EMPLOYEE STOCK OWNERSHIP PLANS AND GENERAL STOCK OWNERSHIP TRUSTS

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-FIFTH CONGRESS

SECOND SESSION

ON

S. 3241

A BILL TO AMEND THE INTERNAL REVENUE CODE OF 1954, AND THE TAX REDUCTION ACT OF 1975, WITH RESPECT TO EMPLOYEE STOCK OWNERSHIP PLANS

S. 3223

A BILL TO AMEND THE INTERNAL REVENUE CODE OF 1954, TO PROVIDE TAX INCENTIVES FOR THE ESTABLISHMENT OF GENERAL STOCK OWNERSHIP PLANS

H.R. 13882

A BILL TO AMEND THE INTERNAL REVENUE CODE OF 1954, AND THE TAX REDUCTION ACT OF 1975, WITH RESPECT TO EMPLOYEE STOCK OWNERSHIP PLANS

JULY 19 AND 20, 1978

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EMPLOYEE STOCK OWNERSHIP PLANS AND GENERAL STOCK OWNERSHIP TRUSTS

WEDNESDAY, JULY 19, 1978

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 9 a.m. in room 2221, Dirksen Senate Office Building, Hon. Russell B. Long (chairman of the committee) presiding.

Present: Senators Long, Byrd, Jr., of Virginia, Gravel, Packwood, Roth, Jr., Laxalt, and Danforth.

[The committee press releases announcing these hearings and the bills S. 3241, S. 3223, H.R. 13882 follow:]

[U.S. Senate, Committee on Finance Press Release, June 26, 1978]

SENATOR LONG ANNOUNCES HEARINGS ON EMPLOYEE STOCK OWNERSHIP PLANS

Senator Russell B. Long (D.-La.), Chairman of the Senate Committee on Finance, announced that hearings have been scheduled on Employee Stock Ownership Plans (ESOPs) on Wednesday, July 19, 1978 and Thursday, July 20, 1978.

The hearings will be held in Room 2221, Dirksen Senate Office Building and will begin at 9:00 A.M. on both days.

In announcing the Committee hearings on ESOP, Senator Long stated, "Since 1973, Congress has passed five pieces of legislation which broaden the access of employees to stock ownership:

The 'Regional Rail Reorganization Act of 1973' (P.L. 93-236),
The 'Employee Retirment Income Security Act of 1974' (P.L. 93-406),
The 'Trade Act of 1974' (P.L. 93-618),
The 'Tax Reduction Act of 1975' (P.L. 94-12, and
The 'Tax Reform Act of 1976' (P.L. 94-455).

"In addition, earlier this year, the Senate Committee on Commerce, Science and Transportation reported out S. 2788, the 'Regional Rail Reorganization Act of 1978'; this bill contains extensive provisions regarding the adoption of an ESOP by the Consolidated Rail Corporation (Conrail)."

Senator Long pointed out that "Another topic of the hearings will be an examination of Senator Mike Gravel's S. 3223, a bill to establish the first general stock ownership plan, a concept which goes beyond ESOP in broadening the access of individuals to stock ownership, and S. 3241, the 'Expanded Employee Stock Ownership Act of 1978,' which I introduced last week.

"We will be using these hearings as the basis for setting new and more comprehensive legislative goals for further expansion of the ESOP concept as a means of getting our stagnating economy going again and of giving a piece of the action to millions of America's working men and women."

Senator Long explained that "The ESOP hearings will cover three major topics. At the outset, we will try to determine the value, both intrinsically and monetarily, of the benefits which stock ownership provides for employees and employers. In addition, we will attempt to determine what legislation is needed to promote the broadening of stock ownership and prevent its abuse.

"Finally, we will try to ascertain whether the various Federal agencies have complied with the clear statement of Congressional intent regarding ESOP which

was contained in Section 803(b) of the Tax Reform Act of 1976. I think it is time that we evaluate the product of our efforts and find out if our goals are being achieved."

Witnesses who are scheduled to testify at the first day of ESOP hearings, July 19, are:

(1) The Honorable Mike Gravel, U.S. Senator from Alaska.

(2) Panel consisting of The Honorable Stanley N. Lundine, U.S. Representative from New York, The Honorable Peter H. Kostmayer, U.S. Representative from Pennsylvania, and The Honorable Matthew F. McHugh, U.S. Representative from New York.

(3) Mr. J. R. Bullis, President, South Bend Lathe Company.

(4) Mr. H. Jack Cofer, President, Rich-SeaPak Corporation.

(5) Mr. Robert L. Strickland, Executive Vice President, Lowe's Companies, Inc.

(6) Mr. Glen W. White, Director of the Tax Department, The Dow Chemical Company.

(7) An officer of Sears, Roebuck and Company.

(8) Ronald L. Ludwig, Counsel, Employee Stock Ownership Council of America.

(9) Mr. Jeffrey R. Gates, Hewitt Associates.

Witnesses for the second day of hearings, July 20, will be from several Federal agencies whose programs involve ESOP legislation which has been enacted by the Congress. Among the agencies which may be invited to testify are Small Business Administration, Office of Management and Budget, National Aeronautics and Space Administration, Economic Development Administration, Defense Contract Audit Agency, Treasury Department, etc.

Requests to testify.—Senator Long stated that other witnesses desiring to testify during these hearings must make their request to testify to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510, not later than Monday, July 10, 1978. Witnesses will be notified as soon as possible after this date as to when they are scheduled to appear. If for some reason the witness is unable to appear at the time scheduled, he may file a written statement for the record in lieu of the personal appearance.

Legislative Reorganization Act.—Senator Long stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committees of Congress "to file in advance written statements of their proposed testimony, and to limit their oral presentation to brief summaries of their argument."

Witnesses scheduled to testify should comply with the following rules:

1. A copy of the statement must be filed by noon the day before the day the witness is scheduled to testify.

2. All witnesses must include with their written statement *a summary of the principal points included in the statement.*

3. The written statements must be typed on letter-size paper (not legal size) and at least 75 copies must be submitted by the close of business the day before the witness is scheduled to testify.

4. *Witnesses are not to read their written statements to the Committee,* but are to confine their *ten minute* oral presentations to a summary of the points included in the statement.

5. No more than 10 minutes will be allowed for oral presentations.

Written testimony.—Senator Long stated that the Committee would be pleased to receive written testimony from those persons or organizations who wish to submit statements for the record. Statements submitted for inclusion in the record should be typewritten, not more than 25 double-spaced pages in length and mailed with five (5) copies by August 15, 1978, to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510.

[U.S. Senate, Committee on Finance Press Release, July 14, 1978]

SENATOR LONG ANNOUNCES ADDITIONAL WITNESSES FOR HEARINGS ON EMPLOYEE STOCK OWNERSHIP PLANS

Senator Russell B. Long (D.-La.), Chairman of the Senate Committee on Finance, announced that the Finance Committee has scheduled additional witnesses for its hearings on Employee Stock Ownership Plans (ESOPs) which are scheduled for Wednesday, July 19, 1978 and Thursday, July 20, 1978.

The hearings will be held in Room 2221, Dirksen Senate Office Building and will begin at 9:00 A.M. on both days.

In scheduling the additional witnesses for the hearings, Senator Long pointed out "A June 19 New York Times article by Steven Rattner stated that 'Productivity is important since producing more with the same amount of labor is the only way lasting economic growth occurs. When productivity is declining, labor costs increase and prices begin to rise.' A June 20 article in the Washington Star pointed out that 'the downward trend of productivity is one of the most serious problems facing the national economy. Projections of the trend warn of a diminished standard of living, higher labor costs, less competitive prices and more inflation.' The article goes on to state that officials recognize 'a deterioration in morale in the work force.' Clearly, the problems of inflation and decreasing employee motivation and productivity are self-contributing.

"I am firmly convinced that providing employees with a permanent stake in their companies by broadening their access to stock ownership will substantially increase their productivity and help to combat this spiraling inflation."

Senator Long stated that "in addition to receiving testimony regarding the experience of companies which have adopted ESOPs and testimony regarding the various pieces of ESOP legislation which have been introduced this year, the Committee will be exercising its oversight function in that we will receive testimony on problems involving various Federal agencies and employee-owned companies under section 803(h) of the Tax Reform Act of 1976."

The additional witnesses scheduled to testify at the Committee hearings, both on July 19 and July 20 are:

1. Mr. A. Dean Swift, President and Chief Administrative Officer, Sears, Roebuck & Company.
2. Mr. W. Reid Thompson, President and Chairman of the Board, Potomac Electric and Power Company.
3. Mr. Andrew J. Biemiller, AFL-CIO.
4. Mr. William R. Denton, Vice President for Industrial Relations, Southern Pacific Company.
5. Mr. Louis O. Kelso, Kelso & Co., Incorporated.
6. Mr. Kenneth R. Cunningham, Chairman of the Board, Metropolitan Contract Services, Inc.
7. Mr. Jim Rice, President, Oklahoma Aerotronics, Inc.
8. Mr. Johathan M. Conrad, First Pennsylvania Bank, N.A.
9. The National Dividend Foundation.
10. Mr. Robert Hamrin.

95TH CONGRESS
2D SESSION

S. 3241

IN THE SENATE OF THE UNITED STATES

JUNE 23 (legislative day, MAY 17), 1978

Mr. ROBERT C. BYRD (for Mr. LONG) introduced the following bill; which was read twice and referred to the Committee on Finance

A BILL

To amend the Internal Revenue Code of 1954, and the Tax Reduction Act of 1975, with respect to employee stock ownership plans.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That this Act may be cited as the "Expanded Employee
4 Stock Ownership Act of 1978".

5 **SECTION 1. CREDIT FOR ESTABLISHING EMPLOYEE**
6 **STOCK OWNERSHIP PLAN.**

7 (a) IN GENERAL.—Subpart A of part IV of subchapter
8 A of chapter 1 of the Internal Revenue Code of 1954 (rela-
9 ting to credits allowed) is amended by inserting after section
10 44B the following new section:

II

1 "SEC. 44C. EMPLOYEE STOCK OWNERSHIP PLAN CON-
2 TRIBUTIONS.
3 "(a) GENERAL RULE.—In the case of a corporation
4 which meets the requirements of section 416, there is allowed
5 as a credit against the tax imposed by this chapter for the
6 taxable year, an amount equal to the greater of—
7 "(1) Two percent of the qualified investment (as
8 determined under subsections (c) and (d) of section
9 46) of the taxpayer for the taxable year, or
10 "(2) One percent of the aggregate participants'
11 compensation (as defined in section 415 (c) (3)) paid
12 by the corporation during the taxable year.
13 "(b) TRANSFER OF NEW EMPLOYER SECURITIES RE-
14 QUIRED.—The credit allowable under subsection (a) for
15 any taxable year shall not be allowed unless, in meeting the
16 requirements of such section for such taxable year, at least
17 half of the value of the employer securities transferred to
18 the trust for that taxable year is represented by new em-
19 ployer securities. For purposes of this subsection, the term
20 'new employer securities' means employer securities (as
21 defined in section 416 (a) (9)) not previously issued.
22 "(c) LIMITATION BASED ON TAX LIABILITY; CAR-
23 RYOVER OF EXCESS CREDIT.—
24 "(1) LIMITATION.—The amount of the credit
25 allowed under subsection (a) for the taxable year

1 shall not exceed the liability of the taxpayer for tax
2 under this chapter for the taxable year.
3 "(2) CARRYOVER OF EXCESS CREDIT.—If the
4 amount of the credit determined under subsection (a) for
5 the taxable year exceeds the amount of the limitation
6 imposed by paragraph (1) for such taxable year
7 (hereinafter in this paragraph referred to as the 'un-
8 used credit year'), such excess shall be a credit carryover
9 to the taxable year following the unused credit year, and,
10 subject to the limitation imposed by paragraph (1),
11 shall be taken into account under subsection (a) in such
12 following taxable year.
13 "(d) LIMITATION WITH RESPECT TO CERTAIN COM-
14 PANIES.—In the case of a regulated public utility, no credit
15 shall be allowed by subsection (a) if the taxpayer's cost of
16 service for ratemaking purposes is reduced by reason of any
17 portion of the credit allowable by subsection (a) (deter-
18 mined without regard to this subsection), or if the base to
19 which the taxpayer's rate of return for ratemaking purposes
20 is applied is reduced by any reason of any portion of the
21 credit allowed by subsection (a) (determined without regard
22 to this subsection).".
23 (b) Subpart B of part I of subchapter D of chapter 1 of
24 such Code is amended by adding at the end thereof the fol-
25 lowing new section:

1 "SEC. 416. SPECIAL EMPLOYEE STOCK OWNERSHIP PLANS.
2 "(a) PLAN REQUIREMENTS FOR TAXPAYERS CLAIM-
3 ING SECTION 44C CREDIT.—In order to meet the require-
4 ments of this subsection—
5 "(1) Except as expressly provided in subsections
6 (b) and (c), a corporation (hereinafter in this sub-
7 section referred to as the 'employer') shall establish an
8 employee stock ownership plan (described in paragraph
9 (2)) which is funded by transfers of employer securities
10 in accordance with the provisions of paragraph (6) and
11 which meets all other requirements of this subsection.
12 "(2) The plan referred to in paragraph (1) shall
13 be a defined contribution plan established in writing
14 which—
15 "(A) is a stock bonus plan, a stock bonus and
16 a money purchase pension plan, or a profit-sharing
17 plan,
18 "(B) is designed to investment primarily in
19 employer securities, and
20 "(C) meets such other requirements (similar
21 to requirements applicable to employee stock own-
22 ership plans as defined in section 4975(e)(7))
23 as the Secretary may prescribe.
24 "(3) The plan shall provide for the allocation of
25 all employer securities transferred to it or purchased by

1 it (because of the requirements of section 44C) to the
2 account of each participant (who is an employee of the
3 employer at the close of the plan year) as of the close
4 of each plan year in an amount which bears substan-
5 tially the same proportion to the amount of all such
6 securities allocable to all participants in the plan for that
7 plan year as the amount of compensation paid to such
8 participant (disregarding any compensation in excess of
9 the first $100,000 per year) bears to the compensation
10 paid to all such participants during that year (disregard-
11 ing any compensation in excess of the first $100,000
12 with respect to any participant). Notwithstanding the
13 preceding sentence, the allocation to participants' ac-
14 counts may be extended over whatever period may be
15 necessary to comply with the requirements of section
16 415. For purposes of this paragraph, the amount of com-
17 pensation paid to a participant for a year is the amount
18 of such participant's compensation within the meaning
19 of section 415(c) (3) for such year.
20 "(4) The plan must provide that each participant
21 has a nonforfeitable right to any stock allocated to
22 his account under paragraph (3), and that no stock
23 allocated to a participant's account may be distributed
24 from that account before the end of the eighty-fourth
25 month beginning after the month in which the stock

1 is allocated to the account except in the case of separa-
2 tion from the service, death, or disability.

3 "(5) The plan must provide that, in the case of
4 securities issued by an employer which has a class of
5 securities registered under section 12 of the Securities
6 Exchange Act of 1934, or which would be required to
7 be so registered except for the exemption from registra-
8 tion provided in subsection (g) (2) (8) or (g) (2) (9)
9 of that section, each participant is entitled to direct the
10 plan as to the manner in which any employer securities
11 which are allocated to the account of the participant are
12 to be voted.

13 "(6) On making a claim for credit under section
14 44C, the employer shall state in such claim that it
15 agrees, as a condition of receiving any such credit—

16 "(A) to transfer employer securities to the
17 plan having a value at the time of the claim equal
18 to the amount of the credit claimed under section
19 44C for the taxable year of which at least one-
20 half (in value) shall consist of new employer se-
21 curities (as defined in section 44C (b)),

22 "(B) except as provided in subparagraph (C),
23 to effect the transfer not later than 30 days after the
24 time (including extensions) for filing its income tax
25 return for a taxable year, and

1 "(C) in the case of an employer whose credit
2 (as determined under section 44C (a)) for a taxable
3 year, exceeds the limitations of subsection (c) of
4 such section to effect that portion of the transfer
5 allocable to credit carryovers of such excess credit
6 at the time required under subparagraph (B) for
7 the taxable year to which such portion is carried
8 over.
9 For purposes of meeting the requirements of this para-
10 graph, a transfer of cash shall be treated as a transfer
11 of employer securities if the cash is, under the plan, used
12 to purchase employer securities.
13 "(7) Notwithstanding any other provision of law
14 to the contrary, if the plan does not meet the require-
15 ments of section 401—
16 "(A) stock transferred under paragraph (6)
17 and allocated to the account of any participant under
18 paragraph (3) and dividends thereon shall not be
19 considered income of the participant or his bene-
20 ficiary under this chapter until actually distributed
21 or made available to the participant or his bene-
22 ficiary and, at such time, shall be taxable under sec-
23 tion 72 (treating the participant or his beneficiary
24 as having a basis of zero in the contract),
25 "(B) no amount shall be allocated to any par-

1 ticipant in excess of the amount which might be
2 allocated if the plan met the requirements of section
3 401, and

4 "(C) the plan must meet the requirements of
5 sections 410 and 415.

6 "(8) (A) Except as provided in subparagraph (B)
7 (iii), if the amount of the credit determined under sec-
8 tion 46 is recaptured or redetermined in accordance with
9 the provisions of section 47 and the amount of the credit
10 claimed under section 44C for the taxable year to which
11 such recapture or redetermination relates was computed
12 under paragraph (1) of section 44C(a), the amounts
13 transferred to the plan under this subsection in subsec-
14 tion (c) and allocated under the plan shall remain in
15 the plan or in participant accounts, as the case may be,
16 and continue to be allocated in accordance with the plan.

17 "(B) If the amount of the credit determined under
18 section 46 for a taxable year is recaptured in accordance
19 with the provisions of section 47 and the amount of the
20 credit claimed under section 44C for the taxable year to
21 which such recapture relates was computed under para-
22 graph (1) of section 44C(a)—

23 "(i) the employer may reduce the amount
24 required to be transferred to the plan under para-
25 graph (6) of this subsection, or under paragraph

1 (3) of subsection (e), for the current taxable
2 year or any succeeding taxable years by the portion
3 of the amount so recaptured which is attributable to
4 reduction in the qualified investment (as determined
5 under section 46 (c) and (d) of the employer),
6 "(ii) notwithstanding the provisions of para-
7 graph (12), the employer may deduct such portion,
8 subject to the limitations of section 404 (relating to
9 deductions for contributions to an employees' trust
10 or plan), or
11 "(iii) if the requirements of subsection (c)
12 (1) are met, the employer may withdraw from
13 the plan an amount not in excess of such portion.
14 "(C) If the amount of the credit claimed by an
15 employer for a prior taxable year under section 38 is
16 reduced because of a redetermination of the qualified
17 investment for such prior taxable year which becomes
18 final during the taxable year, and the employer trans-
19 ferred amounts to a plan which were taken into account
20 for purposes of this subsection for that prior taxable
21 year, then—
22 "(i) the employer may reduce the amount it
23 is required to transfer to the plan under paragraph
24 (6) of this subsection, or under paragraph (3) of
25 subsection (e). for the taxable year or any succeed-

1 ing taxable year by the portion of the amount of
2 such reduction in the credit or increase in tax which
3 is attributable to the contribution to such plan, or
4 "(ii) notwithstanding the provisions of para-
5 graph (12), the employer may deduct such portion
6 subject to the limitations of section 404.
7 "(9) For purposes of this subsection—
8 "(A) EMPLOYER SECURITIES.—The term
9 'employer securities' means common stock issued by
10 the employer or a corporation which is a member
11 of a controlled group of corporations which includes
12 the employer (within the meaning of section 1563
13 (a), determined without regard to section 1563 (a)
14 (4) and (e) (3) (C)) with voting power and
15 dividend rights no less favorable than the voting
16 power and dividend rights of other common stock
17 issued by the employer or such controlling corpora-
18 tion, or securities issued by the employer or such
19 controlling corporation, convertible into such stock,
20 and
21 "(B) VALUE.—The term 'value' means the
22 average of closing prices of the employer's secu-
23 rities, as reported by a national exchange on which
24 securities are listed, for the 20 consecutive trading
25 days immediately preceding the date of transfer or

1 allocation of such securities or, in the case of secu-
2 rities not listed on a national exchange, the fair
3 market value as determined in good faith and in
4 accordance with the regulations issued by the
5 Secretary.

6 "(10) The Secretary shall prescribe such regula-
7 tions and require such reports as may be necessary to
8 carry out the provisions of this section.

9 "(11) If the employer fails to meet any require-
10 ment imposed under this section or under any obligation
11 undertaken to comply with a requirement of this section,
12 he is liable to the United States for a civil penalty of an
13 amount equal to the amount involved in such failure.
14 The preceding sentence shall not apply if the taxpayer
15 corrects such failure (as determined by the Secretary)
16 within 90 days after notice thereof. For purposes of this
17 paragraph, the term 'amount involved' means an amount
18 determined by the Secretary, but not in excess of the
19 amount of the credit claimed by the taxpayer for the
20 taxable year under section 44C (a) and not less than the
21 product of one-half of 1 percent of such amount multi-
22 plied by the number of months (or parts thereof) during
23 which such failure continues. The amount of such
24 penalty may be collected by the Secretary in the same

1 manner in which a deficiency in the payment of Federal
2 income tax may be collected.
3 "(12) Notwithstanding any provision of this title
4 to the contrary, no deduction shall be allowed under sec-
5 tion 162, 212, or 404 for amounts transferred to an
6 employee stock ownership plan and taken into account
7 under this subsection.
8 "(13) (A) As reimbursement for the expense of
9 establishing the plan, the employer may withhold from
10 amounts due the plan for the taxable year for which
11 the plan is established, or the plan may pay, so much
12 of the amounts paid or incurred in connection with the
13 establishment of the plan as does not exceed the sum
14 of 10 percent of the first $100,000 that the employer
15 is required to transfer to the plan for that taxable year
16 under paragraph (6) (including any amounts trans-
17 ferred under subsection (e) (3)) and 5 percent of any
18 amount in excess of the first $100,000 of such amount.
19 "(B) As reimbursement for the expense of admin-
20 istering the plan, the employer may withhold from
21 amounts due the plan, or the plan may pay, so much of
22 the amounts paid or incurred during the taxable year
23 as expenses of administering the plan as does not exceed
24 the smaller of—
25 "(i) the sum of 10 percent of the first $100,-

1 000 and 5 percent of any amount in excess of
2 $100,000 of the income from dividends paid to the
3 plan with respect to stock of the employer during
4 the plan year ending with or within the employer's
5 taxable year, or

6 "(ii) $100,000.

7 "(14) The return of a contribution made by an
8 employer to an employee stock ownership plan designed
9 to satisfy the requirements of this subsection or subsec-
10 tion (b) (or a provision for such a return) does not fail
11 to satisfy the requirements of this subsection, subsection
12 (b), section 401(a), or section 403(c)(1) of the
13 Employee Retirement Income Security Act of 1974 if—

14 "(A) the contribution is conditioned under
15 the plan upon determination by the Secretary that
16 such plan meets the applicable requirements of this
17 subsection, subsection (b), or section 401(a),

18 "(B) the application for such a determination
19 is filed with the Secretary not later than 90 days
20 after the date on which the credit under section 44C
21 is allowed, and

22 "(C) the contribution is returned within one
23 year after the date on which the Secretary issues
24 notice to the employer that such plan does not

1 satisfy the requirements of this subsection, subsec-
2 tion (b), or section 401 (a).
3 "(15) Notwithstanding any provision of this title
4 to the contrary, employees who are included in a unit
5 of employees covered by a collective bargaining agree-
6 ment between an employee representative and one or
7 more employers and who satisfy the minimum age and
8 service requirements, if any, established by the plan
9 shall not be excluded from eligibility under the plan,
10 unless the employee representative declines coverage
11 for employees in the unit. Where the employee repre-
12 sentative declines coverage, section 410(b)(2)(A)
13 shall apply.
14 "(b) ADDITIONAL PLAN REQUIREMENTS.—
15 "(1) The employer may not make participation in
16 the plan a condition of employment and the plan may
17 not require matching employee contributions as a condi-
18 tion of participation in the plan.
19 "(2) Employee contributions (if any) under the
20 plan must meet the requirements of section 401(a)(4)
21 (relating to contributions).
22 "(c) RECAPTURE.—
23 "(1) GENERAL RULE.—Amounts transferred to a
24 plan under subsection (a)(6) may be withdrawn from

1 the plan by the employer if the plan provides that while
2 subject to recapture—
3 "(A) amounts so transferred with respect to a
4 taxable year are segregated from other plan assets,
5 and
6 "(B) separate accounts are maintained for
7 participants on whose behalf amounts so transferred
8 have been allocated for a taxable year.
9 "(2) COORDINATION WITH OTHER LAW. Not-
10 withstanding any other law or rule of law, an amount
11 withdrawn by the employer will neither fail to be con-
12 sidered to be nonforfeitable nor fail to be for the exclu-
13 sive benefit of participants or their beneficiaries merely
14 because of the withdrawal from the plan of amounts de-
15 scribed in paragraph (1), nor will the withdrawal of
16 any such amount be considered to violate the provisions
17 of section 403 (c) (1) of the Employee Retirement In-
18 come Security Act of 1974.
19 "(d) EFFECT OF RECAPTURE PROVISIONS ON DIS-
20 TRIBUTION TO A PARTICIPANT (OR HIS BENEFICIARY).—
21 A distribution to a participant (or his beneficiary) which
22 otherwise satisfies the requirements of subsection (e) (4)
23 (A) of section 402 shall be treated as a lump sum distribu-
24 tion for purposes of section 402, notwithstanding the fact that

1 a portion of the amount allocated to the participant's ac-
2 count under the plan as provided in this section is retained in
3 the plan following the distribution to him in order to permit
4 an amount previously transferred to the plan to be with-
5 drawn by his employer under subsection (a) (8) (B) of
6 this section. Any portion of this amount retained in the plan
7 which is not withdrawn by the employer and which is sub-
8 sequently distributed to the participant (or his beneficiary)
9 shall not be treated as a lump sum distribution.".
10 (c) CONFORMING CHANGES.—
11 (1) Paragraph (2) of section 46(a) of such Code
12 (relating to amount of credit for current taxable year)
13 is amended—
14 (A) by striking out "Except as otherwise pro-
15 vided in subparagraph (B), in the case of property
16 described in subparagraph (D)," and inserting in
17 lieu thereof the following: "In the case of property
18 described in subparagraph (C),",
19 (B) by striking out subparagraph (B) and
20 redesignating subparagraphs (C) and (D) as (B)
21 and (C), respectively,
22 (C) by striking out "subparagraph (D)," in
23 subparagraph (B) (as so redesignated) and in-
24 serting in lieu thereof "subparagraph (C)",
25 (D) by striking out "subparagraphs (A) and

1 (B)" in subparagraph (C) (as so redesignated)
2 and inserting in lieu thereof "subparagraph (A)",
3 and
4 (E) by striking out the last sentence of sub-
5 paragraph (C) (as so redesignated).
6 (2) Subparagraph (A) of section 46(c)(3) of
7 such Code (relating to public utility property) is
8 amended by striking out "subsection (a)(2)(C)" and
9 inserting in lieu thereof "subsection (a)(2)(B)".
10 (3) Paragraph (9) of section 46(f) of such Code
11 (relating to limitation in case of certain regulated com-
12 panies) is amended—
13 (A) by striking out "makes an election under
14 subparagraph (B) of subsection (a)(2)," and in-
15 serting in lieu thereof "claims the credit allowed by
16 section 44C,",
17 (B) by striking out "then, notwithstanding
18 the prior paragraphs of this subsection, no credit
19 shall be allowed by section 38 in excess of the
20 amount which would be allowed without regard to
21 the provisions of subparagraph (B) of subsection
22 (a)(2)" and inserting in lieu thereof "then no
23 credit shall be allowed by such section".
24 (d) CLERICAL AMENDMENTS.—
25 (1) The table of sections for subpart A of part IV

1 of subchapter A of chapter 1 of such Code is amended
2 by inserting immediately after the item relating to sec-
3 tion 44B the following new item:

"Sec. 44C. Employee Stock Ownership Plan Contributions.".

4 (2) The table of sections for subpart B of part I
5 of subchapter D of chapter 1 of such Code is amended
6 by adding at the end thereof the following new item:

"Sec. 416. Special employee stock ownership plans.".

7 **SEC. 2. TREATMENT OF ESOP ANNUITIES FOR ESTATE**
8 **PURPOSES.**

9 Subsection (c) of section 2039 of such Code (relating
10 to exemption of annuities under certain trusts and plans) is
11 amended—

12 (1) by striking out "(other than a lump sum dis-
13 tribution described in section 402(e)(4), determined
14 without regard to the next to the last sentence of section
15 402(e)(4)(A))" and inserting in lieu thereof "(other
16 than an amount which the taxpayer elected, under
17 section 402(e)(4)(B), to treat as a lump sum dis-
18 tribution)", and

19 (2) by inserting after "section 401(a)" in para-
20 graph (1) the following: ", or under an employee
21 stock ownership plan".

22 **SEC. 3. RETIREMENT SAVINGS BY ESOP PARTICIPANTS.**

23 (a) AMENDMENT OF SECTION 219.—Paragraph (4)

1 of section 219 (c) of such Code (relating to participation in
2 governmental plans by certain individuals) is amended—
3 (1) by inserting "; participation in certain em-
4 ployee stock ownership plans" after "individuals" in the
5 caption of such paragraph, and
6 (2) by adding at the end thereof the following new
7 subparagraph:
8 "(C) CERTAIN EMPLOYEE STOCK OWNERSHIP
9 PLANS.—A participant in an employee stock owner-
10 ship plan described in section 416 is not considered
11 to be an active participant in a plan described in
12 subsection (b) (2) solely because of his participa-
13 tion in the employee stock ownership plan.".
14 (b) AMENDMENT OF SECTION 220.—Paragraph (5)
15 of section 220 (c) of such Code (relating to participation
16 in governmental plans by certain individuals) is amended—
17 (1) by inserting "; participation in certain em-
18 ployee stock ownership plans" after "individuals" in the
19 caption of such paragraph, and
20 (2) by adding at the end thereof the following
21 new sentence: "A participant in an employee stock
22 ownership plan which meets the requirements of sec-
23 tion 416 is not considered to be an active participant in
24 a plan described in subsection (b) (3) solely because

1 of his participation in the employee stock ownership
2 plan.".

3 **SEC. 4. ROLLOVER OF ESOP INTO IRA.**

4 Paragraph (6) of section 402(a) of the Internal Rev-
5 enue Code of 1954 (relating to special rollover rules) is
6 amended by adding at the end thereof the following new
7 subparagraph:

8 "(C) CASH IN LIEU OF EMPLOYER SECURITIES.—
9 For purposes of paragraph (5), the transfer of all
10 money received in lieu of a distribution of employer
11 securities (as defined in section 416(a)(9)(A)) or of
12 the proceeds from the sale of a distribution of employer
13 securities to the employer or to the trust or plan main-
14 tained by the employer, shall be treated as a transfer
15 of a distribution of such securities.".

16 **SEC. 5. PUT-OPTION REQUIREMENT FOR CERTAIN ESOP**
17 **CONTRIBUTIONS.**

18 "Notwithstanding any other provision of law, an em-
19 ployee stock ownership plan (as defined in section 416 or
20 4975(e)(7) of the Internal Revenue Code of 1954) which
21 permits a participant to elect to receive cash in lieu of a
22 distribution of employer securities shall not be required to
23 provide a put option for any securities distributed from the
24 plan, nor shall the provision of such an election be deemed

1 to be an offering of a security to the participant for purposes
2 of Federal and State securities laws.".
3 **SEC. 6. ELECTION WITH RESPECT TO UNREALIZED AP-**
4 **PRECIATION OF EMPLOYER SECURITIES.**
5 Subparagraph (J) of section 402 (e) (4) of such Code
6 (relating to unrealized appreciation of employer securities)
7 is amended by inserting after "there shall be excluded" the
8 following: ", at the election of the taxpayer (made at such
9 time and in such manner as the Secretary may prescribe
10 by regulation),".
11 **SEC. 7. DEDUCTIBILITY OF CERTAIN ESOP CONTRIBU-**
12 **TIONS, BEQUESTS, ETC.**
13 (a) DIVIDENDS PAID DEDUCTION.—In addition to the
14 deductions provided under section 404 (a) of the Internal
15 Revenue Code of 1954, there shall be allowed as a deduc-
16 tion to an employer the amount of any dividend paid by that
17 employer during the taxable year with respect to employer
18 securities (as defined in section 416 (a) (9) of such Code)
19 if—
20 (1) the employer securities were held on the record
21 date for the dividend by an employee stock ownership
22 plan, and
23 (2) the dividend received by the plan—
24 (A) is distributed, not later than 60 days

1 after the close of the plan year in which it is re-
2 ceived, to the employees participating in the plan,
3 in accordance with the plan provisions.

4 (b) BEQUESTS; CHARITABLE CONTRIBUTIONS, ETC.—
5 For purposes of sections 170 (b) (1), 642 (c), 2055 (a) and
6 2522 of the Internal Revenue Code of 1954, a contribution,
7 bequest, or similar transfer of employer securities or other
8 property to an employee stock ownership plan (described in
9 section 416 of such Code) shall be deemed a charitable con-
10 tribution to an organization described in section 170 (b) (1)
11 (A) (vi) of such Code, if—

12 (A) such contribution, bequest, or transfer is allo-
13 cated, pursuant to the terms of such plan, to the em-
14 ployees participating under the plan in a manner con-
15 sistent with section 401 (a) (4) of such Code;

16 (B) no part of such contribution, bequest or trans-
17 fer is allocated under the plan for the benefit of the tax-
18 payer (or decedent), or any person related to the tax-
19 payer (or decedent) under the provisions of section
20 267 (b) of such Code, or any other person who owns
21 more than 25 percent in value of any class of outstand-
22 ing employer securities (as defined in section 416 (a)
23 (9) of such Code) under the provisions of section 318
24 (a) of such Code; and

1 (C) such contribution, bequest, or transfer is made
2 only with the express approval of such employee stock
3 ownership plan.

4 SEC. 8. ELIMINATION OF MINIMUM TAX ON EMPLOYEE
5 STOCK OWNERSHIP PLAN CONTRIBUTIONS.

6 In determining the regular tax deductions under section
7 56 (c) of the Internal Revenue Code of 1954, the taxes im-
8 posed by chapter 1 of such Code shall not be reduced—
9 (A) In the case of a taxable year ending after Decem-
10 ber 31, 1974, and beginning before January 1, 1978, by the
11 excess, if any, of the credit determined pursuant to section
12 46 (a) (2) (B) of such Code over the credit which would
13 have been determined pursuant to section 46 (a) (2) (A)
14 of such Code, or
15 (B) In the case of a taxable year beginning after De-
16 cember 31, 1977, by the amount of credit determined pur-
17 suant to section 44C of such Code.

18 SEC. 9. EFFECTIVE DATE.

19 Except as provided in section 8, the amendments made
20 by this Act shall apply with respect to taxable years begin-
21 ning after December 31, 1977.

95TH CONGRESS
2D SESSION

S. 3223

IN THE SENATE OF THE UNITED STATES

JUNE 22 (legislative day, MAY 17), 1978

MR. GRAVEL introduced the following bill; which was read twice and referred to the Committee on Finance

A BILL

To amend the Internal Revenue Code of 1954 to provide tax incentives for the establishment of general stock ownership plans.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 **SECTION 1. GENERAL STOCK OWNERSHIP TRUSTS.**
4 Subsection (c) of section 501 of the Internal Revenue
5 Code of 1954 (relating to list of exempt organizations) is
6 amended by adding at the end thereof the following new
7 paragraph:
8 "(22) A general stock ownership trust which is
9 established in writing by the United States or the gov-
10 ernment of a State or a political subdivision of a State

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1 exclusively for the purpose of broadening stock owner-
2 ship and integrating the corporate income tax by pur-
3 chasing, receiving, holding, pledging, and distributing
4 securities (within the meaning of section 251 (b)) of
5 one or more corporations, and which is empowered to
6 receive, hold, and distribute amounts paid to the trust
7 by corporations whose securities are held by the trust
8 (or trust participants) and incur, amortize, and guaran-
9 tee indebtedness in furtherance of the trust purposes, but
10 only if the trust—

11 "(A) provides for participation by all resi-
12 dents of the sponsoring jurisdiction as of the date
13 each such resident completes at least 12 consecutive
14 months of residency within the jurisdiction,

15 "(B) provides for the allocation of one share
16 of each issue of securities held by the trust to the
17 account of each participant (within the meaning of
18 section 251 (b)) as of the last day of the trust year
19 in which the individual initially becomes a partici-
20 pant in the trust in a manner which does not dis-
21 criminate among such participants on the basis of
22 race, sex, age, income, or ownership of property,

23 "(C) provides that each participant has a non-
24 forfeitable right to any stock allocated to his ac-
25 count, but that no stock allocated to a participant's

1 account may be distributed to the participant from
2 that account before the last day of the trust year
3 next following the trust year of the participant's
4 death or, if earlier, the last day of the trust year
5 next following the later of—
6 "(i) the participant's completion of 5 years
7 of participation in the trust, or
8 "(ii) the participant's attainment of 18
9 years of age,
10 "(D) provides that all amounts received by the
11 trust will be distributed not later than the due date
12 for the filing of the trust's information return under
13 section 6033 for the trust year in which such
14 amounts are received,
15 "(E) provides that no person may purchase or
16 otherwise acquire except by gift or devise from any
17 participant directly or indirectly more than 10
18 shares of any security held by or upon which
19 dividends are distributed through the trust, and
20 "(F) meets such other requirements as the
21 Secretary may by regulation prescribe.".
22 SEC. 2. INCOME TAX TREATMENT OF DISTRIBUTIONS
23 FROM GENERAL STOCK OWNERSHIP TRUSTS.
24 Securities (as defined in section 251(b) of the Internal
25 Revenue Code of 1954) transferred to a participant or to

1 the account of a participant in a trust described in section
2 501(c)(22) of the Internal Revenue Code of 1954 shall
3 not be considered income of the participant under the
4 Internal Revenue Code of 1954 until such time as the
5 participant sells or exchanges such a security. Amounts
6 paid by the trust in connection with securities held by the
7 trust in the account of a participant shall not be considered
8 income of the participant under the Internal Revenue Code
9 of 1954 until actually received by the participant and, at
10 such time, shall be treated, for purposes of such Code, as
11 dividends.

12 SEC. 3. CORPORATE DEDUCTION FOR AMOUNTS PAID TO
13 GENERAL STOCK OWNERSHIP TRUSTS.

14 (a) IN GENERAL.—Part VIII of subchapter B of
15 chapter 1 of the Internal Revenue Code of 1954 (relating
16 to special deductions for corporations) is amended by adding
17 at the end thereof the following new section:

18 "SEC. 251. AMOUNTS PAID TO A GENERAL STOCK OWNER-
19 SHIP TRUST.

20 "(a) GENERAL RULE.—In the case of a corporation
21 there shall be allowed as a deduction an amount equal to
22 the amount paid for the taxable year by such corporation
23 to a trust described in section 501(c)(22), not in excess
24 of the amount determined by multiplying the corporation's
25 net taxable income (determined without regard to any

1 deduction allowable under this section) by a fraction, the
2 numerator of which is the total number of shares of the
3 corporation's securities held by the trust (including shares
4 held by participants in the trust which were acquired, other
5 than by purchase, from the trust) and the denominator of
6 which is the total number of shares of the corporation's
7 securities outstanding. Amounts paid to the trust not later
8 than the date established by law for filing the corporation's
9 return of tax for a taxable year, including any extension
10 thereof, shall be treated as paid for that taxable year.
11 "(b) DEFINITIONS.—For purposes of this section and
12 sections 4975 (c) (4) and 501 (c) (22)—
13 "(1) DISTRIBUTED.—The term 'distributed' means
14 actually paid to the participants of the trust, paid as
15 ordinary and necessary expenses of trust operation, or
16 paid in retirement of debt principal and interest incurred
17 in furtherance of the trust's purposes.
18 "(2) PARTICIPANT.—The term 'participant' means
19 any individual for whom an account is maintained under
20 a trust described in section 501 (c) (22), for whose ben-
21 efit allocations are made under the trust, and to whom
22 benefits are distributed from the trust, and any individual
23 who succeeds to the interest of a participant in a trans-
24 action in which gain is not recognized.
25 "(3) SECURITIES.—The term 'securities' means

1 common stock issued by a corporation with voting power
2 and dividend rights no less favorable than the voting
3 power and dividend rights of other common stock
4 issued by the corporation.".

5 (b) CLERICAL AMENDMENT.—The table of sections for
6 such part is amended by adding at the end thereof the
7 following new item:

"Sec. 251. Amounts paid to a general stock ownership trust.".

8 **SEC. 4. FAILURE TO DISTRIBUTE.**

9 Section 4975 (c) of the Internal Revenue Code of 1954
10 (relating to prohibited transactions) is amended by adding
11 at the end thereof the following new paragraph:

12 "(4) SPECIAL RULE FOR GENERAL STOCK OWNER-
13 SHIP TRUSTS.—It shall be a prohibited transaction with-
14 in the meaning of this section for a trust described in
15 section 501 (c) (22) to fail to distribute all amounts
16 transferred to it as required by section 501 (c) (22)
17 (E).".

18 **SEC. 5. EXEMPTION OF GENERAL STOCK OWNERSHIP**
19 **TRUSTS FROM TAX ON UNRELATED BUSINESS**
20 **INCOME.**

21 Section 511 (a) (2) of the Internal Revenue Code of
22 1954 (relating to exempt persons) is amended by adding at
23 by inserting "or in section 501 (c) (22)" after "section 501
24 (c) (1)".

1 SEC. 6. ELIGIBILITY FOR INDUSTRIAL DEVELOPMENT
2 BONDS.

3 Section 103(b)(3) of the Internal Revenue Code of
4 1954 (relating to exempt persons) is amended by adding at
5 the end thereof the following new subparagraph:

6 "(C) an organization described in section 501(c)
7 (21).".

8 SEC. 7. EFFECTIVE DATE.

9 The amendments made by this Act, and the provisions
10 of section 2 of this Act, shall apply with respect to taxable
11 years beginning after December 31, 1978.

95TH CONGRESS
2D SESSION

H.R. 13882

IN THE HOUSE OF REPRESENTATIVES

AUGUST 15, 1978

Mr. WAGGONNER (for himself, and Mr. FRENZEL) introduced the following bill; which was referred to the Committee on Ways and Means

A BILL

To amend the Internal Revenue Code of 1954, and the Tax Reduction Act of 1975, with respect to employee stock ownership plans.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That this Act may be cited as the "Expanded Employee
4 Stock Ownership Act of 1978".

1 SEC. 2. CREDIT FOR ESTABLISHING EMPLOYEE STOCK OWN-
2 ERSHIP PLAN.

3 (a) IN GENERAL.—Subpart A of part IV of subchapter
4 A of chapter 1 of the Internal Revenue Code of 1954 (relat-
5 ing to credits allowed) is amended by inserting after section
6 44B the following new section:

7 "SEC. 44C. EMPLOYEE STOCK OWNERSHIP PLAN CONTRIBU-
8 TIONS.

9 "(a) GENERAL RULE.—In the case of a corporation
10 which meets the requirements of section 416, there is al-
11 lowed as a credit against the tax imposed by this chapter for
12 the taxable year, an amount equal to the greater of—

13 "(1) not more than 2 percent of the qualified in-
14 vestment (as determined under subsections (c) and (d)
15 of section 46) of the taxpayer for the taxable year, or

16 "(2) not more than 1 percent of the aggregate
17 participants' compensation (as defined in section
18 415(c)(3)) paid by the corporation during the taxable
19 year.

20 "(b) TRANSFER OF NEW EMPLOYER SECURITIES RE-
21 QUIRED.—The credit allowable under subsection (a) for any
22 taxable year shall not be allowed unless, in meeting the re-
23 quirements of such section for such taxable year, employer
24 securities equal in value to the credit claimed are transferred
25 to the trust and at least the total amount of the credit
26 claimed under subsection (a)(1) in excess of 1 percent of the

1 qualified investment, or at least one-half of the credit claimed
2 under subsection (a)(2) is represented by new employer secu-
3 rities transferred to the trust. For purposes of this subsection,
4 the term 'new employer securities' means employer securities
5 (as defined in section 416(a)(9) not previously issued.

6 "(c) LIMITATION BASED ON TAX LIABILITY; CAR-
7 RYOVER OF EXCESS CREDIT.—

8 "(1) LIMITATION.—The amount of the credit al-
9 lowed under subsection (a) for the taxable year shall
10 not exceed so much of the liability for tax for the tax-
11 able year as does not exceed $50,000, plus 95 percent
12 of as much of the liability of the taxpayer for tax under
13 this chapter for the taxable year as exceeds $50,000.

14 "(2) CARRYOVER OF EXCESS CREDIT.—If the
15 amount of the credit determined under subsection (a)
16 for the taxable year exceeds the amount of the limita-
17 tion imposed by paragraph (1) for such taxable year
18 (hereinafter in this paragraph referred to as the
19 'unused credit year'), such excess shall be—

20 "(A) an ESOP credit carryback to each of
21 the 3 taxable years preceding the unused credit
22 year, and

23 "(B) an ESOP credit carryover to each of
24 the 7 taxable years following the unused credit
25 year, and

1 subject to the limitations imposed by paragraph (1),
2 shall be taken into account under the provisions of sub-
3 section (a) in the manner provided in that subsection.
4 The entire amount of the unused credit for an unused
5 credit year shall be carried to the earliest of the 10
6 taxable years to which (by reason of subparagraphs (A)
7 and (B)) such credit may be carried and then to each of
8 the other 9 taxable years to which it may be carried.
9 "(d) LIMITATION WITH RESPECT TO CERTAIN COM-
10 PANIES.—In the case of a regulated public utility, no credit
11 shall be allowed by subsection (a) if the taxpayer's cost of
12 service for ratemaking purposes is reduced by reason of any
13 portion of the credit allowable by subsection (a) (determined
14 without regard to this subsection), or if the base to which the
15 taxpayer's rate of return for ratemaking purposes is applied is
16 reduced by any reason of any portion of the credit allowed by
17 subsection (a) (determined without regard to this subsec-
18 tion).".
19 (b) Subpart B of part I of subchapter D of chapter 1 of
20 such Code is amended by adding at the end thereof the fol-
21 lowing new section:
22 "SEC. 416. SPECIAL EMPLOYEE STOCK OWNERSHIP PLANS.
23 "(a) PLAN REQUIREMENTS FOR TAXPAYERS CLAIMING
24 SECTION 44C CREDIT.—In order to meet the requirements
25 of this subsection—

1 "(1) Except as expressly provided in subsections
2 (b) and (c), a corporation (hereinafter in this subsection
3 referred to as the 'employer') shall establish an em-
4 ployee stock ownership plan (described in paragraph
5 (2)) which is funded by transfers of employers securi-
6 ties in accordance with the provisions of paragraph (6)
7 and which meets all other requirements of this subsec-
8 tion.

9 "(2) The plan referred to in paragraph (1) shall be
10 a defined contribution plan established in writing
11 which—

12 "(A) is a stock bonus plan, a stock bonus
13 and a money purchase pension plan, or a profit-
14 sharing plan,

15 "(B) is designed to investment primarily in
16 employer securities, and

17 "(C) meets such other requirements (similar
18 to requirements applicable to employee stock
19 ownership plans as defined in section 4975(e)(7))
20 as the Secretary may prescribe.

21 "(3) The plan shall provide for the allocation of
22 all employer securities transferred to it or purchased by
23 it (because of the requirements of section 44C) to the
24 account of each participant (who is an employee of the
25 employer at the close of the plan year or, if applicable,

1 the date as of which the allocation is made) as of the
2 close of each plan year in an amount which bears sub-
3 stantially the same proportion to the amount of all
4 such securities allocable to all participants in the plan
5 for that plan year as the amount of compensation paid
6 to such participant (disregarding any compensation in
7 excess of the first $100,000 per year) bears to the
8 compensation paid to all such participants during that
9 year (disregarding any compensation in excess of the
10 first $100,000 with respect to any participant). Not-
11 withstanding the preceding sentence, the allocation to
12 participants' accounts may be extended over whatever
13 period may be necessary to comply with the require-
14 ments of section 415. For purposes of this paragraph,
15 the amount of compensation paid to a participant for a
16 year is the amount of such participant's compensation
17 within the meaning of section 415(c)(3) for such year.
18 "(4) The plan must provide that each participant
19 has a nonforfeitable right to any stock allocated to his
20 account under paragraph (3), and that no stock allocat-
21 ed to a participant's account may be distributed from
22 that account before the end of the 84th month begin-
23 ning after the month in which the stock is allocated to
24 the account except in the case of separation from the
25 service, death, or disability.

1 "(5) The plan must provide that, in the case of
2 securities issued by an employer which has a class of
3 securities registered under section 12 of the Securities
4 Exchange Act of 1934, or which would be required to
5 be so registered except for the exemption from regis-
6 tration provided in subsection (g)(2)(8) or (g)(2)(9) of
7 that section, each participant is entitled to direct the
8 plan as to the manner in which any employer securities
9 which are allocated to the account of the participant
10 are to be voted.

11 "(6) On making a claim for credit under section
12 44C, the employer shall state in such claim that it
13 agrees, as a condition of receiving any such credit—

14 "(A) to transfer employer securities to the
15 plan having a value at the time of the claim equal
16 to the amount of the credit claimed under section
17 44C for the taxable year, a portion of which, as
18 required in section 44C(b), shall consist of new
19 employer securities (as defined in section 44C(b)),

20 "(B) except as provided in subparagraph (C),
21 to effect the transfer not later than 30 days after
22 the time (including extensions) for filing its income
23 tax return for a taxable year, and

24 "(C) in the case of an employer whose credit
25 (as determined under section 44C(a)) for a taxable

1 year, exceeds the limitations of subsection (c) of
2 such section to effect that portion of the transfer
3 allocable to credit carryovers of such excess credit
4 at the time required under subparagraph (B) for
5 the taxable year to which such portion is carried
6 over.
7 For purposes of meeting the requirements of this para-
8 graph, a transfer of cash shall be treated as a transfer
9 of employer securities if the cash is, under the plan,
10 used to purchase employer securities.
11 "(7) Notwithstanding any other provision of law
12 to the contrary, if the plan does not meet the require-
13 ments of section 401—
14 "(A) stock transferred under paragraph (6)
15 and allocated to the account of any participant
16 under paragraph (3) and dividends thereon shall
17 not be considered income of the participant or his
18 beneficiary under this chapter until actually dis-
19 tributed or made available to the participant or
20 his beneficiary and, at such time, shall be taxable
21 under section 72 (treating the participant or his
22 beneficiary as having a basis of zero in the con-
23 tract),
24 "(B) no amount shall be allocated to any
25 participant in excess of the amount which might

1 be allocated if the plan met the requirements of
2 section 401, and
3 "(C) the plan must meet the requirements of
4 sections 410 and 415.
5 "(8)(A) Except as provided in subparagraph
6 (B)(iii), if the amount of the credit determined under
7 section 46 is recaptured or redetermined in accordance
8 with the provisions of section 47 and the amount of the
9 credit claimed under section 44C for the taxable year
10 to which such recapture or redetermination relates was
11 computed under paragraph (1) of section 44C(a), the
12 amounts transferred to the plan under this subsection
13 and allocated under the plan shall remain in the plan
14 or in participant accounts, as the case may be, and
15 continue to be allocated in accordance with the plan.
16 "(B) If the amount of the credit determined under
17 section 46 for a taxable year is recaptured in accor-
18 dance with the provisions of section 47 and the amount
19 of the credit claimed under section 44C for the taxable
20 year to which such recapture relates was computed
21 under paragraph (1) of section 44C(a)—
22 "(i) the employer may reduce the amount re-
23 quired to be transferred to the plan under para-
24 graph (6) of this subsection, for the current tax-
25 able year or any succeeding taxable years by the

1 portion of the amount so recaptured which is at-
2 tributable to reduction in the qualified investment
3 (as determined under section 46 (c) and (d) of the
4 employer),
5 "(ii) notwithstanding the provisions of para-
6 graph (12), the employer may deduct such por-
7 tion, subject to the limitations of section 404 (re-
8 lating to deductions for contributions to an em-
9 ployees' trust or plan), or
10 "(iii) if the requirements of subsection (c)(1)
11 are met, the employer may withdraw from the
12 plan an amount not in excess of such portion.
13 "(C) If the amount of the credit claimed by an
14 employer for a prior taxable year under section 38 is
15 reduced because of a redetermination of the qualified
16 investment for such prior taxable year which becomes
17 final during the taxable year, and the employer trans-
18 ferred amounts to a plan which were taken into ac-
19 count for purposes of this subsection for that prior tax-
20 able year, then—
21 "(i) the employer may reduce the amount it
22 is required to transfer to the plan under paragraph
23 (6) of this subsection for the taxable year or any
24 succeeding taxable year by the portion of the
25 amount of such reduction in the credit or increase

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1 in tax which is attributable to the contribution to
2 such plan, or
3 "(ii) notwithstanding the provisions of para-
4 graph (12), the employer may deduct such portion
5 subject to the limitations of section 404.
6 "(9) For purposes of this subsection—
7 "(A) EMPLOYER SECURITIES.—The term
8 'employer securities' means common stock issued
9 by the employer or a corporation which is a
10 member of a controlled group of corporations
11 which includes the employer with voting power
12 and dividend rights no less favorable than the
13 voting power and dividend rights of other common
14 stock issued by the employer or such controlling
15 corporation, or securities issued by the employer
16 or such controlling corporation, convertible into
17 such stock. For purposes of this subparagraph, the
18 term 'controlled group of corporations' has the
19 meaning given to such term by section 1563(a),
20 except that—
21 "(i) 'more tha 50 percent' shall be sub-
22 stituted for 'at least 80 percent' each place it
23 appears in section 1563(a)(1), and

1 "(ii) the determination shall be made
2 without regard to subsections (a)(4) and
3 (e)(3)(C) of section 1563.
4 "(B) VALUE.—The term 'value' means the
5 average of closing prices of the employer's securi-
6 ties, as reported by a national exchange on which
7 securities are listed, for the 20 consecutive trad-
8 ing days immediately preceding the date of trans-
9 fer or allocation of such securities or, in the case
10 of securities not listed on a national exchange, the
11 fair market value as determined in good faith and
12 in accordance with the regulations issued by the
13 Secretary.
14 "(10) The Secretary shall prescribe such regula-
15 tions and require such reports as may be necessary to
16 carry out the provisions of this section.
17 "(11) If the employer fails to meet any require-
18 ment imposed under this section or under any obliga-
19 tion undertaken to comply with a requirement of this
20 section, he is liable to the United States for a civil
21 penalty of an amount equal to the amount involved in
22 such failure. The preceding sentence shall not apply if
23 the taxpayer corrects such failure (as determined by
24 the Secretary) within 90 days after notice thereof. For
25 purposes of this paragraph, the term 'amount involved'

1 means an amount determined by the Secretary, but not
2 in excess of the amount of the credit claimed by the
3 taxpayer for the taxable year under section 44C(a) and
4 not less than the product of one-half of 1 percent of
5 such amount multiplied by the number of months (or
6 parts thereof) during which such failure continues. The
7 amount of such penalty may be collected by the Secre-
8 tary in the same manner in which a deficiency in the
9 payment of Federal income tax may be collected.

10 "(12) Notwithstanding any provision of this title
11 to the contrary, no deduction shall be allowed under
12 section 162, 212, or 404 for amounts transferred to an
13 employee stock ownership plan and taken into account
14 under this subsection.

