital gains tax is appropriate for investors who structure their investments to expand capital ownership, particularly among employees. Proponents argue that by linking the investor incentive to employee ownership, the proposal should also help the company attract both investors and motivated employees during its critical start-up stage. Proponents also note that this provision was approved by the finance committee in 1984.

Some suggest that the partial deductibility of dividends be permitted provided the paying corporation maintains a specified threshold of employee stock ownership (e.g., 30 percent). Alternatively, it is suggested that partial deductibility of dividends be permitted provided the company maintains an increasing percentage of employee stock ownership.

Proponents suggest that the deductibility of dividends should be permitted only in corporations whose capital structure benefits a broad base of taxpayers and particularly corporate employee taxpayers.

Some suggest that the highest tax rate on corporate income be computed based on a combination of corporate income and percentage of employee stock ownership, with a lower rate allowed corporations with greater percentages of employee stock ownership.

Others suggest that all or a portion of depreciation tax benefits in excess of useful life depreciation could be conditioned on their being funded through an ESOP or ESOT, or alternatively, that relief from the Administration's proposed excess depreciation recapture rules be provided the tax benefits are funded through an ESOP or ESOT.

Those opposing the provision of new corporate tax incentives for employers maintaining an ESOP or ESOT question whether such an approach would be consistent with the overall tax policy goal of simplification. Others argue that if employee stock ownership increases productivity, an employer maintaining an ESOP or ESOT has a market advantage. Thus, it is argued, no additional tax incentives need be provided.

Others argue that it may be inappropriate to provide ESOTs even those corporate tax incentives added by the Deficit Reduction Act of 1984. They argue, for example, that even if it is appropriate to provide tax benefits designed to encourage employers to create ESOPs or ESOTs, it is unnecessary to provide additional tax benefits to lenders who finance securities acquisition loans, or those individuals or estates who sell employer securities to an ESOP or ESOT. They question whether those incentives effectuate the tax policy goal by broadening employee ownership or whether they merely reduce the tax liability of parties involved in the transaction.

Those opposing the Administration's proposal to repeal the provision enabling an ESOP to assume certain estate tax liabilities question why it is appropriate to provide an installment payment mechanism for those estates consisting largely of an interest in closely held businesses essentially benefiting the estate and a decedent's heirs while denying similar benefits to the ESOP. Some suggest that it is more appropriate to provide the benefit for the ESOP because the ESOP benefits a broader class of individuals and enhances the public policy goal of broadening ownership.

Certain qualified plan limits and pension plan reversions

It is suggested that a higher limit be permitted on contributions to 401(k) plans provided the extra amount is invested in employer securities for a period of time. It is suggested that defined benefit pension plan sponsors be provided relief from the Administration's recapture excise tax on pension plan reversions provided such recaptured funds are used to establish (or provide additional funds for) an ESOP or ESOT.

Estate tax exclusion for sales to ESOPs

Proponents of the proposal to provide an estate tax exclusion for 50 percent of the proceeds realized on the sale of employer securities to an ESOP argue that this would increase the incentive for stockholders to sell their companies to their employees who helped them build the company rather than liquidate, sell to outsiders or have the corporation redeem their shares on behalf of existing stockholders. Proponents also note that this provision was approved by the Finance Committee in 1984.

Opponents of the proposal note that the provision, as adopted, permitted an estate tax exclusion for all sales—including lifetime sales of employer securities to an ESOP. They point out that this would create tracing problems, causing administrative difficulties for both taxpayers and the Internal Revenue Service. Because the proposal did not limit lifetime transfers eligible for the exclusion, it would arguably permit an individual to churn stock holdings through a buy-sell pattern designed to eliminate estate tax liability, effectively permitting an individual to claim multiple exclusions based on sales of the same stock. Unless the proposal were modified to preclude this result, it is argued, an individual could eliminate estate tax liability without significantly increasing the ESOP's ownership of employer securities, and, thus, without expanding the base of individuals sharing ownership of the employer.

Even if the proposal were modified to preclude this result, some opponents question why it is appropriate to provide any additional tax benefit to an individual who receives proceeds presumably reflecting fair market value for the securities sold. Some argue further than it is particularly inappropriate to provide an exclusion based on total proceeds rather than the amount of taxable gain. They point out that under the proposal, the seller would be subject to income tax (possibly at capital gains rates) only on the gain, but would receive an estate tax exclusion for 50 percent of the proceeds (including that portion of the proceeds excluded from the income tax base).

ESOPs treated as charitable organization

Proponents of the proposal to treat ESOPs as a charitable organization argue that the proposal would encourage shareholders to leave their wealth to those who helped them create it. It is suggested that this would also strengthen the tax base as amounts left to charity are generally lost to the tax base whereas amounts left to an ESOP would eventually be restored to the tax base as the stock is distributed. Proponents also contend that this provision would help anticipate the need for charity by promoting economic self sufficiency through expanded capital ownership. They note that this provision was approved by the Finance Committee in 1984.

Those opposing the proposal argue that it is inappropriate to provide a charitable deduction for what is, in essence, the provision of a benefit to a targeted group that is not a charitable class. They argue that charitable deductions historically have been provided only for contributions to organizations serving the general public, and not, for example, for direct contributions to particular individuals.

In addition, some favoring expanded employee stock ownership suggest that the Treasury be directed to report periodically on the extent to which tax benefits for capital formation operate to expand the base of capital ownership. Proponents suggest that government-provided tax benefits for capital formation should be structured to steadily expand the base of taxpayers who benefit from the ownership of such capital and that periodic Treasury reports would enable Congressional tax-writing committees to evaluate whether tax policy is advancing the goal of expanded capital ownership. Those favoring stock ownership also suggest that tax policy be coordinated with monetary policy by adapting Federal Reserve discounting policy to encourage the use of ownership-expanding capital formation financing techniques. Proponents argue that this would enable capital formation financing to proceed more rapidly as the economy's existing pool of savings would no longer limit the financial system's ability to tap the economy's physical capacity for capital formation.

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