15 "(13) (A) As reimbursement for the expense of es-
16 tablishing the plan, the employer may withhold from
17 amounts due the plan for the taxable year for which
18 the plan is established, or the plan may pay, so much
19 of the amounts paid or incurred in connection with the
20 establishment of the plan as does not exceed the sum
21 of 10 percent of the first $100,000 that the employer
22 is required to transfer to the plan for that taxable year
23 under paragraph (6) and 5 percent of any amount in
24 excess of the first $100,000 of such amount.

1 "(B) As reimbursement for the expense of admin-
2 istering the plan, the employer may withhold from
3 amounts due the plan, or the plan may pay, so much of
4 the amounts paid or incurred during the taxable year
5 as expenses of administering the plan as does not
6 exceed the smaller of—
7 "(i) the sum of 10 percent of the first
8 $100,000 and 5 percent of any amount in excess
9 of $100,000 of the income from dividends paid to
10 the plan with respect to stock of the employer
11 during the plan year ending with or within the
12 employer's taxable year, or
13 "(ii) $100,000.
14 "(14) The return of a contribution made by an
15 employer to an employee stock ownership plan de-
16 signed to satisfy the requirements of this subsection or
17 subsection (b) (or a provision for such a return) does
18 not fail to satisfy the requirements of this subsection,
19 subsection (b), section 401(a), or section 403(c)(1) of
20 the Employee Retirement Income Security Act of
21 1974 if—
22 "(A) the contribution is conditioned under
23 the plan upon determination by the Secretary that
24 such plan meets the applicable requirements of
25 this subsection, subsection (b), or section 401(a),

1 "(B) the application for such a determination
2 is filed with the Secretary not later than 90 days
3 after the date on which the credit under section
4 44C is allowed, and
5 "(C) the contribution is returned within one
6 year after the date on which the Secretary issues
7 notice to the employer that such plan does not
8 satisfy the requirements of this subsection, subsec-
9 tion (b), or section 401(a).
10 "(15) Notwithstanding any provision of this title
11 to the contrary, employees who are included in a unit
12 of employees covered by a collective-bargaining agree-
13 ment between an employee representative and one or
14 more employers and who satisfy the minimum age and
15 service requirements, if any, established by the plan
16 shall not be excluded from eligibility under the plan,
17 unless the employee representative declines coverage
18 for employees in the unit. Where the employee repre-
19 sentative declines coverage, section 410(b)(2)(A) shall
20 apply.
21 "(b) ADDITIONAL PLAN REQUIREMENTS.—
22 "(1) The employer may not make participation in
23 the plan a condition of employment and the plan may
24 not require employee contributions as a condition of

1 participation in the plan. However, the plan may
2 permit employee contributions to be made.
3 "(2) Employee contributions (if any) under the
4 plan must meet the requirements of section 401(a)(4)
5 (relating to contributions).
6 "(c) RECAPTURE.—
7 (1) GENERAL RULE.—Amounts transferred to a
8 plan under subsection (a)(6) may be withdrawn from
9 the plan by the employer if the plan provides that
10 while subject to recapture—
11 "(A) amounts so transferred with respect to
12 a taxable year are segregated from other plan
13 assets, and
14 "(B) separate accounts are maintained for
15 participants on whose behalf amounts so trans-
16 ferred have been allocated for a taxable year.
17 "(2) COORDINATION WITH OTHER LAW.—Not-
18 withstanding any other law or rule of law, an amount
19 withdrawn by the employer will neither fail to be con-
20 sidered to be nonforfeitable nor fail to be for the exclu-
21 sive benefit of participants or their beneficiaries merely
22 because of the withdrawal from the plan of amounts
23 described in paragraph (1), nor will the withdrawal of
24 any such amount be considered to violate the provi-

1 sions of section 403(c)(1) of the Employee Retirement
2 Income Security Act of 1974.
3 "(d) EFFECT OF RECAPTURE PROVISIONS ON DISTRI-
4 BUTION TO A PARTICIPANT (OR HIS BENEFICIARY).—A
5 distribution to a participant (or his beneficiary) which other-
6 wise satisfies the requirements of subsection (e)(4)(A) of sec-
7 tion 402 shall be treated as a lump sum distribution for pur-
8 poses of section 402, notwithstanding the fact that a portion
9 of the amount allocated to the participant's account under the
10 plan as provided in this section is retained in the plan follow-
11 ing the distribution to him in order to permit an amount pre-
12 viously transferred to the plan to be withdrawn by his em-
13 ployer under subsection (a)(8)(B) of this section. Any portion
14 of this amount retained in the plan which is not withdrawn by
15 the employer and which is subsequently distributed to the
16 participant (or his beneficiary) shall not be treated as a lump
17 sum distribution.".
18 (c) CONFORMING CHANGES.—
19 (1) Paragraph (2) of section 46(a) of such Code
20 (relating to amount of credit for current taxable year)
21 is amended—
22 (A) by striking out "Except as otherwise
23 provided in subparagraph (B), in the case of prop-
24 erty described in subparagraph (D)," and inserting

1 in lieu thereof the following: "In the case of prop-
2 erty described in subparagraph (C),",
3 (B) by striking out subparagraph (B) and re-
4 designating subparagraphs (C) and (D) as (B) and
5 (C), respectively,
6 (C) by striking out "subparagraph (D)," in
7 subparagraph (B) (as so redesignated) and insert-
8 ing in lieu thereof "subparagraph (C)",
9 (D) by striking out "subparagraphs (A) and
10 (B)" in subparagraph (C) (as so redesignated) and
11 inserting in lieu thereof "subparagraph (A)", and
12 (E) by striking out the last sentence of sub-
13 paragraph (C) (as so redesignated).
14 (2) Subparagraph (A) of section 46(c)(3) of such
15 Code (relating to public utility property) is amended by
16 striking out "subsection (a)(2)(C)" and inserting in lieu
17 thereof "subsection (a)(2)(B)".
18 (3) Paragraph (9) of section 46(f) of such Code
19 (relating to limitation in case of certain regulated com-
20 panies) is amended—
21 (A) by striking out "makes an election under
22 subparagraph (B) of subsection (a)(2)," and insert-
23 ing in lieu thereof "claims the credit allowed by
24 section 44C,",

1 (B) by striking out "then, notwithstanding
2 the prior paragraphs of this subsection, no credit
3 shall be allowed by section 38 in excess of the
4 amount which would be allowed without regard to
5 the provisions of subparagraph (B) of subsection
6 (a)(2)" and inserting in lieu thereof "then no
7 credit shall be allowed by such section".
8 (d) CLERICAL AMENDMENTS.—
9 (1) The table of sections for subpart A of part IV
10 of subchapter A of chapter 1 of such Code is amended
11 by inserting immediately after the item relating to sec-
12 tion 44B the following new item:

"Sec. 44C. Employee Stock Ownership Plan Contributions.".

13 (2) The table of sections for subpart B of part I of
14 subchapter D of chapter 1 of such Code is amended by
15 adding at the end thereof the following new item:

"Sec. 416. Special employee stock ownership plans.".

16 **SEC. 3. TREATMENT OF ANNUITIES FOR ESTATE PURPOSES.**

17 Subsection (c) of section 2039 of such Code (relating to
18 exemption of annuities under certain trusts and plans) is
19 amended—
20 (1) by striking out "(other than a lump sum distri-
21 bution described in section 402(e)(4), determined with-
22 out regard to the next to the last sentence of section
23 402(e)(4)(A))" and inserting in lieu thereof "(other than

1 an amount which the taxpayer elected, under section
2 402(e)(4)(B), to treat as a lump sum distribution)", and
3 (2) by inserting after "section 401(a)" in para-
4 graph (1) the following: ", or under an employee stock
5 ownership plan".

6 **SEC. 4. RETIREMENT SAVINGS BY ESOP PARTICIPANTS.**

7 (a) AMENDMENT OF SECTION 219.—Paragraph (4) of
8 section 219(c) of such Code (relating to participation in gov-
9 ernmental plans by certain individuals) is amended—

10 (1) by inserting "; PARTICIPATION IN CERTAIN
11 EMPLOYEE STOCK OWNERSHIP PLANS" after "INDI-
12 VIDUALS" in the caption of such paragraph, and

13 (2) by adding at the end thereof the following new
14 subparagraph:

15 "(C) CERTAIN EMPLOYEE STOCK OWNER-
16 SHIP PLANS.—A participant in an employee stock
17 ownership plan described in section 416 is not
18 considered to be an active participant in a plan
19 described in subsection (b)(2) solely because of his
20 participation in the employee stock ownership
21 plan.".

22 (b) AMENDMENT OF SECTION 220.—Paragraph (5) of
23 section 220(c) of such Code (relating to participation in gov-
24 ernmental plans by certain individuals) is amended—

1 (1) by inserting "; PARTICIPATION IN CERTAIN
2 EMPLOYEE STOCK OWNERSHIP LANS" after "INDIVID-
3 UALS" in the caption of such paragraph, and
4 (2) by adding at the end thereof the following new
5 sentence: "A participant in an employee stock owner-
6 ship plan which meets the requirements of section 416
7 is not considered to be an active participant in a plan
8 described in subsection (b)(3) solely because of his par-
9 ticipation in the employee stock ownership plan."

10 **SEC. 5. ROLLOVER OF ESOP INTO IRA.**

11 Paragraph (6) of section 402(a) of the Internal Revenue
12 Code of 1954 (relating to special rollover rules) is amended
13 by adding at the end thereof the following new subparagraph:
14 "(C) CASH IN LIEU OF EMPLOYER SECURI-
15 TIES.—For purposes of paragraph (5), the transfer af
16 all money received in lieu of a distribution of employer
17 securities (as defined in section 416(a)(9)(A)) or of the
18 proceeds from the sale of a distribution of employer se-
19 curities to the employer or to the trust or plan main-
20 tained by the employer, shall be treated as a transfer
21 of a distribution of such securities.".

22 **SEC. 6. PUT-OPTION REQUIREMENT FOR CERTAIN ESOP CON-**
23 **TRIBUTIONS.**

24 Notwithstanding any other provision of law, an em-
25 ployee stock ownership plan (as defined in section 416 or

1 4975(e)(7) of the Internal Revenue Code of 1954) which per-
2 mits a participant to elect to receive cash in lieu of a distribu-
3 tion of employer securities shall not be required to provide a
4 put option for any securities distributed from the plan, nor
5 shall the provision of such an election be deemed to be an
6 offering of a security to the participant for purposes of Feder-
7 al securities laws.

8 **SEC. 7. ELECTION WITH RESPECT TO UNREALIZED APPRECIA-**
9 **TION OF EMPLOYER SECURITIES.**

10 Subparagraph (J) of section 402(e)(4) of such Code (re-
11 lating to unrealized appreciation of employer securities) is
12 amended by inserting after "there shall be excluded" the fol-
13 lowing: ", at the election of the taxpayer (made at such time
14 and in such manner as the Secretary may prescribe by regu-
15 lation),".

16 **SEC. 8. DEDUCTIBILITY OF CERTAIN ESOP CONTRIBUTIONS,**
17 **BEQUEST, ETC.**

18 (a) DIVIDENDS PAID DEDUCTION.—In addition to the
19 deductions provided under section 404(a) of the Internal Rev-
20 enue Code of 1954, there shall be allowed as a deduction to
21 an employer the amount of any dividend paid by that employ-
22 er during the taxable year with respect to employer securities
23 (as defined in section 416(a)(9) of such Code) if—

1 (1) the employer securities were held on the
2 record date for the dividend by an employee stock
3 ownership plan, and
4 (2) the dividend received by the plan is distribut-
5 ed, not later than 60 days after the close of the plan
6 year in which it is received, to the employees partici-
7 pating in the plan, in accordance with the plan provi-
8 sions.
9 (b) BEQUESTS; CHARITABLE CONTRIBUTIONS, ETC.—
10 For purposes of sections 170(b)(1), 642(c), 2055(a), and 2522
11 of the Internal Revenue Code of 1954, a contribution, be-
12 quest, or similar transfer of employer securities or other
13 property to an employee stock ownership plan shall be
14 deemed a charitable contribution to an organization described
15 in section 170(b)(A)(vi) of such Code, if—
16 (A) such contribution, bequest, or transfer is allo-
17 cated, pursuant to the terms of such plan, to the em-
18 ployees participating under the plan in a manner con-
19 sistent with section 401(a)(4) of such Code;
20 (B) no part of such contribution, bequest or trans-
21 fer is allocated under the plan for the benefit of the
22 taxpayer (or decedent), or any person related to the
23 taxpayer (or decedent) under the provisions of section
24 267(b) of such Code, or any other person who, in the
25 year of contribution or any of the five preceding tax-

1 able years, has owned, directly or indirectly, more than
2 25 percent in value of any class of outstanding employ-
3 er securities (as defined in section 416(a)(9) of such
4 Code) under the provisions of section 318(a) of such
5 Code; and
6 (C) such contribution, bequest, or transfer is made
7 only with the express approval of such employee stock
8 ownership plan.

9 **SEC. 9. ELIMINATION OF MINIMUM TAX ON EMPLOYEE STOCK**
10 **OWNERSHIP PLAN CONTRIBUTIONS.**

11 In determining the regular tax deductions under section
12 56(c) of the Internal Revenue Code of 1954, the taxes im-
13 posed by chapter 1 of such Code shall not be reduced—
14 (1) in the case of a taxable year ending after De-
15 cember 31, 1974, and beginning before January 1,
16 1978, by the excess, if any, of the credit determined
17 pursuant to section 46(a)(2)(B) of such Code over the
18 credit which would have been determined pursuant to
19 section 46(a)(2)(A) of such Code, or
20 (2) in the case of a taxable year beginning after
21 December 31, 1977, by the amount of credit deter-
22 mined pursuant to section 44C of such Code.

23 **SEC. 10. EFFECTIVE DATE.**

24 Except as provided in section 9, the amendments made
25 by this Act shall apply with respect to taxable years begin-
26 ning after December 31, 1977.

The CHAIRMAN. The committee will come to order.

The purpose of this hearing is to give the committee an opportunity to examine the present status of development of employee stockownership plans in the United States and to ascertain what additional legislation is necessary to promote this concept and accomplish the expansion of each individual's access to stock and capital ownership.

The broadening of stockownership, thereby permitting each citizen to acquire a capital interest in America's corporate might, will have a significant effect on many of the economic problems which plague America. If we are ever going to curb the economic inflation which seems to bedevil us, we must find some way in which to encourage each man and woman to become more productive in his and her job. Providing each individual an ownership share in his employer, making him a partner with his employer in the profits which his labor generates, can provide us with an excellent step in that direction. However, as long as we continue to have excessive concentration of stockownership in the hands of too few individuals, we will never be able to give each working American such a share in America's economic future.

The broadening of stockownership through ESOP's, or through a general stockownership trust, such as that proposed by Senator Gravel, should help us to accomplish this end.

Finally, the use of an employee stockownership plan will stimulate the formation of capital and help us bridge the projected gap of $1.5 trillion in new capital over the next decade.

Today, we are going to receive testimony from several employers which have, through ESOP or some related program, provided their employees with an ownership interest in their companies. These employers have expressed positive convictions regarding te beneficial effects which this sharing of ownership has provided for each employer and its employees. Their testimony should do much to dispel the negativism which has been expressed by "doubting Thomases" who argue that such a program is meaningless.

In addition, we will be looking at several pieces of legislation which are designed to promote the broadening of stockownership and receiving testimony regarding this legislation and other legislative changes which might be made, and which will further promote the concept.

Tomorrow, we will be conducting an oversight function and reviewing the ways in which Federal agencies have dealt with employee stockownership plans and employee owned companies.

At this time I would like to introduce into the hearing a written statement by Senator Wendell R. Anderson of Minnesota regarding the ESOP concept. Senator Anderson and Senator Gravel are cosponsoring S. 3241, the employee stockownership plan bill which I introduced several weeks ago and which we will consider and discuss in hearings today.

[The material referred to follows:]

SENATOR WENDELL ANDERSON'S COMMENTS ON S. 3241, THE EXPANDED EMPLOYEE STOCK OWNERSHIP ACT OF 1978

It is with great pleasure that I have joined with Senator Long as a co-sponsor of his proposed Expanded Employee Stock Ownership Act of 1978. History will recognize this legislation as a landmark in advancing the cause of democratizing ownership-sharing in our free enterprise system among rank-and-file workers.

While over 2,000 corporations have already adopted ESOPs and TRASOPs, I feel confident that the added incentives provided under this legislation will prove irresistable to those within business and labor circles who still stand on the sidelines of this progressive step forward. Expanding ownership participation among workers, within a framework that victimizes no one yet benefits everyone with a stake in the productiveness of our economy, is simply an idea whose time has finally come.

While I support and recognize the practical significance of all of the measures contained within this bill, I think that two features in this bill deserve special attention: the first aimed at reforming our inheritance system, and the second designed to point to a wholly new direction in reforming and restructuring our tax system. Both of these reforms are based on strengthening the institution of private property in corporate capital and both will encourage the broadening of future ownership opportunities on a more equitable and democratic basis.

Many Americans have attacked our inheritance laws. Some say it is confiscatory. Others say it does nothing to decentralize the ownership of large accumulations of wealth. In Minnesota in 1974, we were the first state in the union to reconcile both positions. In 1974 I was privileged to have signed into law a measure that passed both houses of the Minnesota legislature, almost without opposition, to make ESOPs the equivalent of charitable foundations for purposes of estate, gift and income taxes. Several prominent Minnesota businessmen have indicated that they will revise their wills to take advantage of this new option as soon as similar federal laws are enacted. Other wealthy Americans have agreed to do likewise. I am pleased that Senator Long and other sponsors of this legislation will now make it possible for affluent taxpayers to make gifts to qualified employee trusts in order to reconnect the ownership of already-accumulated capital with a broader base of private individuals, namely productive workers of whom some have contributed to the building of the donor's fortunes. This is undoubtedly the most progressive advance in our inheritance policies in at least a century.

Safeguards have been added to insure that the donor or his relatives cannot benefit from the stock donations, and currently existing ESOP laws and regulations insure that annual donations will be equitably spread among all employees participating in the ESOP. To the extent dividends on donated stock are passed through the employee trust, they become an immediate source of a taxable second income to employees, a noninflationary way to raise the earnings of employees which this bill will also encourage, as I will describe below. In addition, allocations of property donated to employee trusts become retirement estates for employee beneficiaries and their heirs, reducing some of the pressures on today's hard-pressed retirement systems and the Social Security System.

On the other hand, donations to employee trusts would deprive the Government of no revenues since such contributions made to charitable organizations are already exempt from taxation. While profits from donated income-producing property are frequently accumulated tax-free within most charitable organizations, by connecting these profits and assets to individual employees through their trust accounts, this income and property become added again to the government's tax base. From a tax standpoint, therefore, the government can only come out ahead.

From a standpoint of charitable and public policy, this reform to our inheritance policies truly reflects the spirit of the American Dream, the dream that a propertyless immigrant could find in America an escape from wage serfdom and the degradation of dependency on welfare or charity. In America our ancestors came to find a piece of the action, an opportunity to become self-sufficient, a place to find true economic justice. Since the highest order of charity is to help other persons to help themselves, so that they can avoid the need of charity, I feel strongly that helping the wealthy to spread their wealth more broadly among their workers and future generations may someday be recognized as the most noble feature of this most worthy package of reforms. What we did through land distributions under the Homestead Acts, the source of our greatness in agricultural production, we can now provide to our industrial workers through the ESOP and other ownership-spreading reforms. By spreading the direct ownership of income-producing property to working Americans, this change should not only help reduce labor conflict and improve productivity, but will improve the image of the American free enterprise system as the economic foundation upon which all our freedoms and human rights most ultimately rest.

For those who think no changes are needed in our inheritance policies, let me state a few facts.

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Total privately held wealth today in the United States amounts to over $3.5 trillion in current dollars, net of liabilities. (See testimony of Professor James Smith of Pennsylvania State University before the Hearings of the House Budget Committee, September 26 and 29, 1977, on "Data on Distribution of Wealth in the United States," p. 175; figures for 1972.)

Most of this wealth is owned by rich people. The top one percent of the U.S. adult population have accumulated close to $1 trillion, representing over 25 percent of the total wealth and over 50 percent of all personally owned corporate stock in America. By their ownership of half of all corporate equity, one can say that the top one percent of the population literally controls all corporate assets in the United States. The richest one percent also hold over one-third of all bonds and virtually 100 percent of tax-free municipal bonds. In addition, the top one percent have 91 percent of personally held trust assets, one beneficial way for wealthy people to transfer wealth from one generation to another. (Testimony of Prof. Smith, Budget Hearings, p. 9.) In contrast, the net worth of the average American over the age of 20 was $3,536 in 1972, while 24 percent of Americans were below $1,000 in net worth. (Budget Hearings, pp. 177, 180.)

Much of America's wealth is passed along to heirs about once every generation, roughly every 25 years. Thus, about $140 billion changes hands each year, $40 billion from the richest one percent alone.

If through changes in our inheritance laws, such as the ESOP reform we are proposing, wealthy people could be given the additional option to distribute portions of their estates free of estate and gift taxes to less wealthy Americans, particularly to workers who helped create these fortunes, it would create a significant and growing direct ownership stake in our free enterprise system for millions who own little or no equity today. To illustrate, if the wealth passed on by the richest one percent each year could be spread more equitably, say in individual chunks averaging $10,000 each, then a growing base of economic security could be built into 4 million to 5 million Americans yearly, or 100 million to 125 million new ownership-sharing opportunities over the next generation, from previously accumulated wealth alone.

In the light of these facts and the opportunities they present to healing old wounds within our social fabric, the proposed reform to treat the ESOP as a means to deconcentrate large holdings of wealth is truly a modest step in the right direction.

The second feature of this bill which should be highlighted is the provision making dividends 100 percent deductible (like wage and interest payments under present laws) for purposes of corporate income taxes, if they are paid out on a current basis to the workers on stock held in their individual ESOP or TRASOP accounts. Thus, corporations would be encouraged to pay higher dividends as a means of increasing the annual earnings of their employees, which would be taxable like wage earnings. This could be a step toward the general deductibility of dividends at the corporate level, thus eliminating at the source much of the problem of capital gains (to the degree appreciated stock values stem from retained earnings) and the protests over the double taxation of corporate profits. It is a good step toward the integration of corporate and personal income taxes, one of the goals of most tax reformers. This could also lead toward other steps toward making the tax system more simple to understand and administer and vastly more equitable.

But most important, forcing or encouraging corporations to distribute their profits through dividend deductibility would encourage corporations to finance their growth externally through new equity issuances. And this in turn would induce them to look more closely at the classical ESOP as a new market for their new equity issuances. Thus, through their ESOP, employees of a company would be able to buy large blocks of newly issued company stock, using credit secured by future profits of the corporation. Ideally the credit for acquiring growth equity to be spread among the employees through their ESOP should be repayable with the tax-deductible dividends earned on the newly issued stock, as well as through the use of employer cash contributions as under present ESOP law. I would urge the cosponsors of this bill to add this change.

By encouraging the deductibility of dividends, Congress will be adding a major incentive for capital creation, potentially much more significant for increasing investment rates and therefore productive jobs in the private sector than the investment tax credit and other traditional subsides to capital formation. What makes this move more interesting for liberals and conservaties alike is that this deduction would not be a subsidy in any traditional sense, but rather a move

toward genuine tax reform. It is a way to make the capital creation process and tax reforms to accelerate private sector investment rates begin to work for working Americans. Only through ownership-sharing can workers gain a direct vested interest in the profits and productive capital that tax reform can generate. Considering the trillions of dollars industry will need in the decades ahead, it is hard to conceive of a more politically practical approach to meeting these capital growth needs than by cutting workers in on a piece of the action.

In summary, the ESOP inheritance law change will add equity to the way in which already accumulated weath is distributed from one generation to the next, and the deductibility of dividends on ESOP and TRASOP stock will encourage greater equity in the manner in which we will finance future growth within our corporate sector. These provisions deserve the support of all people seeking to strengthen our free enterprise economy and to increase our revenue base from added private sector paychecks and dividend checks among our productive work force.

The CHAIRMAN. Any further statements, gentlemen?

Senator GRAVEL. I have no statement.

The CHAIRMEN. I will call, then, as the first witness Mr. A. Dean Swift, president and chief administrative officer of Sears, Roebuck & Co.

We are very pleased to have you with us, Mr. Swift——

Mr. SWIFT. Senator, I am pleased to be here.

The CHAIRMAN [continuing]. To hear about the fine contributions that your company has made to better employee-employer understanding down through the years.

Mr. SWIFT. Thank you.

STATEMENT OF A. DEAN SWIFT, PRESIDENT, SEARS, ROEBUCK & CO.

Mr. SWIFT. My name is A. Dean Swift. I am president of Sears, Roebuck & Co. I am accompanied by Ray Bilger, vice president-taxes at Sears, Ted Bower, tax attorney at Sears, and Frank McDermott, our tax counsel. I am pleased to be here today and tell the committee about our employee stock ownership programs, and in particular, our profit sharing fund's 62 years of experience in investing in Sears stock for the benefit of the fund members. I also would like to tell you about the incentives which are created for employees by being owners of the company. First, I will briefly describe Sears profit-sharing fund.

SEARS PROFIT-SHARING FUND

The Sears fund was created on July 1, 1916, over 62 years ago. From the start, one of its principal purposes was to invest its assets in Sears stock so employees could acquire a proprietary interest in the company, thereby sharing in its earnings as both an employee with an interest in profit sharing, and as an owner. From the very beginning, the rules of the profit-sharing fund stated:

> It is intended that, so far as practicable and advisable, the fund will be invested in shares of stock of Sears, Roebuck & Co., to the end that depositors may, in the largest measure possible share in the earnings of the company.

This policy has remained virtually unchanged since 1916. In that first year, 1916, the fund purchased 2,473 shares of Sears stock worth slightly more than $500,000. Since that time Sears stock has been split 386 to 1 reflecting the growth of the company over that 62 year period.

At the end of 1977, the fund owned more than 66½ million shares of Sears stock worth more than $1.8 billion. This investment represented approximately 20.68 percent of the company's outstanding shares.

About 70 percent of the assets of the Sears profit-sharing funds are invested in Sears stock. The remaining 30 percent of the assets not invested in Sears stock are invested in a diversified portfolio called "general investments." As of December 31, 1977, the general investments portfolio was valued at approximately $777 million.

As of December 31, 1977, there were approximately 300,000 participants in the fund. Each members can elect to deposit either 2, 3, 4, or 5 percent of the first $15,000 of annual compensation. The company's contribution at present is 6 percent of profits before taxes.

Under our present profit-sharing plan, the company's contribution is allocated to employees' accounts in proportion to their own deposits for the year. The maximum annual deposit any employee can make is $750—5 percent of $15,000, thus limiting the participation of the higher paid executives to $15,000 maximum.

Every fund member receives an annual statement showing the number of shares of Sears stock in his or her account and the dollar value of the account's general investments. Also, each year, members may instruct the trustees of the fund on how to vote their shares of Sears stock at the company's annual meeting.

The fund provides its members with full and immediate vesting. Shares of Sears stock are distributed in kind unless the member requests payment in cash and general investments are always paid in cash on the basis of their market value.

RECENT CHANGES IN SEARS RETIREMENT PLANS

Because Sears stock, like many others in recent years, has either remained stable or declined in price, Sears made a thorough review of its retirement programs. This review culminated last year with substantial changes in our programs. Our pension plan is designed to provide employees with assured retirement benefits in the form of company pensions. At the same time, our profit sharing plan permits employees to continue to participate in the values of ownership of the company's stock.

Our pension plan—which previously had covered salaried employee on their earnings of more than $15,000 annually—was broadened to cover all employees regardless of the amount they earned. Pension benefits were also strengthened and were tied to social security.

In addition, the company's annual contribution to the profit sharing plan was reduced from 11 to 6 percent of pretax profits to compensate partially for the substantial increase in costs of our expanded pension plan. Other changes in the plan were made to decrease the fund's emphasis on retirement security. This was done by easing the fund's rules on partial withdrawals and relaxing the restrictions on total withdrawals while remaining employed.

Under our revised programs, employees will not now have a guaranteed retirement income based on a percentage of their final compensation—part coming from Social Security and the remainder from the pension plan. In addition, retiring fund members will have the sub-

stantial added benefits of ownership of Sears stock plus the money they receive from their share of the fund's general investments.

The revision of our profit-sharing plan does not mean that we have altered our belief that Sears stock ownership in the long run is a valued financial resource for our employees, nor that we have a reduced interest in the desirability of the profit-sharing concept. That is why the basic thrust of our profit-sharing fund—investing in Sears stock—has remained unchanged through the years and through both the ups and downs of the market.

OTHER STOCK OWNERSHIP PLANS

In addition to encouraging ownership of Sears stock through our profit-sharing fund, the company, for more than 50 years, has encouraged direct ownership of our stock by employees through a variety of stock purchase plans. In the past 25 years alone, we have issued more than 67,000 stock option contracts to employees, granting them the right to buy more than 32 million share of our stock.

Moreover, our option contracts have not been limited to top management, but traditionally have been issued to most of or salaried employees. In 1978 nonqualified option contracts were distributed to more than 18,000 salaried employees. Our thought has been that it is advantageous to both the company and our employees to have the maximum number of regular employees sharing an ownership stake in the company—either through profit sharing, direct stock ownership, or both.

We estimate that our present and retired employees, either through profit sharing or their personal holdings, own more than 120 million shares of the company's stock, or approximately 40 percent of the stock outstanding.

VALUES IN EMPLOYEE STOCK OWNERSHIP

We see great value for our employees and for the company in the employee ownership of our stock.

Last year, the employees withdrew 3.4 million shares of Sears stock from the fund when their membership ended. Most of these shares went to persons retiring from the company. As the newly registered owner of the stock, they received all the rights and privileges of share ownership. For many, this was the first time they had ever received a dividend check, and this became an important part of their retirement security. They were now also entitled to sell or otherwise dispose of the stock.

But, even in a year when the market value of Sears stock declined, withdrawing members took deliver of two shares of stock for each share they asked to be converted to cash as their employment ended. And we know that retirees maintain their attachment for the company's stock. We estimate approximately 40 million shares are owned by former employees—not including shares that have passed by gift and inheritance to later generations.

I have brought some examples of comparison of average retirees fund accounts. These examples show both employees retiring in 1977 and 1972. Employees retiring in 1977 with 25–29 years of service took out an average of $56,792 from profit sharing. Employees with 30–34

years of service took out an average of $76,731 while employees with 35–39 years of service took out $153,083. I would like to point out that these are averages.

It is worth noting that because Sears stock is distributed in kind to departing members, severe declines in the value of the stock are not as traumatic for these members as would be the case if they received cash payouts based on asset values at retirement. The market value of the stock becomes a critical consideration at the time the stock is sold. Most members do not expect to sell their stock when their accounts are closed and the record clearly shows they generally do not do so.

The profit-sharing fund is also of great value to the company. While it is difficult to attribute significant business success or failure to any single factor or any single policy, much of our success has been due to the motivation which Sears stockownership has provided for hundreds of thousands of our past and present employes. Stockownership is another avenue through which our employees gain a direct economic stake in our enterprise, and they know their labors can influence the rewards flowing to them—through changes in profits, dividends, and stock price.

We are, as you know, the country's No. 1 retailer. And we think it is significant that we also have had a policy of encouraging employee stock ownership longer than most other retailers.

The importance of profit sharing is reflected in the fact that the turnover rate of our employees is significantly lower than other employers. This is indicated in the following table which compares Sears turnover of full-time employees with that of U.S. manufacturers.

TURNOVER RATE

[In percent]

	Sears	U.S. manufacturers [1]
1968	29.1	55.2
1969	29.9	58.8
1970	27.0	57.6
1971	20.1	50.4
1972	23.0	50.4
1973	20.8	55.2
1974	23.3	57.6
1975	16.8	50.4
1976	15.3	45.6
1977	17.0	45.6

[1] U.S. Bureau of Labor Statistics.

We do not have information as to the turnover of other retailers so a comparison with them is not available. However, we do know that Sears State unemployment compensation tax rates, which reflect merit rating, are consistently lower than other major retailers indicating a lower turnover for Sears. We believe our policy of encouraging employee stock ownership is among the factors explaining our lower turnover.

It is difficult to establish the value of profit sharing to Sears in terms of dollars and cents. But, Sears management is convinced that profit sharing and employee stock ownership is a unifying force in the company and is important in maintaining good employee morale.

COMMENTARY ON S. 3241

Allow me to conclude my statement with a brief comment on S. 3241.

The Tax Reduction Act of 1975, as you know, allowed an additional 1 percent investment credit on qualifying new machinery and equipment if an employer would contribute this additional amount to an employee stock ownership plan.

But because retailing is labor intensive and retailers seldom make heavy investments in new machinery and equipment, the incentive this credit was intended to provide often is slight. In our case, for example, the additional credit would result in only small additional allocations to our many profit-sharing fund members, and larger expenses in administering our plan.

S. 3241 recognies the problem of labor-intensive businesses like ours. As an alternative, it allows a 1-percent credit on participants' annual compensation.

Thus, we feel S. 3241 provides the type of incentive that employers in labor-intensive industries need to start or strengthen their stock ownership plans.

Mr. Chairman, because we share your conviction that broad employees stock ownership is good for business, good for employees, and good for the country, we are pleased to endorse the principle of S. 3241 and its formula, and the work you are doing on its behalf. We hope our comments today have helped clarify the issues surrounding this important piece of legislation.

The CHAIRMAN. Thank you, Mr. Swift.

I am positive, in my mind, if the free enterprise system of this Nation should ever fail it will not be the fault of Sears, Roebuck & Co. I do think that there should be, in the record, at least some record to the executives of your company down through the years who initiated and favored these kinds of policies. Would you mind just telling us, from your recollection, who the chief executive officers and the principal movers of this type of a farsighted employee participation program has been?

Mr. SWIFT. Well, I will not go into much of the history of the company. We started in 1886 with Richard Sears. But Julius Rosenwald, one of our early chairmen in the early part of this century was a very social-minded man and cared for his employees and in 1916, he started our profit-sharing plan. He was the chairman at the inception of the profit-sharing plan in July of 1916.

The next person that I should mention is Gen. Robert E. Wood, who took over from Mr. Rosenwald and encouraged the increase in acceptance of profit sharing, plus the stock options which he initiated and which have been very good for our employees as well.

I think those really are the principal movers, but we have all inherited that interest and, over the years, it has been a very good thing for our employees.

The CHAIRMAN. As it stands today, the 1-percent investment tax credit would only mean about $10 to the average one of your employees?

Mr. SWIFT. That is the top. It would not really be average. That would be the most that any employee would actually receive.

The CHAIRMAN. So the average would be a lot less than that?

Mr. SWIFT. Yes.

The CHAIRMAN. I take it that it would hardly be worth participating to have to incur the burden of dealing with Federal regulations and one thing and another involved in that plan. Are you participating in that, that 1-percent investment tax credit?

Mr. SWIFT. We do not claim the 1-percent investment tax credit because it is too small.

The CHAIRMAN. It is so small that it is almost meaningless to your employees? Would the labor-intensive credit for ESOP contributions which is contained in S. 3241 be of greater value to Sears?

Mr. SWIFT. The 1-percent investment tax credit would be, and it would mean an increase in administrative expense, which would nullify part of it. And we would have to make some changes in the rules of our fund, as well.

However, if this bill comes to pass, or anything like it, we would certainly take a very good look at it, and I am sure we would participate.

The CHAIRMAN. Senator Gravel?

Senator GRAVEL. Thank you, Mr. Chairman, and let me compliment Sears for its progress over the years. I would gather that it is out of the ordinary for 40 to 60 percent of a major U.S. corporation to be owned by its employees and that you are the only one?

Mr. SWIFT. I believe that is true.

Senator GRAVEL. Just on that alone, I think you and your predecessors in the corporation really deserve a great accolade.

I would like to ask one question. You quoted from another sheet that was not part of your testimony. I wondered if I could get a copy of that?

Mr. SWIFT. You are very welcome to it, and here it is.

Senator GRAVEL. Two, if you do not have it readily at hand, could you supply for the record what the income or dividend distribution is.

Mr. SWIFT. It is 386 to 1 since this started.

Senator GRAVEL. That is the appreciation of value that comes to the stock.

Mr. SWIFT. That is not only appreciation. That is the number of shares. If you owned a share of stock in 1916, you would now have 386 shares.

Senator GRAVEL. I realize that; but, you see, that is appreciation.

Mr. SWIFT. That is true.

Senator GRAVEL. I would like to see if you have some figures as to what the dividend return on the stock has been over the years, so that we could get some measure of what the income stream would have been on a share of stock.

I am sure various firms on Wall Street keep records as to what the profit return has been over the years, and I am sure that you do also.

Mr. SWIFT. Senator, do you mean if you add up all of the dividends that they received on a share of stock over the years?

Senator GRAVEL. Yes.

Mr. SWIFT. We could certainly get that information. I have it since 1967 here for the last 10 years. I would be glad to furnish that to you. But way back to 1916—I did not bring that with me.

Senator GRAVEL. No; but if you could just send it to us.

Mr. SWIFT. We certainly will.

[The following was subsequently supplied for the record:]

SEARS PROFIT SHARING FUND—SEARS STOCK INVESTMENTS

Year	Market value of Sears stock at end of year		Dividends in year			Number of shares of Sears stock owned at end of year		
	Original	Adjusted for splits and stock dividends	Original	Adjusted for splits and stock dividends	Sears dividends received in year	Original	Adjusted for splits and stock dividends	Percent of total shares outstanding
1916	$224.375	$0.68	$7.00	$0.108		$2,473	$955,033	0.04
1917	135.00	.44	7.75	.025	$25,062	11,231	3,470,020	1.49
1918	175.00	.57	8.00	.026	91,808	21,096	6,517,989	2.81
1919	231.00	.75	8.00	.026	156,183	27,049	8,357,275	3.60
1920	96.50	.44	8.00	.036	256,667	57,363	12,659,096	5.46
19[illegible]	64.125	.29	2.00	.009	85,562	54,391	12,003,223	5.43
19[illegible]	86.50	.39	2.08	.009	7,701	52,474	11,580,172	5.24
1923	86.75	.39	0	0		54,548	12,037,871	5.45
1924	154.875	.70	3.00	.014	110,502	73,981	16,326,423	7.39
1925	236.00	1.07	6.00	.027	396,968	82,713	18,253,436	8.23
1926	54.00	.98	2.25	.041	699,743	371,818	20,518,405	8.85
1927	87.625	1.59	2.50	.045	873,803	399,356	22,038,062	9.5
1928	179.75	3.32	2.50	.046	914,318	390,203	21,113,104	9.1
1929	98.50	1.72	2.50	.048	854,343	367,136	19,073,449	8.09
1930	45.125	.90	2.50	.05	788,013	365,601	18,259,576	7.7
1931	33.00	.67	2.50	.051	839,884	437,651	21,429,144	8.89
1932	19.125	.39	1.25	.026	466,379	412,670	20,205,974	8.63
1933	42.50	.87	0	0		412,498	20,197,552	8.62
1934	39.625	.81	0	0		442,003	21,642,235	9.21
1935	65.75	1.34	1.75	.036	758,545	456,047	22,329,885	9.51
1936	83.375	1.70	3.75	.077	2,844,088	502,336	24,596,380	9.17
1937	54.00	1.10	5.50	.112	2,795,918	546,014	26,735,029	9.87
1938	73.25	1.50	5.50	.112	1,648,751	580,602	28,428,596	10.50
1939	85.125	1.74	4.25	.087	2,496,867	639,183	31,296,956	11.32
1940	78.125	1.60	4.25	.087	2,624,475	702,600	34,402,106	12.31
1941	52.125	1.06	4.25	.087	2,897,928	743,835	36,421,137	12.87
1942	61.875	1.26	4.25	.087	3,215,321	785,170	38,445,064	13.58
1943	89.00	1.82	4.25	.087	3,299,722	788,869	38,626,182	13.51
1944	105.00	2.14	4.25	.087	3,438,112	835,839	40,926,021	14.24
1945	36.25	2.96	1.06	.087	3,577,140	3,365,981	41,199,607	14.27
1946	38.875	3.18	1.75	.143	5,958,497	3,547,519	43,421,633	15.0
1947	37.875	3.09	1.75	.143	6,663,796	3,978,110	48,692,066	16.83
1948	39.25	3.21	2.25	.184	9,795,793	4,051,423	49,589,418	19.04
1949	44.125	3.61	2.25	.184	10,536,[illegible]27	4,936,617	60,424,192	20.87
1950	52.50	4.29	2.75	.225	14,412,267	5,426,574	[illegible]6,421,266	22.95
1951	56.00	4.58	2.75	.225	15,237,036	5,619,818	68,786,572	23.77
1952	60.00	4.90	2.75	.225	15,822,281	6,053,964	74,100,519	25.13
1953	62.00	5.07	1.50	.123	17,037,212	6,279,285	76,858,448	25.94
1954	77.25	6.31	3.05	.25	18,929,611	6,331,814	77,501,403	26.08
1955	36.00	8.82	1.00	.245	18,735,462	18,805,506	76,726,464	25.45
1956	28.625	7.09	1.00	.248	18,565,690	18,845,465	76,135,679	25.16
1957	25.25	6.31	1.10	.275	20,936,712	19,499,322	77,997,288	25.99
1958	39.75	9.94	1.20	.30	23,455,942	19,809,300	79,237,200	26.37
1959	50.625	12.66	1.40	.35	28,115,707	20,266,432	81,065,728	26.94
1960	56.625	14.16	1.40	.35	28,093,957	19,789,831	79,159,324	26.25
1961	89.25	22.31	1.50	.375	29,529,513	19,750,813	79,003,252	26.14
1962	77.00	19.25	1.65	.413	32,286,053	19,317,551	77,270,204	25.51
1963	97.875	24.47	1.75	.438	33,317,672	18,905,584	75,622,336	24.90
1964	129.25	32.31	2.00	.50	36,621,261	18,076,093	72,304,372	23.75
1965	66.00	33.00	1.125	.56	39,761,699	35,417,956	70,835,912	23.23
1966	44.625	22.31	1.20	.60	42,258,722	35,615,784	71,231,568	23.32
1967	57.375	28.69	1.20	.60	42,864,784	36,040,698	72,081,396	23.55
1968	62.25	31.13	1.30	.65	46,009,838	34,924,763	69,849,526	22.76
1969	68.00	34.00	1.35	.68	46,050,627	33,624,918	67,249,836	21.81
1970	76.25	38.13	1.35	.68	44,435,940	32,768,916	65,537,832	21.22
1971	102.50	51.25	1.50	.75	48,611,341	32,203,264	64,406,528	20.73
1972	116.00	58.00	1.61	.81	50,241,039	30,735,251	61,470,502	19.58
1973	80.25	40.13	1.75	.88	52,179,447	29,655,190	59,310,380	18.86
1974	48.25	24.13	1.85	.93	54,685,444	30,269,300	60,538,600	19.18
1975	64.50	32.25	1.85	.93	56,449,935	31,432,433	62,864,866	19.83
1976	69.00	34.50	[1] 1.60	.80	50,722,404	32,101,335	64,202,670	20.13
1977	28.00	28.00	1.08	1.08	69,419,493	66,565,524	66,565,524	20.68
Total					1,063,905,705			

[1] Yearend extra dividend deferred to April 1977.

Senator GRAVEL. That would be important for our comparisons.

I just want to underscore one other point. You are tied to a social security or a pension plan, a profit-sharing plan. Now, obviously social security terminates at death. Do your pension plans also terminate at death so that if a person dies, his children get nothing from his pension plan.

Is that correct, or is that not the case?

Mr. SWIFT. There are various options that an employee can select which can continue his pension for his widow.

Senator GRAVEL. So it is closed end. Now, the profit-sharing plan is not closed end; as you underscored, a person's children could inherit it. His grandchildren could inherit it. So you place in motion a legacy which is carried down through the generations.

Mr. SWIFT. That is true, so they have the best of all possible worlds. We have both types of plan.

Senator GRAVEL. I would just like to underscore that that feature, I think, is very vital to capital distribution.

Legislation which I introduced raises the limitation on the amount of money that can go into the ESOP plan from 25 percent of payroll to 50 percent of payroll. I notice that you have a maximum of 15 percent. I have forgotten the figure.

Mr. SWIFT. Presently, we contribute 6 percent of profits before taxes. This amount is substantially below the limitation of 25 percent of payroll. We therefore have no problems with the limitations at this time.

Senator GRAVEL. The part that I am driving at, is if you wanted to go into extensive financing and you are limited by what can be borrowed for this trust and then paid back through distributions from payroll, you are then forced to go into other forms of debt rather than into ESOP debt. Where if ESOP were the same situation, you might go into that and that would accelerate the ownership rate of employees. Does that pose a problem for you?

Mr. SWIFT. We do not finance the company through the profit-sharing plan.

Senator GRAVEL. You just go ahead and pay it out as it goes?

Mr. SWIFT. Yes; profit sharing is a way that an employee can save money. It is a savings plan plus, of course, the profit-sharing stock is an incentive to him to do better, and to enhance his retirement income thereby.

Senator GRAVEL. Have you looked at the other facet of ESOP's wherein you could borrow money and pay it out from corporate contributions which are deductible, which could give some leverage to your activity?

Mr. SWIFT. No, sir, we have not. We have not studied that.

Senator GRAVEL. That answers may prior question. You do not have a limitation on it.

I thank you, Mr. Chairman. That is all the question I have, and I again want to compliment your corporate enterprise for having 40 percent of it plus—I think it is important.

Mr. SWIFT. Thank you, Senator.

The CHAIRMAN. Mr. Roth?

Senator ROTH. To me, the proof of the pudding, or the success of your various programs, has been the attitude of the employees that I

have come into contact with in Delaware. I cannot say it is a very broad sampling, but I have had some contact, and there does seem to be a very positive attitude toward the company and its employee benefit programs.

I would also like to express my appreciation to your company's program of permitting, during a campaign, the various candidates for public office to have the opportunity to speak to the employees. I think it is a very positive and fine program. I might like it better if you did not let my opponents come in, but——

Mr. SWIFT. I do not think that is possible.

Senator ROTH. I have been an enthusiastic backer of our chairman's efforts in this area, the employee stockownership plans. I think it can have a very beneficial effect.

I would like to ask you two or three questions that have been somewhat critical of this kind of approach.

Obviously, the plan has worked well in the case of Sears, but Sears itself has been very successful. While your stock may have not done as well recently because of the problems of the economy, the pattern is one of very positive growth.

As a broad national policy, does it bother you that employees may have too much invested in a particular company—not only his job, his salary, but also his pension and maybe a principal part of his stock.

I notice that, in your own program, you at least have 30-percent diversification, as I understand it.

Mr. SWIFT. Yes, sir.

Senator ROTH. Would you care to comment that, as a general approach, do you think this raises serious problems?

Mr. SWIFT. In our case, naturally, I am prejudiced, Senator. You have to remember that. I do not believe this raises serious problems. That 30 percent is in general investments; 30 percent of that is in fixed income securities. It would be highly unlikely, in the worst possible instances, that people would lose what they put into the fund and probably even get more out. Even in the worst instance that you can possibly think of, so they are pretty well protected.

If they took their funds and used them themselves, if they were lucky they might be able to do better, or they might do worse. There is, of course, some enlightened self-interest on the part of the company. But it has been good for the employees over the years.

Senator ROTH. I notice under your plan, the employee may vote the stock as he chooses. Do you ever see efforts—or perhaps it has already been done—for the employees to put their own directors on the board?

Mr. SWIFT. That is always possible. We have not seen that yet. As a matter of fact, over 90 percent of the employees vote in favor of management, which I think is pretty good.

Senator ROTH. What percentage?

Mr. SWIFT. Over 90 percent. My recollection is 94 percent. You always have a few dissidents.

Senator ROTH. You have a more liberal policy than the U.S.S.R.

Mr. SWIFT. We are very enlightened on that score. They can vote the way they see it.

Senator ROTH. Well, Mr. Chairman, I think that is all of the questions, except I join you in saying that——

The CHAIRMAN. There is just one thing—this chart you provided for us indicates that the average employee who has been there for a number of years apparently had an account of less value in 1977 than in 1972. Was that because of the declining stock market?

Mr. SWIFT. The stock was at its peak in 1972, Senator. At this point, we are not at our peak. The stock market is at a relatively low point. We would expect and hope that there would be the right things happening in Congress and in the country so that the stock market will go up and our stock will appreciate again.

The CHAIRMAN. Well, if you measure the stock market against inflation, it would present an even more discouraging figure than it has now. In other words, if the stock market were indexed for inflation, the decline of recent years would appear to be even sharper than it was.

Mr. SWIFT. The reason we put those 1972 figures in, Senator Long, was we thought it would only be fair to show them. The last time we testified on profit sharing, we mentioned those figures. So we are comparing them with the current values to show that the market can come down.

Of course, that is one of the reasons that we changed the retirement benefit program last year. It was a very emotional and difficult thing for us to do, because we had been so oriented to profit sharing since 1916. It has been our tradition, as I said.

But in order to make sure that our employees do, indeed, have an insured retirement income, we did institute the pension plan across the board for all employees. So they have now social security, the pension plan, and the profit-sharing plan. If the company prospers and the company stock appreciates, then the employees do well.

The CHAIRMAN. Let me get this straight. What percentage of the stock was owned by the employees in Sears?

Mr. SWIFT. In the profit-sharing fund, it is 20.68 percent. But then there are, as I said, other stock options and open market purchases and stock that is kept by retirees and people leaving the company. In total, about 40 percent is in the hands of either present, past, or retired employees.

The CHAIRMAN. Well, then it would not take much more of that trend to where you would be really caught in this as an employee-owned company.

Mr. SWIFT. That would be all right with me.

The CHAIRMAN. Well, now, in 1972, the employees who had been in the company 40 years and over had an average of $438,000 in their account.

Mr. SWIFT. That is right. But the stock was selling for—if you count the two for one split, the stock was selling for $60. Today it is $23.

The CHAIRMAN. Of course, that is because of the decline in the stock market that it has done that.

Mr. SWIFT. Of course, a lot of those people sold their stock, too.

The CHAIRMAN. Sold it at the high point, you think?

Mr. SWIFT. Yes.

The CHAIRMAN. Well, that might have accounted somewhat for its going down.

I think that that type figure is what made is possible for that employee that I knew personally to, when he retired after working a long period of time like that for the company, to take his wife on a trip around the world and then to, every year, have all of his friends in for

a nice party. He would serve them all the champagne—to be fair about it, he did not buy the most expensive imported champagne but it still achieved its purpose of making them all feel good.

Mr. SWIFT. We train them that way.

The CHAIRMAN. And then he would hire a couple of buses and take them all out to the football game, and that type of thing about once a year.

Mr. SWIFT. He will have to cut down on that a little now.

The CHAIRMAN. Well, now, that is the kind of affluence that I would like to see for the average employee.

Now, you have shown $438,000 for the average employee in that type of situation at that point, and I hope very much that we can do our part toward making the economy move toward where it is back up there again.

Mr. SWIFT. I have faith that we will.

The CHAIRMAN. About how much income would that type of employee be drawing, in addition to his social security—this is a retired employee I am speaking of? Can you give us some idea of how much income he would be drawing?

Mr. SWIFT. You would have to convert it to what an annuity would be.

What would you say?

Mr. BILGER. $153,000 would be about $15,000. Or, if it were $225,000, about $22,000, about that ratio, if you convert it into an annuity. For instance, if a man participates in our pension plan, he——

The CHAIRMAN. But let's look at your high figure, $438,000 worth, which is your 1972 figure, what would that convert to?

Mr. BILGER. Over $40,000 annual income with a pension.

The CHAIRMAN. Well, that plus his social security, I think he could make it.

Senator GRAVEL. I would like to be more specific in my request for a chart from you, and I think you have the information readily at hand. What I would like is the average value of appreciation per year from 1916 to date, including an average return or overage profit per year from 1916 to date and an annual dividend per year from 1916 to date. Obviously the volume of stock is constantly changing so include the volume for each year that you do this.

Mr. SWIFT. The amount of stock of the company that was owned?

Senator GRAVEL. Right. It is so that you get a feel for what the changes would be and so you can see my goal. Maybe you could add additional data, using your own judgment. Some of the changes made are that there is not enough income from corporate stock to be very significant in society if people are living off of corporate stock, or that profits would be too diffused or fluctuations too severe. I want to try and determine if this is the case. I am asking for information from you since you are probably the only corporation in the United States that would give us a good analysis of that. I am trying to get a feel for this by seeing what has happened since 1916 with all of your corporate activities in relationship to diffusion of stock.

Mr. SWIFT. We have made a note of your questions, Senator, and we will certainly answer them and give you whatever ancillary information you need.[1]

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[1] See p. 67.

Senator GRAVEL. I would appreciate it if you would send a copy both to the committee for insertion in the record and a copy to me personally. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, sir.

Mr. SWIFT. Thank you, Senator.

The CHAIRMAN. Next we will call Mr. Robert L. Strickland, of Lowe's Cos., Inc.

STATEMENT OF ROBERT L. STRICKLAND, LOWE'S COS., INC.

Mr. STRICKLAND. Mr. Chairman, good morning.

I welcome this opportunity to endorse for my company, the unique and intrinsic value of employee stock ownership.

I am neither an economist nor an actuary, but a businessman who believes very deeply in motivation and productivity, and through 17 years with Loew's Cos., I have watched employee stock ownership work, and work well. From salesmen to truck drivers, from secretaries to store managers, the motivation and productivity of Lowe's employees is a matter of public record.

Lowe's is a group of retail stores selling building materials to homebuilders and homeowners in the southeastern quadrant of the country from Indiana over to Delaware, down to Florida and over to Louisiana, Mr. Chairman, where we have seven stores at present.

In 1960, Lowe's was a private company, with 16 stores and $31 million in volume. Carl Buchan, the founder and owner, stated then, "I now desire to build this business into the largest and most successful of its type in the world, owned and controlled by those who work here and who build it."

To that end, he had established Lowe's profit-sharing plan for every employee and gave the plan the option to buy the stock upon his death.

He died within a year after giving us that option and, in 1961, after financial settlement with his estate and a public stock offering, Lowe's employees, through the profit-sharing plan, wound up with 48 percent ownership of the company's stock at that time. Lowe's employees to this day are still inspired by Mr. Buchan's vision, his commitment to growth, and his early commitment to employee stock ownership.

Today, those 15 stores have grown to 185 in 17 States. A $31 million volume has grown to $660 million. The stock, adjusted for splits and dividends, sold for about $1 in 1961. It traded last December 31 for $22.75.

Many of our employees became wealthy in the process, and the success of Lowe's employee stockownership began making news.

Fortune magazine, in 1972, quoted our chairman: "We are convinced that profit sharing, and employee stockownership, gives our employees a direct, personal self-interest in improving the company's earnings." Fortune went on to say, "The bounty springs from the fund's portfolio, 90 percent of which is invested in Lowe's common stock."

Newsweek magazine, in 1975, featured Charles Valentine, who retired after 17 years with $660,000 worth of Lowe's stock and cash. The Charlotte Observer—this is a negative reproduction of a positive story—gave us front page and the headlines about a Lowe's truckdriver named Ferrell Bryant who, in their words, retired rich.

In Lowe's own report to our employees, we featured Mrs. Mary Marsh, a secretary, and she states, "Because it is based on Lowe's stock, it is really an incentive to employees to help make the company grow and prosper."

We also featured, Mr. Chairman, what we called our first six-figure man, Mr. Spencer Bungarner, who retired after 13 years of working for our lumber company subsidiary, and at the time of his retirement, his $150,000 trust fund balance was greater than the book value of the lumber company that he worked for.

The profit-sharing research council ran this cover story, "Why Lowe's Grows," by John Walker, and also featured a store manager, a salesman, and a warehouseman, all three of whom retired with large balances. And we were delighted when, in March of 1976, Mr. Louis Kelso testified before the Senate Finance Committee and told the Lowe's story of employee stock ownership success in accordance with the news release we received from his office.

Mr. Kelso has said, on previous occasions, that Lowe's profit-sharing plan was, in reality, an employee stock ownership plan, because 80 to 90 percent of the fund's assets had been invested in company stock.

Mr. Chairman, these success stories were created by employee stock ownership. The motivation which was thereby created, the growth in our profitability which ensued from that, and the increase in the price of Lowe's stock, as Lowe's incentives and growth patterns were recognized by the financial community.

But what about those shareholders who are not employees? Do they benefit from employee stock ownership? The evidence is a convincing yes.

Mr. Burt Metzger is president of the Profit-Sharing Research Foundation, and his comprehensive study, "Does Profit-Sharing Pay," authoritatively details how all employees will benefit by employee stock ownership. And in the paper we presented to the Committee, we reproduced the charts which measure employee stock ownership companies, as exemplified by profit-sharing companies, and it shows that the profit sharing companies produce more profit for employers, a higher return on shareholder equity, resulting in higher earnings, higher dividends, and higher market value for all shareholders.

Finally, Mr. Metzger's letter of July 5 confirms that those high-performing companies were heavily invested in their own company's stock.

Well, Mr. Chairman, just as Senate bill 3241 seeks to expand and improve on a concept, so Lowe's management decided, in 1976, that we must improve our plan for employee stock ownership in order to restore and maintain the high level of motivation which had existed during the plan's first 15 years.

There were several contributing factors. The plan's ownership of Lowe's stock had declined from that 48 percent of total outstanding to about 19 percent, due to the retirement of some of these people we have just talked about, and one public offering for cash liquidity purposes.

Simultaneously, our number of employees had grown from 300 to 4,000. Consequently the average number of Lowe's shares per plan member was declining each year for new and old members, and motiva-

tion was declining and suffering, as they saw their opportunity for stock ownership decline.

After much research, employee surveys, and valuable consultation and advice from many people, we decided to freeze the membership in the old profit-sharing plan on one day and to begin membership in a new employee stock ownership plan on the following day.

Portions of the Tax Reform Act of 1976, and other recent legislation, encouraged us in this planning, because they helped solidify our belief that ESOP's are the wave of the future in this country.

So we froze the membership in the old plan on December 31, 1977, and began our new ESOP on January 1 of this year. The profit-sharing trust fund was not disbursed. Rather, we established 10 optional subsidiary funds, each with a different mix of Lowe's stock and cash, beginning with 100 percent cash, then 90 percent cash and 10 percent stock, and going in 10 percent increments to 10 percent cash and 90 percent Lowe's stock, in which each member could elect to hold his balance to retirement.

We held this rather exciting election in November of 1977 and we had a turnout of 97 percent of the eligible voters—our plan members. More than 3,000 cast these written ballots. Seventy-seven percent of them requested 90 percent Lowe's stock—the most stock they could get. Another 11 percent requested 80 percent of Lowe's stock. It was a tremendous vote of confidence by our people: in themselves, in their future, in their company, and for our decision to adopt the new ESOP.

Their requests totaled 2.7 million shares, and the trust held just 2.2 million shares, 500,000 shares shortfall. They said in effect, "You do not have enough Lowe's stock in the plan to satisfy us, and we are glad the trustee of the new ESOP will be acquiring more in 1978."

Mr. Chairman, members of the committee, Lowe's people believe very much in employee stock ownership, because we have seen it work. We believe it is creative capitalism. Through our actions, we have endorsed the concept even more. We are firmly committed to it.

We thank the chairman, and this committee, for your leadership in helping make this great concept part of the law of the land in this great country.

The CHAIRMAN. Mr. Strickland, will you give us your thoughts about employee motivation as it results from employee stock ownership?

Mr. STRICKLAND. Yes, Mr. Chairman. I could talk for a long time about that. Perhaps a good measure of that might be something that we published in our annual report, comparing the sales and profits for the average Lowe's employee compared to the five leading retailers in the country of the nonfood retailers. The range of the five top retailers, according to Fortune magazine, runs from $25,000 sales per year to $49,000 sales per year. Last year, the average Lowe's employee accounted for $123,000 in sales per year.

In terms of net profit before tax, per employee, the five leading retailers ranged from $1,000 per employee to about $3,500 per employee. Lowe's last year was $8,800 net profit, before tax, per employee. We think that speaks well for their desire and their drive.

The CHAIRMAN. Mr. Byrd?

Senator BYRD. Do I understand correctly that the stock is not distributed to the individual, but the stock is put into a retirement fund; is that it?

Mr. STRICKLAND. Yes, sir. The stock is presently held in each individual's name. They have beneficial ownership in their number of shares with the freezing of the membership in the old plan, and it will be held there for them until their retirement.

Senator BYRD. But it is not actually distributed to them?

Mr. STRICKLAND. Not until retirement.

Senator BYRD. Not until retirement.

And then the stock itself is distributed?

Mr. STRICKLAND. Yes, sir. We have had, over the years, various options for settlement of our profit-sharing balances, Senator. The most popular one, in recent years, has been lump sum. The employees have requested lump sum, and we have actually distributed the stock in kind to them—a certain number of shares to the nearest whole share and the balance in cash.

Senator BYRD. Is there a tax consequence to the employee at that point?

Mr. STRICKLAND. Yes, sir. I understand there is a favorable tax consequence, because he pays capital gains on the basis of the stock to the trust. Later if he sells it, of course, he would pay capital gains tax on the difference between that basis and the selling price.

Senator BYRD. Thank you.

Senator GRAVEL. As I understand it, with this new departure now, you have not, as yet, used ESOP as a device for capital expansion, have you?

Mr. STRICKLAND. No, sir. We do not have a leveraged ESOP.

Senator GRAVEL. Have you looked into that possibility of going to the marketplace for a loan to the ESOP and then taking that for capital expansion and then just using that income to retire that obligation on a nontaxable basis?

Mr. STRICKLAND. Senator, we have looked into it. Our chief financial officer said that we did not need that financial leverage at this time. However, we are very interested in the concept, and we would not rule out possible amendment to do just that sometime down the road when capital demands dictated that.

Senator GRAVEL. Presently, most of your financing is done through debt or retained earnings? Could you give me a percentage?

Mr. STRICKLAND. Through retained earnings and debt for fixed assets, but retained earnings for working capital.

Senator GRAVEL. I think you appreciate the difference, that when you are using debt, supposing your distribution is 60-40—60 public and 40 employees—when you use debt, you leverage the nonemployees more than you do the employees. If you use the financing device of an ESOP, you would leverage the employees. In other words, the employees would be the greater beneficiaries of that activity, then would be the other people who work for the company.

In other words, there is a built-in advantage——

Mr. STRICKLAND. And as our ESOP grows, Senator, through contributions over the next 3 to 5 years, I think we are going to be looking harder at that. And if Senate bill 3241 passes, as we hope it does, then, of course, we will be looking at that also.

Senator GRAVEL. Thank you.

Senator ROTH. Are your employees able to vote the stock they hold?

33-902—78——6

Mr. STRICKLAND. Senator, they were not able to vote the stock in the old profit-sharing plan. They will be able to vote the stock in the new ESOP. We passed through the voting in the ESOP.

We look upon the ESOP, frankly, in a period of a few years, sir, as having an equal amount of stock as the profit-sharing plan, as people retire out of the profit-sharing plan.

Senator ROTH. My only other question is that, I notice under your plan, the options go up to 90 percent of your stock.

Does it give you any concern that this may place too much of the employees holdings in one company?

Mr. STRICKLAND. Well, Senator, rather than that being part of the problem, we believe that can be part of the solution. In fact, prior to the November vote, we held two prior straw votes in April of 1976 and in April of 1977, and our stock also has been in a period of decline during that time.

Interestingly, the lower the price of the stock went, the more stock the employees voted for. In April of 1976, our stock price was about $31 and only 67 percent of the employees said give us the 80-percent fund or the 90-percent fund.

In April of 1977, the stock was down to $27, and 73 percent elected the 80- and the 90-percent funds.

By November 1977, the stock was trading at $24, and 88 percent went for the 80- and the 90-percent funds, because the earnings per share had doubled from 1975 to 1977; the dividend rate had tripled, from 10 cents per share to 30 cents per share; and the book value was up by almost 50 percent.

So here we have secretaries and truck drivers and a broad cross section of employees making some rather sophisticated financial decisions, in our opinion.

Senator ROTH. So you think the plan would be successful for all companies, not only for a growth company like your own, but broadly speaking?

Mr. STRICKLAND. For who, sir?

Senator ROTH. For industry in general?

Mr. STRICKLAND. Yes, sir. I think it can be part of the solution.

Senator ROTH. I congratulate you on your success. Thank you, Mr. Chairman.

Mr. STRICKLAND. Thank you, sir.

Senator GRAVEL. Mr. Chairman, could I ask also if this witness would provide for the record a performance of his stock during the period that he has had an ESOP? It may be too short a period of time, but I would just like to get a feel for what the return is on that stock.

Mr. STRICKLAND. On the ESOP or the profit-sharing plan?

Senator GRAVEL. It would be just your stock alone, as a corporation. I would like to see what returns or dividends you have paid over the course of the year.

Mr. STRICKLAND. Yes, sir. I would be delighted to furnish that. I do not have it at the present time. We went public in 1961, and I think I can furnish it since then.

Senator GRAVEL. Good. I would appreciate that.

[The following was subsequently supplied for the record.]

1. Initial Offering Stock Price, October, 1961 (=Cost) : $12.25 Per Share.
2. Current Stock Price (8/1/78) : $20 Per Share.

3. Intervening Stock Splits and Stock Dividends: 100% Stock Dividend, May, 1966; 2 for 1 Stock Split, November, 1969; 50% of Stock Dividend, December 1971; 33⅓% Stock Dividend, July, 1972; 50% Stock Dividend, June, 1976.

4. Current Value of One Original Share (Stock Price Adjusted Back for Stock Splits and Stock Dividends): $240.

5. Annual Per Share Cash Dividend Payments, Adjusted for Stock Splits and Stock Dividends:

1962[1]	$.03	1970	$.07	6 mo. through July 31, 1978	$.17
1963	.03	1971	.07	6 mo. through July 31, 1978	.20
1964	.04	1972	.07		
1965	.04	1973	.08		
1966	.05	1974	.08		
1967	.05	1975	.09		
1968	.06	1976	.10		
1969	.06	1977	.21		

[1] Fiscal years ending July 31, 1962–77.

6. Total Per Share Cash Dividends Since Offering: $1.50.

7. Total Cash Dividends Per Each Original Share: $18.00.

8. Total Return on Original Share =4+7−1 Or −$240.00+$18.00−$12.25= $245.75.

9. Compound Rate of Return on Original Cost:
Base Year—1962—$12.25.
End Year—1978—$258 ($240+$18).
C.G.R. (16 periods)=21.0%.

The CHAIRMAN. If you would make available to us those publications which you have mentioned, Mr. Strickland——

Mr. STRICKLAND. They are part of the record, Senator. They are in the presentation that I gave you.*

The CHAIRMAN. We would like to have that available to us.

One thought that has been discussed is the thought that it might be worthwhile to develop a program by which an employer could insure the value of the contribution to the employee stock ownership plan, so it would always be worth at least as much, in terms of dollars, as had been put in there to begin with.

Had you given any thought to that type approach?

Mr. STRICKLAND. We have heard of it, Senator, and we have heard that Burlington Industries and some other people in our area have studied that more than we have. We have felt that we were too small, and we have felt that we were still in the entrepreneurship stage, and we have not felt that necessary.

Perhaps, as we grow larger and as the ESOP grows larger, we will have to give some thought to that.

The CHAIRMAN. All right. Now, one thing you have going for you with a good employee stock ownership plan is that if your business is competitive with others, those employees have the potential to make that business succeed, is that not correct?

Mr. STRICKLAND. Yes, sir, Senator. They think, when they look around and see refrigerators and doors and windows in the warehouse, they look at it as dollars, and they think part of those dollars belong to them, and they want to take care of them.

The CHAIRMAN. Thank you very much, sir.

Senator GRAVEL. Could I just make a comment?

Do you think there should be a limit to the amount of stock held by employees? Do you think it should eventually go to 100 percent, or

*The annual report was made a part of the committee file.

do you think a good mix might be 50 percent? Do you think there should be some public fertiliation there?

Mr. STRICKLAND. We would prefer about a 50–50 mix, but that is not what we are going to have at the end of this calendar year, Senator.

Senator GRAVEL. Your corporate goal would be to have that mix?

Mr. STRICKLAND. Well, we enjoy public ownership as well as employee stock ownership, but our corporate goal, as you now stated, could be to get a 50–50 mix and sort of leave it at that.

Over time, we expect to achieve that, and we would not rule out any secondary stock offerings from the company in order for the employee stock ownership to continue to grow, and yet have public stock ownership continue to grow.

I think public ownership is necessary for market value considerations.

Senator GRAVEL. Mr. Chairman, could I just ask if there are any one of the Sears gentlemen who are here, if they have a corporate policy of what their goal would be in that regard?

Mr. SWIFT. We never found it necessary.

Senator GRAVEL. So you have not given any thought to it one way or the other?

Mr. SWIFT. No.

Senator GRAVEL. Thank you.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Strickland follows:]

STATEMENT OF ROBERT L. STRICKLAND, EXECUTIVE VICE PRESIDENT, LOWE'S COMPANIES, INC.

SUMMARY OF PRINCIPAL POINTS

1. Lowe's Companies, Inc. strongly endorses value of Employee Stock Ownership.

2. 17 years of Lowe's Employee Stock Ownership proves that the concept motivates, creates incentive, creates growth, and creates wealth.

3. Lowe's growth from 15 stores to 185, from $31 million in sales to $660 million inseparable from substantial Employee Stock Ownership.

4. Success of Lowe's and its employees publicized by Fortune, Newsweek, and others.

5. Value of Employee Stock Ownership concept attested to by former and present Lowe's employees.

6. Lowe's experience cited by Louis O. Kelso, Esquire, widely considered as "Father" of Employee Stock Ownership concept, as "successful yardstick for all U.S. corporations to try to match."

7. Survey of benefits of Employee Stock Ownership for Stockholders who are not employees is cited.

8. Lowe's changes from Profit-Sharing Plan to Employee Stock Ownership Plan, believing it to be "Creative Capitalism" and "in the wave of the future" for employee benefit and motivation and productivity.

9. Landslide vote of acceptance and confidence by Lowe's employees to change from old Plan to new Employee Stock Ownership Plan.

10. Lowe's expresses appreciation to Senator Long and the Senate Finance Committee for their leadership role in Employee Stock Ownership.

Mr. Chairman and Members of the Senate Finance Committee: I welcome this opportunity to endorse the unique and intrinsic value of Employee Stock Ownership.

I am neither an economist, an actuary, nor a psychologist, but a businessman who believes deeply in motivation and productivity, and through 17 years with Lowe's, I have watched employee stock ownership work and work well. From

salesmen to truck drivers, from secretaries to store managers, the motivation and productivity of Lowe's employees is a matter of public record.

Lowe's is a group of retail stores selling building materials to home builders and home owners in the Southeastern quadrant of the country from Indiana to Delaware to Florida to Louisiana.

In 1960, Lowe's was a private company with 15 stores and a $31 million annual volume. Carl Buchan, the founder and owner, stated then, "I now desire to build this business into the largest and most successful of its type in the world, owned and controlled by those who have built it." To that end, he had established Lowe's Profit-Sharing Plan for every employee, and gave the Plan the option to buy his stock upon his death.

He died within a year after giving us that option, and in 1961, after financial settlement with his estate and a public stock offering, Lowe's employees, through the Profit-Sharing Plan, wound up with 48% ownership of the company's stock.

Lowe's employees have always been inspired by Buchan's vision, his commitment to growth, and to employee stock ownership.

Today, those 15 stores have grown to 185 in 17 states. Our $31 million annual sales volume has grown to $660 million. The stock, adjusted for splits and dividends, sold for $1.02 in 1961. It traded last December 31 for $22.75. Many of our employees became wealthy in the process, and the success of Lowe's employee stock ownership began making news.

Fortune magazine in 1972 quoted our Chairman, "We are convinced that profit sharing (and its employee stock ownership) gives our employees a direct, personal self-interest in improving the company's earnings." Fortune went on to say "The bounty springs from the fund's portfolio, 90% of which is invested in Lowe's common stock." (Exhibit 1)

Newsweek magazine in 1975 featured Charles Valentine, a $125 a week warehouseman who retired after 17 years with $660,000 with of Lowe's stock and cash. (Exhibit 2)

The Charlotte Observer headlined Ferrell Bryant, a truck driver who "Retired Rich." (Exhibit 3)

In Lowe's own report to employees, we featured Mrs. Marsh, a secretary, (Exhibit 4) who stated, "because it is based on Lowe's stock, it's really an incentive to the employees to help make the company grow and prosper", and also our first six-figure man, Mr. Spence Bumgarner (Exhibit 5) who worked for our lumber company subsidiary for 13 years. When he retired, his $150,000 fund balance was greater than the book value of the lumber company!

The Profit Sharing Research Council ran this Cover Story, "Why Lowe's Grows" by John Walker and also featured a Store Manager, a Salesman, and a Warehouseman, all three of whom retired with balances ranging from $400,000 to $2,000,000. (Exhibits 6, 7, and 9) And we were delighted when in 1976 Mr. Louis O. Kelso testified before this Committee and told the Lowe's story of employee stock ownership success. (Exhibit 10)

Mr. Kelso has said on previous occasions that Lowe's Profit-Sharing Plan was in reality an Employee Stock Ownership Plan because 80 to 90% of the fund's assets were invested in company stock.

Mr. Chairman, these success stories were created by:

A. Employee Stock Ownership.

B. The motivation which was thereby created.

C. The growth in profitability which thereby ensued.

D. The increase in the price of Lowe's stock as Lowe's incentives and growth pattern were recognized by the stock market and financial community.

But what about those shareholders who are not employees? Do they benefit from employee stock ownership? The evidence is a convincing "yes". Mr. Bert Metzger is President of the Profit Sharing Research Foundation, and his comprehensive 1971 study "Does Profit Sharing Pay" authoritatively details how all shareholders are served by employee stock ownership. I quote, "What we need today are organizational incentives—programs which can motivate all factors contributing to corporate growths—stockholders, management, and employees. Employee profit sharing (and stock ownership) is multimotivational because it focuses attention on a common goal and rewards all factors." And this has been Lowe's experience.

The study compared the performance of retailers with and without employee profit sharing. The charts in Exhibit 11 to this paper show that employees of profit sharing companies produced more profit per employee, more profit on sales

and a higher return on shareholder equity. This resulted in higher earnings, higher dividends and higher market value per share for all shareholders, including employees. And Mr. Metzger's leter of July 5 (Exhibit 12) confirms that the high performance companies were heavily invested in their own company's stock.

But Mr. Chairman, just as Senate Bill 3241 seeks to improve upon a concept, so Lowe's management decided in 1976 that we must improve our Plan for employee stock ownership in order to restore and maintain the high level of motivation which had existed during the Plan's first 15 years. There were several contributing factors. The Plan's owenrship of Lowe's stock had declined from 48% of total outstanding to 19%, due to retirements and one public offering for cash liquidity purposes. Simultaneously, our employees had grown from 300 to 4,000. Consequently the average number of Lowe's shares per Plan Member was declining each year for both new and old members, and motivation was suffering as they saw opportunity for stock ownership declining.

After much research, employee surveys, and valuable consultation and advice from qualified people like Mr. William Lieber and Ms. Dianne Bennett of the staff of the Joint Comittee on Internal Revenue Taxation, Mr. Al Barnes and Mr. Glen Ford of the Internal Revenue Service in Greensboro, and the following Attorneys and Counselors at Law: W. H. McElwee, Leon L. Rice, Jr., William A. Davis, II, and James W. Page of North Carolina, Ronald L. Ludwig of California, and Lathan M. Ewers, Jr., and Alexander C. Graham III of Virginia, we decided to freeze the membership in the Profit-Sharing Plan on one day, and to begin a new Employee Stock Ownership Plan on the following day. Portions of the Tax Reform Act of 1976 and other recent legislation encouraged us in this planning because they helped solidify our belief that ESOPs are in the wave of the future in this country.

So we froze the membership in the old Plan on December 31, 1977 and began the new ESOP on January 1, 1978. The Profit-Sharing Trust Fund was not disbursed, rather we established ten optional subsidiary funds, each with a different mix of Lowe's stock and cash, beginning with 100% cash, then 90% cash/10% stock, and going in 10% increments to 10% cash and 90% stock, in which each member could elect to hold his balance until retirement.

We held this election in November of 1977, and we had a turnout of 97% of the eligible voters (Plan Members). 77% requested 90% Lowe's stock and another 11% requested 80% Lowe's stock. We said at the time that it was a landslide vote *for* Employee Stock Ownership. It was a tremendous vote of confidence by our people:

1. In themselves . . .
2. In their future . . .
3. In their company . . .
4. For our decision to adopt the new ESOP . . .

Their requests totalled 2,700,000 shares, and the Trust held just 2,200,000 shares, a 500,000 share shortfall. They said in effect, "you don't have enough Lowe's stock in the old Plan to satisfy us, and we're glad the Trustee of the ESOP will begin acquiring more in 1978!"

Mr. Chairman and Members of the Committee, Lowe's people believe in Employee Stock Ownership. We have seen it work to create incentive, motivation, and wealth. We believe it is Creative Capitalism, and we are more firmly commited to the concept than ever before. We thank the Chairman and this Committee for your leadership in helping make this great concept part of the law of the land in this great country. Thank you, gentlemen.

EXHIBIT 1

[From Fortune, December 1972]

LOWE'S COMPANIES

Profit sharing can be profitable indeed if you work for Lowe's Companies of North Wilkesboro, North Carolina, a chain of eighty-six building-supply outlets in the South. Two store managers retired recently with $3 million apiece—believed to have been record payouts for any profit-sharing trust. Thirteen store managers, salesmen, warehousemen, and office workers who retired last year col-

lected a total of $17,500,000. Says Lowe's Chairman Edwin Duncan: "We are convinced that profit sharing gives our employees a direct, personal self-interest in improving the company's earnings."

The bounty springs from the fund's portfolio, 90 percent of which is invested in Lowe's common stock. The stock has zoomed to thirty-five times its initial value since the company went public in 1961 (recent price: $56 per share). Although Lowe's has paid only $8 million into the fund, the rise in the stock has pushed the net assets to more than $161 million. Whether profit sharing is the cause or the effect, the company has increased earnings 24 percent a year for ten years, to $9 million on sales of $234,600,000 for the fiscal year ended last July. As for Duncan, who at sixty-seven has no immediate plans to retire, he would collect a mere $900,000 if he quite tomorrow. But then, he has worked for Lowe's only eleven years.

EXHIBIT 2

[From Newsweek, Mar. 31, 1975]

PROFIT SHARING: LOWE'S LARGESSE

Charles Valentine never made more than $125 a week in his seventeen years as a warehouse laborer—yet he retired with at least $660,000. Jack A. Allen, a store manager, is 33 and thinks he may stop working in four years—with $200,000 to enjoy. And personnel manager Cecil Murray, retired at 50, can afford to lavish money on his hilltop mansion or spread it around when he goes to the racetrack, since his retirement nest egg came to $3.5 million.

The three men did not save, win or inherit their retirement fortunes, but they did share one break. All three went to work for the Lowe's Companies, Inc., of North Wilkesboro, N.C., a building-supply chain that claims to have the richest profit-sharing fund in the U.S. on a per-capita basis. More than 50 Lowe's employees have retired with an equity in six figures. Says Murray, one of a score of millionaires the program has produced: "When you work all your life and all of a sudden you don't have to work, it's fantastic." Valentine, the son of a tenant farmer, now owns a dairy farm, two cattle farms and two houses. "I never believed it would happen," he says.

The sum that seems like a sudden windfall to Lowe's workers actually has accumulated over a period of fifteen years or more. The company, which runs 129 stores in sixteen Southern, mid-Atlantic and Midwest states, put aside an amount equal to 15 per cent of an employee's salary each year on a store-by-store basis, if the store has met its profit goals; employees pay nothing into the fund. Ninety per cent of the money is invested in Lowe's stock—and that's the secret. The stock has performed spectacularly since it went public at $12.25 a share in 1961; allowing for splits, the value of one share soared. Even today, after the worst market shake-out in almost 40 years, the value of that initial share is still worth 25 times the offering price.

The profit-sharing fund is the biggest owner of Lowe's stock, and an employee may take his money and retire after fifteen years, regardless of age. The receipts are subject to regular and capital-gains taxes, which can be hefty, but there's still plenty left.

Stakes: The realization of what's at stake makes Lowe's 3,000 employees "profit-conscious and sales-conscious," according to Dwight E. Pardue, who administers the profit-sharing trust. "Quite frankly, we have the most dedicated employees in the world," he says, because "basically, they are working for themselves." Such incentive was the goal of H. Carl Buchan, Lowe's late cofounder, whose 889,180 shares of stock were sold to the fund at his death in 1960. Buchan had expanded Lowe's from a modest hardware business in North Wilkesboro into a modern, discount operation and figured the company would keep on growing if it were owned and controlled by those who built it. Buchan's faith has paid off. Lowe's sales have jumped from $119 million annually to $362 million over the past six years. Net earnings more than tripled during that time, from $4.6 million to $14.6 million. And Lowe's workers looked well-motivated indeed: profits per employee were two to three times better than those at a smoothly run pair of retailing giants, Sears and J. C. Penney.

[From the Charlotte Observer, Friday, Aug. 27, 1971]

$125-A-Week Worker Retires Rich

By Clyde Osborne, Observer Rural Life Editor

SPARTA—Ferrell Bryant last December made his last delivery as a $125-a-week dock worker-truck driver for Lowe's, Inc. store here, returned to the store and was told this his net worth, exclusive of his week's wages, was $413,000.

It was the truth.

It hasn't sunk in fully on Bryant, or his wife, who still works as a domestic, for a Sparta family, that they are wealthy.

Bryant, 47, has planted some corn on his 50-acre Allegheny County farm, is raising 11 pigs and a big garden "to have plenty to eat," and is generally relaxing after retiring from 20 years and four months of work with the 25-year-old hardware and building supply firm.

Bryant's bonanza came from Lowe's profit-sharing trust in which all employees may participate.

He was given a check for $213,000 and $200,000 worth of Lowe's stock figured at $33.75 a share on the over-the-counter market. On Friday the stock was selling at $69.25 a share, meaning that Bryant's stock is now worth around $350,000.

"I can't get used to the idea at all," said the pleasant, talkative, round-faced man.

"I had some fun when they handed me that check though. I took it to the bank. I asked for cash. I was joking of course. But I acted serious, and the teller, she looked at the check, and then she looked at me, then back at the check.

"Finally, she said she didn't know if the bank had that much cash or not. She told me to see the manager," he grinned.

His wife, he says, just won't believe the bank balance.

"I put some in an account for her and told her to spend it. But she hasn't even spent the interest," he said.

Planning any trips, like to Nassau, or Europe?

"No. We haven't been anywhere, and we haven't really planned a trip. But we think we'll go to the Church of God convention in New York next summer," he replied.

[From Lowe's 1972 Profit-Sharing Annual Report]

Mary Marsh . . . Profit Sharing the Second Time Around

"You don't pay in any money. Then when you have to leave and you receive your profit sharing, you wonder, "Do I deserve this?'" This is how Mary Marsh felt when, after 6½ years with Lowe's as a sales secretary, she left the company when she and her husband moved to Florida. Of course, she did deserve her profit sharing money, because, just like every Plan member, her efforts had helped make that profit possible. Lowe's management feels that it is in the true American entrepreneurial spirit that those who create profits should share in them. And that's why we have the profit sharing plan.

The Profit Sharing Plan was a big incentive for Mary to return to Lowe's when she moved back into the North Wilkesboro area from Florida. Now Mary is back at work as an executive secretary and is again participating in Lowe's Profit Sharing Plan.

Mary feels that the Profit Sharing Plan is really good because participation in the Plan does not cost the members anything. "And," she continues, "because it is based on Lowe's stock, it helps keep your interested in the company. It's really an incentive to the employees to help make the company grow and prosper."

Exhibit 5

[From Lowe's 1972 Profit-Sharing Annual Report]

Lowe's First Six-Figure Man, Spence Baumgarner

"They worked up this thing several years ago—kept telling us what a good deal it was—but like a doubting Thomas, I didn't think it'd amount to anything. But it sure did!" Indeed it did! J. S. "Spence" Bumgarner worked at

Buchanan Lumber Company as a lumber grader for 13 years; when he retired his Profit Sharing amounted to $150,000—more than the net worth of Buchanan Lumber at that time? "I was surprised to death. I wasn't figuring on getting but 50 percent." Because Spence was 65 when he retired, he invested 100 percent (forfeited none) of his profit sharing. "I'd always heard it was better to be born lucky than rich, and that was one time I believed it!" Spence had also worked for the old Oak Furniture Company for 29 years as a lumber grader.

What's Spence doing with his money? Helping his children and fixing up his home. "He let it run down for 40 years," his wife said. "Now it's going to take some time building it back up." "Yes," added Spence, "and Lowe's and Buchanan Lumber are getting a lot of that profit sharing money back."

Spence's plans for the future are variable; he gardens, keeps milk cows, and works around his place. "I may work me up a hobby. I've got some wood-working tools my family gave me." Whatever, we wish Spence and his wife many years of healthy, happy retirement. Spence expressed his gratitude to Lowe's emphatically, "Tell all of them I think Lowe's is the greatest!"

EXHIBIT 7

[From Profit-Sharing Council of America Monthly Bulletin]

THE EXECUTIVE

James Fred Walters Jr., who retired from Lowe's in 1972 after managing several of their stores, joined them in 1953 straight out of the Army when they had only three stores.

"I was just out of service and looking for work and jobs were scarce. So, when I heard they were hiring—the store was just six months old them—I went down and applied."

He adds, not without some pride, "Within six months I was their leading salesman."

And, when he retired, he was the third oldest employee in point of time. His profit sharing fund was worth more than $2,000,000.

"When they first created the plan in 1957, many of us didn't realize what it was or what it would become. It had no significance. It wasn't until the plan began buying Lowe's stock and we saw its value multiply—almost seven times over—that we paid attention."

Walters has a clear-eyed view of what makes the plan so successful. "It's the people. It attracts good people and it keeps good people and it gives them the incentive to make good money and to make their own contribution. There's no finer place to work—even now."

Walter's windfall hasn't changed his life much. He moved back to his hometown of Asheville, North Carolina, where he first started with Lowe's, bought a new home, and it occupies most of his time now.

He also contacted a local bank and engaged a lawyer to help him manage his funds. But he'll probably go back into business on his own some day.

"I'm only 44. I've got some good years left."

EXHIBIT 8

[From Profit-Sharing Council of America Monthly Bulletin]

THE WHITE COLLAR WORKER

Archie Hayes, like Walters, came straight out of service and into Lowe's. Unlike Walter he stayed at the same store in his home town of Sparta, North Carolina, throughout his career with the giant merchandiser.

He began in 1956 as a salesman, and retired 15 years later as a millionaire. His fully vested account was worth that much in 1971.

Hayes is just 42 years old.

He was qualified for his salesman's job. In the Air Force he had been assigned to supplies and tech-order distribution, so he was familiar with merchandise. As a salesman, he handled Lowe's complete line of goods and services.

The huge payoff hasn't changed Hayes' lifestyle too much.

"We still live in the same house, and have no plans to move. I just consider it all financial security for my family."

Hayes has a daughter, 19, in college, and a son, 10, in grammar school.
He took his account partly in cash and partly in Lowe's stock, and, with it, has been investing in real estate and some stock speculation. And he's doing it without any outside advisors.
His wife's reaction to the whole thing? "She thinks it's unbelievable."
So do a few others.

EXHIBIT 9

[From Profit-Sharing Council of America Monthly Bulletin]

THE BLUE COLLAR WORKER

Ferrell Bryan is one of Lowe's earliest employees. He began with the firm in 1930 as a warehouse boy, and, when he retired 21 years later, the last 14 as a truck driver, he was almost half-a-millionaire.
His Profit Sharing account was worth $426,000. His top salary at Lowe's at retirement was $125 a week. He was then 47.
Bryan took his fund half in cash and half in Lowe's stock. The cash he invested in a small farm near Sparta, North Carolina, and in savings accounts, and the stock he kept is now worth considerably more. Just like Lowe's, it keeps growing.
Bryan's lifestyle made a definite change, from truck driver, at which he had a near-perfect record, to farmer. He keeps some cattle, and enough crops to feed the cattle and put food on the table.
He calls the Profit Sharing plan the "best thing that ever happened in my life." Even toward the end, he couldn't believe it.
"It wasn't until some of the other old timers started to leave, and collect their accounts, that I knew it was true."
His wife had trouble believing it, too. She refused to quit her job until he had collected his account and the money was in the bank.
Bryan is still one of Lowe's best customers. "Anything I need for the farm or the home I go into the store in town. I know I'm going to get my money's worth. They've got the best goods and services around."
He ought to know. He handled a lot of it.

[Press Release From Louis O. Kelso, Esq., Mar. 31, 1976]

EXHIBIT 10

KELSO URGES SENATE TAX COMMITTEE TO MAKE AMERICAN WORKERS INTO MINI-CAPITALISTS

Louis O. Kelso testified before the Senate Finance Committee today on his proposals for restructuring the nation's tax laws to unharness America's underutilized manpower and technological potential, and to remove present tax barriers to new capital formation by making the ownership of new capital more accessible to American workers. To provide new incentives for saving capitalism and making it more relevant to our domocratic ideals, Mr. Kelso called for Congress to establish as a national target for the remainder of the twentieth century the creation of opportunities for every worker, and eventually every consumer, to accumulate a tax-free capital estate of up to $500,000 over his working lifetime.
"What we are proposing is no less than the industrial counterpart to the Homestead Act", Kelso said. "Land is finite, but the potential for capital development is unlimited. Just as in 1862, when those Americans with limited means were given the chance to own and develop up to 160 acres of productive land, Americans should now be afforded the opportunity to become owners of significant holdings in our growing frontier of productive capital. By amending the nation's tax laws, we can begin to extend to every American a meaningful opportunity to carve out a personal stake in the multi-trillion dollar frontier of future capital formation."
As an example of what he hopes would be accomplished on a national scale, Kelso related the story of Lowe's Companies, Inc., a North Wilkesboro, North Carolina-based building-supply chain, where a warehouse laborer who never made more than $125 a week in the 17 years he worked for the company, retired

with over $660,000 in Lowe's stock without having contributed a cent. Kelso acknowledged this as the most successful example of what employee ownership might achieve, but suggested it as a yardstick for all U.S. corporations to try to match.

EXHIBIT 11

[From Lowe's 1971 Annual Report]

MOTIVATION—THE MARKET

Lowe's: How We Grow

A MARKETING DEFINITION

The concept of Marketing which seems most appropriate to us was written by Clarence E. Eldridge, who defined it as, "The art of determining the needs and wants of customers and filling them, at a profit to the organization." This customer-oriented approach is essential to marketing success, and the profit discipline is essential for corporate success. Therefore, an increasing amount of emphasis is being placed on research, in the attempt to keep our antennae trained towards the market, and to interpret the signals.

MARKETING RESEARCH

Our research efforts take varied forms. 12,000 research opportunities visit our stores each day, called customers. Lowe's personnel are trained and financially motivated to maintain a helpful, listening attitude, and to channel this information back to the person in decision-making authority. Formal opportunities for market information flow include weekly store meetings of all personnel; weekly written reports from each store manager with sections for comments on inventories, advertising, delivery, and customer service; and regular managers' meetings.

Our data processing system provides valuable information feedback. Patterns of customer behavior with regard to products and services have often been spotted first in IBM reports. We had not realized, for example, the extent of increasing consumer buying of 2 x 4 studs until a purchase quantity analysis revealed it.

Formal marketing research is a continuous process as our stores, product line, and customer mix grow and evolve. Customer surveys, market definitions, and market studies are conducted regularly.

EXHIBIT 12

PROFIT SHARING RESEARCH FOUNDATION,
Evanston, Ill., July 5, 1978.

Mr. HENRY CHURCH,
Lowe's Companies, Inc.,
North Wilkesboro, N.C.

DEAR HENRY: As a follow up to your phone call the other day I am pleased to send you and Bob some information which may be helpful in preparing appropriate testimony on the value of profit sharing and employee stock ownership.

The following items warrant your attention:

(1) Our 1971 study entitled *Does Profit Sharing Pay?* in which the 5 companies with broad coverage profit sharing programs outperformed by substantial and widening margins the companies without profit sharing. Not so incidentally, the 5 broad coverage programs were all heavily invested in own company stock.

(2) "Performance" data on 38 large profit sharing companies is compared to *Fortune* medians reflecting return on sales and equity. This information appears under the heading "Evidence of Superior Performance" in Vol. II of *Profit Sharing in 38 Large Companies* for the years 1973–1976 inclusive.

(3) The prevalence and growth of profit sharing and ESOP plans—ie.. current trends toward defined contribution plans, profit sharing programs and ESOPs.

(4) Prevalence and extent of own company stock holdings among the 38 large profit sharing trusts. Thirty-six out of 38 invested their profit sharing funds to some extent in own company stock; 17 of 38 had from 60–100 percent of

their portfolios in own company stock. Altogether $5.9 billion out of $9.9 billion (60 percent) was invested in own company stock by these 38 trusts at the end of 1976.

(5) Over one million employees have a "piece of the action" through these 38 profit sharing programs.

(6) The financial benefits for long-term participants under these profit sharing/share ownership programs exceeded typical pension benefits by modest-to-substantial margins in almost all cases. Twenty-seven out of the 33 companies who provided such data (82 percent) generated benefits under their profit sharing programs which ranged from 112 percent to 1011 percent of the "pension standard."

You might also want to check the recent survey of ESOPs undertaken by five graduate U.C.L.A. students under the auspices of the ESOP Council of America.

I do hope that Bob will not focus in too narrowly on ESOPs as the only road to broad employee stock ownership.

Most ESOPs are funded by company contributions geared to corporate performance and, therefore, are "profit sharing" ESOPs. In addition, there is only a very thin line between an ESOP and an EPSOP. The latter is an Employee Profit Sharing and Ownership Plan. I would consider Lowe's former profit sharing program and Hallmark Cards current profit sharing program to be EPSOPs. Most of the programs in *Does Profit Sharing Pay?* and *Profit Sharing in 38 Large Companies* could also be described as EPSOPs. If a profit sharing program specifically designates that up to a certain percentage of the portfolio (e.g. 25%, 50% or 100%) can be invested in own company stock, we have an EPSOP. Own company stock is consonant with the nature of such a trust and Congress, it seems, should bestow like tax incentives on EPSOPs as on ESOPs.

Bob Midkiff covers this point nicely in his article on "Helping Workers to Become Owners" in our PSRF booklet, *New Horizons for Capitalism*.

We hope this letter and enclosures prove useful. If we can help further or answer any questions, please don't hestitate to call on us.

Best regards,

BERT L. METZGER, *President*.

The CHAIRMAN. Next, we will call Mr. W. Reid Thompson, chairman of the board and president of Potomac Electric Power Co.

STATEMENT OF W. REID THOMPSON, CHAIRMAN OF THE BOARD AND PRESIDENT, POTOMAC ELECTRIC POWER CO.

Mr. THOMPSON. Mr. Chairman, it is a pleasure to appear here this morning. I am representing not only my own company, Potomac Electric Power Co., but also the Edison Electric Institute which is the trade association for 99 percent of the investor-owned power companies in the country, representing 77 percent of the electricity users.

With me is Mr. Ray Dacek tax counsel to the institute and Mr. Richard Bliss, counsel also to the Edison Electric Institute.

Mr. Chairman, I would note at the outset a fact with which you are thoroughly familiar, and that is that the electric power industry is the most capital-intensive industry in the United States. In the course of the next 5 years, we contemplate the need to invest about $135 billion, of which almost 60 percent, or $75 billion, will be acquired from outside financing.

That will account for perhaps 50 percent of all the common stock financing that is done by American industry in the next 5 years, and some 15 to 20 percent of all securities issued. In the $600 billion. So the capital formation problem is a severe one for the electric utility industry, and anything which helps and assists in that matter, such as the ESOP program, is good for the industry.

We would like to say, Mr. Chairman, that we were most pleased to be able to participate in the ESOP program that was established in 1975.

We probably are the biggest user of that program, along with the telephone industry. We made a study about a year ago—we have not updated that study today, which would show far greater participation; we are in the process of doing it—but the study indicated that about 42 of the 233 investor-owned electrical utilities had already established programs at that time. Now, the number, while only 42, represented over half of the industry, because all of the larger companies are in it. So more than half of the electric utility employees were covered at that time, in early 1977.

Of those 42 companies, in 1975, participation amounted to $23 million, up to $68 million in 1976, up to $100 million in 1977, so over $200 million has been invested by initial input into the ESOP plan established by those companies for the benefit of employees. This is not taking into account, those figures do not, the employee matching contributions available in 1977.

We wish to heartily endorse the provisions of 3241 as an extension and expansion of the principles and provisions set forth in that original act.

I would like to comment about three or four specific matters that we think are most important.

1. First, and most importantly, is the expansion of the credit from 1 percent to 2 percent, or from 1.5 to 2 percent, with the elimination of the employee matching fund. Of course, the expansion of the credit to 2 percent gives broader participation and broader ownership in the industry they work for, and additional capital formation.

While many companies, including my own, have set up programs to provide for employee matching, it is a tremendous administrative problem and difficulty, and we think that a salutary feature of this bill is to eliminate the employee matching.

2. Of course, we applaud too, Mr. Chairman, while not directly affected ourselves, we applaud the extension of the principle through the alternate method, based on payroll by labor-intensive industries, which ours is not. Ours is at the opposite end of the spectrum, being capital-intensive.

3. Many features of the bill, such as the elimination of the requirement that employees who are not there at year-end need participate we think are most helpful administratively, because it is extremely difficult to locate employees who have been gone for more than a year.

4. The elimination of the possibility that minimum tax will result from the adoption of an ESOP, we also think encourages further use of these programs.

5. We think it is also vitally important that this bill does continue to recognize that the credit, the ESOP credit, is not a factor that can, in some manner, be applied by regulatory commissions to reduce rates, because that would defeat the purpose of the provision.

We would like to suggest, with your indulgence, Mr. Chairman, four possible improvements for your consideration which might be made in the pending bill.

First, we agree with the idea in the bill that the time has come for an integration of dividends so that there is not the double taxation that presently exists, and this bill is a step in that direction, providing certain circumstances that there would be a deduction or exclusion for the dividends paid into this plan.

The electric utilities position has always been, and is now, that the exclusion of the credit should be to the individual who receives the dividend rather than to the corporation. That is particularly important to the electrical utility industry, if it is to be a capial formation provision, because any credit to the company or deduction is also a reduction in the cost of doing business and it would then most likely be flowed through in a rate case, so that no capital formation results.

The second point we would make is that this bill requires that newly issued stock be used for at least half of the program. Most companies now do provide for newly issued stock in the plan, as does my company. We think it might be more appropriate if the bill would make the requirement only if the stock is selling at least at book value, because a forced sale of stock at below book value might cause some companies to hesitate about participation in this plan and you are, of course, very familiar with the evils of selling stock below book value. Our industry has had to do that, and does today in many instances, but it is not a good thing to do. That is one possibility for improvement.

Third, we think the bill probably should clarify somewhat the situation in which the total credit not being utilized in the current year. That is the carry-forward and carry-back provisions, and the division of the credit if the total credit is not utilized, need clarification.

And then, finally, in connection with bargaining unit employees, the current bill would make a change to provide that benefits must be extended to all employees unless specifically rejected by a labor representative. We think it is preferable that the present law continue, which requires under IRS rulings, good faith collective bargaining.

I might mention that, in our industry, we know of only seven plans that do not provide coverage to all employees, and those have a minimum number of total employees involved. But we think it is important to leave that as a part of the bargaining process rather than mandate it, which would somewhat complicate that process.

Finally, Mr. Chairman, let me again reiterate the strong support of the electric utility industry for the ESOP program begun under the Tax Reduction Act of 1975, under your wise and innovative leadership. We think it has benefited many employees who are becoming owners of American industry. We know it is also a capital formation help to industries such as ours, and we heartily endorse the provisions of this bill to strengthen and extend that.

Thank you, Mr. Chairman.

The CHAIRMAN. Let me ask you this, Mr. Thompson, how much stock does the average employee of your company have, as of now?

Mr. THOMPSON. My company, Mr. Chairman, which represents about 1 percent of the total electric utility industry, is therefore a relatively small portion, but it is a significant thing for our employees.

In the 3 years of the plan's existence, we have assets, when the current year of 1977 is complete, of about $2.35 million—$2,350,000. With 3,827 participants, that is an average of $616 per participant.

That is a little less than the industry generally. For the industry generally, we estimate that the average participation accumulated over the 3 years is between $800 and $1,000 per participant.

The CHAIRMAN. Now, is that enough stockownership to where the employees are beginning to take an interest in the matter and where it begins to reflect itself in better employee relations?

Mr. THOMPSON. It is debatable as to whether that amount, in and of itself, is enough to have a strong interest, but the accumulated effect—it is beginning to build up, Senator, and as each year passes that will expand, not only with increased contributions, but the reinvestment of dividends. So I think it is certainly an adequate beginning—a very significant beginning—to instill in the employee a real ownership feeling, a proprietorship interest in his corporation, because he then begins to have the feelings of an owner and the understanding that this can increase.

If it were to stop right now with just that $800, I would have some doubt that that would hold his interest, with inflation like it is. But the buildup potential is significant.

The CHAIRMAN. Well, let me just say that it really pleases me, as one who believes in employee stockownership, to see you come here, Mr. Thompson, and testify for an entire industry. And I hope that, as we go forward in this area and amend it to make it more attractive to other industries, that the day will come when we see others speaking for industry will come and testify for an entire industry.

I appreciate your statement very much.

Senator Byrd?

Senator BYRD. No questions.

The CHAIRMAN. Senator Gravel?

Senator GRAVEL. If we were to design what is called a CSOP, which would be a consumer stockownership plan then that stock could be distributed to the people who use your utilities. The utilities seem to lend themselves readily to that approach. To establish the company, a lot of capital would be needed. If we provided a device wherein you could set up a trust and borrow that capital and then use the income to pay that capital back and, at the same time, pay for the cost, the net capital would be reflected not in debt, but would be reflected in a stock. sale. That stock could then be distributed to the consumers of the utilities. That way, you would have the double incentive of having employees who are interested in the well-being of the company and consumers, like myself, who would be similarly interested in the well-being of the company.

If we made it possible in law for you to have a plan so that your consumers could own a piece of your company, would you avail yourself of that vehicle?

Mr. THOMPSON. It is an intriguing concept, Senator Gravel. I am not prepared—I have not examined the thing thoroughly—to specifically endorse the proposal that you advance, but I would say that it is intriguing and one that we would study, because we are always interested in new sources of capital.

The concept itself has some appeal. We have to ask questions, of course, as to the ownership of the facility. We think it is imperative for our companies to still own the facilities that we operate. In most instances, if this is a source of capital—an additional source of capital—it would be most intriguing.

Senator GRAVEL. Well, no; the company would still own it. I think I may have misstated it. The company would be the same company it is right now. The only thing is, that when you would need to get another $100 million, you would issue, or sell, stock for that $100 million.

That $100 million—that stock—would be purchased by the CSOP. They would have the debt; they would retire the debt, but you would just sell stock to your own consumers.

Mr. THOMPSON. What it sounds like, Senator, is a stock issue plan that would be arranged in such a manner that consumers of a utility itself would be more likely to be the purchasers as you suggest, and the public generally—that has a great deal of appeal. The details, of course, I cannot comment on, but the concept is one we would have to study with considerable interest.

Senator GRAVEL. Under your ESOP plan, have you used any leverage in financing?

Mr. THOMPSON. No; we have not. We made some studies of that, and I am not prepared to give the details. But for various reasons we determined, our traditional financing methods have been more appropriate, up until now. There may be some regulatory complication that lingers in my mind about that sort of leverage financing, if it involves corporate guarantees other than standing behind our own securities.

It is a complex subject, Senator. All I can tell you is that we have investigated it, and we have not used it.

Senator GRAVEL. As a product of that investigation, would you like to submit an additional statement as to why you have chosen not to go into the debt area for leverage——

Mr. THOMPSON. I will be glad to do so. I will be glad to have my finance officer submit that from my company, and if there is industry information, I will also submit that.

[The following was subsequently submitted for the record:]

ADDITIONAL STATEMENT OF W. REID THOMPSON

On July 19, 1978, I appeared before Senate Committee on Finance on behalf of the Edison Electric Institute and my company, Potamic Electric Power Company. My testimony was presented in support of the Expanded Employee Stock Ownership Act of 1978, S. 3241.

In the course of my appearance, Senator Gravel asked whether Potomac Electric Power Company had elected to lever our ESOP program. When I stated that we had studied the matter and had elected not to finance our operations by means of a leveraged ESOP, Senator Gravel asked me to provide the rationale for this decision. I have done so in the paragraphs below:

As you are well aware, the capital investment requirements of the electric utility industry are the most intense of any industry and are projected at nearly $600 billion over the next 15 years. Because we must generate that investment within certain debt to equity ratios and under constant regulatory review, the capital requirements which may be funded with debt are directly dependent upon the amount of new equity capital which is generated.

With the enactment of the original investment credit related ESOP provisions in 1975, we at Pepco performed a study of the opportunities for the generation of investment capital through use of the ESOP program and found that the program is an excellent source of investment capital for the company, while at the same time offering motivation for increased employee productivity by expanding employee participation in corporate ownership.

Our study of the ESOP included a review of the potential benefits of a leveraged ESOP. The primary benefit of leveraged ESOP is that the leverage could lead to further increases in employee ownership of the company. One of the underlying principles of the leveraged ESOP, however, is the corporate guarantee of

ESOP debt. Our study also revealed that a guarantee of ESOP debt by the Company would require regulatory approval and we felt that regulatory authorities would not respond favorably to such a proposal. Our study further indicated that the company's guarantee would be considered by the investment community as an additional debt of the corporation, and would serve to increase rather than decrease ratio of debt to equity. This guarantee would, therefore, have a substantial adverse effect upon the rating of our senior securities, a substantial impact upon the manner in wihch we may generate investment capital and would serve to increase our cost of service.

Senator GRAVEL. What I am beginning to discern here is that people think it is a good idea, but nobody is being aggressive, thus far, in really expanding it. You could get 10 times the rapid expansion into employee ownership if you did some leveraging. I know everybody is borrowing money——

Mr. THOMPSON. I would be delighted. I want to refresh my own memory of the reasons and I would be delighted to furnish my answers for the record, and for you, Senator.

Senator GRAVEL. I think that would be very important to us. What it might show is one, the policy attitudes; and two, some structural constraints that may exist in the debt market area that we may want to address and correct.

I would just ask you and the other members that have testified thus far if they want to make comment as to why there has been no use of debt leverage. I think the committee would find that information most valuable.

Mr. THOMPSON. We will do so.

Senator GRAVEL. Thank you.

The CHAIRMAN. Senator Packwood?

Senator PACKWOOD. No questions.

The CHAIRMAN. Senator Roth?

Senator ROTH. No questions.

The CHAIRMAN. Senator Danforth?

Senator DANFORTH. No questions.

Mr. THOMPSON. Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, sir.

[The prepared statement of Mr. Thompson follows:]

STATEMENT OF W. REID THOMPSON, EDISON ELECTRIC INSTITUTE

My name is W. Reid Thompson. I am Chairman of the Board and President of Potomac Electric Power Company and Chairman of the Board of the Edison Electric Institute (EEI). The Edison Electric Institute is a national association of investor-owned electric utilities which represents 99 percent of the investor-owned electric utilities in this Country and its members companies supply 77 percent of all electricity users in the United States. I am appearing today on behalf of EEI as well as my own company. It is a particular pleasure for me to appear as a representative of the industry that is probably the greatest user of the form of employee stock ownreship plan created by the Tax Reduction Act of 1975, and expanded by the Tax Reform Act of 1976.

A 1977 study reveals that 42 of the 238 investor-owned electric utilities, including most of the larger utilities and representing more than half of all electric utility employees, had implemented employee stock ownership plans, and many more had plans under consideration. The equity which has accrued annually to industry employees through these plans in their companies has grown significantly from 23 million dollars in 1975, to 67.7 million dollars in 1976 to nearly 100 million dollars in 1977. Out of an industry total of 416,000 employees, 223,000, or more than half, are eligible for participation in plans in effect for 1977.

ENDORSEMENT OF S. 3241

We heartily endorse the Expanded Employee Stock Ownership Act of 1978, S. 3241, which will open the door to much greater use of employee stock ownership plans and accordingly will extend their benefits to many more corporate employees. The measure will further economic democracy by broadening the ownership of corporation stocks and will strengthen our economy by promoting capital formation and stimulating higher employee productivity.

COMMENTS ON S. 3241

Because our industry is so deeply involved with employee stock ownership plans, I would like to comment on a few of the specifics of S. 3241. Most significantly, the bill increases the credit based on investment to two percent. The bill also takes a major step in furthering employee ownership of stock in labor-intensive corporations by providing an alternative credit based on payroll. The increased credit based on investment will advance employee ownership while providing an important source of capital for capital-intensive industries such as the electric utility industry. The alternative credit based on payroll will greatly increase the number of situations in which establishment of an ESOP is worthwhile. It will expand ESOP participation in segments of industry which have previously realized little or no benefits from the Tax Reduction Act ESOPs. In short, S. 3241 has the potential of broadening employee ownership of all corporations while strengthening such corporations financially.

Another very constructive feature is elimination of the contributory requirement that now must be met if maximum advantage is to be taken of the Tax Reduction Act form of ESOP. The handling of matching contributions of participants presents serious administrative problems. Also, many employers already have contributor benefit plans that use up the arbitrary six percent of compensation limit that IRS says is as far as is safe to go with mandatory employee contributions in order to avoid a danger that plans are discriminatory and therefore cannot be qualified plans. A Tax Reduction Act ESOP can hardly be discriminatory, but if this IRS rule is applied with present law in effect it means that either there will be no contributory ESOP or that other benefit plans or the ESOP will have to be cut back. This is a problem that under the present law requires a solution, whether it be S. 3241 or some other measure.

We are pleased, also, that an individual who is not an employee at the end of the plan year need not participate in that year. The present requirement of allocating contributions among all persons who were participants at any time during the year presents real problems. It is extremely difficult to trace many ex-employees a year later to deliver ESOP distributions for the final period of employment.

Elimination of the possibility that minimum tax will result from adoption of an ESOP will greatly encourage adoption of ESOPs. Also, we greatly appreciate the continuation of the importance provision which correctly recognizes that the credit is not a factor that can in some manner be applied to reduce the rates of regulated public utilities.

We wish to note, and urge your consideration of four suggested improvements of S. 3241:

First, the provision that in some circumstances permits the deduction of dividends paid to an ESOP is a step in the direction of integrating the corporation and personal income taxes, an idea whose time has come. The utility industry is on record as endorsing the concept of integrating individual and corporate income taxes. However, the industry position is that integration should be effected at the shareholder level. We therefore suggest that the bill be revised to allow the shareholder whose dividend has flowed through an ESOP a credit or an exclusion rather than to permit the corporation to take a deduction.

Second, transferred employer stock should not have to be new-issue stock *if* market value of the stock is less than book value. Although the requirement of S. 3241 relates to only half of the value that is transferred, the possibility of dilution of interests of existing shareholders would be a real deterrent to use of an ESOP. Our industry is all too familiar with stock selling below book value.

Third, the bill does not anticipate and adequately cover situations in which the total credits of a corporation are not utilized in the current year. There is a considerable amount of uncertainty under present law as to the sequence of use of the components of the credit allowed by Section 46. Another sequence-of-use

problem that needs to be dealt with is created by this new credit and the overly restrictive one-year carry-over provision.

Fourth, in connection with bargaining unit employees, while most existing ESOPs, including my own company's, provide for participation by employees generally, we believe that no special requirement for offering ESOP participation is appropriate. Internal Revenue Code Section 410(b)(2)(A) ties the participation rules for qualified plans to good-faith bargaining over benefits, and to require anything more will only complicate collective bargaining.

CONCLUSION

We in the electric utility industry hailed the provision for employee stock-ownership in the Tax Reduction Act of 1975 as a truly innovative and important achievement in corporate finance. This program has benefited employees and employers by its two-pronged thrust, on the one hand promoting widespread advancement of stock ownership among the working people of America in the corporations they work for, while at the same time providing an additional means of capital formation, especially important to the capital intensive and extremely hard pressed electric utility industry.

We support S. 3241 as a further strengthening and expansion of this important program begun in 1975.

The CHAIRMAN. Next, we will call Mr. J. R. Boulis, president of South Bend Lathe.

Mr. Boulis, we are very pleased to have you here today. We have heard a lot about your company and what it has been doing to save that company and the jobs of those workers. We appreciate your testimony.

Mr. BOULLIS. Thank you, Senator Long.

STATEMENT OF J. R. BOULIS, CHAIRMAN AND PRESIDENT, SOUTH BEND LATHE

Mr. BOULIS. I am Dick Boulis, chairman and president of South Bend Lathe and this is Jerry Vogel. Jerry is one of our skilled machinists. He is vice president of our Union, Local 1722 of the Steelworkers, and he is a member of the board of directors.

I think it is important to note, at the outset, that Jerry is not here representing the United Steelworkers of America, but representing our local and our employees.

I would like to say, Mr. Chairman and Senators, that I apologize for not having submitted written testimony in advance. Unfortunately, I have been on a 2-week vacation. I was up in the north woods, fishing. I was not aware of the requirements until I returned to the office Monday. But I will certainly submit it following my return.

Let me give you a little background about our company, because we are quite unique. I would assume that most of you people are aware of us, since we have had volumes of publicity in the past 3 years—probably 75 to 100 articles have been written about what has happened in South Bend, including articles in the Wall Street Journal, Business Week, Newsweek, and many, many others.

But to give you that background, South Bend Lathe is a producer of machine tools. Initially, it was world famous for the production of small lathes. It was founded in 1906 in South Bend, Ind.

In 1959, the company was acquired by Amsted Industries, Chicago, and along about the late sixties or early seventies Amsted became disenchanted with South Bend Lathe, due to the profit performance, and

in late 1974, I was advised that the division would be sold if a buyer could be found. I was not too concerned at this news, because I felt that a buyer would be found. Since they had told me that they were not going to sell it at a bargain price, I felt the operation would be continued.

Unfortunately, in early 1975, I was advised that the company would be sold at substantially less than book value, and it appeared that the prospective purchaser would quite evidently liquidate the division and put some 500 employees on the streets of South Bend.

At this point, I started searching for a way to buy the company. I have no private funds myself. I could not do it. I tried to get our distributors together, I talked to many of our employees, and it looked like we were about to strike out.

Along about this time, a friend of mine in South Bend, the president of a local foundry, asked me if I had ever heard of ESOP. Frankly, I had not, but in a matter of 3 or 4 days, I had become somewhat conversant with employee stock ownership plans and the benefit that you could gain from it. I commenced working with John Gibson of the Chicago Office of the Economic Development Administration, a local bank, and many other people who are too numerous to give credit to at this time, but I thank all of them for their efforts. As a result of these efforts, in a matter of about 3 months, we put the deal together and on July 3, 1975, we acquired our division from Amsted Industries and established a 100-percent employee stockownership plan whereby our employees immediately became the beneficial owners of South Bend Lathe.

This acquisition was accomplished by a $5 million grant from the Economic Development Administration to the city of South Bend. This grant then flowed through our employee stockownership trust and was loaned to the new corporation at 3-percent interest repayable over 25 years. Well, some people have said—well, 3-percent interest; that was some gift. But you have to remember that we were really not a financeable company at that time, and this $5 million was not all that was required. We had to go out and borrow another $5 million. We raised that through conventional financing sources, not at 3 percent, but a major portion of it was at 7 points over prime.

So our average rate that we had to pay to acquire the company was more than normal.

From a financial point of view, our employee stockownership has been a resounding success, and I would like to give you just a brief summary of the financial position of our company at the end of the current fiscal year, which just ended June 30.

We have had 3 profitable years after a series of unsatisfactory years under Amsted. Profits have improved each year, and for the year just ended, the profits were approximately 10 percent before taxes.

Sales were slightly depressed during our first year, due to the unfortunate rumors that many of our competitors had been passing in the marketplace that we were about to be closed, and also due to the general economic conditions, but since then, our sales have steadily increased and, in fiscal 1977 and 1978, they were higher than any prior years in South Bend's history, dating back to 1906.

Sales for the year just ended was $18.5 million which represented a 34-percent increase over the first fiscal year.

We started off completely in debt—we simply had nothing to start with, except the debt that we leveraged—but we worked hard at it, and we presently have no bank debt whatsoever. We paid off all of our bank loans and the total commercial debt which was approximately $4.5 million. That was completely paid off in May 1977, and I may remind you, that was only 22 months after we had started our operations.

Our current banking arrangements provide for a $3 million line of credit, should we need the funds, at the national prime rate of interest. We are not using this line of credit, at all. We have a quite liquid position. I think we currently have around $600,000 or $700,000 in cash or short-term investments.

Our current ratio has steadily improved and, at June 30, was 3.2 to 1. Earnings per share have increased from $20.30 the first year to $52.24 the second year and $69.48 in the third year.

I think it is important to note that these financial accomplishments were not achieved at the expense of our employee stockholders. Since we acquired our company, our employee's earnings have steadily increased and for the fiscal year just ended averaged over $15,000 a year.

With the general increase to be put into effect on August 1, our average employee's earnings will have increased by 45 percent since our ESOP was established and since we acquired the company.

Of course, these increases included bonuses that we have distributed. Since acquiring the company, we have distributed seven bonuses, the last six of which were equal to a week's pay. Three of these were distributed in this past fiscal year.

The maximum tax-deductible contribution of 15 percent was made to our ESOP for each of these 3 years, and our employee stockowners will now have an average of $6,000 in company stock, credited to their ESOP account.

From our analysis of statistics in our industry, it appears that our contribution to our employee stockownership plan is approximately twice the average contribution to pension plans for companies in our industry. We do not have a conventional pension plan or retirement plan at South Bend Lathe. Unfortunately, when we acquired our company, it did not appear that we could be financially successful if we had to assume the costs and legal liabilities for the pension plans in effect at that time.

All of our employees were aware of this and agreed to work for the new corporation for an employee stockownership plan in lieu of the pension plan in existence at that time.

In terms of employee motivation, our productivity increased very, very substantially in all areas of our company for the first several months after the acquisition. Unfortunately, the fact that our people had agreed to work for an employee stockownership plan rather than the previous pension plan created problems with the International Steelworkers that still have not been resolved. There is a suit pending in Federal court that has been pending there for 2 years wherein the steelworkers are attempting to have us named as the successor to Amsted which, in reality, means we would have to assume the pension liabilities and reinstate the pension plan that was in effect at that time.

This obviously has taken the edge somewhat off our success. Our employees spend time talking about this and they wonder which way to bounce. But regardless of that, our productivity under ESOP is

still significantly better than under the prior ownership, and we thank employee stockownership for that.

We have not established a TRASOP at our company because of the relatively low level of equipment purchases and the costs involved to make these distributions.

We have accomplished a lot in South Bend. The job is not yet finished. We still have many things that have to be done in order that each of our employee stockowners can be secure, but we are confident. Thanks to ESOP, we believe that we have a bright future.

Now, we do not profess to be experts in the economic theories of ESOP. As I said earlier in my testimony, in early 1975 when a friend told me, about ESOP I did not know what it was, and I had to start reading on it. I am still not an economic expert on ESOP. But it works. It works in our company.

There definitely is a better rapport, better morale; regardless of the problems that we have had with the Steelworkers, we get along better.

I think one reason why I personally support employee stock ownership is I am concerned about the decline of the American industry that is facing our country. At one time, and for many, many years, America led the world in the production of machine tools. We no longer do. We have been replaced by West Germany and Japan. Much of that has to be attributed to a decline in productivity.

Now, there are some experts that say productivity in America is increasing. I do not profess to have all of the answers, and I am sure that depending on how you define productivity it probably is. With more sophisticated machines, sophisticated materials, sophisticated methods and tools, the tool output per employee no doubt is increasing. But, from my observations, in our industry, the factories that I visit, and the factories that I visit abroad, the American work ethic is not what it used to be, especially with the people entering the labor market.

And we think that employee stockownership is the answer. We really sincerely believe that this is a way to revitalize American industry and to put us back on top of the heap, if you will.

And, Senator, we thank you for the opportunity to visit with you today.

The CHAIRMAN. Mr. Boulis, what was your relationship to the company, or your position with the company, when you were first told that South Bend would be closed.

Mr. BOULIS. I was president. I was head of South Bend Lathe. I was transferred there from another Amsted entity in 1969 to take over the division and I was president of the operation.

The CHAIRMAN. Did the employees take a pay cut to get this thing started or not?

Mr. BOULIS. No, they did not. What the employees did do, and this was—I had mass meetings with the employees to advise them of what was going on. The employees did have to give up their pensions. We did not see any way that we could be financially successful if we continued the pension plans that were in effect at that time. Except for that, all other benefits were continued—and increased, in fact.

The CHAIRMAN. Are you a former union member?

Mr. BOULIS. Well, I have to explain that a bit. Yes. I come from a town in Michigan, near Flint. It was raised there in the depression.

As you were well aware, that was somewhat of a hotbed of the UAW-CIO.

I come from a union family, and at one point in my career I worked in a factory in my hometown and participated in the organization of the plant by UAW-CIO and went or led the people in my department out on strike to get better wages and benefits. So yes, I belonged to the union, and I believed in the union. I still do to a degree.

The CHAIRMAN. You may know that I was the one who went to Mr. Mizell and urged him to make a grant to help get this operation going, to help your people save their jobs, and I have followed what you have done with great interest. Now, in situations of that sort, businesses failing and the potential of a tremendous employee interest might save it, it would seem to me that we ought to have a chance to see what employee stockownership can do in terms of motivation, and yours, of course, is a prime example.

Now, unions are interested in the jobs of their people. I regret to say that they do not have as much enthusiasm for employee stockownership as they do about pension plans.

Could you just give me your thought, and this committee your thought, as to how you would hope the union would react to employee stockownership?

Mr. BOULIS. Well, that, of course, has been one of our problems. Some of that I have to take the blame for. Before we bought the company I did not talk to the international. I kept our local advised every step of the way. I was somewhat ignorant of the fact that I should be talking to the international.

But I would hope that they would join us. I would hope that the big unions would get behind employee stockownership.

Frankly, Mr. Chairman and Senators, I am not sure of why they do not. You asked the question of did I ever belong to the union; yes, I did and my father did. I have to say—and this is my opinion—I have to say that maybe the present union leaders do not have the same goals that Samuel Gompers and other people who started the labor movement did.

I always thought that unions were to raise the standard of living for the employees and give them more benefits. Employee stockownership certainly has done that in our company. There is no question that our people are far, far ahead of what they were before, and yet I have to say that the Steelworkers still have not embraced our employee stockownership plan.

I do not have the answer as to why. I can only give my opinion.

The CHAIRMAN. Thank you very much.

Mr. Byrd?

Senator BYRD. I have no questions.

The CHAIRMAN. Senator Packwood?

Senator PACKWOOD. I have no questions.

The CHAIRMAN. Mr. Gravel?

Senator GRAVEL. Mr. Chairman, I will not take the time of the committee. I will ask Mr. Boulis if he would have the time this afternoon to meet with me privately. I would like to go into some depth as to the financial structures involved.

Mr. BOULIS. Certainly.

Senator GRAVEL. Will you still be here at 5 o'clock?

Mr. BOULIS. I will make arrangements to.

The CHAIRMAN. Senator Roth?

Senator ROTH. I wonder if either you or the gentleman who, as I understand, represents the local union, would care to comment as to what might be done to hopefully build greater support in the union movement for this kind of approach, a participation by blue-collar workers in stockownership.

Mr. BOULIS. If I understand your question, Senator, you are asking if anything can be done to get the unions behind employee stockownership?

Senator ROTH. Yes.

Mr. BOULIS. The only thing I know is when there are enough employee stockownership plans in existence and the employees still see fit to belong to the unions, the big unions are going to have to get with it to maintain their place. It is a very difficult question to answer, because, obviously, I have had it said to me that employee stockownership is aimed at getting rid of unions. Believe me, that was not the case in South Bend Lathe.

In fact, before we bought the company, we sent the Steelworkers a contract and said, please sign it. Our bankers wanted to make sure we had a stable workforce. Our bankers wanted to make sure we had a union contract.

But they chose not to. We bought the company anway.

I am afraid I cannot answer that.

Mr. VOGEL. As I said, it has been around for many, many years, but to us it is a brandnew concept and I think that maybe the big unions are a little reluctant to get involved in it because it is so new. Therefore, I think the education of it is very important at this time.

Senator ROTH. I take it you are president of the local union?

Mr. VOGEL. No; our president was unable to make it, and this is why Mr. Boulis has said that neither one of us are really prepared to come into this meeting. We more or less are winging it. But I am the vice president, and I have been involved with the ESOP program ever since its inception.

Senator ROTH. Have there been any discussions, as far as you know, between your local leadership and the international on the ESOP?

Mr. VOGEL. We have discussed it with them many times, sir. And they chose to just let it lie. So, more or less, this is why we just took it on our own to do what we did.

Senator ROTH. By education, you mean both with the leadership and membership?

Mr. VOGEL. Yes.

Senator ROTH. Thank you.

The CHAIRMAN. Senator Danforth?

Senator DANFORTH. In your opinion, would 100 percent employee-owned companies provide a disincentive to additional equity financing, to a new issue?

If you have a company that is owned 100 percent, or even more substantially than half, say, by its employees, in essence it seems to me what you have is a company that is financed entirely by debt, as far as its capital structure is concerned.

What effect would this have down the road as far as deluding the employee?

Mr. BOULIS. We are not on the market. Our stock is not avaliable. We would not finance expansion by that method.

I might say this, though, that we have been looking hard at that, because we want to diversify. Machine tools are quite cyclical, as we all know. We have talked to our bankers, and we recently were holding negotiations with a company three times as large as we are. Our bankers assured us that they would stand behind a $10 million offer, based upon our performance to date and our 100-percent employee stock-ownership plan and the assets.

Senator DANFORTH. But even if you did that, you would have a larger company, but you would still be really, in effect, your whole financing would be debt financing.

Mr. BOULIS. That is right.

Senator DANFORTH. Do you think that that is sound?

Mr. BOULIS. Well, I think time will tell. You have to recognize that, in our situation, it was a matter of necessity being the mother of invention, and it has worked so far.

In less than 2 years, we have paid off over $4 million in commercial debt—just completely eliminated it. The value of our stock has increased. It is currently being valuated now. We have to have ours evaluated by private firms—it is not on the market—but we expect to see a definite increase in the value of the stock.

Senator DANFORTH. You pretty much rule out the possibility of a new issue being offered?

Mr. BOULIS. At the present time. However, we have looked at acquiring a public company and at that time, exchanging our stock and being on the market, but not issuing new stock for a public offering.

Senator DANFORTH. Thank you.

[The prepared statement of Mr. Boulis follows:]

SOUTH BEND LATHE, INC.,
South Bend, Ind., July 25, 1978.

Hon. RUSSELL B. LONG,
Russell Office Building, Washington, D.C.

DEAR SENATOR LONG: Jerry Vogel and I certainly were pleased to have the opportunity of meeting you, joining you for breakfast, and testifying before the Senate Finance Committee.

Attached is a typewritten copy of the general text I followed in my testimony. I apologize for not having submitted these comments in advance.

Senator Long, there is a subject which I didn't get a chance to discuss with you, and I will therefore cover it now. When we set up our Employee Stock Ownership Plan, the one point we had the most difficulty with was the formula used for allocating stock to our employee stockholders. Every company that we have discussed this subject with allocate stock on the basis of annual earnings, but our union president insisted the stock should be allocated equally. This may sound ridiculous, but a large segment of the blue collar workers and clerical force embraced this idea.

We finally adopted a formula, over the objections of the union president, allowing 20 points for each $1000 of salary up to the limits allowed by IRS and 10 points for each year of service up to 15 years. However, many of our people still believe we are being unfair and should allocate the stock equally as originally proposed by the union president. In fact, this point has been the cause of more discord in our company than any other single item.

It seems to me if you are in agreement that the allocation of stock should rather closely approximate the distribution of annual earnings, it would be well if this could be covered in S3241.

It is probably too late for this to be of any significant benefit to our company—although it might be of some assistance in calming the waters—but it would

certainly be an assist to companies adopting an ESOP in the future if they could advise their employees the stock is being allocated on an equitable basis in accordance with the legal requirements.

Once again, Senator Long, we appreciated the invitation to testify on behalf of your very important bill and I would appreciate any consideration you can give to the above suggestion relative to the method for allocating stock.

Sincerely,

J. R. BOULIS,
President and Chairman.

Attachment.

GENERAL TEXT OF COMMENTS

I'm Dick Boulis, Chairman and President of South Bend Lathe and this is Jerry Vogel of our company. Jerry is one of our skilled machinists, Vice President of our union—Local 1722 of the Steelworkers, and a member of our Board of Directors.

Unfortunately, since our plant was shut down the first two weeks of July, Jerry wasn't aware he would be attending this meeting until this past Monday morning. Therefore, he does not have a prepared statement. However, if Jerry doesn't agree with any of my comments, you can be assured he will state his own position. It's important to note that Jerry is not here as a representative of the Steelworkers but is representing Local 1722 and the hourly employees of SBL.

Let me now give you a little background about South Bend Lathe, although I would assume that most of you have seen some of the many articles that have been written about us in the past three years. There have been at least 75 articles written about what has happened at our company including articles in the Wall Street Journal, Business Week, Newsweek and many other leading publications.

South Bend Lathe is a producer of machine tools and was founded in South Bend, Indiana in 1906. In 1959 Amsted Industries of Chicago acquired SBL—but in the early Seventies Amsted became disenchanted with the profit performance of SBL and in late 1974 I was informed that the Division would be sold if they could find a buyer. I was advised it would not be sold at a bargain price and therefore I was not concerned as to the future for I believed the operation would be continued.

However, in early 1975, it became apparent SBL would be sold at substantially less than book value and it also appeared evident the prospective purchaser would quite likely liquidate our company and close the doors which would have put almost 500 people out of work.

I immediately started searching for ways to buy the company but was not having any success until one day a friend asked if I had ever considered an Employee Stock Ownership Plan. Shortly after this, in the spring of 1975, I began working with the Industrial Development Department of the First Bank and Trust in South Bend, John Gibson of the Economic Development Administration office in Chicago, and several other people too numerous to mention at this time and things began to happen. These efforts were finally successful and on July 8, 1975 the acquisition of SBL from Amsted Industries was finalized and the employees immediately became the beneficial owners of their company through the establishment of a 100% Employee Stock Ownership Plan.

The acquisition was accomplished by a $5 million grant from the EDA to the City of South Bend who then loaned this to our ESOP at 3% interest repayable over 25 years. An additional amount of approximately $5 million was required and this was provided by conventional financing sources—a major portion of which was at an interest rate of 7 points over prime.

From a financial point of view, our ESOP has been a resounding success, and I would like to give you a brief summary of the financial condition of our company at the end of our 3rd fiscal year which ended June 30th.

1. We have had 3 profitable years after a string of unsatisfactory years as a division of Amsted.

2. Profits have improved each year, and for the fiscal year just ended, the profit before taxes was almost 10% of sales.

3. Sales were slightly depressed during our first year due to the general economic conditions at the time and due to rumors that had circulated in the marketplace for several months concerning the possible closing of SBL. But since then, our sales have steadily increased and Fiscal 1977 and 1978 were higher than any prior years in SBL's history.

4. Sales for the year just ended were approximately $18.5 million or a 34% increase over our first year.

5. We have no bank debt at the present time. The commercial loans of almost $5 million were completely paid off in May of 1977, and our current banking arrangements provide for a $3 million line of credit at the prime rate of interest.

6. Our current ratio has steadily improved and at June 30 was 3.2 to 1.

7. Earnings per share increased from $20.30 our first year to $52.24 the second year, and to $69.48 for our third fiscal year that just ended.

I think it's important to note these financial accomplishment were not achieved at the expense of our employee-stockholders.

Since we acquired our company as of June 30, 1975, our employees' earnings have steadily increased and with the general increase to be put in effect August 1st, the average earnings of our employees will have increased by about 45% to an amount averaging in excess of $15,000 annually.

Since acquiring SBL we have distributed seven bonus checks to our employees—the last six of which were each equal to a week's pay.

The maximum tax deductible contribution of 15% of salaries and wages has been made to our ESOP for each of the three years, and this annual contribution has averaged $2,000 per employee. This is 2.5 times the average contribution to pension plans in our industry. Our employee stockholders now have an average of $6,000 in company stock credited to their ESOP account.

We do not have a conventional pension or retirement plan at SBL. Prior to acquiring our company it didn't appear we could financially succeed if we had to assume the costs and related liabilities of the hourly and salaried pension plans in effect at that time. All of our employees were aware of this and agreed to work for the new corporation with an ESOP in lieu of the pension plan.

In terms of employee motivation, our productivity increased very substantially in all areas of our company for the first several months after the acquisition. Unfortunately the fact our people agreed to work for an ESOP rather than the previous pension plan created problems with the Steelworkers which still haven't been resolved. There has been a suit pending in Federal Court for over two years wherein the Steelworkers are attempting to have us named as the successor to the contract in effect with Amsted at the time we bought the company—or in oher words to force us to reinstate the pension which had been in effect when Amsted owned our company. Unfortunately, these problems have taken the edge off our success and productivity has declined somewhat. However, it is still significantly better than when we were a division of Amsted.

We have not established a TRASOP at our company because of the relatively low level of new equipment purchases as compared to the problems involved in allocating the additional tax credit to the employee stockholders. We would, therefore, encourage the adoption of a program for labor intensive companies based on payroll.

We've accomplished a lot at South Bend in three years but the job is not finished—we still have many things that must be accomplished in order that the future of our employee-stockholders can be reasonably secure. However, we're confident that we will solve the problems that are still plaguing us and that the future of our ESOP is bright.

We don't profess to be experts as to the economic theories of ESOP. However there is no question it is getting the job done at our company.

Certain experts claim that productivity in the U.S. is increasing. I guess it depends on how you define productivity. There isn't any question that output in terms of product per man hour is increasing as a result of more sophisticated equipment, tools, materials, and methods. But in my opinion, and I have visited many plants in the U.S. and abroad, the individual work effort in our country is declining and lags behind our foreign competitors. We believe that Employee Stock Ownership will go a long way toward reversing this situation.

We don't have all the answers, but we're working at it. We've come a long way at South Bend Lathe in the past three years and if we ever get rid of the one main problem that has been plaguing us—the suit pending in Federal Court—we're confident we'll really break out into the clear and be an extremely successful company.

Thank you, Senator Long, for inviting Jerry and me to testify here today. We certainly appreciate your efforts to encourage the establishment of ESOP's, and we at SBL are especially appreciative for your intercession with Mr. Mizell on our behalf in 1975 when our request for the $5 million grant was pending at the EDA.

Thank you.

The CHAIRMAN. Next we will call Mr. Glenn W. White, of Dow Chemical Co.
Mr. White?

STATEMENT OF GLENN W. WHITE, DIRECTOR OF TAX DEPARTMENT, DOW CHEMICAL CO.

Mr. WHITE. Good morning, Mr. Chairman and members of the committee. My name is Glenn White. I am the director of the tax department of Dow Chemical Co.

We appreciate the opportunity to testify regarding this proposed legislation to expand the scope of employee stock ownership plan.

We want to tell you about Dow's experience with employee stock ownership. As early as 1953, Dow had adopted a plan which provided to a broad group of employees shares in the company without out-of-pocket cost to the employee. The Dow stock benefit plan makes available to that group of employees an investment by the company in shares for the employee's account at the rate of 2 percent of base salary per year.

The shares are distributed to the employee upon termination or retirement. The Dow concept of employee stockownership was expanded with the adoption if the Dow investment benefit plan. This was our response to the employee stockownership legislation contained in the tax reduction act of 1975. As a result, employees now receive an additional benefit as provided under the employee stock ownership plan provisions to the extent of 1 percent of Dow's investment in qualified property each year.

This plan was extended to cover all U.S. employees through at least 1 year of service. This includes those represented by bargaining units, about 8,400 employees.

As a result, 90 percent of 32,600 employees, or 29,300 people have become shareholders in our company. This has helped make possible a long-term management objective of making as many Dow employees as possible owners of the company. In addition to the Stock Benefit Plan and the Investment Benefit Plan, Dow also has an Employee Stock Savings Plan that permits Dow employees on a worldwide basis to purchase stock in the company at favorable prices.

The Dow investment benefit plan was so named to express the concept that through the company's investments in new plants and equipment, the employees are sharing in the planning, building, and operation of the company and thus are deserving of receiving under this plan a share of the corporate ownership.

Without Dow's growth and capital investment, there would be neither tax benefits nor employee stockownership plan stock benefits.

In 1976, the first year our plan was in operation, $5,900,000 was contributed to the plan. This was used to acquire about 187,000 shares of stock. That is 6.4 shares for the average employee, for a value of about $200.

Also, the plan guarantees that each participant will receive at least one share of stock per year under our allocation formula. The real advantage to employee stock ownership plans from Dow's point of view is not derived from the tax benefit. The tax benefit makes a desirable plan economically feasible.

We see the real advantages as: (1) The creation of broad stock ownership by the employees of the company; (2) participation by the employees in the capital investment growth and the resultant rewards of that growth; (3) improved communication by way of employees receiving shareholders' messages, such as quarterly or annual reports and feedback from employees by way of their voting participation as common shareholders and by their comments to the company as shareholders.

(4) The creation of greater awareness in the employees of the companies progress; (5) and, in small measure, the investment benefit plan serves to build the personal retirement savings of the employees. This decreases demands for and the need for increasing social security and other retirement benefits.

From our point of view, S. 3241 is largely very meritorious. The contribution increase from 1 to 2 percent of qualified investment is very valuable, since it makes the individual benefit more substantial and meaningful.

Although capital intensive companies such as Dow would not benefit from the 1-percent compensation alternative, we believe this option will expand the use of employees' stock ownership plans because it will encourage participation by labor-intensive businesses. Thus, they and their employees may benefit, as have we.

Making the provisions for this benefit plan permanent is an extremely desirable feature. Letting the program die is like cutting the pay of all of the affected persons.

This fact highlights the need for stability in our tax laws.

The provision which would allow deductions for dividends paid for an employee stock ownership plan trust, which are subsequently distributed, is excellent. Elimination of double taxation on corporate profits is a desirable goal, and the proposal here is certainly a step in the right direction.

This bill addresses, in a helpful manner, other difficult technical problems such as reconciling investment tax credit recapture provisions with lump sum distribution benefit provisions to retirees.

I would like also to comment briefly on a provision of the bill requiring one-half of the employee stock ownership benefit contribution to be in newly issued securities. Although we appreciate the spirit in which this proposal is made, we believe that there are several reasons why the idea needs further thought.

(1) Under existing law, we believe the issuance of new securities would require the meeting of SEC registration requirements. (I do understand though, from conversations with other counsel last night, that that may be inaccurate.) (2) The employer may be reluctant to issue new securities at times when the price of the stock is depressed, or when to do so would significantly reduce earnings, and that might very well happen at a time of high capital expansion with consequently depressed earnings.

(3) Also, the rule could be circumvented if the employer repurchases shares of stock on the market.

Curing these enumerated problems may be difficult and costly. However, we do not reject this or any other idea with respect to employee stock ownership.

In summary, we are very supportive of this bill and feel that its concept, philosophy and purpose are worthwhile. We feel that our experience has been very positive as a result of employee stock ownership plan provisions of the Tax Reduction Act of 1975 and especially as modified in 1976.

And this bill will further desirably expand the value of the employee stock ownership plan.

Turning briefly to comments on the general stock ownership plan that has been introduced by Senator Gravel, we recognize that this is part of a highly innovative concept, Senator Gravel has been exploring for some time. It presents another aspect of the same thing of employee stock ownership plans.

There should be an effort to encourage more of the people in our society to participate in the ownership of stock in American corporations. Dow has actively advanced that position for many years by encouraging the ownership of corporate shares by its employees. Certainly, Senate bill 3223 is a better solution to broader public participation than governmental ownership.

We recognize that this proposal is essentially enabling legislation. However, the details necessary for development of a successful general stock ownership plan are not present in it. These details would be essential to be a successful development of the concept. Policy problems such as what investment criteria should be used, must be considered.

Thank you for the opportunity to testify. Dow believes that our employees have benefited from the employee stock ownership program and we hope for its continued and expanded existence.

The CHAIRMAN. Thank you very much, sir, for your very fine statement.

Any questions, gentlemen?

Senator GRAVEL. I have none, except to thank him for the endorsement.

Senator BYRD. No questions.

Senator DANFORTH. No questions.

Senator LAXALT. No questions.

The CHAIRMAN. Thank you very much, sir.

[The prepared statement of Mr. White follows:]

STATEMENT OF GLENN W. WHITE, DIRECTOR OF TAX, THE DOW CHEMICAL COMPANY, JULY 19, 1978

Summary

The Dow Chemical Company has been interested in Employee Stock Ownership Plans for some time, and has maintained a similar stock program for employees since 1953. The Employee Stock Ownership Plan legislation has allowed Dow to expand its program so now most of its U.S. employees are shareholders.

Following are *details* of Dow's plan:

1. Of 32.600 total U.S. employees, 29,300 are participants in the Employee Stock Ownership Plan. This is all of Dow's U.S. employees, except those employed less than one year. Employees represented by bargaining units are automatically participants.

2. In 1976, the first year of operation, the contribution to the Plan was $5,900,000. This was used to acquire about 187,000 shares of stock, providing 6.4 shares to the average employee for a value of about $200 per employee.

3. The contribution is divided among participants on the basis of compensation under $100,000. Corporate directors are not included as participants. Each participant is guaranteed at least one share of stock per year.

SENATE BILL 3241

Dow is strongly in favor of this Bill and believes the following provisions to be very meritorious:

1. Contribution increase from 1% to 2% of qualified investment is very valuable and meaningful to employees.
2. 1% of compensation alternative, although not helpful to Dow, should encourage participation by labor intensive businesses.
3. Permanent legislation is extremely desirable.
4. Deductions for dividends paid is a good step in the direction toward elimination of double taxation on corporation profits.
5. Correction of the technical problem regarding lump sum distribution will solve a problem Dow has been having relative to its Employee Stock Ownership Plan in that it would be able to use the separate account method of claiming investment tax credit recapture without affecting employees tax treatment on lump sum distribution.

AN AREA OF CONCERN

"Newly issued share" requirement would require SEC registration, creates administrative difficulties, dilutes the value of the stock the employee receives, and can be circumvented if the employer repurchases shares on the market.

CONFUSING PROVISIONS

1. Does proposed Section 416 (b) require that we give each employee the option of participation even though the Plan is not contributory? If so this would create a significant administrative burden.
2. A literal reading of proposed Section 7 (b) would allow an employer a charitable contribution in addition to a tax credit. Certainly this windfall is not intended.

SENATE BILL 3223

Although this is a highly innovative concept, we believe the detail should be worked out prior to passage of such enabling legislation.

Statement

Good morning. My name is Glenn White. I am the Director of the Tax Department for The Dow Chemical Company. We appreciate the opportunity to testify regarding this proposed legislation to expand the scope of Employee Stock Ownership Plans. We want to tell you about Dow's experience with employee stock ownership.

As early as 1953 Dow had adopted a plan which provided, to a broad group of employees, shares in the Company without out-of-pocket cost to the employee. The Dow Stock Benefit Plan makes available to a broad group of our employees an investment by the Company in shares for the employee's account at the rate of 2 percent of base salary per year. This plan is noncontributory. The shares are distributed to the employee upon termination or retirement.

The Dow concept of employee stock ownership was expanded with the adoption of the Dow Investment Benefit Plan. This was our response to the Employee Stock Ownership legislation. As a result, the employees now receive an additional benefit as provided under the Employee Stock Ownership Plan provisions to the extent of 1 percent of Dow's qualified property each year. This plan was extended to cover all U.S. employees with at least one year service, including those represented by bargaining units. As a result, 90 percent of 32,600 employees or 29,300 people became shareholders. This has helped make possible a long-term management objective of making as many Dow employees as possible owners of the Company.

In addition to the Stock Benefit Plan and the Investment Benefit Plan, Dow also has an Employee Stock Savings Plan that permits Dow employees on a worldwide basis to own stock in the Company.

The Dow Investment Benefit Plan (Dow's Employee Stock Ownership Plan) was so named to express the concept that through the Company's investment in new plants and equipment, the employees are sharing the planning, building, and operation of the Company and, thus, are deserving of receiving under this plan a share of the ownership. Without Dow's growth of capital investment, there would be neither tax benefits nor Employee Stock Ownership Plan stock benefits.

In 1976, the first year our plan was in operation, $5,900,000 was contributed

to the plan. This was used to acquire about 187,000 shares of stock (6.4 shares for the average employee or about $200).

As prescribed in the law, the contribution is divided among participants on the basis of compensation under $100,000. However, following our intent that this plan substantially benefit rank-and-file employees, the corporate directors elected not to participate in this plan. Also, the plan guarantees that each participant will receive at least one share of stock per year in the allocation formula.

The real advantage to Employee Stock Ownership Plans from Dow's viewpoint is not derived from the tax benefit. The tax benefit makes a desirable plan economically feasible. We see the real advantages as:

1. The creation of broad stock ownership by the employees of the Company.
2. Participation by the employees in the capital investment growth and the resultant rewards of that growth.
3. Improved communications by way of employees receiving shareholder messages, such as quarterly and annual reports.
4. Creation of greater awareness in the employees of the Company's progress.
5. In small measure, the Investment Benefit Plan serves to build the personal retirement savings of the employees. This reduces the demands and need for increasing Social Security and other retirement benefits.

SENATE BILL 3241

This proposal is for the most part very meritorious. The contribution increase from 1 to 2 percent of qualified investment is very valuable since it makes the individual benefit more substantial and meaningful. Although capital intensive companies such as Dow would not benefit from the 1 percent of compensation alternative, we believe this option will expand the use of Employee Stock Ownership Plans because it will encourage participation by labor intensive businesses. Thus, they and their employees may benefit as have we.

Making the provisions for this benefit plan permanent is extremely desirable. Letting the program die is like cutting the pay of all affected persons. This fact highlights the need for stability in our tax laws.

The provision which would allow deducations for dividends paid to an Employee Stock Ownership Plan trust, which are subsequently distributed, is excellent. Elimination of double taxation on corporation profits is a desirable goal, and the proposal here is certainly a step in the right direction.

A technical problem about which we have been concerned is handled in the bill. Under current law there are three alternatives for dealing with shares affected by investment tax credit recapture.

One of these alternatives is to allow the plan to set up separate accounts for each participant which are segregated from other plan assets, against which investment credit recapture can be drawn. The problem arises when an employee retries or otherwise terminates his employment. It may not be known for a period of seven years thereafter if this "separate" account will be used up by the investment credit recapture, since the investment credit recapture rules are operable for a period of seven years after the investment credit property is placed in service.

Since our Employee Stock Ownership Plan also qualifies as a stock bonus plan under the Internal Revenue Code, lump sum distributions of employer securities from this plan qualify for special tax treatment on lump sum distributions under Section 402(e) of the Internal Revenue Code. Lump sum distribution treatment is a very desirable tax provision as far as our employees are concerned. We are anxious to preserve its applicability. However, the term lump sum distributions is defined in Code Section 402(e) (4) (A) as the balance in the account to the credit of the employee. The Treasury Department has issued rather explicit regulations defining these terms at Section 1.402(e)-2(d); and as we interpret these regulations, an employee receiving a lump sum distribution from our Employee Stock Ownership Plan upon retirement would not be entitled to the special tax treatment on lump sum distributions under Section 402(e) because the plan had not distributed to him the balance of his account, since there remained this "separate" account for investment credit recaptures. The only way

to preserve the special tax treatment for the retiring employee would be to hold the retiree's entire distribution for a period of seven years (an option which is obviously not very satisfactory from the employee's point of view), or for the company to use one of the other investment credit recapture provisions.

As a matter of fact, because of this problem, we have chosen to use one of the other recapture provisions. However, our choice, absent this problem, would have been to use the "separate account" method. Since Congress approved this as one of the legitimate methods of dealing with the investment credit recapture problem, we cannot believe that this contradiction with the lump sum distribution rules was intended. Rather, we are confident this was simply an oversight in the previous legislation and are pleased that the amendment to Section 416(d) would alleviate this problem.

An alternative solution which would constitute a major departure from past practice would be to disregard investment tax credit recapture in respect of the Employee Stock Ownership Plan percentage. The chance for significant revenue loss seems remote since the employee is the beneficiary and the control over disposition of the assets is under the control of the employer.

I would also like to comment briefly on the provision in the bill requiring one half of the Employee Stock Ownership Plan contribution to be in newly issued securities. Although we appreciate the spirit in which this proposal is made, we believe there are several reasons why the idea needs further thought:

1. Under existing law the issuance of new securities would require the meeting of SEC registration requirements;

2. The employer may be reluctant to issue new securities at times when the price of the stock is depressed or when to do so would significantly dilute earnings; or

3. The rule could be circumvented if the employer repurchases shares on the market.

Curing these enumerated problems may be difficult and costly.

The SEC registration problem could be remedied by specifically exempting shares issued for an Employee Stock Ownership Plan from registration requirements.

Companies may avoid setting up a plan if the shares being issued are so issued at a very depressed price. For small companies, in the midst of expansionary cycles, the issuance of new shares could significantly dilute earnings. Moreover, issuance of new shares will naturally lower the price of all shares with the consequence that the employees may receive slightly less than would otherwise be the case.

There are many reasons why companies buy their own shares. It would not be feasible to prevent all purchases of company stock, and yet it would almost require a measure that stringent to prevent circumvention of the rule. For these reasons, we doubt whether this provision should be adopted.

There are two provisions in the bill whose purposes seem somewhat obscure. The first of these is Proposed Internal Revenue Code Section 416(b) which says that the employer may not make participation in the plan a condition of employment and the plan may not require matching employee contributions as a condition of participation in the plan. We are not sure how this would apply to a plan like ours that automatically includes all employees but does not require employee contributions. We cannot think of any reason why an employee would not want to be part of the plan, and we certainly have not had any of our employees ask not to be covered. It would impose a significant administrative burden on us to affirmatively grant each employee an option of participation. We hope that the proposed legislation can be changed so that will not be a requirement.

Proposed Section 7(b) of the bill would allow a charitable contribution for Employee Stock Ownership Plan contributions. Certainly it cannot be the intent of this bill to grant an employer a charitable contribution in addition to a tax credit for the same contribution. However, we believe a literal reading of Section 7(b) could cause this result. This seems particularly likely since the limiting language in Section 1(b) for amending Internal Revenue Code Section 416(a)(12) does not include Section 170.

For companies that are in heavy growth cycles, the one year carryforward may not be sufficient. Employee Stock Ownership Plans might be very worth-

while for such companies and their employees, but there may be a reluctance to use such plans when the carryforward is limited to one year.

There are two matters that are of concern which remain apart from this bill. The provision for recovery of administrative expenses is inadequate. As in the current law, the Proposed Section 416(a)(13)(B) of the Code continues to tie administrative cost reimbursement to a percentage of income earned by the Employee Stock Ownership Plan trust. (This differs from the provision at Proposed Section 416(a)(13)(A) which allows for reimbursement of establishment cost tied in to a percentage of first-year contributions.) Our experience has been that recoupment of all administrative costs has not been possible since the income earned by the trust is insufficient. However, if the administrative cost reimbursement provision was tied to contributions, as is start-up cost, there would be no problem.

From an administrative convenience point of view, it would be helpful if a retiree could be paid his benefit without delay upon retirement. This would be more easily done if the last year of service could be disregarded. Under existing law, the final benefit for a retiree cannot be determined until the filing of the corporation's federal income tax return for year of retirement. This return is filed in the succeeding year. For instance, the benefit due an individual retiring on January 31, 1978, would not normally be determinable, in the instance of a large corporation, until about September 1, 1979.

We regard these two items as desirable changes that could be addressed. They are, however, relatively minor and are unlikely to affect a decision by an employer to adopt or fail to adopt an Employee Stock Ownership Plan.

In summary, we are very supportive of this bill and feel that its concept, philosophy, and purpose are worthwhile. We feel that our experience has been very positive as a result of the Employee Stock Ownership Plan provision of the Tax Reduction Act of 1975, and this bill will desirably expand the value of Employee Stock Ownership Plans.

COMMENTS ON GENERAL STOCK OWNERSHIP PLAN

Senate Bill 3223 is part of a highly innovative concept Senator Gravel has been exploring for some time. It presents another aspect of the same theme as Employee Stock Ownership Plans. There should be an effort to encourage more of the people in our society to participate in the ownership of stock in American corporations. Dow has actively advanced that position for many years by encouraging ownership of corporate shares by its employees.

Certainly Senate Bill 3223 is a better solution to broadened public participation than governmental ownership. We recognize that this proposal is essentially enabling legislation. However, the details necessary for development of a successful General Stock Ownership Plan are not present. Those details would be essential to the successful development of the concept. Policy problems such as what investment criteria will be used must be considered.

Proper screening methods will be important to maximize the opportunity for success of a plan. Solution to mechanical problems, such as how to get the proper number of shares per person per investment, must be reached. While these details may seem too finite for this bill, they and many others need examination and resolution before we can give a meaningful comment on the program.

We do clearly support the concept of expanding stock ownership in our society.

Thank you for this opportunity to testify. Dow believes our employees benefit from the Employee Stock Ownership Plan program and that Senate Bill 3241 would make the Investment Benefit Plan more attractive to our employees, and at the same time encourage more companies to do as we have done.

Dow's Investment in New Plants and Equipment . . . Means Dow Stock For You

This booklet is intended to cover the highlights of the Dow Investment Benefit Plan in a non-technical fashion. Questions regarding specific situations should be addressed to your local Employee Relations or Benefits Counselors. Complete details of the plan are contained in a legally controlling document entitled "Dow Investment Benefit Plan" which is available for your review at your local Retirement Office.

This booklet reflects the contents of the plan as of August 1, 1977, and may be supplemented at a later date should material modifications to the plan be made.

WHAT IS THE DOW INVESTMENT BENEFIT PLAN?

It is a plan under which Dow U.S. employees become stockholders in the Company at no cost to themselves. Its purpose is to provide shares of Dow common stock to employees in recognition of their contribution to the Company's capital growth. The plan is in addition to and completely separate from other Dow benefit plans.

HOW DOES THE PLAN WORK?

The Tax Reduction Act of 1975, as amended, allows the Company an added tax credit of 1% for eligible capital expenditures to fund and administer an employee stock ownership plan (ESOP).

This means that in the fall of the year following each of the covered years (presently 1976 through 1980), the Company will make a contribution to a trust in either cash or Dow common stock. The trustee converts any cash to Dow common stock by purchase on the open market. The stock is then allocated to individual member accounts (called "Individual Investment Benefit Accounts" by the Plan) in proportion to each member's annual earnings up to a maximum of $100,000. The assets of these accounts are held in trust for the member.

Distribution from the trust to the member will be made when the member terminates employment with the Company for any reason or if the plan is discontinued.

HOW DO I BECOME A MEMBER?

Regular full-time and part-time employees who were employees on January 1, 1976, and continued employment for 12 full months through December 31, 1976, are automatically members. Employees hired after January 1, 1976 will become members on the first December 31 following 12 months of continuous employment. Temporary employees who work 1,000 hours or more during a covered year become eligible for membership as described above for regular full and part-time employees.

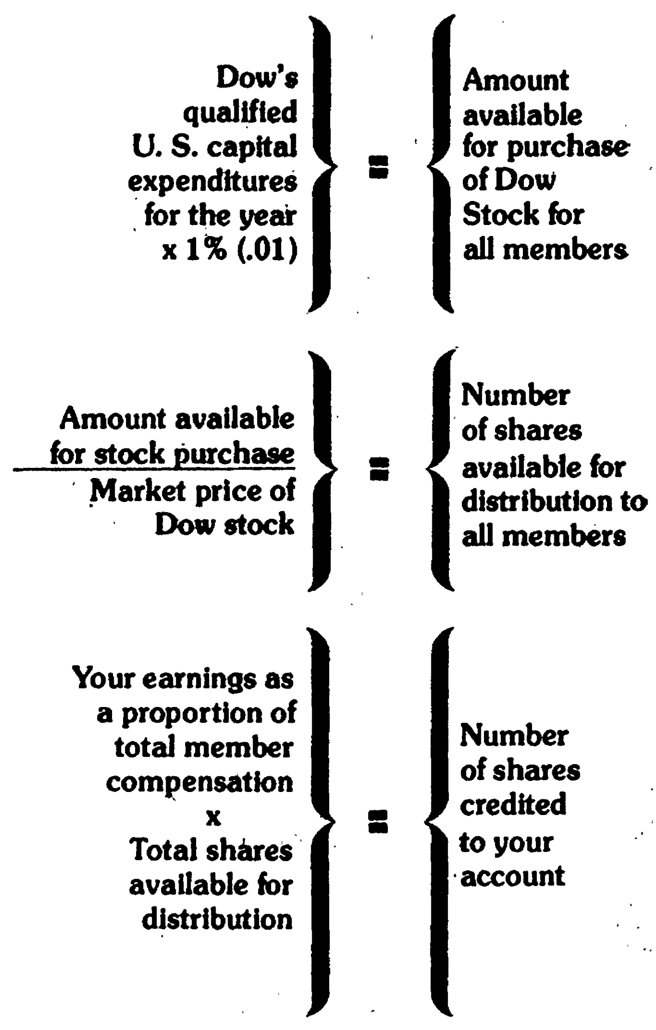
Members who have been terminated less than 12 months will be reinstated upon the date of their reemployment. Former members who have been terminated for more than 12 months will become eligible for membership under the rules applicable to new employees.

Students are eligible for membeship unless they become regular employees. Also, directors of the Company have excluded themselves from membership in the plan.

The employees of a company acquired by Dow may become eligible for membership if approved by both Boards of Directors.

WHO PAYS FOR THE PLAN?

The plan costs you nothing. The Company makes all contributions to the plan.



HOW MANY SHARES WILL MEMBERS GET UNDER THE PLAN?

Since Dow historically has had a high rate of capital investment (building for the future), this plan is especially attractive to Dow employees. Subject to any maximums defined by law, the number of shares credited to a member's account is based on the tax credit available to the Company for the capital expenditures, the market value of the stock, and the member's earnings. Assuming that there is enough investment tax credit, each member will receive a minimum of one (1) share for the year.

Example: For the year 1976, it is expected that each member could be credited with approximately one(1) share of stock for each $5,000 of earnings, with a minimum of one (1) share for each member.

WHAT ARE MY RIGHTS AS A STOCK OWNER UNDER THIS PLAN?

The stock allocated to members' accounts under this plan will be held in trust. Each member will have voting rights through the trustee for each share of stock in his or her account. Additionally, all dividends will automatically be reinvested in Dow common stock for each member's account. Members will receive annual and quarterly stockholders' reports. For all practical purposes, the plan will make each member a Dow stock owner.

WHAT REPORTS WILL MEMBERS RECEIVE ABOUT THE PLAN?

After the contribution is made each year, members will receive a statement from the Administrative Committee showing the balances of their accounts and the changes which have occurred since the last report. Each member will also receive a summary financial report for the plan.

WHEN WILL MEMBERS RECEIVE THEIR STOCK?

Members will receive their shares of stock following termination of employment, upon written application for the benefit on the form prescribed. The distribution will take place as soon as practicable after the Company's last contribution to the member's account.

In the event of a member's death, payment will be to his or her designated beneficiary (forms are available from your local Retirement Office or Employee Relations Department). If no beneficiary has been designated, the account will be distributed to the member's spouse. If there is no spouse, the account will be distributed to the member's children (if any) or, finally, to the member's estate.

HOW DO MEMBERS APPLY FOR BENEFITS?

Application for benefits must be made in writing to your local Retirement Office or Employee Relations Department, using the form provided by them for this purpose. Appeals of benefit decisions may be made in writing to the Plan's Administrative Committee. The appeals procedure is available through the Retirement Office or Employee Relations Department at your location.

HOW LONG WILL THE PLAN BE CONTINUED?

The law currently is written to cover the calendar years 1976 through 1980. The Company intends to continue the plan as long as the current tax law or its successor provides for the appropriate funding as part of the investment credit. The plan, however, may be discontinued at any time by the Board of Directors. If the plan is discontinued, all of the assets of the plan shall be used for the benefit of members or their beneficiaries in accordance with the terms of the plan.

PARTICIPANTS' RIGHTS

As a participant in the Dow Investment Benefit Plan you are entitled to certain rights and protections under the Employee Retirement Income Security Act of 1974 (ERISA). ERISA provides that all plan participants shall be entitled to:

Examine, without charge, at the Plan Administrator's Office and at other locations, all plan documents and copies of all plan documents filed by the plan with the U.S. Department of Labor, such as detailed annual reports and plan descriptions.

Obtain copies of all plan documents and other plan information upon written request to the Plan Administrator. The Administrator may make a reasonable charge for the copies.

Receive a summary of the plan's annual financial report. The Plan Administrator is required by law to furnish each participant with a copy of this summary annual report.

Obtain a statement telling you whether you have the right to receive a benefit under the plan at normal retirement age and, if so, what your benefit would be at normal retirement age if you stop working under the plan now. If you do not have a right to a benefit under the plan, the statement will tell you how many more years you have to work to get a right to a benefit under the plan. This statement must be requested in writing and is not required to be given more than once a year. The plan must provide the statement free of charge.

FIDUCIARY RESPONSIBILITIES

In addition to creating rights for plan participants, ERISA imposes obligations upon the people who are responsible for the operation of the employee benefit plan. The people who operate your plan, called "fiduciaries" of the plan, have a duty to do so prudently and in the interest of you and other plan participants and beneficiaries. No one, including your employer, you union, or any other person, may fire you or otherwise discriminate against you in any way to prevent you

from obtaining a benefit or exercising your rights under ERISA. If your claim for a benefit is denied in whole or in part, you must receive a written explanation of the reason for the denial. You have the right to have plan review and reconsider your claim.

Further, under ERISA, there are steps you can take to enforce the above rights. For instance, if you request materials from the plan and do not receive them within 30 days, you may file suit in a federal court. In such a case, the court may require the Plan Administrator to provide the materials and pay you up to $100 a day until you receive the materials, unless the materials were not sent because of reasons beyond the control of the Administrator. If you have a claim for benefits which is denied or ignored, in whole or in part, you may file suit in a state or federal court. If it should happen that plan fiduciaries misuse the plan's money, or if you are discriminated against for asserting your rights, you may seek assistance from the U.S. Department of Labor, or you may file suit in a federal court. The court will decide who should pay court costs and legal fees. If you are successful, the court may order the person you have sued to pay these costs and fees. If you lose, the court may order you to pay these costs and fees; for example, if it finds your claim is frivolous. If you have any questions about your plan, you should contact the Plan Administrator. If you have any questions about this statement or about your rights under ERISA, you should contact the nearest Area Office of the U.S. Labor-Management Services Administration, Department of Labor.

SUMMARY INFORMATION ABOUT YOUR PLAN

Name of Plan: Dow Investment Benefit Plan.

Employer: The Dow Chemical Company, 2030 Dow Center, Midland, Michigan 48640, and certain of its U.S.A. subsidiaries.

The Plan's Employer Identification Number: 38-1285128.

Plan Number: 009.

Type of Plan: Tax Reduction Act Employee Stock Ownership Plan.

Plan Administrator: Administrative Committee, Dow Investment Benefit Plan, 2030 Dow Center, Midland, Michigan 48640, (517) 636-2448.

Trustee: The Cleveland Trust Company, 900 Euclid Avenue, Cleveland, Ohio 44101.

Agent for Service of Legal Process: General Counsel, Corporate Legal Department, The Dow Chemical Company, 2030 Dow Center, Midland, Michigan 48640. Service of legal process may also be made upon the Trustee.

Ending Date of Plan's Fiscal Year: December 31.

Termination Insurance: Due to the fact that benefits under the plan depend solely on the amounts in individual accounts, ERISA provides that the plan is not required to be (and is not currently) insured by the Pension Benefit Guaranty Corporation.

The CHAIRMAN. Next, we will call Mr. Jack Grady, president of Juice Bowl Products, Inc.

STATEMENT OF JACK GRADY, PRESIDENT, JUICE BOWL PRODUCTS, INC.

Mr. GRADY. Thank you, Mr. Chairman.

I am very pleased to have had an opportunity to come up and talk to this group on behalf of the smaller companies of America. You have heard this morning from a number of representatives tell you about the things that ESOP has been able to do for large and very large corporations.

Juice Bowl Products is a small company, and I think the experience that we have had with ESOP should be of considerable interest to you as you debate Senate bill 3241.

We are canners of single-strength juice from Florida, citrus processors. The company today is privately held, with approximately 78 percent of the stock being owned by myself and my family; 22 percent of the stock being held by Juice Bowl employees stockownership trust.

The company is 10 years old. I bought this company in 1967, from Mead-Johnson Corp., at a time when it had really no business. It had two things. It had facilities and it had a labor force.

I bought it with a small down payment and a slow note, and over the years, the note has been paid off and the company has prospered.

In the first year, we sold about $2 million worth of juice, and in the current year, we will sell $22 million worth of juice.

Over that time when I first took the company over, we had no label. We developed a small business packing for two of America's larger companies, the H. J. Heinz Co., and Libby. And, for a period of several years, our business grew at a slow rate and in 1973, we were doing business at a rate of about $5 million a year and we still had two customers.

Two things happened at that time. We introduced our own label and we instituted our ESOP program. Today, we have, as I stated, $22 million worth of business and over 1,800 customers.

In a competitive business such as ours, it is people more than financing, more than processing techniques, or more than uniqueness of product that makes for the difference in success or failure. You really have nothing secret when you produce orange juice. There are hundreds of companies doing it.

Here I sat with a growing company, the equity increasing, and becoming wealthy for the first time in my life, and yet here were a group of people who were contributing to that, and how do you share it with them?

How do you recognize the contribution of a shipping clerk who never considers his day done, who takes the same pride as a satisfied customer as the owner does and who worries just as much about a dissatisfied customer?

How do you reward an employee who comes in early to fix a machine that would have cost 50 percent in daily production if he had reported at the regular time?

What about all of the employees who have done things over and beyond the narrow definition of their job? The owner cannot, as a practical matter, pay them more money than his competition pays or his costs and prices will be out of line. You can thank them, but that becomes pretty hollow after awhile, as the company becomes more and more successful and the employee's reward is limited to his paycheck and perhaps a modest pension program.

Stock bonuses can be given, but the employee would pay taxes on them out of his current income and he would get no dividends on a stock which pays no dividends, and he would have no market for it.

We thought initially we had solved the problem at Juice Bowl with a profit-sharing trust, but it did not really work out. There was no direct connection between the company growth and the employee's interest in the trust. Also, the investment of the trust assets was a problem.

What happened to the money was dependent upon outside factors and the employees themselves had no influence on it.

In 1972, I first learned about Louis Kelso and his employee stock-ownership plan; 2 weeks later, I was in San Francisco and spent the better part of the afternoon listening to the views of this man who I

firmly believe has a clear vision of the kind of changes that are needed in the ownership of companies if capitalism as we know it is to survive.

The result of that talk was on August 1, 1973, Juice Bowl became the first company in Florida to have an approved ESOP plan. Next month, we will make our fifth contribution to the stockownership trust. At that point, our employees will own something over 20 percent of the company.

Besides ownership itself, the value of the shares that they have acquired have appreciated considerably since the initial transaction. Trust assets have increased from $150,000 to over $1 million at this point; 75 percent of the assets of our trust are invested in company stock and the balance is in cash and other equity. The stock is reappraised annually and the growth of the employees' balances have amounted, between company contribution and appreciation, to over 23 percent of their total earnings each year.

We do not have a formal retirement plan at Juice Bowl. However, the projections indicate that ESOP's will end up doing a much superior job for our people.

At the present time, the average balance for the 100 employees that are in this plan is something over $11,000 and employees who were in the plan from the beginning—and these are people whose earnings have probably never exceeded $15,000—have $35,000 and $36,000 in their balances.

The opportunity to develop team effort through ESOP appears to me to be endless. There is no employee who is not in a position to make the company better if he is really motivated to do so. There is no one, from the bottom up, who cannot improve his contribution if he is constantly on the lookout for opportunities.

The key is to unleash the extra thought and extra effort that is hidden away in every employee. We think ESOP does this.

The areas of cost, quality control, cost reduction, customer service, and in all of the places where it takes effort on the part of everybody to get the job done, we see tangible progress.

When a careless forklift truck driver spoils $15 worth of product, everyone who witnesses it knows that they, too, share in the loss.

Downtime on a high-speed production line is no longer a chance for an extra break. Instead, it is lost earnings which affect everyone's investment.

Recently we had a campaign to elicit cost savings ideas and received over 200 sound suggestions. There were no prizes offered; only the recognition of a good idea.

We feel that most of our people are genuinely interested in their company and in its progress, and that kind of an attitude is good for them, good for our customers, and good for our stockholders.

Perhaps the biggest weakness in the ESOP program as it currently exists, and one to which the current bill addresses itself, is that the material rewards are too far in the future for younger employees, particularly, to become excited about them. We have thought and experimented with quarterly bonuses which would somehow be tied to the shares of stock held by the trust in order to give our employees the feeling of benefits of ownership right now. Our tax accountants have discouraged this for fear that the IRS would treat such payments as dividends.

It is my feeling that the proposal to permit ESOP stock to receive tax-free dividends would add a valuable new dimension to ESOP. Quarterly checks which would increase, hopefully, over the years as the employees balances increased, would do a great deal to make the program more timely from the standpoint of employees, especially the younger ones.

I have worked in six organizations over the past 35 years. They have all been fine companies with good employee benefits, some with stock options, and all with the trimmings of modern personnel management. I can tell you, however, with a great deal of personal satisfaction that the degree of teamwork and employee cooperation that exists at Juice Bowl since we adopted the ESOP plan is of a significantly higher order than I have experienced elsewhere.

Increased stock ownership, regardless of how it is accomplished, is a healthy trend in our economy. The ESOP program is a unique way to enable all of the employees in a company to participate in its ownership.

I might say that, in my own case, it was a big change for me when I left one company I had been with 15 years that was a privately held company and in which I was never able to participate except through salary, and then joined a company that had a stock option plan. At that point I began to feel like a real part of the organization.

I believe that favorable action by this committee on the ESOP legislation before you will give a significant boost to an already growing trend to spread the ownership of American industry to more and more people.

Thank you very much.

The CHAIRMAN. Thank you very much, sir.

Any questions, gentlemen?

Senator BYRD. Thank you, Mr. Chairman.

How many employees do you have?

Mr. GRADY. We currently have about 150. There are 120 in the plan. The others will come in as they complete their year, but there is, in our business, a certain turnover of employees.

We are a seasonal business and we employ more people in the packing season.

Senator BYRD. And before being eligible for the plan, the employee needs to be with the company for 1 year, did you say?

Mr. GRADY. Twelve months. Essentially, it works on a date. It can be quicker than a year; it cannot be longer than 12 months.

Senator BYRD. Then does the individual automatically become a part of the plan?

Mr. GRADY. Yes.

Senator BYRD. If he automatically becomes a part of the plan, how does that—it is not tied in with his productivity or his workability.

Mr. GRADY. No, but he becomes eligible then to have set aside for him in the trust stock balances that are purchased for him each year. So he becomes, in essence, a stock owner of the company.

Senator BYRD. The stock instrument does not actually pass to him?

Mr. GRADY. He does not actually get the stock in his own name until he retires or until he leaves the company. It is vested at a rate of 10 percent per year.

So today, the employees that were in this plan from the beginning, all of them could walk out tomorrow and walk out with their full balances.

Senator BYRD. You make the point in your opening remarks that all of the other witnesses had been representatives of large companies and that yours is a small company. I think that is very important. I can see how it would work quite well, and should work quite well, with large companies, but smaller companies, I have a little more difficulty in understanding it.

For example, you say that your company is 78 percent privately owned, family owned, and 22 percent, roughly, employee. Suppose that gets to the point of 50–50. Then how does that affect the control of the company?

Mr. GRADY. Well, in theory, if you pass the 50 percent mark, the control of the company would pass to the employees. Actually, the way the current law reads, the stock remains in a trust and the trust is administered by a committee. That committee is appointed by the board of directors.

So under the present law, as it now stands, there would be no change in the control of the company.

Senator BYRD. Well, if among the private stockholders, there is a close division, would the employee stock ownership stock then be in a position to side with one group or side with another group and thereby control the company?

Mr. GRADY. Well, I think that the practical matter might be that whoever would control the board of directors, would, in effect, control the committee, dictate to the committee, and the committee would vote the stock of the ESOP so that the situation would really, in a sense, not change.

If you had a fight between the stockholders, the controlling stockholder would be able to dictate to the committee and, in that way, you would, in essence, vote the employees' stock.

Senator BYRD. The directors appoint the committee?

Mr. GRADY. The directors appoint the committee.

We are not at the point today where we have to wrestle with the problem of transfer of ownership from the family to the employee, but I would say this, that one of the values in a company of our size where you find yourself ending up with a substantial ownership of the company that is increasing in value and you face the proposition that if you were to die that this stock would have to be sold, and you would not know what would happen to your company, you would be able, this way, through a leverage proposition to make available that stock to the employees' trust so that that company would stay in the control of the same people that had it before.

And if you look ahead with our company, say 10 or 15 years, it would not bother me at all to see it move in the direction of South Bend Lathe Co. where the employees control the company. I would certainly rather leave that company to the people who have been my partners and my associates in the business than to throw it up for grabs and have it belonging to somebody else.

Senator BYRD. Is there any requirement as to composition of the committee?

Mr. GRADY. It is designated by the board of directors.

Senator BYRD. Designated by the board.

Mr. GRADY. And we designate a committee which is representative. We have one representative who is in the production end of the business and presumably represents that part of the people.

This committee—actually, the trustee votes the stock, and the trustee, in our case, is a bank in Winter Park, Fla. But they vote that stock at the direction of the committee.

The committee, in addition, of course, acts on retirees and the manner in which they take their benefits, and other administrative details of the plan, so, to that extent, the committee is one which is in contact, or in touch with, the broad employees' interests.

Senator BYRD. The committee is really the representative of the board of directors?

Mr. GRADY. That is right.

Senator BYRD. Thank you, sir.

Senator GRAVEL. Did the trust borrow money?

Mr. GRADY. Initially, the trust borrowed money.

Senator GRAVEL. And it borrowed the stock that was involved?

Mr. GRADY. That is right. Because we felt at the time—and I think this along the line that you were talking, Senator Gravel, we thought at the time that we wanted to give the trust a little more than just a purchase of stock. We wanted to give them a block of stock so that there would be some opportunity for appreciation as well as just adding the stock.

In other words, to start out and say, you own 3 percent of the company—that does not amount to much. But if you say you are essentially an owner of 20 percent of the company, then that is something else again.

Senator GRAVEL. Did the 25-percent limitation pose any difficulty in your financing in that regard?

Mr. GRADY. No.

Senator GRAVEL. But if you wanted to sell out totally to your employees that would pose a problem.

Mr. GRADY. It might.

Senator GRAVEL. So the expansion that I advocate to 50 percent would facilitate that sale to your employees, if you chose to do it?

Mr. GRADY. I think it is for the social good. To the extent that the money is used in this fashion, I see no particular benefit to a limitation.

Senator GRAVEL. I thank you, sir, and I want to commend you on your philosophy.

The CHAIRMAN. Thank you very much. That was a very fine statement.

[The prepared statement of Mr. Grady follows:]

STATEMENT OF JOHN P. GRADY, PRESIDENT, JUICE BOWL PRODUCTS, INC., LAKELAND, FLA.

My company is a canner of single strength juices and juice drinks. We have been in business for a period of ten years during which time our sales have increased from two million dollars the first year to $22,000,000 in the current year.

In 1973, we installed an Employee Stock Ownership Trust plan, and, currently, the employees' trust owns 22 percent of the stock. My family and I own the balance.

In a business such as ours success is heavily dependent on people and their attitude towards the company and their job.

Normal employee rewards such as wages, pensions, health benefits are worthwhile but they fail to give the employee a chance to participate in the wealth their efforts help produce.

Consequently, many fail to connect their work habits with the success of the company.

ESOP has proven to be logical means of giving the employee a "stake" in the enterprise he works for. The results, at least in our case, is that he begins to take an increasing interest in the success of his company and his contribution improves accordingly.

One shortcoming of the program is that the rewards of ownership do not pay off until the employee retires or leaves his job. This makes the appeal of the program less for the younger person.

Granting a company the right to pay dividends on stock held by the ESOP from pre tax earnings, provided the dividends were passed through to the employees, would make the ESOP of current benefit to the employee and increase the appeal of stock ownership.

The popularity of ESOP and employee stock ownership generally is on the increase. Action taken by the Senate Finance Committee and eventually the Congress to increase the attractiveness of ESOPs would give further impetus to this trend—which in my opinion is one of the healthiest developments in recent years for the free enterprise system.

STATEMENT

My name is John P. Grady. I am President of Juice Bowl Products, Inc., a canner of single strength juices and juice drinks.

Our company is privately held with approximately 78 percent of the stock being owned by myself and my family and 22 percent of the stock being held by the Juice Bowl Employees Stock Ownership Trust.

The company is 10 years old and has grown during that time from sales of approximately 2 million dollars in our first year to 22 million dollars in our most recent year.

In a competitive business such as ours, it is the people in the company more than the financing, the processing techniques, or the uniqueness of the product that makes the difference between success and failure.

How does the owner of such a company share the rewards with all of the people who have helped build a successful enterprise. How does he recognize the contribution of a shipping clerk who never considers his day finished—who takes the same pride in a satisfied customer that the owner does, and who worries just as much about a dissatisfied one?

How does the owner reward the employee who comes in three hours early to fix a machine that would have cost 50 percent of the daily production if he had reported at the regular time? What about all of the employees who have done things over and beyond the narrow definition of their jobs.

The owner cannot, as a practical matter, pay them more money than his competition pays or his costs and prices will be out of line. He can thank them, of course, but that becomes pretty hollow after a while when the corporate equity is growing and the employees reward is limited to his pay check and perhaps a modest pension program.

Stock bonuses might be given, but the employee would pay taxes on them out of his current income, would probably get no dividends, and would have no market for the stock.

We thought we had solved our problem at Juice Bowl Products with a profit sharing trust, but somehow it never worked out. There was no direct connection between company growth and the employees interest in the trust. Also, the investment of trust assets was a problem. What happened to the money was dependent upon outside factors and the employees themselves had no influence over it.

It was in 1972 when I first learned about Louis Kelso and his Employee Stock Ownership Plan. A few weeks later, I was in San Francisco and spent the better part of an afternoon listening to the views of this man who I firmly believe has a clear vision of the kind of changes that are needed in the ownership of companies if capitalism, as we know it, is to survive.

The result of that talk was that on August 1, 1973, Juice Bowl became the first company in Florida to have an approved ESOT plan. Next month we will make our fifth contribution to the Stock Ownership Trust. At that point, our employees will own something over 20 percent of the company. Besides the ownership itself,

the value of the shares owned have appreciated substantially from the basis on which they were acquired. Trust assets have grown from $150,000 to over $1,000,000.

Currently over 75 percent of the assets of our Trust are invested in company stock and the balance in cash and other equities. The stock is reappraised annually and the growth of the employees balances have amounted, between company contribution and appreciation, to about 23 percent of their total earnings each year. We do not have a formal retirement plan at Juice bowl. However, projections indicate that the ESOT will end up doing a much superior job for our people.

The opportunities to develop a real feeling of team effort through ESOT appear to be endless. There is no employee who is not in a position to make the company better if he is really motivated to do so. There is no one from the bottom man on up who cannot improve his contribution if he is constantly on the lookout for opportunities to do so.

The key is to unleash this extra thought and extra effort that is hidden away in every employee. We think ESOT does this. In the area of cost, quality control, cost reduction, customer service, and all the other places where it takes extra effort on the part of everybody to get the job done, we can see tangible progress.

When a careless forklift driver spoils $15 worth of product, everyone who witnesses this, knows that they too share in the loss. Down time on a high speed production line is no longer a chance for an extra rest break. Instead, it is lost earnings which affect everyone's investment. Recently, we had a campaign to solicit cost savings ideas and received over 200 sound suggestions. There were no prizes offered—only the recognition of a good idea. We feel that most of our people are genuinely interested in their company and its progress, and that kind of an attitude is good for them, good for our customers, and good for our stockholders.

Perhaps the biggest weakness sn the ESOT program, as it currently exists, is that the material rewards are too far in the future for the younger workers, particularly, to become excited about.

We have thought of paying quarterly bonuses that would be tied to shares of stock held by the Trust in order to give our employees a feeling of the benefits of ownership right now.

Our tax accountants have discouraged us for fear that the IRS would treat such payments as dividends.

It is my feeling that the proposal to permit ESOT stock to receive tax free dividends would add a valuable new dimension to ESOT. Quarterly dividends checks which would increase hopefully over the years as the employees balances increased would do a great deal to make the program more timely from the standpoint of the employees—especially the younger ones.

I have worked in six organizations over the past 35 years. These have all been fine companies with pension plans, selective employee benefits such as stock options and bonuses, and all the trimings of modern personnel management. I can tell you, however, with great personal satisfaction that the degree of teamwork and employee cooperation that exists at Juice Bowl since we adopted an ESOT plan is of a significantly higher order than I have experienced elsewhere.

Increased Employee Stock Ownership, regardless of how it is accomplished, is a health trend in our economy. The ESOP program is a unique way to enable all of the employees of a company to participate in its ownership.

I believe that favorable action by this committee on the ESOP legislation before you will give a significant boost to an already growing trend to spread the ownership of American industry among more and more people.

Thank you very much.

The CHAIRMAN. Next, we will call one of our members, Mr. Mike Gravel, to——

Senator GRAVEL. Mr. Chairman, could I just put my statement into the record? It is carrying coals to Newcastle to read it to you, and I would like to hear comments by these other witnesses. I know you have an obligation at 12 noon and so I would like to put my statement in the record.

The CHAIRMAN. I assure you, Senator, I will read every word of it.

[The prepared statement of Senator Gravel follows:]

STATEMENT OF SENATOR MIKE GRAVEL

Mr. Chairman: I want to talk about six trillion dollars. That is a rough estimate of the capital growth our economy will experience before the turn of the next century. The question we must ask ourselves is who will own this six trillion dollars? If we do not take some dramatic action soon it will be the same people who own our existing wealth; it will be the wealthiest 5 percent of our people who today control 50 percent of our wealth, it will be the same 1 percent which owned 25 percent of America in 1925 and who own 25 percent today, the same 1 percent who own 60 percent of all corporate bonds, 50 percent of all corporate stock and receive half of all corporate dividends paid in America. I repeat, half of all corporate dividends paid in America today go to 1 percent of the population. Unless we act soon the years will pass with the rich getting richer, and when nothing has changed by the year 2000 the nation will have us to blame.

Mr. Chairman, you have been the leader in addressing this vexing issue of capital concentration. I have lauded and supported your efforts. The employee Stock Ownership Plan, the TRASOP, and a range of other ESOP legislation was an important first step in the expansion of capital ownership. But, the ESOP alone is not sufficient to prevent the continuing concentration of American wealth. Its contribution limitations and narrow focus on employees does not allow for rapid expansion of stock ownership.

In order to effectively address the question of "who will own America's new wealth" we must adopt new programs with broader focus. We must move beyond programs benefitting employees exclusively, and we must do it soon. I have introduced a bill, S. 3223, which would allow the more rapid expansion of capital ownership in America. This bill provides for the expansion of stock ownership plans beyond employees to the general public and therefore I refer to it as the General Stock Ownership Plan.

The General Stock Ownership Plan would be sponsored by state governments, but would not involve state ownership. Indeed, the GSOP concept has become important to me and my state as an alternative to state ownership of private industry. The GSOP merely allows the use of a states' credit power to build equity ownership into its citizens.

HOW WOULD THE GSOP WORK?

1. A state government would establish a trust to hold and distribute stock to the people of the State.
2. Each resident of the state would have an equal interest in any stock acquired by the trust.
3. The trust would borrow money to invest in corporate stock.
4. Earnings from the investment would be used to pay off the loan.
5. The stock would be distributed to the individual beneficiaries, the citizens of the state, putting equity ownership and dividend income into the citizens' hands.

In putting legislative flesh on the GSOP bones I was aiming at two goals, rapid amortization of acquisition financing and the vesting of actual ownership in the hands of the citizens. To accomplish these objectives S. 3223 changes various provisions of the tax law with respect to a General Stock Ownership Plan adopted by a state. I would like to run down briefly the changes made by S. 3223 and then explore how these changes and the GSOP concept interface.

The major changes wrought by S. 3223 are as follows:

1. A new type of tax exempt trust may be created by the state to hold GSOP stock and act on behalf of the states' citizens to borrow money; buy, hold, and distribute stock, and pass through dividends.
2. Dividends and other payments by a corporation on stock held by the trust are deductible to the corporation (eliminating the corporate tax on these payments).
3. The trust must annually pay out all dividends received. The dividends can be used for trust expenses, debt retirement, or they may be passed through to the citizens of the state. Dividends would be taxable to a citizen/beneficiary when received from the trust.
4. The trust will hold stock on behalf of each citizen of the state and must distribute out the participants' stock upon request after the participant has been in

the plan for five years. Upon this distribution the recipient citizen has no tax liability.

5. However, when the citizen beneficiary sells his distributed stock he is taxed at ordinary income rates on the full proceeds of the sale.

6. The GSOP may use tax exempt bonding in its financing.

Much of what the GSOP does could be accomplished under existing law. It would merely require direct state ownership of the profitable enterprise with distribution of profits through a refundable state income tax credit. But this approach would not put real ownership in the hands of individuals and would put control of the investment in the hands of bureaucrats. The GSOP proposal by passing through voting rights on the trust stock puts control in the hands of the people who have an economic interest, rather than a political interest in the viability of the enterprise.

Our economic system is in deep trouble. Millions of our people do not have sufficient incomes to keep body and soul one. With the laudable goal of aiding these unfortunate many we have developed an incomes policy to provide a minimal standard of living. But, this incomes policy, paying government income to people unable to earn their way, costs money. To finance it we raise taxes, we take income away from producers and pay it to those who cannot produce. We transfer income, and this income transfer by the federal government has grown from $32 billion in 1967 to $188 billion in 1977. The burden of these programs threatens to swamp us and we look for ever more ingenious tax devices to raise the necessary funds. In final surrender we accept that an annual budget deficit of "only" $50 billion is acceptable. It is time for us to move away from playing Robin Hood. If our economic system is allowed to operate properly we need not take from the rich and give to the poor. If we develop programs such as the one I am suggesting the poor, even without jobs, would have sufficent income from capital to survive without transfer payments.

Let me show you what a GSOP might mean to Americans even on a limited scale. Assuming the adoption of my bill and the creation of a GSOP trust by the State of Alaska we might find the following:

1. The trustees negotiate for purchase of an interest in the Trans Alaska Oil Pipeline. Based on original cost and interest on equity it is not unreasonable to hypothesize that an interest of 15.8 percent could be purchased for approximately $1.5 billion.

2. To finance this purchase the GSOP issues $1.5 billion of tax exempt bonds. Moody average interest rate for all such bonds outstanding in March this year was about 5.5 percent. Annual debt service for the trust would then be about $123,820,000. The actual purchase would be made by a corporation organized by the trust and capitalized with the proceeds of the $1.5 billion loan to the trust.

3. Based on data filed with the Federal Energy Regulatory Commission by British Petroleum a 15.8 percent interest in the oil pipeline can be expected to generate annual revenues of $406,794,000 with the current tariff of $6.35 per barrel and the allocated throughout of 64 million barrels per year.

4. The costs of operation are projected by BP to be approximately $80,452,000 annually.

Using these numbers we find that if the corporation paid all its income to the trust (and therefore incurred no tax liability) after debt service each and every citizen of Alaska could receive a dividend check of $500 per year. And once the debt was retired this dividend could jump to over $800 per citizen per year 1978 dollars.

Now I understand that $500 per year may not mean much to many of you, but in parts of Alaska where the per capita income is less than $3,000 per year it can make a significant contribution. And this is just the beginning. Based on the same data a GSOP with a $10 billion investment (less than the projected cost of the proposed Alaska Gas Line) could guarantee $13,332 per year for a family of four. In addition to this income the family would own a block of stock which becomes more and more valuable as the debt is retired. They can borrow against it, use it for their financial statements so important in buying a home, and pass it on to their children. They may even sell it to cover catastrophic expenses if need be, just like you and I can do with our assets.

This proposal has been criticized as being state ownership. It is not. Ownership and control of the enterprise lies with the citizens voting their stock as any other shareholder. The potential for conflict exists between the GSOP and the sponsoring state government. It is with forethought that this is so. I am trying to create conflict and institutionalize it at an acceptable level. In fact,

this conflict presently exists between the government, in its role as regulator of our economic institutions, and those institutions themselves as they seek to perform, in an unfettered manner, their economic functions of allocating resources by rewarding productivity.

Unfortunately, the government is all powerful and at times oppressive. The excessive growth of government can be mitigated if we give the individual citizen a greater role in our economic institutions. With a stake in our economic success, the citizen may choose to exercise his collective power over government, which is absolute in a representative society, to stop it from excessive and harmful regulatory activity. By keeping the decision making power at the individual level we assure more checks and greater balance between those who govern and those who are governed.

In America there is a direct link between the capital concentration and the malaise which has stricken our economy. In order to address the economic injustice which is the symptom of high concentration of wealth the government pursues policies which hinder economic development. To achieve economic equity we transfer income from the upper and middle classes to the poor. We are faced with the dichotomy of cutting taxes for the rich to encourage capital investment and economic growth because they are the ones with the most capital to invest thereby insuring that they will continue to be so. At the same time we create nonproductive, noneconomic jobs and preserve existing but inefficient jobs because a majortiy of our people still reply on labor for their incomes. We have pursued policies which cannot help but bring about the demise of our economic system.

The fact is that the crisis in our economy today is tied directly to our attempts to treat an economic disease, insufficient income by attacking the sympton of insufficient jobs rather than the cause, a lack of capital diffusion sufficient to produce income for all our people.

As I said before, we must get moving. The key to both economic health and economic equity lies in spreading the ownership of the productive instruments of our society: our corporations. We can begin to treat the root of our problems if we can spread among all citizens the ownership of the companies which produce the nation's wealth. The General Stock Ownership Plan is one means of achieving this widespread ownership without confiscating the property of the wealthy and without creating a monolithic socialist state. It is up to us Gentlemen, who will own the next $6 trillion of America's wealth. The General Stock Ownership Plan is a step toward assuring that a large proportion of that new growth goes to a new group of capital owners.

I would like to take just a moment to address another bill which I have introduced and which is relevant to our discussions during this hearing. The bill is S. 3291 and it increases the contribution limitations for ESOPs from 25 percent of payroll to 50 percent of payroll. This bill raises a question as to the nature of the ESOP. ESOPs developed under the qualified pension provisions of the Internal Revenue Code in order to take advantage of tax exempt trust and the deductibility of employer contributions. However, the ESOP is not primarily a pension plan, but a means of broadening the ownership of American capital wealth. As such, the contribution limitations adopted from qualified retirement plans are inappropriate. By expanding these contribution limitations on ESOPs we make these plans a more flexible tool for the leveraged acquisition of stock on behalf of employees in small and medium size companies. Adoption of this legislation would be a small, but important step in encouraging the broadening of stock ownership through Employee Stock Ownership Plans.

The CHAIRMAN. We will next call Mr. Ronald L. Ludwig, Counsel for the Employees Stock Ownership Council of America.

STATEMENT OF RONALD L. LUDWIG, ESQ., COUNSEL FOR THE EMPLOYEE STOCK OWNERSHIP COUNCIL OF AMERICA

Mr. LUDWIG. Good morning, Mr. Chairman, and other members of the committee.

I am Ronald Ludwig, a San Francisco lawyer. I am here today representing the Employee Stock Ownership Council of America. With me is Mr. Robert Smiley, president of the ESOP Council.

The ESOP Council was formed last year as the first association to represent the interests of ESOP companies in Washington. The ESOP Council is also intended to serve as a forum for the exchange of ideas among ESOP companies, to work to promote the ESOP concept and to make ESOP's more readily usable by the companies that have them.

The ESOP Council certainly is grateful for the support of this committee, and particularly Senator Long, for all of the improvements in the ESOP laws that have been made over the past 5 years.

We believe that this is just a first step, however, and that now is the time to take additional steps to further create incentives to broaden the opportunities for "ownership sharing" among millions of new workers.

We also believe that not only is new legislation needed to create new incentives but, in addition, there are certain problems created by past legislation that can be corrected. Further, we believe that there have arisen in the past year or so certain regulatory problems that must be solved by the Congress.

Particularly, we refer to section 803(h) of the Tax Reform Act of 1976 which stated the intent of Congress regarding ESOP's and which directed the Federal agencies not to promulgate regulations and rulings which would hamper the use of ESOP's. We believe that the agencies have not complied with the intent of Congress in this regard.

We have been pleased over the past several months to provide assistance to the staff of the Finance Committee in the development in S. 3241 and in other matters relating to ESOP's. We strongly support this legislation and urge that it be enacted by Congress as quickly as possible. We believe that this will be an important step which will expand ESOP's from the point where several thousand companies have adopted them to the point where several hundreds of thousands of companies will adopt them, and many millions of workers will be covered by ESOP's.

Our written statement includes greater details on S. 3241 and the reasons that we endorse its provisions, but I just want to point out a few highlights. The provision to create a tax credit for ESOP's based on payroll, we think, is an essential provision. As mentioned earlier this morning by a number of companies, the investment tax credit provisions for ESOP's are not available to many companies. They are essentially limited to capital-intensive companies. We feel that it is critical for tax-credit ESOP's to be extended to those companies where the present investment tax credit provisions do not create a meaningful benefit. We believe that this will not only be of benefit to the 250 members of the ESOP Council, but also that it will enable hundreds of thousands of new corporations to provide "ownership sharing" for their employees.

We also believe that an increase in the additional investment tax credit for ESOP's to 2 percent is an important step, not only to create a more meaningful benefit to employees, but also to eliminate the matching employee contribution provision which were added by the 1976 Tax Reform Act. These provisions have created an administrative nightmare for the companies that have tried to implement them.

We also believe it is an important step to make tax-credit ESOP's a permanent part of the Internal Revenue Code. This will not only give greater permanence to the idea, but will also show the IRS that the Congress means to provide for ESOP benefits on a permanent basis.

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We strongly endorse the provision of S. 3241 which would modify the voting rights provisions of the present TRASOP law. We believe that the providing of voting rights to employees, although desirable, creates great problems for closely-held corporations which do not presently solicit proxies from their shareholders. The costs and burdens of providing for a passthrough of voting rights in companies that are not publicly traded far outweigh the benefits that can be derived by the employees in having the right to vote a small portion of the company's stock. This provision of S. 3241 follows the approach which was suggested by the staff of the Joint Economic Committee of Congress in 1976 to limit the voting passthrough provisions to publicly traded companies which are already soliciting proxies for voting from their shareholders.

S. 3241 also includes an important provision to permit an ESOP to offer an employee the election to receive a distribution of cash in lieu of stock. We believe that in a closely held company, many employess would like to sell their stock and receive cash or cash equivalents in order to provide for retirement income. The present regulations of IRS make this extremely difficult to accomplish, and we believe that this option would be of benefit to ESOP's and employees in closely held companies by simplifying the administration of ESOP's through allowing employees the choice of directly receiving cash or stock.

S. 3241 also includes a provision that permits an individual to claim a charitable deduction for a "gift" to an ESOP, either during his lifetime or from his estate after his death. We think this is an important provision which will create an alternative whereby wealthy shareholders may transfer their stock to employees as an alternative to transferring it to a private foundation, where it would be sterilized forever from the tax base. The charitable deduction provision of S. 3241 would allow the stock to go to people, retain that capital in the tax base, and broaden the ownership opportunities for employees.

The dividend deduction provision of S. 3241, we believe, is also important. One of the problems with ESOP's among employees has been that they receive no current tangible benefits, in that their stock is held for them until they retire or otherwise terminate employment. In many companies, passing through dividends, to employees under present tax law would not provide a substantial enough benefit to the employees to warrant the administrative expenses of passing those dividends through. We believe that a tax deduction provided to the corporation will not only encourage a passthrough of dividends, but will also provide for increases in the payment of corporate dividends to the employees. This should not diminish tax revenues because the dividends now received by the ESOP are received by a tax-exempt trust. This provision would merely pass on the tax to the employees, and would provide a current tangible benefit to the employees to help make their ESOP a more meaningful benefit to them.

S. 3241 also contains a number of provisions which will correct certain problems under existing law. I will not now address these issues, but the ESOP Council certainly suggests that the committee consider these provisions and act favorably upon them.

Last week, Senator Gravel introduced S. 3291, which would have the effect of raising the contribution limitations for ESOP's from 25 percent of payroll to 50 percent of payroll. The ESOP Council supports

such an increase and believes that it will be an important factor in increasing ownership opportunities for employees.

As far as regulatory problems, we believe that the IRS and the Department of Labor have not complied with the intent of Congress regarding ESOP's. It has been 2 years now since the tax-credit ESOP regulations were first proposed, and those regulations have not yet been finalized. We believe this delay is inexcusable and has caused a substantial detriment to companies that have been interested in the tax credit ESOP's.

We also believe that the regulations that the IRS finalized last September on leveraged ESOP's contain certain onerous provisions which are not within the spirit of section 803(h) of the 1976 Tax Reform Act. We understand that the Finance Committee staff has discussed these problems with Treasury and has attempted to get changes made, but we have seen no changes made.

In addition, the Department of Labor has been delegated (under ERISA) with the responsibility for promulgating regulations on valuation of stock for closely held corporations. Four years after the enactment of ERISA, valuation regulations have not yet been issued. These are important regulations for ESOP's and will serve to protect the interests of employees.

Our written statement also includes a number of other suggestions and cites a number of other problems. We will continue our discussions with the staff to help work out these problems and seek solutions. We certainly thank the committee for its past support of ESOP's and urge you to favorably consider future legislation which will help the ESOP concept.

Thank you.

The CHAIRMAN. Thank you very much, Mr. Ludwig. The fact that the program, the employees' stock ownership program, has been able to survive the bureaucracy in the Department of Treasury and the Labor Department speaks well for the program. It takes a really meritorious program to survive all the bureaucracy in those two departments.

Mr. LUDWIG. Senator Long, both the IRS and the Department of Labor have continually talked about the possible abuses of ESOP's. The problem is that they have done nothing to deal directly with such abuses. We have made a number of suggestions to try to prevent abuses. One, in particular, is a procedure whereby the IRS would issue advance rulings on ESOP transactions before they take place. They would review the terms of the proposed transaction, including the valuation of the company stock if it is not publicly traded and any terms of the loan that are used to finance the purchase of this stock, after review, IRS would rule in advance that the proposed transaction complies with the rules of ERISA.

The present attitude of the IRS is to tell companies:

> We cannot help you in advance. Go ahead and enter into your transactions. Of course, if the transaction is improper, we will come back after the fact and we will impose penalties and create liability for the fiduciaries of the plan.

I think this is grossly unfair. The only way to properly deal with abuses is for the IRS to create a procedure whereby the facts can be presented in advance. IRS and all the parties to the transaction can review it in advance to assure that the interests of the employees are protected and that the provisions of ERISA are complied with.

The CHAIRMAN. The Treasury and the Labor Department, in that regard, make me think of a mother who is so protective of her daughter that she insists on going along everytime the young lady goes on a date. Any young lady who had that much protection would have quite a difficulty to acquire a spouse who had any initiative, and it seems to me that perhaps we could help solve some of that by ourselves making the commitment that just, in the event somebody does abuse the ESOP program, that we will tax him retroactively, so that they need not worry.

To me, it is really a shame that these agencies—I guess with good intentions—have done so much to delay and impede a program that has so much to offer for the economy and for the workers of this company.

Mr. LUDWIG. Senator, I think that the agencies do not fully understand the intent of the Finance Committee and the Congress in promoting the ESOP concept, I think that the agencies would prefer that ESOP's would go away so that they will not have to deal with them. We know that 2 years ago the agencies were told what the intent of Congress is, and that ESOP's are to be promoted. The Congress has shown a great deal of evidence that it intends to promote the ESOP concept. It is about time for the agencies to listen to Congress, not impede ESOP's, and not smother them, but to promote them, to promote the proper use of ESOP's and to provide the guidance that the companies need in order to properly operate their ESOP's.

We just have not seen it happen.

The CHAIRMAN. Senator Gravel?

Senator GRAVEL. I have no questions.

I appreciate the fine testimony and echo the views of the chairman. We have to keep pushing the bureaucracy to act on this issue and that is all the more reason why we have to get another law on the books.

The CHAIRMAN. Thank you very much, Mr. Ludwig.

[The prepared statement of Mr. Ludwig follows:]

STATEMENT OF RONALD L. LUDWIG, COUNSEL, EMLOYEE STOCK OWNERSHIP COUNCIL OF AMERICA

INTRODUCTORY REMARKS

The Employee Stock Ownership Council of America ("ESOP Council") welcomes the opportunity to present testimony at the ESOP hearings. We wish to express our gratitude to the Senate Committee on Finance, and to Chairman Long in particular, for the past support of the ESOP concept. The past five years have resulted in major improvements in ESOP legislation and the adoption of new ESOPs by hundreds of companies. The ESOP Council believes, however, that the time has come for the Congress to take steps which will greatly expand the use of ESOPs by thousands of companies. The Expanded Employee Stock Ownership Act (S. 3241) introduced by Senator Long is an important step in the right direction.

The ESOP Council was organized last year as the first national association for ESOP companies. We have had a successful first year of operations, and we are adding new members daily to a membership which is now approximately 250, and includes several of the largest U.S. corporations. We believe that the ESOP Council is the only broad-based organization which serves to represent the interests of ESOP companies and their employees. A copy of our Statement of Purposes is attached to our written testimony.

The ESOP Council serves as a forum for the exchange of ideas among ESOP companies and as a national clearinghouse for ESOP information. We provide assistance to our members in effectively managing their ESOPs and in communi-

cating the benefits of the ESOP to their employees. We have also sponsored several ESOP studies in order to provide some qualitative and quantitative measures of the successful operation of ESOPs. Our First Annual Meeting, held in Los Angeles in May, was most successful and proved to be invaluable to the 140 attendees. We wish to thank Chairman Long for his participation in that meeting, through a filmed talk and through his sending a Finance Committee staff member to speak in person.

We believe that the ESOP Council has an important role in serving as a voice in Washington for ESOP companies. We have been privileged to provide assistance to the Finance Committee staff in the development of S. 3241 and in other matters relating to ESOP. We have also monitored other legislation effecting ESOPs, as well as actions of the Federal agencies which relate to ESOPs.

We believe that ESOPs have been well-received by companies throughout the country. We are aware, however, of various actions (and inaction) by government agencies which adversely affect ESOPs. Our testimony will address itself to the need for additional ESOP legislation, not only to provide additional incentives for companies to provide ownership-sharing for their employees, but also to resolve certain problem areas created by past ESOP legislation and by actions of the agencies. We strongly support the statement of Congressional intent relating to ESOPs which was included in Section 803(h) of the 1976 Tax Reform Act and urge the Congress to enact additional legislation to implement a national policy of broadened stock ownership through ESOPs and similar vehicles.

COMMENTS ON S. 3241

General

The ESOP Council strongly endorses the "Expanded Employee Stock Ownership Act of 1978" introduced by Chairman Long on June 23, 1978, as a means of implementing national policy regarding employee ownership. We were pleased to work with the staff of the Committee on Finance over several months to assist in the development of the provisions for S. 3241. We believe that the enactment of the Act would, for the first time, result in a statutory framework whereby ESOPs would be adopted by thousands of corporations, and millions of employees would be provided with the opportunity for sharing in the ownership of their employers. In addition, S. 3241 contains provisions which correct various ESOP problems under existing law.

The existing provisions of the Internal Revenue Code and the Tax Reduction Act of 1975 provide some tax incentives for the adoption of ESOPs. However, existing law has not yet resulted in the widespread implementation of ESOPs. We strongly urge the Congress to enact the provisions of S. 3241 in order to create incentives for hundreds of thousands of corporations to establish new ESOPs which will enable millions of new workers to share in ownership. We believe that the modest additional incentives under S. 3241 should go a long way toward accomplishing this objective. In addition, the provisions of S. 3241 would solve certain problems for ESOPs which the Internal Revenue Service has been unwilling to resolve.

Labor-Intensive ESOP

The provisions of Section 301(d) of the Tax Reduction Act of 1975 provided for an additional 1% investment tax credit for contributions to a tax credit ESOP (commonly called the "TRASOP"). Experience over the past three years has shown, however, that TRASOPs have largely been adopted only by the relatively small number of corporations which generate a substantial investment tax credit. Those companies which are not capital intensive have been unable to take advantage of the opportunity to establish a TRASOP.

S. 3241 creates an alternative to the additional investment credit, by permitting an ESOP to be established based upon a tax credit of 1% of covered payroll. This modest tax credit will accomplish the objective of prior ESOP legislation, by extending the availability of tax credit ESOPs to those companies which are labor intensive. The ESOP Council strongly endorses these provisions and believes that the objective of broadening capital ownership among all workers far outweighs any potential revenue loss resulting from this new tax credit.

Investment Tax Credit ESOP

The ESOP Council strongly endorses the provision of S. 3241 which increases the additional investment tax credit for ESOPs to 2%. In many cases, the existing 1% additional investment credit does not result in a meaningful benefit to

employees. Further, the additional ½% tax credit which requires matching employee contributions has not been successful, primarily because the matching provisions are extremely difficult to administer properly.

An increase in the additional investment tax credit for ESOPs should result in an increased interest in the TRASOP concept, while at the same time providing an additional incentive for capital formation. It is most appropriate for this additional incentive to provide the benefit of ownership sharing to the workers.

Tax Credit ESOP Included in Code

S. 3241 would add provisions to the Internal Revenue Code for the permanent recognition of tax credit ESOPs. The ESOP Council believes that this is an important step and that permanent provisions for such ESOPs will overcome the reluctance of certain companies to adopt an ESOP under temporary provisions.

The Congress has clearly demonstrated its intent to encourage tax credit ESOPs as a vehicle for providing stock ownership to workers. The time has now come to recognize such ESOPs as a permanent part of the Code. Perhaps such an action will place the Internal Revenue Service on notice that Congress believes that ESOPs are not a temporary part of Federal tax law but will be encouraged as a permanent vehicle.

Voting Rights

S. 3241 would modify the requirement for tax credit ESOPs that voting rights on employer stock be exercised by employees. This requirement has posed a major impediment to the establishment of tax credit ESOPs in the case of closely-held corporations and the ESOP Council strongly endorses the proposed change.

Under S. 3241, the requirement for voting "pass-through" would apply only to ESOPs of publicly-traded companies. This is the approach which was suggested by the staff of the Joint Economic Committee in 1976, following the ESOP hearings held by that Committee in December of 1975.

The present voting rights requirement for tax credit ESOPs poses a major problem for closely-held corporations which do not already provide for the solicitation of proxies for voting of Company stock. The ESOP Council believes that the burden and expense of soliciting proxies from employees in this situation simply is not justified. It is clear that in most cases the stock held by the ESOP will not represent a major portion of outstanding stock and will in no way affect the results of a shareholder vote. Any benefit to ESOP participants provided by voting rights is minimal and in comparison to the cost to the ESOP of providing such rights. We believe that the matter of voting right pass-through to employees should be left in the discretion of the sponsoring company—that is, voting pass-through for ESOPs of closely-held corporations should be an aspect of ESOP design rather than a requirement of law.

Cash Distribution Option

The ESOP Council strongly recommends the adoption of the provision in S. 3241 which authorizes an ESOP to provide an election by a participant to receive a distribution of cash in lieu of stock. In the case of closely-held corporations, it is common for an employee receiving a distribution of stock to be granted a "put option" to sell his stock back to the ESOP or the sponsoring company. In fact, the ESOP loan regulations require a put option in some situations.

Experience has shown that participants in an ESOP of a closely-held corporation generally elect to exercise a put option to sell their stock. In many cases, the result of this repurchase of stock is the equivalent of a cash distribution from the ESOP. The proposed provision for a cash distribution option would alleviate the burden and expense of issuing a stock certificate where the shares are to be immediately resold and would greatly simplify the administration of an ESOP. So long as the option to receive cash is left with the employee, there should be no objection to this provision.

In the past, the ESOP Council has urged the Internal Revenue Service to permit a cash distribution option for ESOPs. We believe that existing law would permit such a change in the regulations. IRS, however, has never looked favorably upon ESOPs and has refused to allow such an option. Accordingly, we urge that legislation be enacted to provide relief to ESOPs in this matter.

Charitable Deduction

S. 3241 would extend charitable contribution treatment under the Code to a "gift" to an ESOP. We strongly endorse this provision and urge the Congress to include it in ESOP legislation. This provision would present an attractive alternative for a wealthy shareholder who may otherwise leave his stock to a private foundation or other charitable institution. A transfer to an ESOP would keep such assets within the tax base rather than "sterilizing" the amounts forever in a tax exempt organization.

We are aware of a number of wealthy shareholders who would take advantage of the charitable deduction provision of S. 3241. We believe that the provision would be an important additional incentive and method for allowing broadened stock ownership opportunities for corporate employees.

Dividend Deduction

S. 3241 would permit a corporate tax deduction for dividends on Company stock which are "passed through" an ESOP to participating employees. We strongly support this provision as a method of allowing current tangible benefits of stock ownership to be enjoyed by workers. Existing law permits dividends to be passed through to employees under an ESOP, but the dividend deduction would provide a tax incentive for companies to effect dividend payments to the workers.

One of the biggest obstacles to the effective use of an ESOP as an employee incentive plan is the fact that the benefits of stock ownership are largely deferred until retirement, death or other termination of service. The pass-through of dividends to ESOP participants will allow employees to receive a current benefit on the same basis as direct shareholders receive dividends. In order to jutsify the administrative expense of a dividend pass-through and to encourage companies to provide this benefit to workers, a deduction for such dividends is appropriate. The result would be the widespread participation by employees in stock ownership benefits under ESOPs.

Other Provisions of S. 3241

The present rules for tax credit ESOPs require that every employee who participated in the ESOP at any time during the year be entitled to share in that year's ESOP contribution. S. 3241 would change this requirement to allow allocations to be made only to participants employed at year-end. The ESOP Council strongly supports this change, as it will provide greater ease in administration of an ESOP and will allow the full benefit of the tax credit to be provided to current employees (rather than to former employees in part).

S. 3241 would require that at least one-half of the tax credit for ESOP contributions be represented by "new issue" stock. Inasmuch as some companies have adopted ESOPs in reliance on the rules of the 1975 Tax Reduction Act which extend through 1980, we suggest that the requirement for "new issue" stock be modified to recognize this problem. Our recommendation is to allow each company electing the ESOP tax credit to elect ESOP contributions *up to* the 2% additional investment tax credit or the 1% of payroll credit (rather than requiring an "all or nothing" election). For years prior to 1981, the "new issue" stock requirement should apply only to ESOP contributions in excess of the current 1% additional investment credit. For years after 1980, and for all ESOP tax credits based on covered payroll, the requirement for one-half of the contribution being represented by "new issue" stock could be maintained in order to recognize the use of an ESOP as a vehicle for capital formation.

Other provisions of S. 3241 will correct certain problems relating to the tax treatment of ESOP contributions and distributions. The ESOP Council endorses these technical changes and believes that they will result in greater simplicity for ESOP participants and will correct certain problem areas under existing legislation.

OTHER PENDING LEGISLATION

S. 3291

Last week Senator Gravel introduced S. 3291 for the purpose of raising the contribution limitations for ESOPs from 25% to 50% of covered payroll. The ESOP Council supports the concept of increased ESOP contributions as a way to increase the opportunities for ownership-sharing by employees.

Although an increase to 50% of payroll is quite large, we believe that added incentives will be beneficial to the objective of providing greater stock ownership by workers. The provisions of S. 3291 would be a welcome addition to the Ex-

panded Employee Stock Ownership Act of 1978 and is consistent with the intent of Congress and the objectives of the ESOP Council.

ERISA Improvements Act

S. 3017 was introduced several months ago by Senators Williams and Javits to make changes and improvements to ERISA. The ESOP Council suggests that S. 3017 be modified to provide certain beneficial relief to ESOPs under existing provisions of Federal and state securities laws.

We suggest that S. 3017 provide that all stock distributed by an ESOP maintained by an SEC reporting company be deemed "unrestricted", in order that employees will not be subject to resale restrictions under Rule 144 under the Securities Act of 1933. We suggest that Section 12(g) of the Securities Exchange Act of 1934 be clarified to assure that stock held by an ESOP will be deemed to be held only by one shareholder, in order to avoid the possibility of an ESOP forcing a company to register with SEC under that Act. We suggest that S. 3017 provide that normal elections by employees regarding ESOP participation and distribution not be deemed a securities offering under the 1933 Act. Finally, we recommend that open-market purchases of stock by an ESOP not be subject to the restrictions imposed under SEC Rule 13e–2. These changes would facilitate the operation of ESOPS in both publicly-traded and closely-held companies.

Finally, provisions should be added to S. 3017 to alleviate certain problems for ESOPs under state "blue sky" laws. These problems will be discussed below.

S. 2788

On May 15, 1978, the Committee on Commerce, Science and Transportation reported the Regional Rail Reorganization Act Amendments of 1978. Included in S. 2788 was a provision requiring the Consolidated Rail Corporation to establish an ESOP for its employees in conjunction with the proposed additional Federal financing of Conrail. The ESOP Council strongly endorses the concept of requiring employee stock ownership as a condition for corporations receiving Federal assistance.

S. 3223

On June 22, 1978, Senator Gravel introduced a bill authorizing tax-favored treatment for General Stock Ownership Plans. The GSOP concept is related to the ESOP concept and provides a vehicle for the broadening of stock ownership among all citizens.

Although S. 3223 does not provide any additional incentives for ESOPs and will not directly affect ESOP companies, the ESOP Council endorses any technique which results in the diffusion of capital ownership on an equitable basis.

H.R. 12094

The proposed Voluntary Job Preservation and Community Stabilization Act would provide for a new Federal financing program for troubled companies and would encourage the adoption of ESOPs in connection with this financing. The ESOP Council endorses any program which encourages the creation of new ESOPs and believes that the Congress should give preference under any Federal financing program where an ESOP is utilized to provide ownership-sharing opportunities for workers.

REGULATORY PROBLEMS FOR ESOP

General

The ESOP Council believes that the Federal agencies have not fully complied with the mandate of section 803(h) of the 1976 Tax Reform Act, in which the Congress expressed its intent to encourage the adoption of ESOPs and cautioned that regulations and rulings of the agencies were not to hinder the establishment and operation of ESOPs. Notwithstanding Section 803(h), both the Internal Revenue Service and the Department of Labor, those agencies charged with the responsibility for the enforcement of ERISA, continue to maintain their past hostile attitudes toward the ESOP concept.

It is clear that Congress has found ESOPs to be consistent with the objectives of ERISA. The intent of an ESOP as an employee benefit plan is to provide employees with the opportunity to share in the ownership of their employer. For some yet unexplained reason, both IRS and DOL continue to be skeptical of ESOPs and have not accepted the clearly stated intent of Congress. The agencies have continued to impose oppressive requirements for ESOPs, have failed to

promulgate sufficient guidelines necessary to the proper operation of ESOPs, and have made little effort to attempt to deal directly with the potential abuses of ESOPs. Rather, the agencies appear to take the position that all ESOPs are inappropriate as employee benefit plans. It appears that the message of Congress regarding ESOPs has not yet been effective in obtaining an appropriate response from the agencies.

Put Option Requirement under ESOP Regulations

On September 2, 1977, final regulations were published relating to "leveraged ESOPs."To a large extent, these regulations reflected the "instructions" set out in the Conference Report under the 1976 Tax Reform Act for the rewriting of the onerous ESOP regulations proposed on July 30, 1976. There are, however, certain remaining problems for ESOPs under the final regulations, reflecting a failure to fully comply with the intent of Congress.

For example, the ESOP loan regulations impose an onerous "put option" requirement applicable to certain stock distributed to employees from an ESOP. The proposed regulations had required a two-year duration for the put option. The Conference Report had suggested a put option period "considerably shorter" than two years. The response of IRS was to require a fifteen-month put opion under the final regulations. It is certainly doubtful that fifteen months is "considerably shorter" than two years. It is also clear that a put option for a shorter period is sufficient to protect employees.

The put option provisions of the proposed regulations did not permit an installment for tendered stock. The Conference Report suggested that installment payments over a "reasonable period" should be permitted. The final regulations generally require installment payments to be no longer than five years under an ESOP put option, while at the same time IRS permits other qualified plans of deferred compensation to make installment distributions over periods of fifteen years or longer. Further, the regulations require that installment payments under an ESOP put option be "adequately secured", while no such requirement is applicable to installment distributions under other plans. This requirement for "adequate security" has the effect of changing the status of an ESOP participant from that of shareholder to preferred creditor, a result which is clearly not supported by the law and should be modified.

Finally, the put option requirement of the final ESOP regulations makes it impossible, in some situations, for national and state banks to utilize "leveraged" ESOPs for the benefit of employees. Both IRS and DOL have acknowledged this problem, but both have been unwilling to provide relief from the onerous requirements. It appears that the agencies will not reaet favorably when presented with ESOP problem areas unless specifically directed to do so by Congress.

The cash distribution option provision included in S. 3241 should solve certain of these problems relating to the put option requirement for ESOPs. Interestingly, such an option has been suggested to IRS on numerous occasions over the past three years. It is clear that such an option would be permissible under existing Income Tax Regulations, but IRS continues its refusal to make interpretations in the ESOP area which will avoid problems for ESOP companies and participating employees. Again, we must seek the assistance of Congress in solving an ESOP problem which IRS could easily solve itself under existing law.

TRASOP Regulations

Regulations relating to tax credit ESOPs under the 1975 Tax Reduction Act were first proposed in July, 1976, at the same time as the regulations relating to leveraged ESOPs and ESOP loans. These regulations have not yet been finalized. It has been almost two years since the final rules for tax credit ESOPs were included in the 1976 Tax Reform Act. IRS has provided absolutely no further guidance in this area.

We believe that this delay is inexcusable. We believe that the absence of guidelines from IRS has caused many companies to elect not to establish tax credit ESOPs. Perhaps it would be appropriate to include in S. 3241 a provision requiring IRS to publish its regulations within a specified time period, in order to avoid the problem of companies not providing ownership-sharing opportunities to employees merely because IRS has failed to provide guidelines.

Valuation Regulations

Section 3(18) of ERISA authorizes the Department of Labor to prescribe regulations for determining the "fair market value" of company stock to be acquired by an ESOP. In the event ERISA's definition of "adequate consideration"

is not satisfied, the sale of stock to an ESOP by a party in interest may be a prohibited transaction.

It has been almost four years since the enactment of ERISA, and no guidance on the issue of valuation has been provided by DOL. We believe that, as a minimum, DOL could have issued temporary regulations stating that IRS rules for valuing corporate stock would be applicable to ESOP transactions.

The valuation area is critical in the case of an ESOP for a closely-held corporation which has no "generally recognized market" for its stock. Both IRS and DOL have often stated that valuation of closely-held corporate stock is an area of possible abuse of ESOPs. Yet DOL has failed to provide the guidance required by ERISA. Perhaps the DOL approach will be to provide *no* guidance, then to audit (along with IRS) and find ERISA violations, and then to return to Congress with examples of abuse which justify "anti-ESOP" legislation. If the agencies are seriously concerned about preventing abuses and protecting the interests of ESOP participants, the valuation regulations should be made a matter of top priority within DOL. How long must we wait for necessary guidance?

Advance Approval of ESOP Transactions

The ESOP Council recognizes the potential for abuse in ESOP transactions. We recognize the need to assure that ERISA's provisions are applied to protect the interests of ESOP participants. We agree with the direction of the ERISA Conference Report that ESOPs be subject to "special scrutiny" and the direction of the Conference Report under the 1976 Tax Reform Act that ESOP regulations "should deal directly with possible abuses." Both IRS and DOL have, in our opinion, failed to provide a mechanism to effect this stated intent of Congress.

We suggeest, therefore, a legislative remedy to this problem. This remedy has been suggested to the agencies in the past, but both DOL and IRS have failed to implement it. We suggest that IRS be required, by legislation, to establish a procedure for advance approval of ESOP transactions. Such a procedure would allow the parties to a proposed sale of stock to an ESOP to present the deails of the transaction (including valuation, terms of purchase, loan terms, etc.) to IRS in advance, in order to receive a ruling that such transaction will not be a prohibited transaction under ERISA. Such a procedure would merely be an extension of the existing advance rulings procedure to include a determination of factual issues, such as valuation.

The existence of an advance approval procedure would place IRS in the position of being able to protect the interests of ESOP participants, by reviewing the proposed transaction terms in advance. In addition, all partise to the transaction would have the assurance in advance that there is no violation of ERISA's prohibited transaction rules. If IRS and DOL are now able to make such determinations after-the-fact, through the audit procedure, there is no reason the same determinations cannot be made in advance.

It is clear that no regulations or rulings can be published to provide complete guidance on the propriety of every ESOP transaction. Particular facts and circumstances of each case will be unique. It is only through an advance approval procedure, administered in good faith by IRS, that potential abuses of the ESOP concept can be protected against. In this way, ESOP transactions will be structured properly and employees will be provided with the opportunities for ownership-sharing under the assurances that ERISA's protections will be complied with.

Prudence Regulations

The Department of Labor published proposed regulations under ERISA's "prudent man" rule last April. Although the Congress had stated in Section 803 (h) of the 1976 Tax Reform Act that ESOPs were not to be treated as "conventional retirement plans", the proposed prudence regulations made no attempt to recognize the special purpose of an ESOP as an employee benefit plan which provides for stock ownership for workers.

Last month, the ESOP Council submitted comments to DOL pointing out the omission in the prudence regulations of the special nature of ESOPs and other plans designed to invest in employer securities. We believe, however, that DOL will again fail to provide sufficient assistance to ESOPs and will continue its position that ESOPs are improper as employee benefit plans. It is only when Congress specifically takes action that the agencies are somewhat responsible. Perhaps

amendments to ERISA's prudent man rule, specifically recognizing the purpose of ESOPs as an owership-sharing technique, is the only way to force DOL to respond properly. It is our position, however, that Congressional intent regarding ESOPs under ERISA has been made clear and that it is merely the hositle attitude of the agencies, and the repeated disregard of Congressional intent, that has caused DOL to omit protective language for ESOPs from its prudence regulations.

ASPR Guidelines

For several years the ASPR Committee of the Department of Defense has been studying ESOPs for the purpose of developing guidelines for ESOP contributions as an allowable cost under government contracts. Proposed guidelines have been circulated which include unreasonable restrictions on reimbursement for ESOP contributions. In addition, several defense contractors have faced serious problems in obtaining allowances for ESOP contributions which appear to satisfy existing ASPR rules.

The ESOP Council has submitted comments to the ASPR Committee objecting to the restictive rules proposed for ESOPs. We believe that the present rules applicable to qualified pension and profit sharing plans adequately cover allowances for ESOP contributions and that no special restrictions are needed for ESOPs. Hopefully, final guidelines will reflect a more realistic position by the Department of Defense and will not result in the denial of ownership-sharing opportunities for employees of defense contractors.

Problems under State "Blue Sky" Laws

Section 514 of ERISA generally supersedes all State laws relating to employee benefit plans. The purpose of this "preemption" provision was to allow ERISA to be the controlling law applicable to such employee plans. However, ERISA's preemption provision specifically does not supersede State securities laws, and this has created problems for ESOPs in several states.

In California, there has existed for many years an exemption from the requirement for "qualifying" company stock to be issued to an employee plan. Last May, the Department of Corporations proposed the deletion of this exemption, based upon the "problems" caused by the increased use of ESOPs. Such action would have a disastrous effect on existing ESOPs in California, would pose a serious impediment to the adoption of new ESOPs in California, and would deny many California workers the opportunity for ownership-sharing. If the change in the California Corporation Securities Rules is made, ESOP companies in California may be forced to provide an "offering circular" to employees as a condition of receiving a "permit" from the Department of Corporation and may face additional expenses and delays in receiving clearance to issue stock to an ESOP. Further, it is possible that the Department of Corporations will require that voting rights on company stock be passed-through to ESOP participants and that the Department will make its own determination of "fair market value" for ESOP purposes. Many ESOPs will be unable or unwilling to comply with such requirements.

In New York State, the Attorney General announced in the Spring of 1977 that ESOPs in New York must register as a "broker-dealer" or must formally request an exemption from such registration requirement. This policy has resulted in additional expense to New York companies (and companies with New York employees) in establishing an ESOP.

The ESOP Council believes that these developments under state blue sky laws have created unwarranted additional burdens and expenses on ESOP companies which provide no additional protection to ESOP participants. ERISA was designed by Congress to provide for protection of employee rights under employee benefit plans, and it was not intended that the states would continue to regulate such plans through state securities laws. We request that Congress take some action to alleviate this problem.

S. 3017, the ERISA Improvement Act of 1978, includes a provision to supersede the effect of the antifraud provisions of Federal and State securities laws as they may relate to employee benefit plans. The ESOP Council has engaged in discussions with the staff of the Human Resources Committee to expand the provisions of S. 3017 to alleviate certain problems for ESOPs. We suggest that ERISA be amended to make it clear that state securities laws cannot be applied to regulate the operation of employee benefit plans, such as ESOPs, which are designed

to invest in employer securities. We believe that the intent of Congress was to leave such regulation as a matter exclusively provided for under ERISA and that no valid purpose is served by allowing regulation of ESOPs under state securities laws.

THE ESOP COUNCIL OF AMERICA: WHAT IT IS, HOW IT WORKS, WHAT IT CAN DO FOR YOU

The Employee Stock Ownership Council of America (ESOP Council) is a non-profit trade association with a current potential membership of over 1,000 companies ranging from industrial giants to firms with fewer than 50 employees who either have ESOPs or some variation of an ESOP. Associate Memberships are also available to individuals or employers not qualifying for full membership in the Council.

Founded in 1976, and incorporated in 1977, the Council is based on the principle that the promotion of employee stock ownership is an important means of fortifying the American system of free enterprise.

Its principal functions are fivefold:

1. To provide a forum for the exchange of ideas among companies which have ESOPs (or some variation of an ESOP) and practitioners involved with ESOPs, so as to provide a better understanding to all concerned. The Council expects that a better understanding of ESOPs by all concerned will also engender a better understanding of the ESOP concept by the Congress and regulatory officials and will promote a more effective use of ESOPs by U.S. industry.

2. To furnish members a well-rounded selection of communications materials. It is the Council's intent to provide film strips, posters, payroll stuffers, house organ copy, and other useful material. The Council also hopes to publish a highly readable periodic magazine or newsletter to keep management up to date on current developments in employee stock ownership.

3. To serve its membership as the voice in Washington for employee stock ownership plans. Members of the Council have already been successful in combating poorly conceived legislative and regulatory proposals. The Council expects that a large majority of its members will rely on the Council as the best means of getting their views across to the Congress.

4. To provide its members with technical "know-how." Members will receive information on current practices; a "how to do it" manual, when it is designed, at a nominal price; recommended administrative procedures; counseling information on distributions; and general knowledge distilled from the accumulated experience of its membership. It will annually poll members, expert consultants, attorneys, banks, and others active in the field in order to keep current. Knowledge thus acquired is then made available to the Council's membership, either through its regular communications channels or in response to member inquiries.

5. To serve as the authoritative national source of employee stock ownership information for news media. The Council will conduct an ongoing campaign to promote the idea of employee stock ownership as a means of increasing profitability and productivity. This major public relations service demonstrates that employee stock ownership (1) allows workers to achieve maximum personal satisfaction, (2) develops a sense of partnership in business, and (3) provides greater rewards for all concerned.

We are confident you will discover the Council provides its members, free of charge, many materials and services, the value of which far exceeds the modest membership dues.

While the members of the Council have been highly effective on behalf of the employee stock ownership concept in the past, experience has shown that an enlarged membership will enable it to widen the scope of its services and to be even more influential for the business community. It is therefore actively seeking new members and Associate Members. If you feel that its functions and services can fit into your corporate benefit structure in a beneficial way, please use the enclosed membership application, or write or call the ESOP Council of America at its national headquarters at 11661 San Vicente Boulevard, Suite 901, Los Angeles, California 90049, (213) 826-1584.

The CHAIRMAN. Our next witness is Mr. Louis O. Kelso. He was in the room a few moments ago; we will come back to him.

We will call Mr. Jeffrey R. Gates, of Hewitt Associates.

STATEMENT OF JEFFREY R. GATES, HEWITT ASSOCIATES

Mr. GATES. Mr. Chairman and Senator Gravel, I am with Hewitt Associates, an independent consulting firm. For the past 2 years, our research department has conducted a TRASOP survey. We surveyed the Fortune 1,000 as well as the 50 largest Fortune-listed commercial banking, life insurance, diversified financial, retailing, transportation, and utility companies.

The purpose of the survey was to determine the prevalence of TRASOP's and to get some sense of the characteristics of those plans which have been adopted.

In the chocolate brown testimony that you have, there are a few charts that might be helpful if you would follow along with me.

We found in 1977 that, of the 493 companies that responded to our survey, 12.6 percent of them had TRASOP's, or soon would have. In this past year's survey, that increased to 28.7 percent or a total of 152 TRASOP companies at this point.

I think it is safe to predict that should the new legislation be adopted, that increase over 1 year would be even more dramatic in the following year.

We also found that of the utilities responding, approximately 85 percent of the large utilities in the United States now have TRASOP's. In the fuel industry, 77 percent now have TRASOP's, and in the paper, fiber, and wood industry, 63 percent of our respondents now have TRASOP's.

We are also finding strong TRASOP prevalence in certain capital-intensive industries, including transportation, chemicals, steel or metals and mining, food processing, and beverages, and some retail industries.

And, not surprisingly, TRASOP prevalence is largely a function of company size, as we chart for you by annual sales, with over 40 percent of surveyed TRASOP's being in companies with sales over $1 billion. That drops to under 15 percent when you get down to companies with sales of under $500 million.

You might notice that the most dramatic increase over the past 2 years has been in companies with sales under $500 million. There is an increase of about 400 percent over last year's survey. Again, it is safe to predict that the prevalence, will increase dramatically should the new legislation be adopted.

One of the most interesting things that we have found is in the people who are eligible to participate in the TRASOP. As you know, there is a $100,000 covered compensation limit. We found in 1977 that 15 percent of the plans were using a lower compensation ceiling in order to give larger benefits to the lower paid.

In 1978, that increased to 30 percent of the plans. So there seems to be a tendency to favor the lesser paid employee with TRASOP contributions.

Another way to get a similar result is to exclude certain highly paid people in your definition of eligibility. We found that several of the plans are now excluding officers or directors or members of certain other stock option plans.

We also found it of interest that the average annual per-employee benefit seems to run to less than $200—roughly 63 percent of surveyed companies expect less than $200, and about 10 percent expect more than $500. That would be for the 1977 benefit.

The last finding that I extracted concerns the matching TRASOP, the contributory TRASOP. All the corporations have complained about the fact that the final TRASOP regulations have not been issued governing the matching feature. And still we have no idea when they will be coming out. In 1977, only 2.5 percent of the plans, which was, at that time one plan, had a contributory TRASOP. That has now increased to roughly 16 percent of the plans, but that is still only 23 plans having the matching feature, and 8 of those are, predictably, utilities where the benefit is substantial.

That really summarizes our findings. There is more detail in the larger report which you have before you.

The CHAIRMAN. Well, thank you very much. I was hoping someone would do a study of this sort. What you have done indicates that the greatest interest and the greatest activity has been in the areas where the companies were capital intensive.

So in view of the fact that this tax reform ESOP had to do with the investment tax credit, it stands to reason that that is where you would find the most interest. Frankly, I am pleased to see that in those very capital-intensive areas that they have a high degree of participation.

Mr. GATES. They have found in capital-intensive industries that they cannot really afford not to do it.

The CHAIRMAN. Well, I would hope that if we are able to extend this to those, in a reasonably beneficial fashion, to those that are labor intensive, as we propose in this legislation, that we would see similar participation in the labor-intensive areas.

Mr. GATES. We put out a notification in the form of a special report to our clients on your pending bill. We got substantial feedback as to great interest among labor-intensive corporations that they were following this very closely and they were quite interested.

The CHAIRMAN. Thank you very much.

Senator Gravel?

Senator GRAVEL. I have no questions.

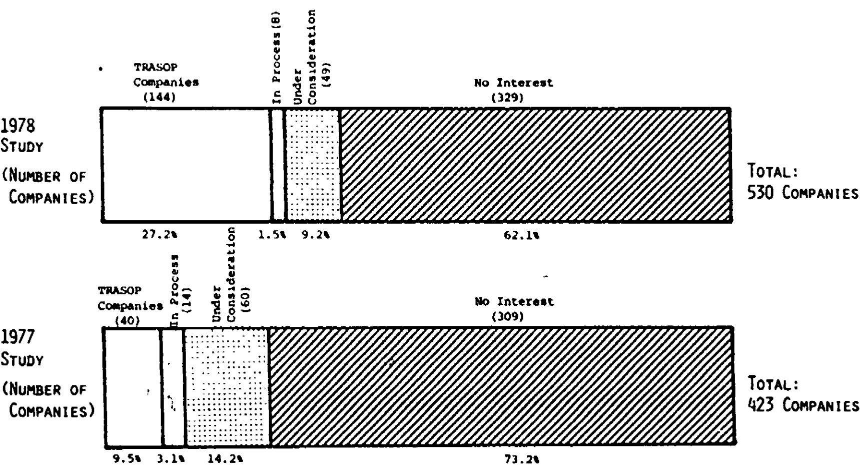
The CHAIRMAN. Thank you very much, Mr. Gates.

[The prepared statement of Mr. Gates follows:]

STATEMENT OF JEFFREY R. GATES, HEWITT ASSOCIATES, BEFORE THE SENATE COMMITTEE ON FINANCE, REGARDING S. 3241, "THE EXPANDED EMPLOYEE STOCK OWNERSHIP ACT OF 1978", JULY 19–20, 1978

SUMMARY OF PRINCIPAL POINTS

I. TRASOP PREVALENCE IN FORTUNE-LISTED COMPANIES



SOURCE: HEWITT ASSOCIATES SURVEY OF TAX REDUCTION ACT ESOPs - 1978, 1977 (COPYRIGHT)

II. TRASOP PREVALENCE BY INDUSTRY GROUP

TOTAL SURVEY PARTICIPANTS:
1978 - 530 COMPANIES
1977 - 423 COMPANIES

UTILITY INDUSTRY:	84.2% OF 38 COMPANIES IN 1978 SURVEY. *69.2% of 26 companies in 1977 survey.*
FUEL INDUSTRY: (OIL OR COAL)	76.9% OF 26 COMPANIES IN 1978 SURVEY. *41.6% of 24 companies in 1977 survey.*
PAPER INDUSTRY: (PAPER, FIBER AND WOOD)	63.0% OF 27 COMPANIES IN 1978 SURVEY. *44.4% of 9 companies in paper industry only.*

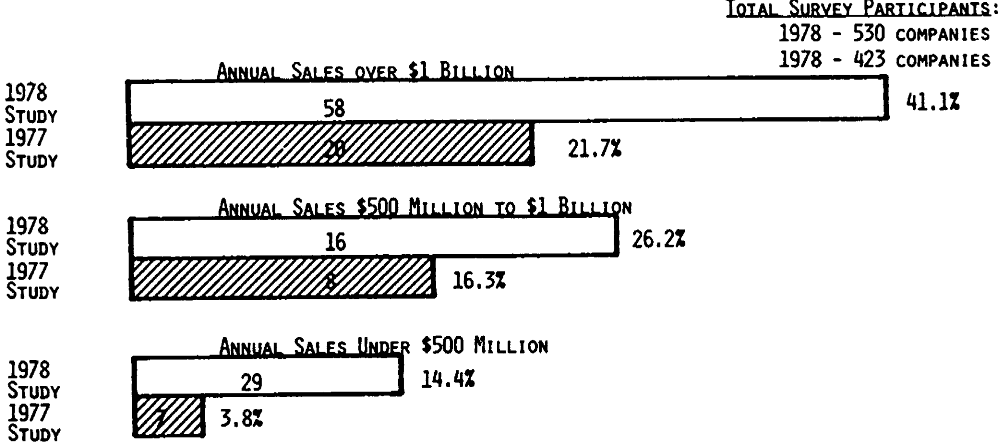
IN 1978, RELATIVELY STRONG TRASOP CLUSTERINGS WERE ALSO FOUND IN THE FOLLOWING INDUSTRIES:

TRANSPORTATION:	36.0% OF 25 COMPANIES
CHEMICALS:	33.3% OF 30 COMPANIES
STEEL OR METALS & MINING:	30.0% OF 30 COMPANIES
FOOD PROCESSING & BEVERAGES:	29.5% OF 44 COMPANIES
RETAIL:	26.3% OF 19 COMPANIES

SOURCE: HEWITT ASSOCIATES SURVEY OF TAX REDUCTION ACT ESOPs - 1978, 1977 (COPYRIGHT)

III. TRASOP PREVALENCE BY COMPANY SIZE

(INDUSTRIAL COMPANIES ONLY)



SOURCE: HEWITT ASSOCIATES SURVEY OF TAX REDUCTION ACT ESOPs - 1978, 1977 (COPYRIGHT)

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IV. IRASOP CHARACTERISTICS

ELIGIBILITY/PARTICIPATION

MOST PLANS COVER ALL OR MOST EMPLOYEES MEETING AGE/SERVICE REQUIREMENTS.

- *40.7% of plans cover all or most employees.*
- *34.3% of plans cover all or most salaried and non-union hourly employees.*
- *25.0% of plans cover all or most salaried employees.*

SEVERAL PLANS EXCLUDE OFFICERS, DIRECTORS OR MEMBERS OF EXECUTIVE STOCK OR INCENTIVE PLANS.

COVERED COMPENSATION

THERE APPEARS TO BE A TREND TOWARD USING AN INDIVIDUAL EARNINGS CEILING OF LESS THAN THE FULL $100,000 PERMITTED FOR ALLOCATION PURPOSES.

- *30% of plans in the 1978 study used a lower ceiling.*
- *15% of plans in the 1977 study used a lower ceiling.*

BENEFIT AMOUNT

THE AVERAGE ANNUAL EMPLOYEE BENEFIT IS LESS THAN $200. OF THE COMPANIES RESPONDING TO THE 1978 STUDY:

- *62.6% expect an average employee benefit of less than $200.*
- *27.8% expect an average employee benefit of $200 to $500.*
- *9.6% expect an average employee benefit of more than $500.*

HEWITT ASSOCIATES

IV. TRASOP CHARACTERISTICS (CONT'D)

MATCHING EMPLOYEE CONTRIBUTIONS

FEW PLANS USE THE ADDITIONAL ½% TAX CREDIT.

- *16.4% of plans in the 1978 study include the matching feature (23 companies).*
- *2.5% of plans in the 1977 study include the matching feature (1 company).*

SOURCE: HEWITT ASSOCIATES SURVEY OF TAX REDUCTION ACT ESOPs - 1978, 1977 (COPYRIGHT).

SURVEY OF TAX REDUCTION ACT ESOPS

HIGHLIGHTS REPORT

April 1978

SURVEY HIGHLIGHTS

During the months of January and February 1978, Hewitt Associates conducted a survey of the 1000 largest industrial companies and the 50 largest commercial-banking, life-insurance, diversified-financial, retailing, transportation, and utility companies as listed in the Fortune Directory.

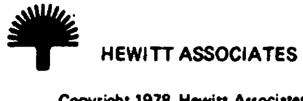
This report presents survey highlights of the complete report that was provided to survey participants.

Purpose of Survey

The survey concerns Tax Reduction Act Stock Ownership Plans (TRASOPs)--the type of employee stock ownership plan which meets the requirements stipulated in the Tax Reduction Act of 1975. The primary purpose of the survey was to gather information on the prevalence of such plans and to examine some important plan characteristics of those TRASOPs that have been implemented.

Survey Participants

Five hundred thirty companies participated in the survey. Participating companies span a wide cross section of business and industry and fall into the general groupings shown below:



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Company Grouping	Number of Companies
Industrial Companies	
• Sales over $1 billion	141
• Sales of $500MM to $1 billion	61
• Sales under $500MM	202
All Industrial Companies	404
Non-Industrial Companies	
• Financial Institutions	42
• Retail	19
• Transportation	25
• Utilities	38
All Non-Industrial Companies	124
Anonymous Responses	2
All Participants	530

TRASOP Prevalence

Survey participants were asked to indicate the current status of a TRASOP in their company. Of the 530 companies participating:

- 144 companies (27.2%) have implemented a TRASOP (plan has been formally adopted by the board of directors).

- 8 companies (1.5%) are in the process of implementing a TRASOP (internal decision has been made to implement TRASOP, but plan has not been formally adopted by board of directors).

- 49 companies (9.2%) do not presently have a TRASOP but are considering implementing such a plan.

- 329 companies (62.1%) do not presently have a TRASOP and are not presently considering implementing such a plan.

Utilities and certain other capital intensive industries have been responsible for much of the activity that has occurred. Among surveyed companies:

- 84.2% of the thirty-eight utilities,

- 76.9% of the twenty-six companies in the fuel industry (oil or coal),

- 63% of the twenty-seven companies in the paper, fiber and wood products industry

have implemented or are in the process of implementing a TRASOP.

Prevalence by Size

Among industrial companies, TRASOP prevalence appears to be influenced by company size as well as by industry. The relationship is not surprising since the cost (as a percentage of payroll) of implementing and administering a plan generally decreases as company size increases. It appears that the prevalence of TRASOPs has increased substantially over the past year in all size categories. A breakdown of prevalence data into size groupings indicates the following:

	Of All Companies in the Following Size Categories, % Which Have Implemented or Are in the Process of Implementing a TRASOP	
	1978 Survey	1977 Survey
Sales over $1 billion	41.4%	21.7%
Sales between $500 million and $1 billion	24.6%	16.3%
Sales under $500 million	14.4%	2.2%

The 1978 survey shows a significant increase in TRASOP prevalence over last year's survey. Only 54 companies (12.8%) out of last year's 423 survey participants had implemented or were in the process of implementing a TRASOP, compared to this year's 28.7%.

Prevalence by Industry Grouping

Code: ( ) - Survey participants (total of 530 companies).
(A) - Company has implemented a TRASOP.
(B) - Company is in process of implementing.
(C) - Company is considering implementing.
(D) - Company is not considering implementing.

	A	B	C	D
Survey Participants (530)	27.2%	1.5%	9.2%	62.1%
Industry Groupings:				
Chemicals (30)	33.3%	-	6.7%	60.0%
Drugs/Pharmaceuticals (14)	14.3%	-	14.3%	71.4%
Electronics/Appliances (30)	10.0%	-	16.7%	73.3%
Financial Institutions (42)	7.1%	-	2.4%	90.5%
Food Processing & Beverages (44)	29.5%	-	11.4%	59.1%
Glass, Concrete, Abrasives, Gypsum (18)	22.2%	-	22.2%	55.6%
Industrial & Farm Equipment (43)	14.0%	-	9.3%	76.7%
Metal Products (27)	18.5%	-	7.4%	74.1%
Measuring, Scientific & Photographic Equipment (16)	18.8%	-	25.0%	56.2%
Motor Vehicles (18)	16.7%	-	16.7%	66.6%
Natural Resources (Fuel)(26)	76.9%	-	-	23.1%
Office Equipment & Computers (12)	8.3%	-	8.3%	83.4%
Paper, Fiber & Wood Products (27)	55.6%	7.4%	7.4%	29.6%
Publishing & Printing (11)	9.1%	-	18.2%	72.7%

TRASOP Prevalence (continued)

	A	B	C	D
Retail (19)	26.3%	-	10.5%	63.2%
Steel or Metals & Mining (30)	30.0%	-	6.7%	63.3%
Textiles & Vinyl Flooring (13)	7.7%	7.7%	-	84.6%
Transportation (25)	28.0%	8.0%	16.0%	48.0%
Utilities (38)	81.6%	2.6%	7.9%	7.9%
Other Companies (45)	4.4%	4.4%	2.2%	88.9%

TRASOP Characteristics

The survey also examined TRASOP characteristics, focusing on the 144 plans of companies which have implemented a TRASOP. These plans revealed the following prevalences:

- 94.4% of the plans are intended to be qualified under both the Tax Reduction Act of 1975 and section 401(a) of the Internal Revenue Code.

- 93.1% of the plans are separate plans (not attached to an existing company plan).

- Employee groups eligible to participate:

	1978 Survey	1977 Survey
All/most Employees	40.7%	55%
All/most salaried and non-union hourly Employees	34.3%	25%
All/most salaried Employees	25.0%	20%

Note: Several plans exclude officers, directors or members of executive stock or incentive plans. The reasoning behind such exclusion might include the following:

1. The desire to increase the benefit provided eligible employees by eliminating from the allocation base the salaries of the highest paid employees.

2. The concern that including such employees might have an unfavorable appearance; or, conversely, excluding such employees might have a favorable appearance.

3. The exclusion might avoid the "insider" considerations that such a stock plan might present under securities law.

- 39.4% of the plans use some form of the maximum service requirement (up to three years) made possible by the fact that a TRASOP must provide for immediate vesting.

- Covered Compensation

	1978 Survey	1977 Survey
Up to $100,000	- 70.0%	85%
Limits between $25-$50,000	- 9.3%	2.5%
Limits between $10-$25,000	- 6.5%	10.0%
Limits between $ 1-$ 6,000	- 7.1%	2.5%
Basically a per capita allocation (e.g., include up to $1 or $100)	- 7.1%	-

Compared to last year's survey, this year's results seem to indicate a trend toward those options that produce a larger benefit for the average participant--i.e., more restrictive eligibility requirements and lower covered compensation amounts.

- Approximate Benefit Level Provided by TRASOP

To gain some insights into the benefit levels provided by TRASOPs, survey participants were asked to give their best estimates of the following:

1. The number of employees participating in the TRASOP.

2. The covered compensation of participating employees.

3. The amount of their company's qualifying capital expenditures for 1977.

Based on these estimates, a benefit per thousand dollars of compensation was computed. The following table displays the range breakdown of the benefit amounts for 100 companies which were able to provide data on this question. Companies allocating the TRASOP contribution on an essentially per capita basis (for example, where the covered compensation is a relatively small amount such as $1 to $5,000) are not included in this table.

Benefit/Thousand Dollars of Compensation

Industry	$1-$7.99	$8-$15.99	$16-$23.99	$24-$31.99	$32-$39.99	$40 & Over
Utilities	2	12	3	3	3	2
Natural Resources (Fuel)	2	8	2	1	0	3
Paper, Fiber, and Wood Products	3	3	3	1	2	0
All Others	21	6	9	2	3	6
Total	28(28.0%)	29(29.0%)	17(17.0%)	7(7.0%)	8(8.0%)	11(11.0%)

- Of the 115 plans responding to the question, seventy-two plans (62.6%) anticipated a benefit for the average

employee of less than $200 for 1977, thirty-two plans (27.8%) anticipated a benefit of from $200 to $500, and eleven plans (9.6%) anticipated a benefit of more than $500.

- The Contributory TRASOP

Additional 1/2% Tax Credit Based on Employee Contributions.

Among 140 surveyed TRASOPs, 23 (16.4%) provide for the possibility of an additional 1/2% tax credit. Eight utilities presently include the matching feature. In the natural resources (fuel) industry, two plans (10%) provide for the extra credit and two others are planning to amend their plans. 21.4% (30 plans) do not presently provide for the possibility of an additional 1/2% tax credit but are waiting to see what administrative guidance the IRS may give regarding such a provision.

The principal problem appears to be determining how much individual employees will contribute while adhering to the legislative rules which stipulate that:

- All participants must be allowed to contribute.

- No participant may be required to contribute.

- The matching employer contribution will be allocated in an amount equal to each employee's matching contribution.

It appears that unless the TRASOP benefit is fairly substantial (as it is for certain utilities and certain companies in the natural resource (fuel) industry), many

companies have decided that the additional administrative burden outweighs the additional 1/2% tax credit. However, in last year's survey, only 2.5% of the surveyed TRASOPs provided for the additional 1/2% tax credit, compared to the current 16.4%.

- Timing of Distributions

56.9% elected to make distributions only at termination of employment. 27.8% chose to make rolling seven-year payments. 9.7% give participants the choice. 3.5% make distributions only at termination except in the case of economic hardship. 2.1% plan to make distributions seven years after the last contribution.

The CHAIRMAN. We will now have Mr. Louis Kelso. We very much appreciate Mr. Kelso testifying at this point.

Would you please take the stand, sir? As one member of this committee, Mr. Kelso, let me express my appreciation to you for the tremendous contribution that you have made and the pioneering work that you have done in the interests of employee stock ownership. We are, in many respects, holding these hearings here because of the work you have done in the area. At least, as far as this Senator is concerned, that is the case. We are pleased to have your statement.

STATEMENT OF LOUIS O. KELSO, KELSO & CO., INC.

Mr. KELSO. Mr. Chairman, I appreciate very much being invited to testify today. I have with me Miss Patricia Hetter, who is coauthor of Two-Factor Theory: The Economics of Reality. This is one of the books that really helped get the whole subject out into the open.

Let me say that we were a lone voice crying in the wilderness until you, Mr. Chairman, took an interest in the subject. You might say that it's becoming a significant subject in public affairs dating from that moment.

I congratulate you upon the bill that has now been introduced by yourself and is pending before this committee, which would increase the investment tax credit from 1½—well, 2 percent if matched—to 2 percent whether or not matched, and permitting 1 percent of that to be based upon covered compensation if that amount is larger than 1 percent of the investment credit.

Many firms—engineering firms, accounting firms, advertising firms—are of a type which is people-intensive, not capital-intensive. They have not been able to take advantage of the investment tax credit and this provision seems to remedy a great bias in favor of the capital-intensive companies.

I particularly would like to comment on the deductibility of dividends paid into the employee stock ownership plan. In many of the financings that we have been intimately involved in, the difference between success and failure really turns upon the deductibility of those dividends, because it is not just the payment by the company into the ESOP, but the dividend power of the stock that is purchased that makes the financing feasible.

Inasmuch as the bill appears to permit dividend deductibility to apply to both common and preferred stock, I believe it to be an extremely helpful and advantageous provision to be added to the law.

Similarly, the provision with respect to giving the ESOP the status of a public charitable corporation under the personal income tax law, the personal gift tax law, and the personal estate tax law, will, I believe, result in clearing up one of the really confused areas in American economic affairs.

A great leader, a great inventor, an entrepreneur can found a company today and pay his employees the going rate of compensation and even put in an employee stock ownership plan (ESOP) and build rather significant ownership into them. But at the end of his life he may wind up, as a citizen down in Florida did recently, with $5 billion worth of capital ownership in his own name.

Now, in that case, he really has only two choices in disposing of his wealth. He cannot take it with him—otherwise, I think he probably would. But his only practical earthly alternatives are to leave it to the Government could be positively expressed by giving his estate to those foundations distribute their largesse on the basis of need, not on the basis of economic input; therefore, they are not economic institutions at all. If a man in Mr. MacArthur's position were able to set up an employee stock ownership plan, a multicompany plan or a series of plans, his natural disinclination merely to turn his estate over to the government could be positively expressed by giving his estate to those employee stock ownership plans or a multicompany plan. This alternative would very materially, very spectacularly, increase the wealth of the thousands of people who helped make him rich. This alternative expresses a sense of fairness, a sense of reciprocity. It is a way of extending hope to the whole American people, of demonstrating that the system really is designed to work for all of them and not just a few of them.

Obviously it is a revenue-raising measure as well, because when wealth goes into the ESOP, it goes back into the tax system. If you make the employee richer, you make him a better income taxpayer; you make him a better property taxpayer; you make him a better gift taxpayer; you make it less likely that he will be asking for welfare payments, or public support, or more social security or anything of the sort. So I think it is an extremely admirable provision.

I am economic advisor to the national association of ESOP companies (NAEC), which is a national organization of the key people, normally the chief executive or the chief financial officer, of ESOP companies. That organization, in pooling its members, has found each of these provisions to be of great importance, ones that will increase their enthusiasm for their employee stock ownership plans, and increase their use of such plans.

Senator Gravel's proposal to increase the limit of deductibility from 25 percent where you have a combined ESOP and fixed contribution ESOP, or money purchase ESOP, to 50 percent of covered payroll will, unquestionably, make many employee acquisitions of businesses and many ESOP's possible that are now not possible. I think it is safe for Congress to trust the board of directors of a company and its executives not to give away the store. They are not going to do anything that impairs the workability of the corporation—its ability to continue to do business effectively.

But you do have to deal with bankers and you do have to deal with insurance companies. In many instances, the length of term of loan financing is such that a greater contribution than 25 percent is necessary, at least in the early years of a financing ESOP's history.

Finally, a very bold step forward is represented, I believe, by Senator Gravel's bill which would authorize each state to set up a general stock ownership plan (GSOP). This is the first of the plans that I had in mind when Mr. Adler and I started proposing applications of the theory of universal capitalism. We did not press its application in the early years following publication of The New Capitalists, the book in which that idea was first advanced, because we thought that growth of the economy could at that time be better promoted by other two-factor financing tools. As expanding economy is the thing that ulti-

mately will help solve our unemployment problem and turn around inflation. To motivate that growth, it is generally desirable to link the acquisition of capital ownership with the performance of a job. Building a more productive economy in order to produce a high general standard of living will be an enormous task.

With that goal in mind, the GSOP did not seem to be as high a priority financing tool as the ESOP. Situations are coming forward now, however, where it is usable. I think the general stock ownership plan is now timely.

As other testimony indicates, Alaska is one such possibility. I believe there are many other potential GSOP applications in the country involving major projects costing multibillions of dollars—for example, rapid transit systems and capital projects intended to achieve self-efficiency in energy—where the GSOP will serve the dual objectives of providing low-cost financing for private enterprise and building broad ownership of productive capital into millions of presently noncapital-owning consumer units.

Thank you very much.

The CHAIRMAN. You have made a good case, those points you have testified to. I think it is worth noting on the point of deductibility of dividend income that it serves a purpose to encourage employees to make investments in the company for which they work, because that encourages productivity, and that is the area where everybody has something to gain. The Nation, the employer, and the employee, the whole free world have something to gain by making this system work.

Nothing makes it work more than productivity, and we ought to encourage the employee if he wants to make an investment, to make it in the activity where he, himself, is devoting its efforts.

Now, through pensions and various other ways, we try to sweeten up the pot, you might say, for those who are working to make the operation succeed for the investors, and I think that it is appropriate that we do something along the lines that you have suggested with regard to deductibility of dividends paid to the employees.

In the last analysis, the company can deduct the wages paid to the employee. Why should not they be permitted to deduct the dividend income paid to the employees into an employee stockownership type arrangement?

I find a lot of appeal to it.

Senator Gravel?

Senator GRAVEL. I would only like to thank Dr. Kelso and associate myself with the introductory remarks that you made concerning Dr. Kelso.

I might state for the record—it is not in my statement that the State Legislature of Alaska after testimony and lobbying by myself and testimony from Dr. Kelso and others, appropriated a quarter of a million to go ahead and set up a GSOP. Now, the success of that GSOP is going to have to be tied to the passage of Federal legislation.

The legislature also passed a directive and appropriated money to investigate the possibility of the State investing in the gas line that has been authorized by the Congress.

Now, if we are not successful in bringing about a GSOP, the State of Alaska is going to make the first move into actual State ownership of these assets. Our choice is very simple, Mr. Chairman. It is very

critical at this point in time. This is my State and I think it is a harbinger of what other States will be doing.

We are either going to move toward State socialism or we are going to have to be imaginative enough to have a device to venture away from that goal into private capitalism.

So I just wanted to underscore what has been done in the State of Alaska in this regard, and I think the ball is in our court, and I want to thank Mr. Kelso for coming forward for his endorsement.

Mr. KELSO. If I may make one closing comment, I do believe that the destiny of the free world is very much in the hands of this committee right now. Socialism is spreading all around the world. Our neighbors both north and south are becoming more and more closely identified as socialist economies, as are the economies of Europe.

We need an exportable, active, aggressive, virulent capitalism in order to have something to offer to those who would adopt socialism as a vote against the capitalism that works for the few but not for the many.

This committee is the committee that is actively creating that.

The CHAIRMAN. Thank you very much, Mr. Kelso.

Let me announce, before I call the next witness, that Mr. Robert Strauss, the Special Trade Representative and the President's Advisor on Inflation for Anti-Inflation Policies, will be our leadoff witness tomorrow.

Mr. Robert Hamrin will testify tomorrow.

Our final witness this morning is Mr. Joseph T. Buxton III, of the National Dividend Foundation, Inc.

STATEMENT OF JOSEPH T. BUXTON III, EXECUTIVE DIRECTOR, NATIONAL DIVIDEND FOUNDATION

Mr. BUXTON. Mr. Chairman, Senator Gravel, I am Joseph T. Buxton, executive director of the National Dividend Foundation.

Before I joined the foundation in 1975, I was a counsel to Newport News Shipbuilding in Virginia and general counsel to a subsidiary, Newport News Industrial Corp.

From 1968 to 1975, I think we saw in this country a significant loss of faith by the American people in the business system. At the same time we saw inflation at the highest that we have seen in peacetime in the history of this country. I think these two are related and they relate directly to what Senator Gravel has proposed in Senate bill 3223, and I would like to restrict my comments to that.

I will not repeat what I have in my written testimony, Mr. Chairman, but I would just like to pass along some observations.

Basically, we are faced today, I think, with two significant problems with our economic system. First, the growing public dissatisfaction with the public sector generally, and I think this was attested to in California. We also see a need to revitalize public confidence in the private sector, which is the only real source for wealth and the earnings necessary to pay for our social progress.

Senator Gravel, through the general stock ownership concept, has recognized both these needs and has sought to reestablish the necessary connection between the public and the economy. He has provided

a mechanism which provides the citizen, either on the State, local, or national level, as I read the proposed legislation, provide the citizen an opportunity for a stake in the system.

At the same time, it limits the role of Government.

GSOP, in effect, is the ultimate extension of ESOP. It provides stockownership opportunities for citizens throughout the society. Yet, I would raise one question this morning, and that is: Is actual stock ownership necessary at the national level to reach these objectives? Those objectives being, enlarging the role of the private sector vis-a-vis the public sector, and revitalizing the public's confidence in the national market economy by giving them a piece of the action.

This is a serious question, and I think it should be considered by the committee. The foundation has worked on a similar proposal to Senator Gravel's proposal of the national dividend plan, which I will outline very briefly. It has the same principles incorporated in it as the GSOP concept.

The national dividend plan was described in some detail by Dr. Martin Gainsborough before this committee some weeks ago and last year before the House Ways and Means Committee, and that is available to this committee, if this needs be.

Very briefly, the plan provides for the establishment of not a national ownership trust, but a national profit-sharing trust. Profits generated in the private sector and paid as corporate income tax would provide the basis for the trust.

Our estimates show that this would amount to about $1,000 per household with universal participation, the only criterion being 18 years of age and registered to vote.

The National Dividend Plan also proposed integration of the corporate income tax by elimination of the tax on dividends at the shareholder level and providing for the national dividend itself to be tax free.

The difference between GSOP and NDP is that it has immediate implementing capability. Benefits could be derived almost immediately by the individual citizen. He would immediately have a stake in the system. He could perceive that the profit economy and its survival and policies affecting it would be in his self-interest.

The plan provides for involving the public also in the budgetary process by relating the national dividend itself, the size of the dividend, to the Federal deficit.

If the deficit were to increase next year and we had a national dividend in effect, that increase would be deducted from the individual recipient's national dividend check.

We are not specific on the method to be used except that the concept of relating the budgetary process to the benefits derived under NDP should make for effective budgetary control exercised by the primary sovereign in this Nation, the electorate. Conceivably, a household receiving $1,000 could have it reduced to $250 because of Federal spending. This does not mean we could not have deficits, but it does mean that the Congress would, in effect, have to justify those deficits to the electorate.

In summary, the National Dividend Plan, national profit-sharing, incorporates the objectives of Senator Gravel's stock ownership con-

cept by giving society a sense of participation in the system. But it does so without changing the equity position of existing or future owners, and there is no transfer of ownership.

It would shift, over the next 5 years—and we propose that this plan be phased in over the next 5 years—$60 billion or $70 billion more from the public sector to the private sector for individual choice and decisionmaking. It does something we think that the GSOP does not do, and that is that it spreads the risk over the entire corporate community so that the individual participant does not have to suffer the loss as a result of the decisions of the trustees with respect to stock purchases.

And finally, it is relatively simple to implement and administer using the existing corporate tax framework.

I would like to close by applauding Senator Gravel, because he has surfaced perhaps one of the most critical needs in our society through the GSOP concept—one that has to be dealt with, and it has to be dealt with soon. That is, we must have a society that perceives the survival of its economic system to be in its own self-interest.

GSOP, ESOP, National Dividend, all work in that direction and I applaud Senator Gravel for his enthusiastic work in this field and the work of this committee with respect to ESOP's.

Thank you, Mr. Chairman.

Senator GRAVEL. Thank you for the endorsement. I have no questions. Thank you very much.

The CHAIRMAN. Thank you very much, Mr. Buxton. I was delighted to receive the testimony of all the witnesses who spoke today; it is gratifying as a Senator to receive testimony about something that really works. The committee will stand in recess until 9 tomorrow morning.

[The prepared statement of Mr. Buxton follows:]

STATEMENT OF JOSEPH T. BUXTON, III, EXECUTIVE DIRECTOR OF THE NATIONAL DIVIDEND FOUNDATION, INC., RIVIERA BEACH, FLA.

Mr. Chairman and members of the Committee. Thank you again for the invitation to testify. My name is Joseph T. Buxton III. I am the Executive Director of the National Dividend Foundation, Inc., which is a tax-exempt educational and research organizations located in Riviera Beach, Fla. For many years, the Foundation has been engaged in fundamental economic and social research directed toward methods for preserving, revitalizing, and making more productive and equitable the American market economy.

Our research [1] has, to a significant extent, focused on both the causes and the consequences of the following interrelated phenomena: increasing inflation, ever larger tax burdens, spiraling growth in the size of the public sector in relation to the private, the lack of any effective restraint on the Federal deficit, and the continuing decline in the rate of growth in productivity and capital investment.

While there are other factors which bear on this complex set of interrelationships, we believe that the single most important is identified by the subject of today's hearings before this Committee—the need to broaden the base of participation in the profits of a free enterprise economy that result from increased productivity and output. In other words, we see the lack of a personal stake in economic growth as a principal cause of the individual citizen's continued reliance upon government (both Federal and State) for services and sustenance which, in turn, leads to higher taxes, larger deficits, growing government, and resulting inflation.

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[1] The Foundation publishes in the public interest periodic monographs and a bimonthly digest of opinions on these and related subjects. In addition, the Foundation supports independent research on issues related to fiscal and tax policies and on the role of incentives

The Employee Stock Ownership Plan (ESOP) provisions of present law, Senator Gravel's proposal for a General Stock Ownership Plan (GSOP), and the National Dividend Plan (NDP) which the Foundation has researched, are all directed toward this fundamental need. We believe that both the ESOP and GSOP techniques will in a significant degree help alleviate the same fundamental concern which underlies the National Dividend Plan: a worry about the decline of capitalism, and a fear that it may finally be overwhelmed by a bloated bureaucracy due to a majority of voters who no longer see themselves as having a direct stake in the profit system.

If few people are proprietors, entrepreneurs or shareholders, the majority of voters will have less interest in preserving the system. We see indications of that presently and in the recent past. The large number of citizens who merely receive wages and salaries from an employer, and the ever growing number of people who merely receive governmental transfer payments or other public assistance, do not normally perceive the profits of productive business enterprise as the ultimate, and indeed only, source of those wages and payments. Nor are they as likely to be concerned about increased deficits and inflation if they see themselves as benefitting more from deficit expenditures and other causes of inflation than from the entrepreneurial capital investment system inflation damages.

On the other hand, if, under systems such as ESOP, GSOP, or NDP more individuals perceived themselves as having an interest in capitalism, and in fact shared directly in its profits and losses, the opposite attitude should exist. The prevailing public and hence, political view would be to act in a manner best calculated to increase productivity and profits. There should, in that event, be a majority constituency for, not against, profits and economic growth, and a majority constituency against, not for, ever growing public sector expenditures and deficits. There should be significantly fewer grounds for a misperceived dichotomy of interest between capital and labor, or between the ordinary individual citizen and so-called "corporations", which today are too often misunderstood as being inanimate, distant, and sometimes, even sinister creatures, separate and apart from everyone else. Instead, there would be an obvious and widely understood identity of interest between the individual and all productive business enterprise.

It is useful to compare and contrast the various techniques that have been advanced for achieving a broader base of participation in productive business enterprise. Our research indicates that, to a significant extent, the ESOP provisions of present law, the GSOP provisions proposed by Senator Gravel, and the National Dividend Plan as developed by the Foundation can be viewed as different versions of the same thing. There are, of course, differences, but many of the fundamental concepts are much the same. All three in varying degrees eliminate one layer of the present double tax on corporate income; all three involve a type of profit-sharing system that over time creates new entrepreneurial interests; and all three in whole or in part create these new entrepreneurial interests by permitting corporations to distribute, directly from the source of profits, varying amounts of corporate tax that otherwise would be paid into the Treasury and subjected to the public expenditure process. All three provide the individual with a stake in the system.

The ESOP program encourages corporations to share the profits of the firm with its employees. Employees do in fact become part owners through the purchase of stock in their employer-corporation. This is accomplished by using both the concepts of after-tax cost and leverage through borrowing. Employers are permitted a deduction for contributions to a trust for the employees. The trust, in turn, invests in stock of the employer-corporation. Frequently, the trust will have borrowed funds from a bank and already have purchased stock in the employer corporation. The employer-corporation then makes annual deductible contributions to the trust in amounts sufficient to pay off the debt. Because the employer-corporation's contribution to the trust is deductible and the trust is tax-exempt, no tax is paid on the earnings which are contributed to the trust until there is a distribution by the trust to the employees. On on that portion of the corporation's earnings, there is no double tax. Earnings which are distributed on stocks owned by the trust are, however, taxed twice—once at the corporate level and once when distributed by the trust to the employees.

Obviously, in the case of an ESOP, 48 percent of the deductible amount the employer contributes to the trust for the employees represents an amount the

employer would have paid to the Treasury in taxes. Instead of paying it to the Treasury, the employer-corporation in effect has distributed a portion of its corporate tax to the profit-sharing ESOP trust for its employees. Moreover, in the case of an investment credit ESOP, the employer-corporation is allowed an additional 1½ percent investment tax credit provided he contributes the tax saving to the ESOP trust for employees. Therefore, again the Internal Revenue Code in effect directs the employer-corporation to distribute to the ESOP trust that portion of the corporate tax otherwise payable to the Treasury.

Our research and analysis indicates that Senator Gravel's GSOP proposal is a logical extension of the basic ESOP concept. Whereas, an ESOP is confined to and covers only the employees of a particular corporation, Senator Gravel's GSOP, as we understand from S. 3223, would extend a similar technique to all citizens of the United States or, alternatively, to all citizens of a particular state or a political subdivision of that state. The other principal differences between ESOP and a GSOP appear to be as follows. First, the GSOP trust could invest in a wide variety of stocks and securities of many different corporations instead of being confined to the stock of a particular employer-corporation, as in the case of an ESOP trust. A second difference is that, unlike an ESOP trust, a GSOP trust does not receive contributions from corporations and therefore, would not rely on contributions to pay off debts incurred to purchase stock. Instead, being an instrumentality of the Federal or State government or of a political subdivision, the GSOP trust would be empowered to issue tax-exempt debt.[2] Thus, in effect, it would utilize the credit of the state or poltical subdivision to borrow funds with which to buy stock.[3] A third difference is that dividends paid by a corporation on stocks owned by a GSOP would be deductible by the corporation paying the dividend.

In that respect, as stated in S. 3223, the GSOP concept would be a substantial step in integrating the corporate tax. The double tax on corporate earnings would be fully eliminated on income received by the GSOP trust. In effect, a corporation of which the GSOP was a shareholder would be permitted to distribute to its GSOP shareholders all or part of the corporate tax it would otherwise pay to the Treasury.

Most important, however, is the connection GSOP seeks to make between the body politic and the American economic system—a connection which has been lost as we moved from a society of farmers and landowners to one of capitalists and emplyees.

While GSOP is concerned principally with state and local application, S. 3223 provides for the possibility of establishing a national general stock ownership trust. Clearly, such a trust would provide for the direct participation by virtually all citizens in the ownership of American corporations. Yet, on the national level, is government-sponsored ownership necessary or even desirable in order to provide Americans the opportunity to participate in and to support the profit and loss system? Perhaps not.

The National Dividend Plan, while an extension of the philosophy represented by ESOP and GSOP, contemplates a national profit-sharing trust rather than a national corporate ownership arrangement. Without diluting or in any way impairing the ownership or management prerogatives of American business, NDP represents a vehicle for accomplishing the basic objectives of GSOP on a national scale, but in a vastly more simple and uniform manner. NDP address the need to broaden participation while protecting the property interests of the owners of American industry. At the same time, NDP provides individual citizens with a sense of participation through profit-sharing, and enhances incentives toward greater political participation, actual stock ownership, less reliance on government, and active support for sound fiscal policy.

Under NDP, each corporaiton would annually or quarterly pay into the National Dividend Trust Fund the entire amount of its corporate tax—the the amount it would otherwise pay to the Treasury (just as a corporation might pay into an ESOP or GSOP trust all or part of the amount it would otherwise pay in tax to the Treasury). Instead of being invested in ownership of corporate stock, as in the case of an ESOP or GSOP, the annual tax payment into the National Dividend Trust Fund would be distributed by the trust quarterly or

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[2] The ability of the GSOP trust to issue tax-exempt debt can be viewed as the counterpart of an ESOP trust's ability to pay off debt out of deductible untaxed contributions of earnings by the employer-corporation.

[3] To the extent the debt was represented by revenue bonds, and not by general obligation bonds, the credit of the government would not, however, be directly involved.

annually per capita to each registered voter as a "national dividend." The national dividend, at approximate current levels of corporate profits, and therefore corporate taxes, would be about $500 to $750 per capita or $1,000 to $1,500 per married couple. Because the corporate tax is a percentage of corporate profits, each voter's national dividend is very much like a special kind of "public" preferred stock—which participates in income, at a stated rate, but, unlike common stock, does not dilute the underlying equity ownership of other stockholders. Participation in the profits and losses of productive corporate business enterprise is the essential characteristic of the national dividend; not any redistribution of existing ownership or wealth. As profits went up, each voter's national dividend would go up; as profits went down, each voter's national dividend would go down. It could be expected that each person would, in a greater degree, be both conscious of and interested in the effect of national policies on corporate profits an would be disposed to pursue policies which would increase productivity, profits, and his national dividend.

This personal identity with and interest in profits and losses is the principal difference from present law respecting corporate profits taxes suggested by the National Dividend Plan. Obviously, today corporations pay a percentage of their profits in tax to the Treasury. They would pay no more if, instead of paying that tax to the Treasury, this amount were paid over to the National Dividend Trust Fund. They might pay less. Currently, much attention is being paid to the perfectly reasonable proposition of feedback revenues—that a tax reduction, such as reduction of the corporate tax rate to some optimum level, would produce greater profits and greater tax revenues than the present higher tax rate applied to a smaller profit base.

Moreover, there is no question that today corporate taxes are distributed to the public, or at least portions of the public. The difference is that, under the National Dividend Plan, those taxes would not first be paid into the Treasury and then he redistributed through the appropriation process to fund an array of Federal expenditures programs. This redistribution process totally obscures the sources of those benefits—the profits of productivity of which the tax is only a percentage—and often radically skews the redistribution. Recently, the redistribution of taxes by means of Federal expenditures has been compounded by the addition of even greater redistributional expenditures financed out of Federal debt. Certainly, this process affords no restraint on the ever increasing level of Federal debt and deficits, and by its nature, tends to add to the growth of the public sector.

In contrast, the National Dividend Plan would place a new and self-enforcing limit on Federal debt and deficits. Like ESOP and GSOP, the National Dividend Plan would, in a very basic way, create a new political constituency for fiscal responsibility solely by virtue of creating in a far greater number of voters a direct interest in the profits of productivity. But the National Dividend Plan, uniquely, would go farther.

The national dividend received by each voter would be reduced in relation to the Federal deficit. For example, a citizen could be liable for a pro rata portion of the increase in the Federal deficit over some base period level such as fiscal 1978. Thus, if as projected, each voter's national dividend was $750, and if, for example, the Congress voted new expenditures which increased the Federal deficit by $250 per voter, each person's national dividend would be reduced by $250 to pay for the new debt. One can imagine that there would be much greater restraint on voting for new expenditures and new debt than at present. New debt could, of course, be voted by the Congress. It might be necessary. But the justification for it would have to be much more compelling than at present—at least sufficient to explain to each voter why his national dividend was reduced by $250.

Despite the restraint on new public debt and the creation of a new constituency, the National Dividend Plan does not, however, imply any necessary reduction in or dismantling of present public assistance and expenditure programs. It is anticipated that, if the National Dividend Plan were phased in over a 5-year period and we maintained a moratorium on any new Federal programs, the national dividend of $500 to $750 per voter could be financed solely out of growth. See testimony of Dr. Martin H. Gainsborough before the Senate Committee on Finance, in March of 1976. Hearings, H.R. 10612, Committee on Finance, 94th Cong., 2d Sess., Part 3, March 29, 30, 31, 1976, at pp. 1357–1384.

The other feature of the National Dividend Plan is, again, similar to both the ESOP and GSOP techniques. The National Dividend Plan would provide a means

for eliminating the double tax on dividends. While ESOP and GSOP do this to a limited extent, the National Dividend Plan would be more comprehensive. The corporate tax would be imposed and distributed to the National Dividend Trust, but when dividends were distributed, that income would not again be subject to a second income tax. Dividends, whether the "national dividend," or a dividend distributed on stock to the actual shareholders, would be excluded from tax. In recent years, much attention and effort has been devoted to developing various techniques for integrating the corporate and shareholder taxes in a manner which imposes only one tax at a progressive rate on income earned in corporate form. The National Dividend Plan provides a method much simpler than other methods for integrating the corporate tax and is equally in tune with maintaining progressive rates of income tax. The details of this aspect of the National Dividend Plan are set forth in Hearings, Incentives For Economic Growth, Senate Committee on Finance, Subcommittee on Taxation and Debt Management, 95th Cong., 1st Sess., May 16, June 14 and 15, 1977, at p. 420.

Finally, we come to one of the principal reasons for relying on the private sector to provide social progress as contemplated by ESOP, GSOP and the NDP: inflation. Our greatest economic concern today is the uncontrolled and increasingly destructive effect of rapidly rising prices. There is no need here to reiterate the various approaches we, as a nation, have taken in attempting to control inflation. None have worked. All seem to involve various techniques for deflating the economy, and all seem to involve the costs of a declining or slower rate of growth and larger unemployment. The one ingredient in our complex economy we have not adequately dealt with is our lesser rate of productivity. We have tried economic stimulus—largely in the form of Federal deficits—to stimulate consumer demand. We have tried, in limited ways, to take steps to stimulate additional capital formation. What we have not done is to pursue policies which would build a constituency for policies that would stimulate both the labor and capital inputs to economic growth. The answer to inflation is a substantially increased national output based on both these elements.

In our opinion, ESOP, GSOP, and NDP are designed to stimulate productivity and to produce a greater output of our national economy. All three are serious, innovative new approaches which cut across ideological lines.

While ESOP and GSOP reestablish the vital connection between people and profits so essential to the survival of capitalism in a democracy, ESOP involves a base too narrow to enhance broad public understanding and support for the private sector and GSOP, while capable of national application, raises serious questions as to the ownership rights of existing owners and as to the impact on risk-taking by prospective owners. On the national level, it would be our conclusion that the objectives of GSOP could be reached far easier through national profit-sharing, as contemplated under NDP, and this approach should be seriously considered when discussing the proposals proffered under S. 3223.

On behalf of the National Dividend Foundation, Inc., I thank the Committee for this opportunity to testify and for its attention. With the Committee's permission, we will, in a few days, submit for the record a longer technical appendix to our written statement.

[Thereupon, at 11:45 a.m., the committee recessed, to reconvene Thursday, July 20, 1978, at 9 a.m.]

EMPLOYEE STOCKOWNERSHIP PLANS AND GENERAL STOCKOWNERSHIP TRUSTS

THURSDAY, JULY 20, 1978

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 9:15 a.m. in room 2221, Dirksen Senate Office Building, Hon. Russell B. Long (chairman of the committee) presiding.

Present: Senators Long, Talmadge, Gravel, Curtis, Hansen, and Packwood.

The CHAIRMAN. The committee will come to order.

Yesterday morning we heard extensive testimony from leading U.S. corporations such as Sears, Roebuck & Co., Dow Chemical Co., Potomac Electric Power Co., and South Bend Lathe regarding the beneficial effects which employee ownership of stock in the employer has provided for those companies and their employees. These companies were unanimous in their feelings that by providing employees with an ownership interest in their employer and a common goal of profitability with their employer, they have greatly increased the motivation and productivity of these employees.

By making each employee more productive, we will increase the productivity of American industry, giving us greater insulation against inflation. Our first witness this morning will be Ambassador Robert S. Strauss, Special Counselor on Inflation. He has agreed to testify before this committee regarding his views on the effectiveness of employee ownership, and the resulting increases in motivation and productivity, in helping curb inflation.

At this time, I would like to introduce into the record the Finance Committee publication on ESOP's, the joint report of the Finance Committee and the Joint Committee on Taxation on the bills which we are taking up today, a report sponsored by the Department of Commerce on the motivational effects of employee stockownership, and a recent publication on ESOP's for banks by Mr. Pete M. Drexel, a Profit-Sharing Council of America report on ESOP's, and a recent article by Mr. Gus Tyler which points out that 16 plywood plants in the Pacific Northwest, which are employee owned, consistently show higher productivity than their non-employee-owned competitors, and analyzes that phenomenon. Finally, I would like to state that Senator Roth has indicated a desire to cosponsor S. 3241, the ESOP bill which I introduced and of which Senators Gravel and Anderson are already cosponsors.

[The material referred to above will be found in the appendix to these hearings.]

STATEMENT OF HON. ROBERT S. STRAUSS, SPECIAL COUNSELOR ON INFLATION

Mr. STRAUSS. Thank you, Mr. Chairman and members of the committee. I appreciate very much the opportunity to be here with you this morning and discuss what I see to be a very far-reaching, imaginative concept of stock ownership plans for groups of employees.

As you know well, I just returned from my trade negotiations in Geneva and the economic summit in Bonn, and I can assure you from my experience in those two places, talking with finance and trade ministers and heads of state of other nations of the world, as well as home here, our own people, that inflation without any question, continues to be a persistent and troubling nemesis for the entire industrialized world, not just our own Nation.

There are not any simple answers, but we have got to keep searching for more profound methods to restrain inflation than we now possess. And it is for that reason, things that we do not now possess and our search for them, that I am exceedingly interested in the testimony that is being taken here and presented to you during the 2 days of your hearings on employee stock ownership plans.

I was not able to get here in time to listen to yesterday's testimony on the result of various corporations' stock ownership plans, but I did have a member of my staff here, and I have examined, in some detail, his written comments.

Let me say just a word or two first about our progress in the inflation effort. The President announced in April his comprehensive effort to tackle inflation, and he has frozen Federal executive pay and imposed a limit of 5.5 percent on Federal employee pay raises, and work is underway to try to get their hands on fiscal year 1979 and 1980 budgets, wherever possible—and let me say that I think they are going to do a good job on that. I have every confidence they are.

A Federal Purchasing Council has been set up to limit the inflationary impact of Federal procurement. An Executive order now requires a thorough review of economic considerations before new regulations get out. And I have established a very small, high-level task force. It is without authority and it is working with departments and agencies of Government trying to find ways to cut down on waste, to improve our efficiency, and reduce spending without adversely affecting essential programs that this Congress has passed.

Since I took this job, we have done our darndest to try to encourage specific deceleration commitments to individual corporations as well as moderation in labor-management settlements, and we have had some modest results in some areas, and we will be working to involve a greater number of people with regional forms and educational and consumer efforts.

And the committee, as they move through this, might keep in mind that we are going to go public and go out in the region and talk about things.

But in order to make a real dent in the rate of inflation over the long-term, we have got to get down to basic, underlying causes. And I need not tell you, Mr. Chairman, or other members of the committee that are here this morning, that what we are doing up to now in inflation

is helpful in a containment way while we seek longer term programs to get at more basic problems. And that is what we have got to do.

And in looking at this whole picture, and in looking at more basic problems, nothing does disturb me, and would disturb any sensible person any more, than the constant downward trend of productivity. It is not the workers' fault, and it is not management's fault, and it is not Government's fault. There is enough blame to go around for everybody to have his share. But the consequences of this decreased productivity are a diminished standard of living and a higher labor cost and less competitive prices and more inflation that adversely affects workers and those for whom they work alike.

And this administration intends, as part of its anti-inflation efforts, to try to focus with a shap spotlight on certain concrete steps that could be taken to stimulate increased productivity.

The economic policy group is concerned about capital productivity. The Treasury Task Force on Capital Formation is looking at steps that can be taken.

The Council of Economic Advisers and the Department of Labor have been considering worker productivity. I spent some time with Jackson Grayson at the productivity center in Houston, as many of you will recall. We were looking at some of his suggestions.

He has a distinguished board of experience and sophisticated people. Some of the leading business managers in America are behind him, and I spent some time on several occasions with Chairman Batten, of the New York Stock Exchange, and they are doing a good deal of work in this area, specifically as it affects capital productivity.

It is within the light of all those things that I am very, very interested to hear the impact that ESOP's have had on work force morale in corporations of all sizes. As I gathered from notes that I read last evening covering some of your testimony here, corporations like Sears, Potomac Electric Power, and Loew's Co., and the Dow Chemical Co. all have had results that were worth noting and reflect a very positive program in place.

I am also aware of the positive experience that Eastern Airlines has had with their profit-sharing plan, and I understand it is a little different one.

The Economic Development Administration's report on employee ownership indicates that over 1,000 firms now have some form of employee ownership plan and even more have a profit-sharing plan.

The report finds that those firms with ESOP's to be more profitable—although I must say that the sample is too small to be very definitive. But that, too, produces a positive response when you look at it.

I do not need to tell you, Mr. Chairman, that I am not an economist or a tax expert and do not plan to be one, and I am not going to get into the detailed implications or attempt to on the two bills that you are talking about here today and will be talking about. That will be provided by others. It would be presumptuous of me to.

I am also well aware that there are some questions and some complications. It is not a simple thing. It is not all yes.

But I have read enough and I know enough and am experienced to know that there are some sound ideas that deserve, and it is almost

your responsibility, to give a much closer inspection and I assure you that this administration will give careful consideration and I personally favor and will give extremely close consideration to all proposed forms of employee stock ownerships that this committee looks at favorably.

And really the point I want to make is broader than any of that.

This Nation today needs creative and bold thinking as much as at any time in its past. And this very committee, and this committee room, this committee that you chair, has the stature, has the talent and the staff, and it has the credibility to provide not only a forum for these new ideas, but to provide new approaches for a sounder American economy.

Now, the things you look at are not going to help us much tomorrow, or this year, or next year, but they have got to be started. And as we do start down the road, I am aware that we have to weigh carefully the revenue costs of meaningful programs. You look at it every day. And it would also be presumptuous for me to tell you the cost of the Government in revenues is too great and the worker or the average citizen will receive in one hand what he pays taxes for on the other hand. You see that kind of foolishness come up here every day, and I am not for that. I do not think these ESOP's have to be that.

I am hopeful that these hearings will mark the beginning of a really hopeful and continuous and intensive examination of some innovative ways and means to improve the morale and productivity of our work force.

The best way to discover meaningful long-term measures to dampen inflation that pollutes us today are going to have to be found in a number of ways, including a reexamination of just some very basic concepts. Few concepts are as basic as the role of workers in the economic structure and as their participation in equity ownership.

Let me conclude by saying, in noneconomic terms and nondiplomatic terms that I have been around long enough to know, or have enough sense to know, that people just do better if they have a piece of the action, and that is what you are talking about here, in my judgment. That is really what you are talking about here.

Thank you, Mr. Chairman. If you have any questions, I will be glad to answer them.

The CHAIRMAN. Thank you very much, Mr. Strauss. You know from your experience how hard young lawyers work to try to make a success for themselves and the same thing is true in the small businessman starting any small business. If a young lawyer starts out, if he has to hang his shingle out and he is only going to work eight hours a day, he might as well forget about it, because he is up against other young people competing who are going to work a lot harder than that during their early years in order to get themselves established.

And really the secret of the free enterprise system is how hard and how much dedication a business person puts in to make his little business succeed.

Now, one benefit that can be paid by any business that is not inflationary is to give the people some stock in the company. If you give them a pension and you pay them these various fringe benefits of other

natures, most of that increases the cost. But it does not increase your cost to give the worker stock in the company, to create more stock, and provide the worker with some of it.

And when he has a significant amount of stock, he takes a bigger interest in the company, as the witnesses here have been testifying. I do not know whether you read the statements of Mr. Jack Grady, of Juice Bowl Products, yesterday. He said that his workers all understand that if somebody takes that forklift and damages some of the merchandise and it spills on the floor, that costs money to everybody who works in that plant because they own the stock of the company and its losses are their losses. He and the employee-owners of his company work to be sure that the best possible job is done to increase productivity and profitability of the company.

Mr. STRAUSS. I fully share that view, Senator, and I know that line, when I said if they have a piece of the action. I do not care whether you work harder on a bill where you have an interest in it, in this Senate, than you do on a bill that may be just as right and just as meaningful but you just do not happen to have any personal interest in that bill, you do not work quite as hard on that as you do on the one where you have a personal interest.

And the same is true of the worker and the same is true of everyone else.

The CHAIRMAN. Senator Talmadge?

Senator TALMADGE. No questions.

The CHAIRMAN. Senator Gravel?

Senator GRAVEL. I would add one thing. I want to thank the Ambassador for coming forward and testifying on this subject. I would just like to give you a few figures, because the statement you have made is a truism. If people have a piece of the action, they do better. Now, one of the fundamental problems with our economy today in the United States is that there are not enough people that have a piece of the action. In fact, the action is going to a minuscule number of people.

This committee did a study which showed that 1 percent of the people in this country own 26 percent of the wealth and 6 percent of the people in this country own 52 percent of the wealth; 1 percent of the people get over 50 percent of the dividend income from the wealth of this Nation.

Now, I think that is surprising to most people because we have assumed since the turn of the century and the years of the robber barons that we have had a diffusion of wealth. We have not. We have had a diffusion of income. This is the only policy that we have.

You addressed the fact that maybe this will not help tomorrow: maybe it is down the road. Let me just show you one example in the legislation I have for setting up a GSOP.

The State of Alaska has appropriated a quarter of a million dollars to do the engineering to set up a corporation. If we are successful in getting legislation out of the Congress, come January we will have a corporation in being and come next year we will distribute to every single citizen of Alaska $500. That is a lot of money. That is a sizable expenditure for anybody. The company we are going to buy out is British Petroleum. It is an owner of the Alaskan pipeline and they do not particularly like that type of investment. If we would buy them out,

the $400 million or $300 million that would be going abroad to pay them back will be going to the people of Alaska.

That is something that can be done in 1 year's time, Mr. Ambassador, so the stuff is not so farfetched or pie in the sky in the future. If we can take steps now, with some immediacy, we will see some results. I just wanted to make that statement.

Mr. STRAUSS. I did not imply it would not be helpful in the short run. I implied we are not going to cure this problem overnight, but I was talking about this whole thing. We have to get started, and this committee room right here is about as good a place as any that I know of to get started, and I am just pleased that you are doing this. I hope that any help I can be in any way, that you will call on me.

The CHAIRMAN. Mr. Secretary—I call you Secretary because you hold a Cabinet job—and it seems to me that there is something that is also of significance in your area.

It is your job to make this system prevail around the world, if we can. In other words, you are dedicated to the free enterprise system, I am sure, just as I am. We want to make it work. And if you are going to make it work and you are going to make it survive when we see more and more countries becoming socialistic, we need to project the image that this is not a system where the rich get richer at the expense of the poor. It is a system that spreads rewards to those who are willing to make a contribution. As a matter of fact the U.S. Department of State has advised me that the "President of France has recently advocated the concept of broadened stockhownership as a national policy."

When we can show people the kind of thing that was being demonstrated yesterday, that the employee working 40 years for the Sears Co., before their stock went down, had $450,000 worth of stock, and he was just the average employee who had worked that long for the company. Now, the stock went down so it is only worth about $250,000 now, but even then it is a lot to show for stockownership that a fellow who has just been doing his job day in and day out, trying to help the company and look after his family, can retire and own his own home and say grace over his property which is valued at $250,000 to $500,000 of productive assets.

Mr. STRAUSS. I do not want to take too much of your time, but I can just say this to you. As I said, I do not know the complications of the tax and income aspects, but I do know this. A number of friends of mine, people I have worked with, grown up with all my life that worked for Sears and other companies have those plans and I know what has happened to them, and they do have security and they feel that that is their company and they are working for themselves, they are in business for themselves. They do not question about that. I do not need to read any books to know that.

As the man says, I seen it with my own eyes. It is just sound.

The CHAIRMAN. Thank you very much.

Mr. STRAUSS. Thank you, sir.

The CHAIRMAN. We appreciate very much your taking the time from your busy day to come here and testify for us.

Mr. STRAUSS. Thank you very much.

[The prepared statement of Ambassador Strauss follows:]

STATEMENT OF AMBASSADOR ROBERT S. STRAUSS, SPECIAL COUNSELOR ON INFLATION

Mr. Chairman and members of this distinguished Committee: I appreciate very much the opportunity to discuss with you this morning the far-reaching concepts of stock ownership plans for groups of employees.

As you know, I have just returned from intensive trade negotiations in Geneva and the Economic Summit in Bonn. I can assure you from our experience in Bonn as well as at home that inflation continues to be a persistent and troubling nemisis for the industrialized world. There are no simple answers, but we must keep searching for more profound methods to restrain inflation than we now possess.

This is why I am so interested in the concrete results that are being presented during your two days of hearings on employee stock ownership plans (ESOP's). I had hoped to be here in time to listen to yesterday's testimony on the results of various corporation's stock ownership plans, but members of my staff were here and I have examined some of the written comments.

Let me say just a word or two about our progress in the anti-inflation effort. The President announced in his April 11th speech a comprehensive effort to tackle inflation. He has already frozen Federal executive pay and proposed a limit of 5.5 percent on Federal employee pay raises; work is underway to severely curtail Fiscal Year 1979 and 1980 budgets wherever possible; a Federal Purchasing Council has been set up to limit the inflationary impact of Federal procurement; an Executive Order from the President now requires thorough view of economic considerations before new regulations are promulgated. We have established a small, high-level Task Force working with the departments and agencies of the government trying to cut waste, improve efficiency, and reduced spending without adversely affecting essential programs.

Since the President's speech, we have sought to encourage specific deceleration commitments from individual corporations as well as moderation in labor-management settlements. We will be working to involve greater numbers of people in our efforts through regional forums and educational and consumer efforts.

But in order to make a real dent in the rate of inflation over the long-term, we must consider the underlying causes. For example, I need not tell the members of this Committee that what we are doing will be helpful but only in containment while we seek longer term programs to get at more basic problems. Nothing disturbs me more than the downward trend of productivity in our nation today. The consequences of a decrease in productivity are a diminished standard of living, higher labor costs, less competitive prices, and more inflation.

This Administration intends as part of its anti-inflation efforts to focus on those concrete steps that can be taken to stimulate increased productivity. The Economic Policy Group is very concerned about capital productivity. There is a Treasury Task Force on Capital Formation looking very closely at steps we can take. The Council of Economic Advisers and the Department of Labor have been considering the problems of worker productivity. I myself have met with Dr. Jack Grayson of the American Productivity Center in Houston to explore his suggestions and with Chairman Batten of the New York Stock Exchange where they have a very active program involving capital productivity.

In light of these efforts, I am fascinated to hear of the impact that ESOPs have had on work force morale in corporations of all sizes such as Sears Roebuck, Potomac Electric Power, Lowe's Companies and the Dow Chemical Company. I am also aware of the positive experience Eastern Airlines has had with a profit-sharing plan. The Economic Development Administration's report on Employee Ownership indicates that over a thousand firms now have some form of employee ownership plan and even more have profit-sharing plants. The report finds those firms with ESOPs to be more profitable though the sample is too small to be definitive.

I am neither an economist nor a tax expert. Detailed comments on the implications of the two bills before you today, S. 3241 and S. 3223, will be provided by others. I am certain that there are some questions and complications, and it will serve no useful purpose for me to get into such areas.

I have heard and read enough to know that there are ideas worthy of much closer inspection being presented at these hearings. I can assure you that this Administration will give careful consideration to all proposed forms of employee stock ownership. This nation needs creative and bold thinking. This Committee has the stature, the talent, the staff and the credibility to provide not only a forum for ideas, but now approaches for a sounder American economy.

In doing so, we must weigh carefully the revenue costs of meaningful programs. It would be presumptious for me to tell you that if the cost to the government in revenues is too great, the worker or citizen will receive in one hand what he pays in taxes with the other hand.

I am hopeful that these hearings will mark the beginning of a continuous and intensive examination of innovative means to improve morale and productivity in our work force. The best way to discover the meaningful long-term measures to dampen inflation which elude us today may be found in a re-examination of basic concepts. Few concepts are as basic as the role of workers in our economic structure and their participation in equity ownership. In non-economic terms, my experience as lawyer, businessman and in public life absolutely convinces me that "people perform better if they have a piece of the action."

I will be happy to answer any questions.

The CHAIRMAN. Next, we will call the Honorable Donald Lubick, Assistant Secretary of the Treasury.

Mr. Lubick, we are very happy to have you with us today and we will be pleased to have your testimony.

STATEMENT OF DONALD LUBICK, DEPUTY ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

Mr. LUBICK. Mr. Chairman and Senator Gravel, I appreciate the opportunity to be with you to discuss the issues surrounding stock ownership plans for groups of employees or for citizens. I believe the committee is most interested today in trying to define the appropriate governmental role to encourage these forms of stock ownership.

I would like first to distinguish between the goal of broadening stock ownership generally and the more specific goal of encouraging the employees to have a stake in the success of their own corporations. Now, these two goals are related, although they are somewhat different.

The goal of expanded stock ownership is to spread ownership of America's corporations across a broader range of people who would then share in the success of the corporate sector of the economy. In giving employees a stake in their own corporations, on the other hand, the goal is to establish a common economic bond between employer and employee so that each has a share in the other's success. As Ambassador Strauss has said, if employees have a piece of the action, one would expect that they would perform more responsively and more productively.

The employees would have a mutual interest with the employer in increasing the productivity and profitability of the firm. Again, if the stake is to be provided through real ownership, the employees would be given full information on the operation of their companies and the opportunity to participate in and vote on the setting of policy. And, indeed, in private practice I have participated in a number of plans where employees have been given a stake in the company and indeed ultimately have taken over the complete responsibility for the company and they have been very successful.

Now, in our discussion today of the Government's role of encouraging stock ownership, I would like to examine the extent to which gov-

ernmental policies are efficient and equitable means of reaching those goals.

We first ask the question, What is the Government's current role in encouraging stock ownership? Through pension and profit-sharing funds, the American worker has indirectly come to own a very large share of the existing productive capital of this country. The growth of pension and profit-sharing plans is fostered by generous tax treatment which is afforded to employer contributions to these qualified plans, as well as to the earnings of the plans.

Neither the employer contributions nor the earnings are taxed until the employee receives the benefits at the time of final distribution, and then the employee is taxed on benefits in excess of his own contributions.

In addition, there are special rules for distributions with respect to unrealized appreciation of employers' securities.

Investments by pension and profit-sharing plans are not generally designed to result in employee ownership of stock of their own employers but they have, in many cases, indirectly broadened stock ownership and led to a wider distribution of corporate wealth.

The tax system has lent additional encouragement to employee ownership of their employers stock through stock bonus plans and various kinds of ESOP's. For a number of years, employer plans providing for distribution to employees solely in the stock of the employer, as I said, have been accorded special benefits. Under a stock bonus plan, like a profit-sharing plan, the employer may maintain discretion over contributions without a fixed formula. By contributions are not limited to amounts set aside out of current or accumulated profits.

The Employee Retirement Income Security Act—ERISA—continued the encouragement for investing in employers' stock by allowing unlimited investment in such stock by defined contribution plans without the normal requirement of diversity, although such an investment is subject to the prudence requirements other than those relating to diversity.

ERISA also lent encouragement to a special leveraging kind of ESOP. This type of ESOP provides for the employer to guarantee a loan which the ESOP trust uses to purchase stock in the employers' company. The employer then makes contributions to the trust sufficient to repay the principal and interest on the loan over time.

ERISA provides for these plans by providing an exception to the general rule which would prohibit the employer from guaranteeing a loan made to the trust.

The Tax Reduction Act of 1975, as amended by the 1976 Tax Reform Act, took another approach to encouraging employee ownership of employer stock. It provides for an extra investment tax credit of 1 percent of qualified investments, plus another one-half of 1 percent, if matched by employee contributions, for contributions to an ESOP.

Excluding the employee matching contributions, if any, the tax credit ESOP is funded entirely from tax liability that would otherwise be owed to the Federal Government. The tax credit ESOP is thus a plan in which, in essence, the Government is financing the purchase of stock for employees based upon the amount of investment of the employer, usually at no extra cost to either employer or employee.

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It is thus a grant of varying amounts of stock to a limited group of employees.

Now, the two bills before the committee today would expand the Government's role in determining stock ownership and portfolio choices of individuals. S. 3241 would expand tax credit ESOP coverage, or direct purchase of stock by the Government, by allowing a credit for contributions to the ESOP equal to the greater of 2 percent of the employer's qualified investment for the year or 1 percent of the aggregate participants' compensation paid by the employer during the taxable year.

S. 3223 is not as directly comparable to a Government purchase, but it would provide significant tax incentives to General Stock Ownership Plans—GSOP's—which are similar to those available to leveraging ESOP's in the employment context, and these are intended generally for the people of a jurisdiction.

S. 3223 would confer tax-exempt status on a trust established to facilitate the ownership of corporate stock by the residents of the United States or by the State or local jurisdiction. The trust could finance the acquisition of corporate stock through the issuance of tax-exempt debt.

Corporate issuers of stock through a GSOP would be permitted to deduct dividends paid to the GSOP. After the debt is paid, the stock would be distributed to the individual beneficiaries taxfree.

Thus, corporate income used to finance the purchase of stock through a GSOP would not be taxed, either to the corporation or the beneficiaries, until the individual beneficiaries sell or otherwise dispose of shares they receive from the plan, or receive cash dividends.

Thus with respect to shares issued to a GSOP trust, in a sense the individual and corporate income taxes would be fully integrated by way of a dividend-paid deduction. The beneficiaries would have two principal tax benefits.

First, the beneficiaries would enjoy the benefit of borrowing at the lower rate applicable to bonds paying tax-exempt interest, which is a privilege generally limited to borrowing for governmental purposes.

Second, the income used to pay the debt would be tax exempt at the corporate level and individual tax would be deferred until sale, and then would be payable at capital gains rates.

Now, that is the current law and a description of the proposals to change that law. I would like to discuss, briefly, what the Government's role should be in encouraging stock ownership.

As in the case of other expenditure programs, if the Government is to be financing the purchase of stock for its citizens, we must ask the question, how many resources should be devoted to the program and how should the benefits of the program be distributed in insure equity?

In the context of employee stock ownership benefit plans, there are approximately 100 million workers and 200 million citizens in the United States, so that for each $1 billion in expenditures, an average of $10 per worker of $5 per citizen in stock can be purchased.

For $10 billion, $100 per worker or $50 per citizen is possible—$100 per worker represents approximately 1 percent of total payroll.

There is a means to provide a greater amount of stock per average recipient at no greater Federal revenue cost. The Government can effectively limit the number of recipients of the grant, and in a sense,

the investment credit ESOP does this by limiting the Government grant to employees of those firms that have made investments.

We believe there is no rationale behind providing one worker a level of contribution different from that received by another worker simply because their employers invested different amounts of money in plant and equipment. As demonstrated in the table attached to the statement, the current law favors workers in certain highly capital-intensive industries.

One bill before you today tends to eliminate some of that discrimination by allowing calculation of the Government grant on the basis of 1 percent of compensation of employees or 2 percent of qualified investments.

For most benefits, a percentage based upon compensation is greater than even the higher percentage based on investment and therefore, the bill would provide greater benefits to workers regardless of the industry in which they work. To that extent, we think it is a superior formula.

The other bill, S. 3223, imposes arbitrary limitations of a different sort. Individual citizens would benefit from the legislation authorizing GSOP plans only if they reside in a jurisdiction whose bonding capacity is such that it could be used in furtherance of corporate equity investments, and even then, only to the extent that each State chose to use available resources for that purpose.

It therefore could be expected that while the citizens of some States might benefit significantly, the citizens of others would not benefit at all.

The basic dilemma to be faced by the committee is to meet standards of equity and provide meaningful grants, while at the same time keeping Government expenditures on the program within reasonable limits.

In my prepared statement, which I assume will be inserted in the record, we have discussed further the problem of portfolio choice and some of the problems involved in the ESOP plans. Basically, I think I would like to refer to in the statement, starting on page 6, and to some of the specific features of the two bills. In connection with the ESOP's, I think, as we have indicated, basing compensation on the wage base rather than the investment base is superior because it enables workers, regardless of the type of industry they are in, to benefit.

We have raised a number of questions here that might give some help on improving the feasibility of ESOP's at any given level of cost. For example, one could limit the amount of wages eligible for stock through an ESOP. In terms of broadening stock ownership, it appears counterproductive to provide a $100,000 a year executive with $1,000 or more in stock while providing a tenth of that amount to a $10,000 a year worker.

In the pension laws, we have reason for encouraging an equal percentage of replacement of wages. In the case of an ESOP program designed to expand new ownership, we might consider a different type of split.

We could also consider what the situation might be if the Government subsidy were less than 100 percent of the total outlay. In that way, presumably, we could influence the same type of behavior to

encourage broader participation in employee stock ownership without the full cost being financed through the tax benefit.

In that case, again, one could provide a broader coverage for more employees without the entire amount being financed out of the tax benefit.

In our prepared statement we have also discussed some of the problems with the GSOP trust. Again, the GSOP trust has as its aim a very desirable objective, in particular under Senator Gravel's objective, to spread the ownership of a very important resource located in his State, to spread the benefits of that and the incentive to make the profits from that type of enterprise across the broad mass of the population of the State, and that is a highly desirable objective.

The questions that we have raised deal with the problem that we have where the tax exemption of this could essentially cause problems across the board. If the governmental tax exemption can be used to finance in all States private endeavors and private enterprises, we have a very serious problem of the Government being in competition with private enterprise.

The same problem is involved in the complete elimination of tax until the beneficiaries sell the equity securities which are distributed to them under the GSOP. Again, there is a significant advantage in doing that, and the basic question is whether the Government, through complete elimination of taxation until ultimate distribution, should undertake that for the advantage of a limited group.

Again, basically, the objective of both ESOP's and GSOP's is one that we share 100 percent—the encouragement of the employees having a stake in the enterprise, a feeling that they are part of it, of increasing productivity. Indeed, I think there are a number of arrangements which were worked on before ERISA and before the Tax Reform Act, where progressive companies have established employee stockownership plans—you have referred to the Sears, Roebuck plan, and there have been many in smaller companies. The objective of broad stockownership under the GSOP plan is also a sound one.

Again, the question is one of allocation of resources in trying to get a maximum incentive to accomplish these objectives, and as broad a range as possible without excessive costs and without the problem of those who are not the beneficiaries in effect financing these benefits for a very limited group.

The CHAIRMAN. Mr. Lubick, I had hoped that we were going to have the Secretary of the Treasury up here to testify about this matter. He came to us from a corporation (the Bendix Corp.) in which he apparently played a major part in putting into effect one of the great employee stockownership plans in America. I thought we might have somebody who believed in that concept.

Now you come up here with a statement which I am not really sure reflects your point of view. It sounds to me as though it reflects a point of some of these ancient bureaucrats who were brought into the Government by Harding or Coolidge or someone back there, back when I was not even old enough to don knee britches, and it makes me wonder whether you people even know what has been going on in this country, whether you are aware of what the mood of Congress has become with regard to issues like this.

Some of us believe, and I think the Secretary probably believes, that to provide an employee with stockownership in his employer and have a program where an employee gets a piece of the action, enormously increases motivation and productivity, and that this is one thing which you can say is a benefit that is not inflationary at all. It is part of what the employee earns, what he works for. In effect, he is a partner in the firm, concerned about its success, and it does not increase the cost at all.

And you come up here and act as though what you see is merely the question of an outlay by the Treasury. Well, what we are talking about is what is a fair economic return on labor to provide to people, those people paying taxes, who permit you and me to live on the fat of the land from their taxes. We have passed five laws in the past 5 years to encourage companies to make their workers partners and to make them a part of what is going on, and yet the testimony you have here sounds like you did not even know that the Congress thinks it is a good idea. I am shocked and disappointed.

Can you tell me what the distribution of wealth in this country is today? Can your assistant there tell me? Do you have anyone here who can tell me?

Mr. LUBICK. I cannot offhand, Senator.

The CHAIRMAN. Well, let me tell you.

The top 15 percent of the people have about 85 percent of all of the net worth in America. The next 35 percent have about 10 percent of it. The next 35 percent have what is left, and the bottom 15 percent have less than zero.

Now, there are some of us who are Democrats and who have managed to keep our party alive, and the reason the party has survived at all is because some new blood was put into it about 50 years ago by a group that was known as the Populists—the old fellows who thought it was not right that a few fellows earned everything—that private property is a good idea, if everybody owns some of it, but that it should not be all just owned by a few. And that thought was not entirely original with them. You will find it right there in the Pilgrim's Covenant, when they landed at Plymouth Rock.

At the same time, the idea that a few people should not have it all is as old as America. It predated the Constitution of the United States by hundreds of years.

The idea that we are discussing today is the fact that capital is not just something owned by a few, but that it should be available to everyone. From your testimony, it sounds like that is a brain-shattering idea that would create a brain hemhorrage if somebody down at the Treasury thought about it.

I am disappointed in your statement here. I can hardly believe that we had heard this from the Secretary of the Treasury if he had come up here, especially if he prepared his own statement.

Is this your opinion about ESOP, or did somebody prepare this for you?

Mr. LUBICK. Senator, the departmental positions are really basically put together by all of us working together.

The CHAIRMAN. Well, one good thing about it, nobody has to take responsibility for that fool thing.

Mr. LUBICK. I could not agree with you more that it is important for everyone to have a piece of the action. I do not think anyone could quarrel with that. And the idea of broadening stockownership and the benefits under the Sears, Roebuck plan which has been referred to, that you referred to, I think no one could dispute that that is appropriate.

The Sears, Roebuck plan, I believe, has been operating probably longer than I have been alive, and it has been operating very successfully. And there have been a number of other stockownership plans, where employers themselves have recognized that their employees would be much more productive if they had a stake in the ownership and it was their company.

The Treasury, I do not believe, doubts that for a minute.

Now, again, if we are talking about a direct 100-percent dollar-for-dollar reduction in tax for the award of stock to particular employees, to give them that stake in ownership, there is really no corporate effort to move to doing that. It does not cost the corporation a nickel to establish a plan. It is entirely financed on a basis of investment that they have made. And that, it seems to me, is in effect, a tax-subsidized grant of the stock.

And if that is to be done, it seems to us that it ought to be done on as broad a basis as possible. There are some limitations on the amount of tax that can be foregone for this purpose, and I think when the Congress determines what that amount is, we are best off if we can get as much stock spread among as many people as possible.

And, indeed, I think one of the questions we raise is, perhaps if the subsidy is not 100 percent, and if perhaps the basis of allocating is not directly in proportion to compensation, so we can have an incentive to spread some of that wealth to persons who do not have the same incentives as the $100,000 executive has, that that would be a more efficient way of allocating those resources.

I do not think anybody is quarreling for 1 minute with the objective or the desirability of broadening stockownership, or giving employees a stake in the business.

The CHAIRMAN. Well, Mr. Lubick, I think that this administration, if they want to endorse your statement, ought to revise what the President is saying about that millionaire amendment over in the House, that so-called capital gains amendment, and make its true feelings clear:

> Now, look, let's just understand this. Not only do we not want to do anything for millionaires, we do not want to do anything for you working people either. We really do not want to help anybody. Because, as a practical matter, while we are concerned for fear that a rich man might make some money, do not worry, Buster. If you are a workingman, we do not want you to have anything either.

Here is somebody on the Senate Finance Committee who is trying to see to it that a workingman would own something. Look at those Sears, Roebuck employees before the stock declined (and it will go back up). A 40-year employee had $450,000 worth of equity in that company when he retired. The Treasury Department seems to be saying, "Well, that might be all right for Sears to do that, but we do not want to do anything to encourage somebody else to do that. That might be a tax expenditure."

Here you express these views. One would think that Sears, Roebuck were the biggest tax cheaters in the history of the country. Has the Government collected tax money out of Sears?

Mr. LUBICK. I do not think that anybody is criticizing Sears. We are saying Sears has set forth an example and was able to establish its plan under the tax laws as they have existed from the beginning and is a model which should to emulated by all American industry.

If Sears can do it, I do not see any reason why they all cannot. And, indeed, I am aware of a number of clients that I have had in the course of my practice that did the very same thing because they found it very beneficial.

The CHAIRMAN. Well, my impression is that most people want to do the right thing, but they need encouragement, and that is what I am here for, and that is what I thought you were there for. And if we provide enough incentive, enough encouragement, all kinds of people will do things.

We have more than 2,000 companies making employee shareholders because we did something up here in the Congress. Incidentally, this was accomplished with little or no help from the Treasury. In fact, I cannot recall them doing anything about this.

But I am dismayed, because I thought we had a Secretary of Treasury who believed in that kind of thing, and we hear a statement such as the one that you made today. I do not understand it.

I thought that you had been exposed enough around here on the Hill to the thoughts of some of us, listening to our conversations about these tax bills down through the years. I thought you realized that we are trying to see that employees would have a little something in hope that someday they might be a substantial shareholder in the country. I thought that the bug might have infected you, Mr. Lubick. I am disappointed to see that you are immune to it.

Senator Talmade?

Senator TALMADGE. No questions.

The CHAIRMAN. Senator Curtis?

Senator CURTIS. I want to concur with the chairman on the desirability of expanding stockownership. I would like to have this booklet on ESOP's, prepared by Deliotte, Haskins and Sells, be made part of the record. I, too, am disappointed in the philosophy expressed by the testimony. In this regard, I want to mention particularly the feeling that all income belongs to the Government and that we should not let any go untaxed. That is a mistake, that is wrong.

[The booklet referred to follows:]

DELLOITTE HASKINS & SELLS, USA, EMPLOYEE STOCK OWNERSHIP PLANS: EXPANDED OPPORTUNITIES FOR EMPLOYERS, SHAREHOLDERS AND EMPLOYEES

"Just as in 1862, when Congress passed a law to allow Americans who had very little money to own and develop up to 160 acres of land, we should not give Americans the opportunity to become owners of our growing frontier of new capital (stock). The way to do this is through laws which encourage the development of programs like ESOP."—*Senator Russell B. Long, Chairman, Senate Finance Committee.*

INTRODUCTION

They have been called everything from a "highly imperfect vehicle" to "the only viable alternative to wage and price controls and state planning" to "a panacea for raising capital for the corporation." Article after article has wrestled

with their advantages and disadvantages, from *Fortune* to *Harvard Business Review* to *Business Week*.

What are they? Employee stock ownership plans, better known as ESOPs.

ESOPs, unlike the traditional stock bonus plan, profit-sharing plan and money purchase plan, have the ability to borrow large sums of money because the employer company can guarantee the loan. This ability to borrow, combined with the stipulation that the plan invest primarily in qualifying employer securities, has led companies of all sizes, public and private, to take a serious look at ESOPs and their potential to raise funds for capital investment, to finance acquisitions and divestitures, and to accomplish transfers of ownership.

Companies that have decided ESOPs appeal to them include: Ruddick Corporation, Florida Power & Light Company, Marathon Oil Company, Duke Power Company, Hallmark Cards, Inc., Shell Oil Company, Dow Chemical Company, Comsat, Atlantic Richfield Company, Pfizer Inc., Ralph M. Parsons Company, Hi-Shear Corporation, GENESCO Inc., and American Telephone and Telegraph Company.

AT&T recently endorsed the concept of ESOPs by announcing one of the largest plans to date. Because the utility obviously is capital intensive and generates sizeable investment tax credit yearly, AT&T's plan will be in the form of a Tax Reduction Act stock ownership plan (TRASOP). Companies are allowed additional investment tax credit if the additional amount is contributed to a TRASOP. AT&T sees its plan as providing not only an extra benefit for its employees but also another source of equity financing.

At Hallmark Cards, a privately owned company, an ESOP will be used by the controlling shareholders for estate planning as well as for transferring some of the ownership from the controlling shareholders to the employees of the company.

Yet, ESOPs are not for every company. For many, the disadvantages discussed later may far outweigh the advantages that ESOPs offer.

Let's take a look at the evolution of ESOPs; review some statistics about certain economic conditions that proponents of ESOPs contend these plans can reverse; discuss the various types of ESOPs, including some of the advantages and disadvantages of which companies should be aware; and discuss how ESOPs can be used by companies for more than the basic employee benefit plan. . . .

HISTORY OF EMPLOYEE BENEFIT PLANS

Employee benefit plans have been in existence in one form or another since 1921 when profit sharing plans and stock bonus plans were first provided for in the Internal Revenue Code. However, according to the Pension Trust Division of the National Office of the Internal Revenue Service, only 300 stock bonus plans were started from 1955 to 1970.

The lack of interest in stock bonus plans over the years can be attributed to several factors. Rules and procedures for establishing stock bonus plans varied from IRS District to IRS District. Also, any investments made by a stock bonus plan had to be for the "exclusive benefit of the employees"; yet, no clear guidelines existed for defining what would be the criterion for the "exclusive benefit of the employees."

The upsurge in interest in stock bonus plans can be traced principally to two key figures: Louis O. Kelso, a lawyer and lay economist, and coauthor of three books on the subject of people's capitalism; and Senator Russell B. Long, Chairman of the Senate Finance Committee, the driving force behind legislative proposals on ESOPs and Kelso's staunchest supporter.

But, of course, more than a desire on the part of Kelso and Long was required to inspire companies to share ownership—it took tax advantages created by the Employee Retirement Income Security Act of 1974 (ERISA), the Tax Reduction Act of 1975 and the Tax Reform Act of 1976. These acts offered a unique combination of retirement benefits and employer-company incentives in the form of ESOPs.

NEW DIRECTION TO CAPITALISM?

By definition, under our economic system, investment in and ownership of the means of production, distribution and exchange of wealth are traditionally made and maintained by private individuals and corporations. In fact, on the basis of information released by the U.S. Department of Commerce, 51 percent of the value of all common stock is owned by only 1 percent of U.S. families, 75

percent of the value of all common stock is owned by only 10 percent of the country's shareholders, and 47 percent of all dividends paid by U.S. companies is received by only 1 percent of all U.S. families.[1]

According to Kelso, Long and other economic theorists, dissatisfaction with the "system" is high among employees. *In a survey by Peter D. Hart Associates, only 17 percent favor the present economic system and 41 percent want major change.*[2]

STRAIGHTENING OUT THE DEFINITIONS

For many years the Internal Revenue Code has allowed favorable tax treatment to tax-qualified, defined-contribution employee benefit plans. In the narrow sense, tax qualified means that the employee benefit plan meets certain specified criteria regarding participation, vesting and the like. In the broader sense, however, tax qualified means that employer contributions to the plan are deductible by the company for tax purposes and are not taxable to the employee until actually distributed or made available to him. Also, tax on any income earned by the plan is similarly deferred. Defined contribution means that the ultimate benefits to the employee are based solely upon the amount contributed to a participant's account and upon any income, expenses, gains and losses allocable to the participant's account.

Prior to ERISA, the term ESOP—for employee stock ownership plan—was used broadly to refer to any type of tax-qualified, defined-contribution stock bonus plan. With ERISA, the term ESOP is no longer synonymous with "stock bonus plan." A stock bonus plan is permitted, with limitations, to invest in qualifying employer securities, but an ESOP is required to invest primarily in qualifying employer securities. Also, an ESOP may purchase employer company stock from the employer or from majority or other shareholders, whereas a stock bonus plan is prevented from engaging in such transactions.

Beginning with the Tax Reduction Act of 1975, and as expanded by the Tax Reform Act of 1976, an additional type of ESOP was created, known as the investment-credit ESOP or TRASOP (for Tax Reduction Act stock ownership plan).

Three types of employee benefit plans fall under the major heading of employee stock ownership plans. They are:

ESOP—stock bonus plan—the "basic" plan.

ESOP—stock bonus/money purchase plan—a variation of the "basic" plan.

TRASOP—investment-credit plan—a plan with unique tax advantages.

The tax advantages unique to the TRASOP allow a company to offer its employees benefits that cost it nothing except for certain administrative costs necessary for the operation of the plan. Because of this, many companies are becoming interested in TRASOPs, and this type of plan may be the form most often seen in the future.

Let's take a look at the basic operation of an ESOP and then look more closely at each of these definitions.

OPERATION OF AN ESOP

The chief advantage that an ESOP has over other types of employee benefit plans is it ability to be used for corporate financing. It can be used in many different ways to accomplish differing objectives, depending on the circumstances confronting a company. An understanding of its basic operation is important here.

Assume a corporation needs to raise $1,000,000. It might need these funds for additional capitalization, for purchase of a new building or equipment or for a variety of other reasons. The corporation can adopt an ESOP and have the ESOP borrow the $1,000,000 from a lending institution. The loan is guaranteed by the corporation and is payable in ten equal annual installments of $150,000. The total interest for the ten-year period is $500,000.

The ESOP uses the loan proceeds to purchase $1,000,000 of newly issued stock from the corporation. The corporation then makes annual cash contributions, which are tax deductible, to the ESOP so as to enable the ESOP to retire the loan. The result is that the corporation received $1,000,000 of new funds and also receives a tax deduction for the repayment of the loan. This series of transaction is illustrated in the following design.

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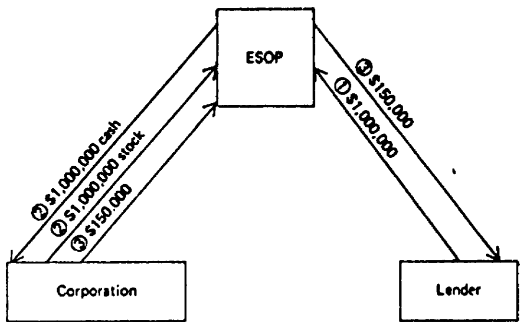
[1] Marshall E. Blume, Jean Crockett and Irwin Friend, "Stockownership in the United States: Characteristics and Trends," *Survey of Current Business*, November 1974.

[2] *Wall Street Journal*, August 22, 1975, p. 1.



1. ESCOP borrows $1,000,000 from a lender.
2. ESOP buys $1,000,000 of stock from the corporation.
3. Corporation makes $150,000 annual contribution to the ESOP which, in turn, makes an annual payment on the loan.

Assuming a 50-percent corporate tax rate, the $1,000,000 in new funds was obtained for $500,000 (interest on the loan is not considered, since it would be deductible by the corporation if it had borrowed the funds directly).

In this example, the ESOP purchased the stock from the corporation because one of the corporation's objectives was to use the ESOP as a means of raising capital. With different objectives in mind, the ESOP could have purchased the stock from existing shareholders or on the open market.

The various advantages and disadvantages of ESOPs are discussed in later sections. Nevertheless, it is important to point out here that the basic operation of our ESOP will result in a broadening of a company's capital base. This broadening may result in a dilution not only of ownership of the present shareholders but also of the earnings of the company.

ESOP-STOCK BONUS PLAN

An ESOP-stock bonus plan is the "basic" plan. It is designed to invest primarily in securities of the employer and to make distributions of these securities to the employee participants. Thus the participants are given a share in the ownership of the company for which they work.

At the same time as ownership is given to the employees, the employer company receives a tax deduction for its contribution to the plan. Moreover, if the employer contribution is in the form of stock, the deduction does not require a cash outlay.

Qualifying Employer Securities. Typically the employer securities used to fund the ESOP consist of the common stock of the employer. But other employer securities, such as bonds, debentures or other evidences of indebtedness, may be used, subject to certain restrictions.

Use of Borrowed Funds. A feature unique to an ESOP is its ability to borrow funds that are required to be guaranteed by either the employer company or a majority shareholder. This is a requirement often imposed by a lender. A profit-sharing, pension or stock bonus plan that is not an ESOP cannot engage in borrowing if either the employer company or the majority shareholder must act as guarantor.

It is not necessary for an ESOP to engage in financing, but the ability to do so offers special advantages to the company. As shown in the illustration, this capability allows the employer to receive the proceeds of the ESOP's loan (via purchase of employer securities by the ESOP with the borrowed funds), yet retire the loan with annual tax-deductible contributions to the ESOP.

If an ESOP uses funds borrowed from or guaranteed by a "party in interest" to acquire employer securities, several specific requirements must be met:

The loan must be for the primary benefit of the participants.

The interest rate must be reasonable in the circumstances.

The proceeds of the loan must be used within a reasonable time to acquire the employer securities, to repay the loan, or to repay a prior qualifying loan.

The loan must be without recourse against the ESOP, although the employer securities acquired by the proceeds of or released as collateral from a prior qualifying loan that is repaid with the current loan may be used as collateral.

Securities purchased with borrowed funds are encumbered and must be held in a suspense account (and not allocated to the employees' accounts). As the loan is repaid, a prorata number of shares (based on total principal and interest to be repaid) are released from the encumbrance.

A "party in interest" includes, among others, the employer corporation and any employee, officer, director or 10 percent or more shareholder of the corporation.

Loans not made or guaranteed by a party in interest are not specifically subject to these requirements, but they are still subject to the requirement that they be made primarily for the benefit of participants and are subject to the normal fiduciary standards.

Contributions to the ESOP-Stock Bonus Plan. The Internal Revenue Code provides that the employer may deduct its annual contribution to the ESOP-stock bonus plan up to a limit of 15 percent of the total annual compensation of employees participating in the plan. Currently, the amount that can be added annually to the account of an individual participant is limited to the lesser of $30,050 or 25 percent of that participant's compensation. This $30,050 is subject to an annual cost-of-living adjustment.

If the contributions are *less than* the 15-percent limitation, the remaining amount may be carried over to a succeeding year. The total amount deducted in the succeeding year is limited to 25 percent of that year's covered compensation. If the contribution is *more than* 15 percent of the covered compensation, the unused amount is carried over to a succeeding year. However, the amount deducted in the succeeding year cannot exceed 15 percent of the succeeding year's covered compensation.

An employee may be required or permitted to contribute to the plan, or both. If he or she contributes voluntarily, he may contribute up to 10 percent of his compensation. If he contributes as a requirement, the amount of contribution required is limited to a maximum of 6 percent of compensation. If he is both required and permitted to make contributions, he may contribute up to 16 percent of his compensation. Voluntary and required contributions are not deductible by the employee. However, any income on these contributions is not taxable to the employee until it is distributed or made available to him.

Vesting of Benefits. The rules for the vesting of participant benefits derived from employer contributions to ESOPs are the same as those prescribed by ERISA for employee benefit plans in general. These minimum vesting requirements may be satisfied through one of the following alternatives:

Full vesting after ten years of service, with no vesting required prior to that time.

A graduated vesting beginning with 25 percent after five years of service, 50 percent after ten years and full vesting after fifteen years.

A graduated vesting beginning with 50 percent at the earlier of ten years of service or when the sum of age and years of service (five or more) totals forty-five. Annual increases of at least 10 percentage points for each year of service thereafter are required.

A separate vesting of each year's employer contribution, with full vesting no later than five years after the close of the year for which the contribution was made.

The participant benefits derived from employee contributions, whether mandatory or voluntary, are always fully vested.

Voting Rights. Under the ESOP-Stock Bonus Plan voting rights may or may not be passed through immediately to the employee, depending on the particular provisions of the plan agreement. If the voting rights do not pass through immediately to the employee, an administrative committee appointed by the company's board of directors will usually vote the ESOP's shares. The members of the committee, of course, may include employee representatives. It is important, however, that the shares be voted solely in the interest of the employees.

Distribution of Securities to Employees. An ESOP must provide a definite, predetermined formula for distributing the securities held by it. The distribution may be made—

After a fixed number of years (at least two years).

Upon reaching a stated age.

Upon occurrence of events such as layoff, illness, disability, retirement, death, or separation from service with the employer.

Unless the employee elects otherwise, distribution of the securities from the ESOP is *required* to begin within sixty days after the *latest* of—

Reaching age sixty-five (or normal retirement age if less than sixty-five).
Participating in the plan for ten years.
Separating from service with the employer.

Right of First Refusal. A right of first refusal gives the employer company the option to repurchase the securities if the employee, upon receipt of the securities, desires to sell or transfer any of his holdings to a third party. Securities acquired with funds borrowed from or guaranteed by a party in interest may be, but are not required to be, subject to this right only if they are in the form of stock or a security convertible into an equity security or other stock and they are not publicly traded at the time that the right is exercised. Having met these conditions, the right itself must meet certain requirements. For example:

The right must be in favor of the employer, the ESOP or both.

The selling price and other terms of the right must be at least as favorable as the greater of the value of the security determined by IRS Regulations or the price and terms offered by another buyer making a good-faith offer to purchase.

The right must lapse no later than fourteen days after the security holder gives written notice that a third party has made an offer for the security.

Put Option. A put option allows the employee to require the company to purchase his securities at their fair market value as determined by IRS Regulations. Securities acquired by the ESOP with funds acquired from or guaranteed by a party in interest must be subject to a put option if they are not publicly traded or are subject to a trading restriction under federal or state securities laws when the securities are distributed. The option must have a life of at least fifteen months beginning when distribution is made from the ESOP. The option must bind the company only. Under no circumstances can it bind the ESOP. However, the option may allow the ESOP to assume the company's rights and obligations. In order to ease the demand that can be placed on a company's cash requirements, the Regulations generally provide for instalment payments over a period of not more than five years from the exercise date. However, the period may be extended to up to ten years.

Call Option and Buy-Sell Agreement. A call option allows the company to require the employee to sell his securities at their fair market value to either the company or the ESOP. A buy-sell agreement obligates the company or the ESOP to purchase company securities owned by a shareholder at the death of the shareholder. Securities acquired with funds borrowed from or guaranteed by a party in interest may not be subject to a call option, buy-sell agreement or similar arrangement.

ESOP-STOCK BONUS/MONEY PURCHASE PLAN

The definition of an ESOP under ERISA also includes a "plan . . . which is . . a stock bonus and a money purchase plan both of which are qualified. . . ."

A money purchase plan is a defined contribution plan. The annual contribution is fixed usually at a flat dollar amount or at a percentage of compensation of the participating employees. The amount of the employee's benefit on retirement depends upon the investment performance of the fund. The ultimate benefit will be that which can be purchased with the employee's interest in the fund.

When a money purchase plan is combined with a stock bonus plan in an ESOP, the characteristics of the money purchase plan and stock bonus plan are essentially maintained. There is one important difference, however. Contributions up to 25 percent of the total annual compensation of participating employees can be deducted for tax purposes.

TRASOP-INVESTMENT-CREDIT PLAN

With the Tax Reduction Act of 1975 a new type of stock ownership plan with special advantages was created. The Tax Reform Act of 1976 expanded these advantages. This type of stock ownership plan has come to be known as a TRASOP (for Tax Reduction Act stock ownership plan).

The unique feature of the TRASOP is that a company is allowed an additional 1-percent investment tax credit if such additional amount is contributed to the TRASOP. Up to another ½-percent investment tax credit is allowed if the amount is contributed by the company to the TRASOP and the employee participants contribute a matching amount.

But TRASOPs are not just regular ESOPs with additional fringe benefits. They may be a separate alternative to be used solely for investment-tax-credit purposes without other ESOP functions. This approach has the advantage of allowing a company to receive a tax credit, which costs the company nothing in

terms of a direct economic cost, as compared with a tax deduction for contributions to an ESOP, which does result in a direct economic cost to the company.

As an example, assume a company annually spends $10 million for additions of plant and equipment that qualify for investment-tax-credit purposes. This means that the additional 1-percent investment tax credit will amount to $100,000. If the company has 500 employees participating in the ESOP, an average of $200 per em-
lowing a company to receive a tax credit, which costs the company nothing in
ployee may be contributed to the plan. *This amount is funded entirely by the U.S. government, it costs the employer absolutely nothing beyond the administrative costs associated with the operation of the plan.*

Contributions. The only securities that may be contributed to the TRASOP are common stock of the employer or securities that are convertible into common stock. The stock must have voting rights and dividend rights no less favorable than of other common stock of the employer.

Cash contributions are also allowed if the cash is used to purchase employer securities within thirty days following the due date (including any extensions of time) for filing the company's income tax return for the taxable year during which the qualified investment is made.

Requirements of a TRASOP. Features unique to a TRASOP as compared with an ESOP are as follows:

Participants must be entitled to vote the stock allocated to their account and to direct the conversion of any convertible securities held in their account.

The plan must provide for immediate and full vesting each year. Forfeitures are prohibited.

All employer securities transferred to or purchased by the plan must be allocated to participants' accounts substantially in proportion to the participants' compensation, disregarding compensation in excess of $100,000.

Except for death, disability or separation from service, participants cannot receive any distributions of securities unless they have been held for at least eighty-four months from the date of allocation to their account.

A company is allowed to recover from a TRASOP the securities representing the additional investment credit where the investment credit is recaptured because of early retirement of property or where it is reduced because of a redetermination of the company's income or investment in property qualifying for investment credit. However, in order to do so, the securities representing each year's additional contribution must be separately accounted for and segregated from other plan assets.

Special Requirement for Public Utilities. The Tax Reform Act of 1976 intended that the entire additional amount of the investment credit go to the TRASOP. If a public service commission requires that a utility flow through any part of the additional credit to the consumer, the entire amount of the additional investment credit will not be allowed to the company.

CONVERSION OF A PROFIT-SHARING PLAN INTO AN ESOP

Properly structured, an existing profit-sharing plan can be converted into an ESOP. But a pension plan cannot be converted into an ESOP without incurring the substantial risk that the Internal Revenue Service might disallow all prior tax deductions for contributions to the pension plan.

There are two potential advantages to converting an existing profit-sharing plan into an ESOP. One potential advantage is that the unused contribution carryover, which is the cumulative amount of allowable contributions to the profit-sharing plan in excess of contributions actually made, can be carried forward to the ESOP. This carryforward will increase the allowable contribution for subsequent years from 15 percent of the compensation of participating employees to as much as 25 percent of such compensation.

The second potential advantage is that the assets in the profit-sharing plan may be used to acquire qualifying employer securities from the company, thereby providing the company with a source of funds. Some district directors of the IRS, however, have not allowed the funds in a profit-sharing plan to be used to acquire company securities and have insisted that these funds be kept separate from other ESOP funds. It is hoped that this inconsistency in policy will be resolved to allow the assets from the profit-sharing plan to be used to acquire company securities, provided that the investment is prudent for the ESOP. The so-called "prudent-man" rule for the evaluation of investments is an important matter when considering the adoption of any ESOP. It is a particularly important matter in the conversion of a profit-sharing plan into an ESOP.

ACCOUNTING AND FINANCIAL REPORTING

In December 1976 the Accounting Standards Division of the American Institute of Certified Public Accountants issued a Statement of Position on "Accounting Practices for Certain Employee Stock Ownership Plans." The statement was intended to help resolve some of the accounting and reporting issues that have arisen as a result of the legislation that created and defined ESOPs and TRASOPs.

The Statement's recommendations include:

Recording in the financial statements of the employer company the obligation to guarantee ESOP loans and/or a commitment to make future contributions to the ESOP in sufficient amounts to meet the loan repayment schedule. The obligation should be recorded as a liability with an offsetting reduction in shareholder's equity. The amount of liability and offsetting reduction in shareholders' equity is reduced as the ESOP makes payments on the debt. The assets held by the ESOP should not be recorded in the financial statements of the employer company.

Charging to expense the amount contributed or committed to be contributed to an ESOP in a given year. Reporting separately the compensation element and the interest element of the annual contribution to the ESOP.

Treating all shares held by an ESOP (whether distributed to employees or not) as outstanding shares in the determination of earnings per share. Charging against retained earnings dividends paid on shares held by an ESOP. These dividends should not be recorded as compensation expense.

Accounting for the additional investment tax credit (allowed through the establishment of a TRASOP) as a reduction of income tax expense in the same year that the contribution to the ESOP is charged to expense, irrespective of the accounting for the normal investment tax credit on property acquisitions.

A significant minority within the Accounting Standards Division believes that the entire annual contribution should be reported as compensation expense. Also, a minority believes that shares should be considered outstanding for earnings-per-share calculations only to the extent that they become constructively unencumbered by repayments of debt principal.

SECURITIES LAW CONSIDERATIONS

Because the operations of an ESOP include the offer or sale of securities, care must be taken to ensure compliance with federal and state securities laws.

The interests of the employees in the ESOP and the employer securities that the ESOP acquires may be considered to be securities requiring registration under the Securities Act of 1933 unless an exemption is available. In addition, purchases or sales by the ESOP of employer securities involve questions of the possible illegal use of nonpublic information. In certain situations, such as in a plan with an option for employee contributions, exemption from registration is probably not available. For these and other reasons, obtaining appropriate legal counsel and accounting expertise is extremely important when consideration is first being given to the formation of an ESOP.

ADVANTAGES AND DISADVANTAGES OF ESOPS

There are three vantage points from which to consider the advantages and disadvantages of ESOPs—the employer company, the major shareholder(s) and the employees for whom the plans were originally developed.

Advantages to Employer Company

ESOPs are the only deferred-compensation plans that can be used as a means of corporate finance. When leveraging is used by the ESOP to purchase employer securities from the company, the company receives an infusion of cash as if it had borrowed directly from a lender; however, the loan is repaid with tax-deductible contributions.

ESOPs help to instill in the employee a sense of identity with the company.

Contributions to the ESOP may, in turn, either create or increase a taxable loss which can be carried back or forward in normal fashion. Thus a noncash item in the form of a contribution of stock can result in a refund of prior taxes paid or in the reduction of future tax liabilities.

If the marketability of a company's stock is limited, as with privately or closely held companies, the ESOP can provide a needed market for the stock.

ESOPs can be used as a means to finance acquisitions of other companies.

ESOPs may also be used in corporate divestitures to spin off a division or a subsidiary to employees.

Congress presently appears to be encouraging ESOPs through tax incentives. The 1- to 1½-percent additional investment tax credit allowed TRASOPs is an example. Such incentives provide the company with a means of providing employee benefits at little or no extra cost.

Disadvantages to the Employer Company

ESOPs are required to invest primarily in employer securities. This results in the retirement benefits of employees being tied primarily to the performance of a single security. Since employees may not fully understand possible changes in profitability and the effect on stock prices, employee unhappiness may result in the company being pressured to provide other benefits.

If the company issues new stock to the ESOP, any dividends paid on the stock will reduce and possibly eliminate the advantage of the repayment of the ESOP debt with tax-deductible funds.

Contributions to an ESOP are charged to expense which, unless offset by earnings on increased cash flow, will result in a dilution of earnings per share and of book value per share.

Contributions of stock to an ESOP will also result in a dilution of value to present owners, especially if contributions are made at times when the market value of the stock is low.

The voting power that an ESOP may develop, as more and more stock is held by the ESOP, can cause difficulties for company management. Members of the ESOP administrative committee, who vote the stock, are often principals of the employer, but they must vote the stock solely in the interest of the employees. This interest may, at times, be different from that of the employer or other shareholders.

The interests of the employees in the ESOP and the employer securities that the ESOP acquires may be considered to be securities requiring registration under the Securities Act of 1933 unless an exemption is available.

Terminating employees, a large number of layoffs, or the death of a principal employee with a large interest in the ESOP may place an unexpected demand on the ESOP for liquidity. While it may be allowable for the ESOP to maintain funds to satisfy this type of contingency, it may be impossible or impractical to do so. A put option with a long payout period will help to mitigate the impact of such demands.

If a company is closely held, determining the value of the stock to be contributed to or purchased by the ESOP can be difficult. If the valuation is found to be in error by the IRS, deductions for previous contributions may be reduced and significant penalties levied.

Unless a company has a sizeable payroll (due to the limitation based on the total annual compensation of participating employees) or makes sizeable capital improvements (the additional investment tax credit allowed through the use of a TRASOP), the amount of the contribution to the ESOP may be so small as to negate the use of the ESOP as a means to retire debt with tax-deductible dollars.

For similar reasons (size of payroll and amount of capital improvements), the portion of the annual contribution that is allocated to a participant' sindividual account may not be significant enough to justify the administrative costs.

As with other employee-benefit plans, an ESOP cannot be terminated without possible penalties to the company and the participating employees.

Advantages to Major Shareholder(s)

An ESOP can provide a much-needed market for the stock held by a major shareholder or his estate.

An ESOP can redeem the shares of a major shareholder using tax-deductible dollars contributed by the company. If the company itself were to redeem the shares, no deduction for tax purposes would be available.

A sale of stock to the ESOP by a controlling shareholder may qualify for capital-gains treatment under circumstances where the proceeds from the sale to the company would otherwise result in treatment as dividend income.

Insurance premiums on key-man life insurance are not normally fully deductible for tax purposes. An ESOP can be used to convert these premiums into deductible payments if the proceeds of the insurance policy are made payable to the ESOP to fund a put option of the shareholder's estate.

Disadvantages to Major Shareholder(s)

While an employee may have a put option,[8] the company is allowed only a right-of-first-refusal option; call options are not permitted. This means that ownership of a closely held company may become more widespread, absent exercise of any put option by the employee. This dilution in ownership may not be consistent with the wishes of the major shareholders.

Borrowing funds through an ESOP may result in increased cash flow and higher earnings per share than regular debt financing if a company replaces a present employee benefit plan with an ESOP. But the dilution in ownership may not be worth the increase in cash flow.

The major shareholder is likely to be a member of the administrative committee of the ESOP. One of the responsibilities of the committee is to ensure that the ESOP purchases the employer securities at a fair price. The major shareholder may face the unwelcome situation of having to disclose to others information concerning his personal financial matters that might not otherwise be made public.

Advantages to Employees

Participation in an ESOP changes the roles of the employee—from that of a wage earner to that of an owner with a "piece of the action." The ESOP provides a form of continual profit sharing not only at the time of contribution but also through the benefits of stock ownership—cash dividends and, hopefully, market appreciation of the stock.

An ESOP is usually capable of acquiring a larger block of stock "up front" than an employee on his own. This is especially the case when the ESOP is used as a financing tool (company sells a large block of stock to the ESOP initially and retires the ESOP's debt over a period of time). Thus the employee enjoys the possibility of greater appreciation in the stock value because of the leverage achieved through ESOP financing.

The employee is not taxed on the contributions to the ESOP or the income received by the ESOP until such time as these amounts are distributed or made available to the employee.

"Lump-sum distributions" of securities are taxed in the year the distribution is made at the value originally assigned to the securities at the time of their contribution to the ESOP. Any appreciation in the value of the securities will receive capital-gain treatment and is not taxed until subsequently sold by the employee.

Disadvantages to Employees

In a smaller company, the ESOP may be the only retirement benefit for employees. Tying the retirement security of employees so closely to the success or failure of the company may not be viewed by them as a sound decision.

Small fluctuations in the market price of the stock will have a dramatic effect on an ESOP that uses leveraged financing. If the ESOP purchased the company stock with 10 percent of its own funds and 90 percent borrowed funds, a 10 percent drop in the market price would virtually eliminate the employee's equity in the plan.

A plan may require an employee to make contributions (up to 6 percent) from his after-tax income. This may be difficult for some employees to accomplish.

A FINAL THOUGHT

Employee stock ownership plans are here to stay. More and more companies are joining the ranks of those who recognize the unique opportunities that ESOPs offer. And Congress seems to be in the mood to foster these plans. In addition to the Employee Retirement Income Security Act of 1974, the Tax Reduction Act of 1975 and the Tax Reform Act of 1976, all of which defined and clarified ESOPs, Congress has before it further proposed legislation concerning ESOPs, including the Accelerated Capital Formation bill. This bill would remove the limit on employer contributions to an ESOP and make dividends paid on ESOP-held stock tax deductible to employers.

In this booklet we have attempted to clarify some of the finer points of ESOPs and to provide a level of insight into their potentialities. A careful analysis should be made of the advantages and disadvantages in each situation. A

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[8] As discussed on page 11, put options are required where securities are purchased with funds borrowed from or guaranteed by a party in interest and are not publicly traded or have certain limitations on trading.

thorough understanding of the long-range implications is necessary because an ESOP, as with many employee benefit plans, cannot be terminated without possible penalties to the company and the participating employees. But at its heart, an ESOP can operate for the benefit of the company, its employees and its shareholders.

Addendum. After this booklet went to press, Senator Russell B. Long, Chairman of the Senate Finance Committee, introduced a bill that would provide incentives to more companies to adopt employee stock ownership plans. Among the key provisions of this bill are 1) an increase in the available investment tax credit to 2 percent from 1 percent, and 2) a tax credit for a portion of the wages paid each year by employers in labor-intensive industries. The Senate Finance Committee will conduct hearings on the bill and other matters relating to ESOPs on July 19 and 20.

Senator CURTIS. Income belongs to the person who earned it or the company who earned it. The only right that we have to tax it is to pay the necessary expenses of government.

I would like to also point out that stockownership would contribute a great deal to relieving the Federal Government of a great amount of expenditures. The biggest item in our budget is not the defense of our country nor the essential expenses of running the Federal establishment. The big items in our budget are the social programs, the payments directly to individuals, counties, and States.

If we could do something in the next few years to add 10 million active stockholders in the country, that would soon be reflected in a decreasing demand for public housing or more social programs, because people would be self-sufficient.

In the early days of the country when taxes were low, individuals were able to accumulate wealth. Under the heavy taxload now, the taxes on the upper brackets do not hurt the extremely wealthy. They can live well on the capital already accumulated. But it is a disincentive to the individuals who has the ability to go clear to the top.

So I am disappointed about that. Incidentally, do you have down in the Treasury any bureaucrats who served under Calvin Coolidge? I wish you would promote them. I wish you would put them in charge. He reduced taxes every year and paid $1 billion on the national debt, and reduced everybody's taxes. Taxes were low enough so that people could accumulate wealth, save, and become owners.

An employee could look forward to going into business for himself, and he did. When he left to start his business, he left a place for somebody else to get a job; and if his business succeeded, he provided even more jobs.

So while I generally agree with my chairman on all of these good things I do disagree on those Coolidge bureaucrats. If you have one down here, do promote him, and put him in charge, because they did not do too badly.

The CHAIRMAN. Thank you, Senator Curtis.

Senator Hansen?

Senator HANSEN. Mr. Chairman, I want to compliment you on your concern and dismay over attitudes that I think we hear too much of. It is not difficult at all—and I say this to my good friend, the Assistant Secretary—to nitpick and to find fault and to criticize any change in our tax laws. I happen to be interested in a revision of the capital gains tax. The Secretary stated in Florida that the objectives that are sought for in the Investment Incentive Act are ones that he favors. He assured securities industry representatives in Florida capital formation would

stimulate the economy and provide more jobs and bring about greater tax revenues to the Treasury. Then, when a bill was introduced to aid capital formation, he vehemently objected.

In the first place, I think what is wrong with the Treasury's attitude is that it just assumes that everything is static. When you come up with a proposal, Treasury assumes nothing else is going to happen, to change what people do. They say, consistently, that if you lower the tax rate, the Government will receive less revenue. They cannot understand that people may react differently, and that an increased incentive will affect people's decisions.

So I am disturbed and discouraged that we are altogether too often confronted with a negative response from Treasury.

I would have to agree with my chairman that I think there may be a number of people down there yet from Coolidge, because they do not seem to have been reading the papers lately. They do not seem to understand that the mood of the country is changing, as indeed it is. I hope that we can take a newer attitude and take a fresh look at what people are thinking about and talking about these days and decide that, while we may not come up with any plan that is going to be perfect, for heavens sake, it is time that we do something.

I believe that when we look at the United States and compare it with the other industrialized nations around the world, we see the advantages of reducing tax rates, to stimulate this economy, as similar tax policy has in Germany and in Japan and in most of the major industrial nations of the world.

I am not an expert on these different programs, but I certainly do think that anyone who is familiar at all with the Sears plan, and with other plans, has to understand the things that will change in the individual's perception as he approaches his job if he has some small piece of the action. And, to that extent, I think that if Treasury gets with it and learns what the people are thinking about and talking about these days, you could very well come back day after tomorrow with a slightly different slant on the way you view this bill.

Mr. LUBICK. Senator Hansen, I just do want to say that the President is very concerned with the high level of taxation and with the percentage of individual income that is taken from taxation and, Senator Curtis, no one takes the position that income is not that of the person who earns the income. We certainly concur with you 100 percent that the level of taxation should be the minimum level of taxation necessary to finance the Government's activities responsibly without imposing upon the American people an indirect tax through inflation which is very serious and very, very unfair. And we certainly agree, and indeed, the President proposed substantial lowering of tax rates on capital and tax rates on labor and on individuals in his tax program.

So we recognize that there will be a feedback effect and a stimulus resulting from the lowering of taxation.

But, again, I think it is important to recognize that there are problems. I think everyone wants his taxes lowered, and everyone would like his taxes lowered completely, and again, there has to be an allocation of priorities and an allocation of the way in which it can be done.

Reasonable men can differ as to what is the best way. I think we all have the same objective, which is to keep this country strong and to keep its economy strong and to give the private sector encouragement and the ability to move ahead in a responsible way to produce the wealth, and efficiently.

I think the President's program is going for that objective, which he shares with you, even if he may not share 100 percent the particular route chosen.

Senator HANSEN. Mr. Chairman, if I could just have the last word—and then I will leave as quickly as I finish speaking—let me say that the criticism that I lodge against the President's proposal is that every Member of Congress on the other end of the Capitol is up for election or is planning to retire this year. Everyone of them.

I think they pretty well know what the people throughout these United States think and believe. The President has made his tax proposals, and so far he cannot muster enough support in the House for an alternative, despite his assurances in 1976 that he could work with the Democratic Congress.

Now, I just think that there is something to be said for looking at the proposals that are coming from the Congress and reading them at the White House and seeing if maybe there is a possibility that he may be misreading what the people in the country think.

So far, I do not find much enthusiasm for any of the significant tax proposals that he has come up with. If that is the case, I do not find it reflected over on the other end of the Capitol, nor on this end.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Gravel?

Senator GRAVEL. I want to share with my colleagues the extreme disappointment over the lackluster position being taken. I do not quite understand it, because we quote from your testimony at your hearings, you said: "We agree it would be a desirable objective to have individual stockownership as widely spread as possible."

I can recall when I had an interview with the Secretary that he told me, as he told the chairman, that he had worked with ESOP extensively at Treasury. But then we get a statement which, for one thing, is factually in error, and I will speak to that in a moment. Second, the statement shows no imagination and offers no leadership in a fundamental problem of the entire capitalist system.

Now, let me just show you where it is factually in error. I think you are led down a primrose path philosophically in Treasury, because on page 2 at the end of the third paragraph, you said, "Led to wider distribution of corporate wealth."

Well, there has not been a wider distribution of corporate wealth since the turn of the century. Now, if you people down there, one, cannot respond off the top of your head to what the wealth distribution is, and, two, are under the impression there have been great advances in this area, then I must comment on both counts. First, you should have the figures on top of your fingers when you are testiyfing on wealth distribution, which is what these plans are for. Second, there has not been great advance in wealth distribution. I would like to ask unanimous consent to have inserted in the record right now a chart prepared by the Joint Tax Committee staff which shows the distribution of wealth in this country, so that you people can study it, and

commit some of this to memory. It will show that there has not been a change since the turn of the century.

[The material to be furnished follows:]

TABLE 1.—PERSONAL WEALTH, 1972

Asset	All persons (1)	Value (billions) held by the richest— 1 percent (2)	Value (billions) held by the richest— 6 percent (3)	Share held by the richest— 1 percent (4)	Share held by the richest— 6 percent (5)
Real estate	$1,492.6	$225.0	$645	15.1	43.2
Corporate stock	870.9	491.7	629	56.5	72.2
Bonds	158.0	94.8	124	60.0	78.5
Cash	748.8	101.2	278	13.5	37.1
Debt instruments	77.5	40.8		52.7	
Life insurance	143.0	10.0		7.0	
Trusts	99.4	89.4		89.9	40.5
Miscellaneous	853.6	83.3		9.8	
Total assets	4,344.4	1,046.9	2,152	24.1	49.5
Liabilities	808.5	131.0	300	16.2	37.1
Net worth	3,535.9	915.9	1,852	25.9	52.4
Number of persons (millions)	209.0	2.1	12.8		

Source: Cols. (1), (2), and (4): James D. Smith and Stephen D. Franklin, "The Distribution of Wealth Among Individuals and Families," 1975. Cols. (3) and (5): Internal Revenue Service, "Personal Wealth," 1976.

Senator GRAVEL. You have made points which are intended to be just reflective of my GSOP proposal. In other words, you try not to be for or against it. Let me just say that we can do everything right now that my GSOP is trying to do. The State of Alaska has the power to do that.

The only difference is it is State socialism. What I am trying to do is to develop an alternative which is a private corporation held by private people to further the tenets of the free enterprise system.

But if we do not get out of the Congress the legislation I am trying to get passed, we will take the other option. We have already received a dictum from the State legislature to do so with gasline. If it is going to be the philosophical approach of the administratio nto rush everybody into State socialism, fine. But some of us are trying to take the status quo and turn it round to some free enterprise advantage.

I want to say again, that everything I am proposing to do in this law, the State of Alaska can do right now. You can dispute that, and I would appreciate it if you would. We have already sold tax-exempt bonds of hundreds of millions of dollars to finance Valdez, which is a municpal situation. All I am trying to do is directly involve the people of Alaska.

Now, another thing. Your statement is strewn with equity. You know, we have to be careful that we have some equity as we move forward. Let me give you some of the equity you are living with right now, and we have not had any concern about it.

According to the figures that we have here, the top 1 percent of the families, owns, in point of fact, over 50 percent of the stock in this Nation. One percent of the families owns 56 percent of the stock in this county. Let us consider the investment tax credit, which you and I suffer under or benefit from. Several people and myself took over

$100,000 investment tax credit last year, and all of us had net worths over $100,000. The projected tax credits for corporations in 1979 was $12 billion.

Based upon the ownership of corporate stock I just talked of, it means that $6 billion of that goes to 500,000 of the 50 million American families we have. Now, that is a gift from the Federal Government of $12,000 per family.

Now, you are concerned—over the fact that we may subsidize the diffusion of capital ownership which is a laudable goal, meanwhile, we have this grossness occurring right now. It is just unbelievable that there would not be a more sympathetic focus on what is trying to be done.

In the next 20 years we are going to probably double the wealth of the Nation. We are going to add another $6 trillion in wealth. Now what plans does the Treasury have to see that that next $6 trillion is going to be owned by more Americans rather than the 1 percent, or 5 percent?

I am a great supporter of President Carter and his administration, but what plan do you have to alter the obscenity which has been occurring in our economic system?

We have come up with a plan. Obviously you do not like it, or you are not enthused about it. What plan do you have down there other than just cutting the taxes this year and adding to the deficit that is going to exist?

Do you have a plan?

Mr. LUBICK. Well, basically, Senator Gravel, I cannot speak to what the plans of the administration are to encourage ownership except——

Senator GRAVEL. You are the chief planner in Treasury.

Mr. LUBICK. I am not the chief planner for spreading the wealth, Senator Gravel. But basically, to the extent that we can keep people employed and get their incomes up to where they can accumulate and save, they will share in the wealth of this country, and basically that has been what the free enterprise system has been doing, and I want to say, as I told Senator Long, I think to the extent that employees, through their employers, get a stake in ownership of the companies, that that is highly desirable and a good way of spreading the wealth.

I think, in point of fact, we always go back to the Sears, Roebuck plan as the most dramatic evidence of it. There is a lot of corporate stockownership spread through a lot of levels of income in the country, and I think basically, by stimulating productivity and incentives to save and to grow that we will achieve that result.

Senator GRAVEL. Well, let me just say that the chairman is right: It has to be Coolidge thinking that is going on. You have not done a darned thing in the past, otherwise we would have a different distribution. I do not mean just you. I mean that the whole free enterprise system in this country has not really diffused the capitalistic system to the American people.

Otherwise, you would not have 1 percent of the people owning 56 percent of the stock.

There is nothing you can do that you can take any credit for. It will not work to say that if we keep up the present income policy a change will be brought about. It will not change. The track record is very clear.

When you are giving out, with our help, $12,000 a year to 1 percent of the people as a gift through the investment tax credit, you are just skewing the distribution, in the same direction.

And I will just add to that, Why is it that the Treasury has not come up with some TRESOP regulations? That was passed 3 years ago. We had testimony all day yesterday from people who cannot use these things that we have passed because you people will not formulate regulations.

Now, why do you not have TRESOP regulations?

Mr. LUBICK. I think the regulations will be out very soon. There are some very complicated problems involved, and I think they are pretty well resolved, with the Revenue Service. They should be out shortly.

Senator GRAVEL. Well, I just hope that is the case and we are not visited with additional delays. On this whole issue the leadership for this issue in Congress has had to bring the Government along kicking and screaming into a room where there are obvious benefits.

Six trillion dollars is coming onstream in the next 20 years. If we can say that 50 percent of the people in this country will own 50 percent of that wealth, the consequences of that with respect to welfare, social security, medicare, and medicaid, is just tremendous. And yet apparently there is no one who will concede that down at Treasury. I do not mean to be insulting to you, sir. The statement you have just presented has got to be the reflection of the hierarchy of Treasury which is supposed to be one of the major fiscal arms of the administration and it is nothing but pablum at best, and at worst is a totally negative about what we are trying to do.

I am really just struck with the lack of sensitivity and understanding as to what is really happening in our free enterprise system. We are losing it. The classic example, which I will state one more time before I stop, Mr. Chairman, is that if we do not get any succor in this, the State of Alaska is going to have to move toward State socialism.

We have a mandate to get involved on an equity basis in the gasline that has been approved by the Congress. If we do not have a GSOP, the State government will get involved, and so it will be State socialism. We can do that right now.

Or we can pass this legislation and put in motion the ability of the people of Alaska to form a private corporation and to earn dividend income.

I just hope that you will go back with the admonishments that have come forward from this committee to both yourself and to the Secretary, since you people are the leaders in the Treasury. See if you cannot shake things up and come back with an imaginative approach. At least give us the reign to come up with a creative solution, but do not be negative or put impediments onto what we are trying to do.

Thank you.

The CHAIRMAN. Mr. Packwood?

Senator PACKWOOD. No questions.

Senator GRAVEL. Mr. Chairman, I might make this brief addendum. From the private sector yesterday we heard testimony all day

long in favor of what we were trying to do. Everybody was affirmative in what we were trying to do. This is the first damper we have had on our efforts.

[The prepared statement of Mr. Lubick and answers to Senator Long's and Senator Gravel's letters follow:]

STATEMENT OF DONALD C. LUBICK, ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

Mr. Chairman and members of this distinguished Committee, I appreciate the opportunity to discuss with you issues surrounding stock ownership plans for groups of employees or citizens. I believe that the Committee is most interested today in trying to define the appropriate governmental role, if any, in encouraging such forms of ownership of stock.

ADVANTAGES OF BROADENED STOCK OWNERSHIP

Let me distinguish between the goal of broadening stock ownership generally and the more specific goal of encouraging employees to have a stake in the success of their own corporations. The two goals are related, but different. The goal of expanded stock ownership is to spread ownership of America's corporations across a broader range of people. These people would then share in the success of the corporate sector of the economy. In effect, corporate wealth would be distributed more widely across the population. In giving employees a stake in their own corporations, on the other hand, the goal is to establish a common economic bond between employer and employee, so that each has a share in the other's success. Together they would share a mutual interest in increasing the productivity and profitability of the firm. If the stake is provided through real ownership, then the employees would presumably be given full information on the operation of their companies and the opportunity to participate in and vote on the setting of policy; that is, they would exercise some control over the company. In my discussion of the government's role of encouraging stock ownership, I will examine the extent to which governmental policies are efficient and equitable means of reaching those goals.

THE GOVERNMENT'S CURRENT ROLE

In order to proceed, we must first ask the question: What is the government's current role in encouraging stock ownership?

Through pension and profit sharing funds the American worker has indirectly come to own a large share of the existing productive capital of this country. The growth of such plans is fostered by the generous tax treatment accorded to employer contributions to qualified pension and profit sharing plans, and to the earnings of those plans. Neither the employer contributions to the plans nor the earnings of the plans are taxed currently to the employees. Only at the time of final distribution are employees taxed on benefits in excess of their own initial contributions. Of course, investments by pension and profit sharing funds are not generally designed to result in employee ownership of stock of their own employers; nonetheless, they have indirectly broadened stock ownership and led to a wider distribution of corporate wealth.

The tax system has lent additional encouragement to employee ownership of their own employer's stock through stock bonus plans and various kinds of ESOPs. For a number of years employer plans providing for distribution to employees solely in the stock of the employer have been accorded special benefits. Like a profit-sharing plan the employer may maintain discretion over contributions; a fixed formula is not required. However, contributions are not limited to amounts set aside out of current or accumulated profits. Moreover, in the case of certain distributions of employer stock, tax on the amount of unrealized appreciation may be deferred until the employee sells the stock.

The Employee Retirement Income Security Act of 1974 (ERISA) continued the encouragement for investment in employer stock by allowing unlimited investment in such stock by defined contribution plans without the normal

requirement of diversity, although such an investment is subject to prudence requirements other than those relating to diversity. ERISA also lent encouragement to a special leveraging type of ESOP. This type of ESOP provides for the employer to guarantee a loan which the ESOP trust uses to purchase stock in the employer's company. The employer then makes contributions to the trust sufficient to repay the principal and the interest on the loan over time. ERISA provides for these plans by providing an exception to the general rule which would prohibit the employer from guaranteeing a loan made to the trust.

The Tax Reduction Act of 1975, as amended by the Tax Reform Act of 1976, took another approach to encouraging employee ownership of employer stock. It provides for an extra investment tax credit of 1 percent of qualified investments (plus another ½ percent if matched by employee contributions) for contributions to an ESOP. Excluding the employee matching contributions, if any, the *tax credit ESOP* is funded entirely from tax liability owed to the Federal government. A tax credit ESOP is thus a plan in which the government in essence purchases stock for employees, based upon the amount of investment of the employer and usually at no cost to either employer or employee. It is a grant of varying amounts of stock from the government to a limited group of employees.

PROPOSED EXPANSIONS OF THE GOVERNMENT'S ROLE

Two bills before you today would expand the government's role in determining stock ownership and portfolio choices of individuals. S. 3241 would expand tax credit ESOP coverage, or direct purchase of stock by the government, by allowing the employer a credit for contributions to the ESOP equal to the greater of 2 percent of the employer's qualified investment for the year or 1 percent of the aggregate participant's compensation paid by the employer during the taxable year.

While S. 3223 is not as directly comparable to a government purchase, it would provide significant tax incentives to General Stock Ownership Plans ("GSOPs") similar to those available through leveraging ESOPs in the employment context even though there is no employment or other bond between the corporate issuers of stock and the intended beneficiaries. S. 3223 would confer tax exempt status on a trust established to facilitate the ownership of corporate stock by the residents of the United States or a state or local jurisdiction. The trust could finance the acquisition of corporate stock through the issuance of tax exempt debt. Corporate issuers of stock to a GSOP would be permitted to deduct dividends paid to the GSOP. After the debt is paid the stock would be distributed to individual recipients tax free. Thus, corporate income used to finance the purchase of stock through a GSOP would not be taxed either to the corporation or the beneficiaries until the individual beneficiaries sell or otherwise dispose of shares they receive from the plan or receive cash dividends. With respect to shares issued to a GSOP trust, the individual and corporate income taxes would be fully integrated via a dividends paid deduction.

Beneficiaries would obtain two principal tax benefits:

1. Beneficiaries would enjoy the benefit of borrowing at the lower rate applicable to bonds paying tax-exempt interest, a privilege generally limited to borrowing for governmental purposes.
2. Income used to pay the debt would be tax-exempt at the corporate level and individual tax would be deferred until sale and would then be payable at capital gains rates.

RULES GOVERNING THE GOVERNMENT'S ROLE

Having described the current law and some proposals to change that law, we must now turn to the question of what type of governmental role is most appropriate to the encouragement of stock ownership.

Providing an equitable and meaningful program at limited revenue cost.—As in the case of other expenditures programs, if the government is to be financing the purchase of stock for its citizens, we must ask the question: How many resources should be devoted to the program and how should the benefits of the program be distributed to insure equity? In the context of employee stock ownership benefit plans, there are approximately 100 million workers and 200 million citizens in the United States, so that for each $1 billion in expenditures an average of $10 per worker or $5 per citizen in stock can be purchased. For $10 billion,

$100 per worker or $50 per citizen is possible. Note that $100 per worker represents approximately 1 percent to total payroll.

There is a means to provide a greater amount of stock per average recipient at no greater Federal revenue cost—the government can effectively limit the number of recipients of the grant. In a sense, this is what the investment credit ESOP does by limiting the government grant to employees of those firms that have made investments.

However, there is no rationale behind providing one worker a level of contribution different from that received by another simply because their employers invested different amounts of money in plant and equipment. As demonstrated in Table 1, the current law favors workers in utility, oil, communications and other capital intensive industries. The government grant can vary from zero dollars per worker in one company to several hundred dollars in another company. One bill before you today tends to eliminate some of that discrimination by allowing calculation of the government grant on the basis of 1 percent of compensation of employees or 2 percent of qualified investments. For most businesses, 1 percent of compensation is greater than 2 percent of investment, and, therefore, the bill would limit the number of workers who received greater than average benefits because of the industry in which they worked.

The other bill before you today, S. 3223, would impose arbitrary limitations of a quite different sort. Individual citizens would benefit from the legislation authorizing general stock ownership plans only if they resided in a jurisdiction whose bonding capacity was such that it could be used in furtherance of corporate equity investments, and even then only to the extent that each state chose to use available resources for that purpose. It, therefore, could be expected that while the citizens of some states might benefit significantly, the citizens of others would not benefit at all.

I believe that one of the major dilemmas to be faced by this Committee is to meet standards of equity and provide meaningful grants while at the same time to keep government expenditures on the program within reasonable limits. To directly provide the average worker with any significant amount of stock would cost the government sizeable revenues which would eventually require the same worker or citizen to pay a sizeable tax. To limit government cost requires either reducing the average grant to an insignificant amount or narrowing the number of qualified recipients.

Maintaining freedom of portfolio choice.—As I have stated, it is desirable for employees to have a stake in their employer's success: divisions can be reduced and the incentive to work can be increased. Yet the ideal form of such a stake varies from company to company and individual to individual. Past history indicates employers and employees will develop such arrangements without tax benefits of the magnitude provided by S. 3241. Many firms give the worker a stake in the success of the corporation by providing for participation in profits in a manner other than specifically allowed under ESOPs. For instance, millions of workers currently participate in over 150,000 profit-sharing plans which do not share in the extra investment tax credit available to ESOPs. In many cases, there may be special reasons why employees would prefer to hold an investment other than their employer's stock. An employer's stock may be too risky for an employee and an asset which he or she would prefer not to own. Moreover, investment in employer stock may enhance the possibility of self-dealing. This is especially true in the case of stock that is hard to value or sell on the open market.

Traditionally, other government programs in this area have remained neutral in the portfolio decisions of individuals and firms. This is best exemplified in the tax advantages that the government offers savings in pension, profit sharing and stock bonus plans. An essential feature of this particular tax incentive is that it applies across all investment assets, not just stock. The government remains neutral in the choice of plan negotiated by the employer and employee, and in the types of investments held by the plan. Nonetheless, broadened ownership of securities has occurred because pension plans have chosen to buy stock and because many companies have established profit sharing and stock bonus plans. By 1977 about 16 percent of the increase in the financial assets of households, or 23 percent of their net individual saving, came from an increase in private pension reserves. Thus, by merely maintaining current law regarding these plans, stock ownership will continue to expand.

ADDITIONAL COMMENTS

I would like to add some comments on certain specific features of S. 3241 and S. 3223.

S. 3241

The theory underlying an ESOP is to give an employee ownership of a capital interest and, in particular, an interest in his or her employer on an ongoing basis. Present law does not fully carry this out. Prior to a distribution from an ESOP, a participating employee has only an indirect ownership interest in the employer corporation through the securities allocated to his or her account under the plan. An employee is further removed from true ownership, since there is no requirement for the pass-through of voting rights under a leveraging ESOP, and under the bill a pass-through in the case of an investment credit ESOP would no longer be required in all cases. Many persons have argued that, consistent with the concept of employee ownership, the employee should in all cases be entitled to voting rights and access to information generally given to shareholders. The bill seems to impact further upon the employee's status as an owner, since it will allow the ESOP to provide for a cash election in lieu of a distribution of employer stock. This reflects the difficulty of reconciling the ESOP theory with the desires of both the employer and the employee regarding ownership by the employees of a minority interest in a closely-held business. Substantial owners of such a business often do not want to dilute either their stock ownership or their actual conrtol, and rank-and-file employees may not want to hold stock in the business. The bill represents an effort to mesh these concerns, but we would suggest further study pointing toward developing a statement of policy which will reconcile the various interests.

S. 3241 would expand the current ESOP provisions by allowing companies an option to base their credit on investment or on some wage base. Treasury does not believe that the amount of the government credit or grant should be based in any manner upon the amount of investment of the firm. As noted above, present law discriminates in favor of certain industries because it is tied to the investment base. It also makes long-range planning for retirement savings difficult. We, therefore, believe that if Congress enacts further legislation use of the wage base is superior to use of the investment base.

However, we also believe that attention must be paid to the cost of ESOPs. By limiting the beneficiaries, present law does at least seek to limit the cost of ESOPs. An alternative means of reducing the cost is limiting the amount of wages which are eligible for stock through an ESOP. In terms of broadening stock ownership, it appears counterproductive to provide a $100,000 a year executive with $1,000 or more in stock while providing one-tenth that amount to a $10,000 a year worker. In the pension laws this type of split is allowed on a theory of equal percentage wage replacement. However, in the case of an ESOP program designed to expand stock ownership, this type of split works counter to the expressed goal of the program.

The cost could also be reduced if the government subsidy were less than 100 percent of the total outlay. It is reasonable to assume that behavior could be influenced in the desirable direction if the cost to those concerned were substantially reduced without the necessity of making the price zero.

Finally, if the base for the credit is to be related to compensation, the Treasury would encourage use of some base which can be readily calculated by employers such as wages subject to income tax withholding. It is not at all clear that aggregate compensation is measured by employers. A new wage base for the credit should require as little extra administration for employers as possible and should not require much new regulatory activity to define "compensation" for purposes of ESOPs.

The bill also contains a number of technical issues which are discussed in the appendix to my testimony.

S. 3223

As for S. 3223, it contains two other features on which I would like to comment specifically. The first is that the bill provides for full integration of the corporate income tax with respect to stock issued to a GSOP trust. As I have stated, complete integration of the corporate and individual income taxes is a matter in which the Treasury has a continuing interest, but which we feel is very much in need of further study. We would be opposed to the *ad hoc* method by which S. 3223 would result in integration but only with respect to stock issued to a general stock ownership plan. This is especially so because the concept of integration assumes

that tax will be payable at the shareholder level in lieu of the corporate income tax. It seems inconsistent with this concept to eliminate the corporate level income tax while the shareholder tax is deferred and, in this instance, partially converted into capital gain.

Second, the proposal specifically would amend the Code to exempt from Federal income tax interest on indebtedness incurred by a GSOP trust to purchase equity securities. It is inconsistent with the principles underlying section 103(b), which restricts the issuance of industrial development bonds, to permit tax-exempt debt to be used to acquire an interest in a profit-making venture. Furthermore, this amendment could have a serious, adverse impact on the yield differential between taxable and tax-exempt securities to the detriment of traditional state and local borrowing.

The goal of the GSOP could be accomplished with less departure from traditional tax principles if the state or local government role (in ventures of the sort for which the GSOP proposal is designed—large scale ventures to develop and exploit natural resources) was direct ownership of the enterprise or some portion thereof. If such an arrangement were viewed as the exercise of an essential government function the income earned by the State would be exempt under section 115 of the Code. Such investments could be financed with the state's debt and, when the debt was retired, the ownership interest would be distributed to the citizens of the state (who would be taxable at that time). It is not at all clear, however, that states should have freedom to engage in traditional, profit-making activities and derive the resulting income free of tax. In fact, the enactment of the unrelated business income tax on exempt organizations suggests a contrary conclusion. It is equally unclear that states should be able to carry on such activities with capital borrowed at tax-exempt rates. I realize that the massive accumulations of capital required for large-scale resource development present an appealing case for facilitating state involvement, but, in other contexts, it may appear that the states are being offered an opportunity to engage in profit-making ventures at an unfair, tax-induced, competitive advantage.

The Chairman also announced that the Committee wishes to examine the degree to which agencies of the Federal government have complied with section 803(h) of the Tax Reform Act of 1976. In regard to the activities of the Treasury Department, that section relates to changes in the proposed regulations which were issued in connection with leveraging ESOPs authorized by the Employee Retirement Income Security Act of 1974 (ERISA). At this point we merely note that the final ESOP regulations were published after the enactment of section 803(h), and we believe that these regulations confrom to both the letter and the intent of that statutory provision and is legislative history.

I will be pleased to answer any questions from the Committee.

TABLE 1.—INVESTMENT CREDIT ESOP'S, 1976 [1]

Industry	Returns claiming credit		Credit		Percent of all employees on nonagricultural payrolls, June 1976 [2]
	Number	Percent of all returns	Amount (thousands)	Percent of total for all industries	
Agriculture, forestry, and fishing	70	6.3	$168	([3])	([4])
Mining	25	2.2	9,272	2.1	1.0
Construction	10	.9	2,144	.5	4.7
Manufacturing	522	46.9	190,204	43.3	23.9
Chemicals	(29)	(2.6)	(30,973)	(7.0)	(1.3)
Petroleum and coal products	(23)	(2.1)	(88,643)	(20.2)	(.3)
Motor vehicles and equipment	(5)	(0.4)	(19,068)	(4.3)	(1.1)
All other manufacturing	(465)	(41.8)	(51,520)	(11.8)	(21.2)
Transportation	17	1.5	15,565	3.5	3.3
Communication	15	1.3	97,249	22.1	1.4
Electric, gas and sanitary services	127	11.4	114,448	26.0	.9
Wholesale and retail trade	267	24.0	4,811	1.1	22.2
Finance, insurance, and real estate	43	3.9	3,375	.8	5.4
Services	18	1.6	2,222	.5	18.5
Government					18.8
Total	1,114	100.0	439,458	100.0	100.0

[1] Statistics of Income * * * 1976, Corporation Income Tax Returns, Preliminary Data.

[2] U.S. Department of Labor, Division of Labor Statistics. Establishment data on employment do not match exactly with tax data by type of industry, especially in the case of conglomerates where the tax return may be placed in 1 industry and establishment data may represent employees as being in several industries.

[3] Less than 1/10 of 1 percent.

[4] Not available.

Appendix

Technical Issues Regarding S. 3241

Section 2

This section would make two changes in the estate tax law relating to employee plans, one of which would have general application to all employee plans.

Prior to enactment of the Tax Reform Act of 1976, any distribution from a qualified pension, profit-sharing, or stock bonus plan was excludible from a decedent's gross estate, except to the extent the distribution was attributable to the decedent's own contributions to the plan. The Tax Reform Act amended section 2039(c) of the Code to preclude this favorable treatment for any distribution from a qualified plan which constitutes a lump sum distribution. If a distribution constitutes a lump sum distribution, the recipient can, in many cases, elect favorable income tax treatment of the distribution. It is not clear whether the 1976 Act precludes the exclusion for all lump-sum distributions or only if the favorable income tax treatment is elected. The bill would clarify this by allowing the exclusion if the recipient does not elect the favorable income tax treatment.

The estate tax exclusion is arguably justifiable where benefits under a qualified plan are paid in an annuity. The annuity might be paid over many years, whereas any estate tax liability attributable to it would be payable soon after the decedent's death and could far exceed the annuity amounts payable up to the time of paying the tax. This liquidity problem does not occur in the case of a lump sum distribution. If the distribution is made in a lump sum, the funds necessary to pay the estate tax are available from the distribution, whether or not favorable income tax treatment is elected or available. There is no sound basis for conditioning an estate tax exclusion upon the presence or absence of favorable income tax treatment. Therefore, if legislation is to be enacted to clarify the law, we would favor denying the estate exclusion to all lump-sum distribution.

In general, the estate tax exclusion applies to distributions from qualified plans. The second change proposed in this section of the bill would extend this treatment to ESOPs whic hare not qualified plans. Investment tax credit ESOPs and ESOPs described in the bill are not required to be qualified plans. However, an ESOP is required to be nondiscriminatory (regarding both participation and contributions) and to satisfy the contribution limitations applicable to qualified plans. Since an ESOP must meet these rules, we do not believe there is good reason to excuse the plan from meeting the balance of the qualification requirements. Hence, we would favor a requirement that all ESOPs be qualified plans. This, in turn, would make the proposed estate tax exclusion for nonqualified ESOPs moot.

Section 3

Under current law, an individual who is not a participant in a qualified plan maintained by his or her employer may generally make deductible contributions to an individual retirement account (IRA) to the extent of the lesser of $1,500 or 15 percent of compensation for the year. No deductible IRA contribution is allowed if the individual participates to any extent in an employer-maintained plan during the taxable year. This has resulted in problems where employer contributions to a qualified plan are insufficient to provide true retirement security or the employee changes jobs frequently so that a retirement benefit never becomes vested.

Section 3 of the bill provides that active participation in an ESOP will be disregarded in determining whether an individual may make a deductible IRA contribution for a year. We believe this is undesirable. The intent of the Congress in enacting the IRA legislation was to make tax-favored retirement savings available to individuals who do not have this benefit through their employer. Under the bill, if an employer maintains no qualified plan other than an ESOP, an individual could make full deductible IRA contributions for a year even though an employer might make fully vested contributions on that employee's behalf to the ESOP in excess of $1,500. Our studies indicate that IRAs are largely utilized under the current rules by high income individuals and are, thus, inherently discriminatory. This provision of the bill would exacerbate that problem, since the tendency would be for highly-paid employees to utilize the available IRA deduction while receiving proportionately large contributions to the ESOP.

There are other, broad-based approaches to the IRA problem being developed in the Congress. One example is Senator Bentsen's simplified retirement plan bill, S. 3140. We believe these approaches offer a better overall solution to the problem.

Section 4

Under current rules for tax-free rollovers of lump-sum distributions from qualified plans to IRAs, the entire amount received in a distribution (except the amount attributable to an employee's own contributions) must be rolled over to the IRA. If property other than cash is received as part of the distribution, that same property must be rolled over to the IRA. The requirement that the same property be rolled over has caused difficulty, since some IRA sponsors are unwilling to accept stock, particularly stock of a closely-held corporation. This section of the bill would resolve that problem by allowing the recipient of employer securities (common stock or convertible securities issued by the individual's employer) to sell the securities after receipt from a qualified plan and deposit the proceeds of the sale with the IRA sponsor as part of the rollover contribution. Although the provision applies only to employer stock, it is not limited to distributions from ESOPs.

This type of solution to the problem is not unacceptable; since a rollover contribution must be made within 60 days after the distribution from the qualified plan, there is not a significant possibility of abuse. However, if this type of approach is used, it should not be limited to employer securities, since the same problem arises with in-kind distributions of other property. Therefore, we believe consideration should be given to applying this rule to all such distributions. If there is to be no recognition, special rules would be needed to exclude the gain from gross income.

Section 6

If a lump-sum distribution from a qualified plan includes securities of the employer corporation, the Code presently provides that net unrealized appreciation attributable to the employer's securities is not included in gross income. Therefore, the net unrealized appreciation is not taxed until the securities are sold, but the currently taxable portion of the lump sum distribution is granted the special 10-year averaging device allowable for certain lump sum distributions if otherwise applicable. This extremely favorable treatment may be somewhat mitigated by the fact that long-term capital gain resulting from the ultimate disposition of the distributed shares would be treated as an item of tax preference.

Section 6 of the bill would allow the recipient of the distribution to elect to have the amount of net unrealized appreciation included in gross income. This would result in the amount of the net unrealized appreciation being subject to the 10-year averaging device and would insulate the distribution from treatment as an item of tax preference. We believe that, in the absence of a tax-free rollover, net unrealized appreciation should be currently taxed in the same manner as any other type of lump sum distribution. No significant policy objective is achieved by singling out employer stock for this special treatment. However, we find the type of taxpayer option which would result from the bill even more objectionable. Therefore, we would prefer no change rather than the change proposed in the bill.

Section 7

Section 7 of the bill would allow a deduction for the employer for dividends paid on employer securities held by the ESOP if the dividends are distributed to participants in the plan. This is a limited form of integration of the corporate and individual income taxes, resulting in taxation of corporate income at only one level. Integration of the corporate and individual income taxes is a problem of extreme complexity which both we and the Congress have begun to examine on an overall basis. We believe the question should be addressed in terms of an overall integration mechanism and should not be limited to a single situation such as stock held by a particular form of employee benefit plan.

Section 7 would also allow a charitable deduction for income, estate, and gift tax purposes for contributions of employer securities or other property to an ESOP. Contributions by an employer to an ESOP, as well as any other type of retirement plan, are forms of compensation. Subject to the special rules for contributions to retirement plans, they should continue to be treated for tax purposes as compensation. Contributions to a plan by a person other than the employer are, in substance, a contribution to capital of the employer rather than charitable contributions in any traditional sense. Therefore, "gifts" to such an entity should not be treated as charitable gifts. Rather, to the extent that they are actually made, they should be treated as noncharitable transfers.

Section 8

Under current law, a corporation is liable for minimum tax equal to 15 percent of the amount by which the sum of the items of tax preference for the taxable year exceeds the regular tax (or, if greater, $10,000). The regular tax deduction in the case of a corporation is generally the income tax for the taxable year, reduced by certain credits, including the investment tax credit determined under section 38. Under section 8 of the bill, the regular tax deduction would not be reduced by the amount of the credit allowed for contributions to the new type of ESOP proposed by the bill. Moreover, for prior years, it would not be reduced by the amount of the investment tax credit attributable to employer contributions to TRASOPS.

The payment of deductible compensation by an employer reduces the regular tax deduction for minimum tax purposes. This principle applies both to ordinary types of cash compensation and deductible contributions to qualified retirement plans. A contribution to any type of ESOP is nothing more than compensation in the form of a contribution to a retirement plan. Therefore, it should not be treated any more favorably for this purpose than any other types of compensation.

LETTER FROM SENATOR LONG TO MR. LUBICK AND HIS ANSWER TO IT

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C., July 25, 1978.

Hon. DONALD C. LUBICK,
Assistant Secretary of the Treasury for Tax Policy,
Department of the Treasury,
Washington, D.C.

DEAR MR. LUBICK: At the Senate Finance Committee hearings on employee stock ownership plans (ESOP) which were held on July 19 and July 20, there were some additional questions which I wished to ask of you but which I chose to defer due to the shortage of time and the number of witnesses whose testimony we wanted to receive on those days. However, I feel that these questions, and your answers, bear directly upon the concept and therefore I request your response to these questions in time for inclusion in the hearing record. For your information, the deadline for receipt of all testimony and information for inclusion in the hearing record is August 15.

During your testimony, Senator Gravel raised the question of the timing for the promulgation of the Internal Revenue Service regulations on ESOPs which are created under the Tax Reduction Act of 1975 (TRASOPs). Senator Gravel pointed out that the TRASOPs had been in existence for almost three years and yet the Treasury Department has not promulgated regulations which can guide employers who adopted TRASOPs to date. This is extremely critical because there are well over 1,000 corporations which have taken advantage of the provisions of the Tax Reduction Act of 1975 and adopted TRASOPs for the benefit of the corporations and their employees. In response to Senator Gravel's question regarding the timing of the promulgation of these regulations, you advised him that they would be finalized soon. I feel that a more definitive answer is necessary. Please advise me regarding the actual status of these regulations and give me a target date for the finalization and promulgation of these regulations.

Perhaps an even more important question is the status of the IRS regulations regarding the matching employee contributions for TRASOPs. This is an area in which most employers have been operating in a complete statutory vacuum because the provisions of the Tax Reform Act of 1976 were necessarily vague in this regard and Treasury has completely failed to offer anny guidance. We have received numerous letters from some of the major corporations in the United States, complaining that they are unsure as to the procedures which should be followed in implementing such a program. I feel that some action by the Treasury Department to clear up this confusion is an absolute necessity. Therefore, I wish to be advised as to the exact status of these regulations and to be given a target date for their finalization and promulgation. In both cases, I feel that an answer that they will be forthcoming "soon" is unsatisfactory.

Approximately three months ago, we met in my office to discuss the possible resolution of a problem which exists regarding the Internal Revenue Service regulations on "put options" for stock distributed from ESOP. At that time, you discussed the matter in great detail with a member of my staff and a member of

the Senate Committee on Finance staff. During the course of this discussion, you suggested that perhaps the way in which the problem could be resolved is to permit a cash distribution from an ESOP/profit sharing plan rather than a distribution of stock, recognizing that such a distribution would relieve the necessity of giving a put option. In the drafting of S. 3241, the "Expanded Employee Stock Ownership Act of 1978", we considered your suggestion. One of the provisions of this Act provides that an ESOP may give the election to a participant to receive a distribution of cash or stock as his benefit; in the event that the ESOP gives such an election, it will not be required to give a put option to any participant who receives a distribution of stock from the ESOP. We went on to provide that the giving of such an election does not constitute the offering of a security from the ESOP for purposes of Federal or State securities laws. In your testimony, you specifically criticized this provision in the bill. My question for you, in light of our conversations of three months ago, during which you assured me personally that you would cooperate with the Congress in resolving problems such as this, is why your office has been absolutely no help in solving this problem and why you chose instead to criticize a valid attempt made by my office to find an equitable solution to the problem. Please advise me regarding what steps you office has taken to work out a solution to this problem, documenting it with regard to any communications from your office to either my office or to the office of the Committee on Finance and advise me regarding a target date when your office will have a concrete proposal ready for this solution to the "put option" problem created by the regulations.

As stated above, I feel that a response to these questions is imperative and should be included in the hearing record. For that reason, I would appreciate having your office expedite the answers to these questions and supplying them to me at your earliest convenience.

With every good wish, I am

Sincerely,

RUSSELL LONG, *Chairman.*

DEPARTMENT OF THE TREASURY,
Washington, D.C., August 11, 1978.

HON. RUSSELL B. LONG,
Chairman, Finance Committee,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: This is in response to your letter of July 25, 1978, requesting additional information relating to employee stock ownership plans to be included in the record of the hearings which were held by the Finance Committee on July 19 and 20.

As you know, the Tax Reform Act of 1976 substantially changed the existing rules governing leveraging ESOPs and 1% investment credit ESOPs established under the Tax Reduction Act of 1975 (TRASOPs). It also added a new provision for an additional one-half percent credit if matched by employees contributions. These provisions, of course, call for new regulations and in addition made our proposed regulations which were issued in 1976 inconsistent with the law in many respects. As a result of these changes, we developed a plan for the promulgation of ESOP regulations which we are in the process of carrying out. The plan called for completion of the leveraging ESOP regulations (accomplished in August 1977) followed by work in stages on the TRASOP regulations.

The first installment of TRASOP regulations will cover all the TRASOP rules including the TRASOP changes made in 1976 Act, other than rules relating specifically to the one-half percent TRASOP credit. The published documents will integrate final regulations for 1-percent TRASOPS, reflecting public comments on the original proposed regulations, with simultaneously proposed and temporary regulations, reflecting changes made by the 1976 Act. The combination of final and temporary regulations will allow the public to have a full set of binding regulations relating to 1-percent TRASOPs.

We are very close to agreement with the Internal Revenue Service on the rules to be contained in these regulations. Therefore, we expect the final documents to begin the process of formal approval at the Service within no more than 3 weeks. We and the Service will make every effort to see that the approval process proceeds smoothly and speedily.

With respect to regulations promulgating the one-half percent TRASOP rules, we and the interested offices at the Service are currently reviewing a draft of proposed regulations. These regulations contain a number of difficult problems

which we will need a little more time to resolve. We expect the final document to begin the formal approval process at the Service within eight weeks. Once again, every step will be taken to assure smooth and speedy approval of the proposed regulations.

Your letter refers to another regulation project which will make technical changes in the regulations covering leveraging ESOPs. The most significant of these problems involves the requirement of the regulations that stock of a closely held corporation distributed by an ESOP must be subject to a put option to the employer. Some corporations, such as certain banks, are unable to comply with this requirement, because applicable state law precludes the type of stock redemption contemplated in the regulations. The problem arises initially because the Internal Revenue Code requires that an ESOP be a stock bonus plan, at least in part. Under historic rules defining a stock bonus plan, such a plan is required to make distributions in employer stock.

We have been working on a resolution which has been communicated to a member of the staff of the Finance Committee who judged it to be a generally satisfactory solution. This resolution involves an amendment of the existing regulations to provide that if an employer is precluded by law from redeeming stock, the put may be to the ESOP rather than to the employer. A further possible requirement is that the employer would be forced to contribute cash to the plan in the event that cash was not otherwise available to honor the puts. A draft of amendments to the regulations to accomplish this result has been prepared and is being reviewed at the Service prior to circulation among the interested agencies. At this point, we do not have assurance that the proposed solution will be acceptable to the Department of Labor.

As you indicate in your letter, one alternative solution which was considered in earlier discussions was a proceeding under the prohibited transaction provisions of ERISA and the Code for an exemption under which a profit sharing plan could function in the same manner as a leveraging ESOP. Since a profit sharing plan is not required to make distributions in employer stock, the problem of the put option could be avoided by the plan making cash distributions. This would have been limited to plans of corporations which are precluded by law from making the required redemptions. S. 3241 would generalize a similar rule, allowing an ESOP to avoid a put option requirement where it permits a participant to elect to receive cash in lieu of a distribution of employer securities. The same consideration led us to question the appropriateness of these solutions in both contexts. The theory underlying ESOPs is that employees are to be made true owners of stock in their employer. That function does not seem to be served where stock subject to the ESOP rules will never get into the hands of the employees. This seems especially true in the case of a credit ESOP which enjoys significant tax benefits not available to a profit-sharing plan. We believe that the approach which we are proposing in the amendment to the regulations is consistent with the ESOP concept. In the meantime, further consideration can be given to this problem on an overall basis.

Sincerely yours,

DONALD C. LUBICK,
Assistant Secretary for Tax Policy.

AUGUST 24, 1978.

Hon. MIKE GRAVEL,
U.S. Senate,
Washington, D.C.

DEAR SENATOR GRAVEL: As requested by your letter of July 25, 1978, I am writing to correct what appears to be a misinterpretation of my July 20, 1978, testimony before the Senate Finance Committee on S. 3223.

My testimony did not state or reflect a preference on the part of the Department of the Treasury for state rather than private ownership of productive assets. Insofar as your General Stock Ownership Plan ("GSOP") proposal is concerned, my testimony considered two issues, one of which was the extent to which this proposal—which is intended to provide tax incentives to encourage acquisition by the residents of Alaska of interests in energy ventures in that state—departs from traditional notions of sound tax policy.

The model for the GSOP proposal is the leveraged Employee Stock Ownership Plan. Such a plan combines the benefit of current deductions at the corporate level for payments to a trust through which shares are purchased for employees, with tax exemption for the trust. The corporate level deduction is permissible because it is for a payment in the nature of compensation, traditionally deductible

in computing taxable income. The exemption of the trust is permitted because it encourages the establishment of nondiscriminatory employee benefit plans. In my testimony, I simply pointed out that these rationales could not be invoked to justify comparable treatment in the case of a GSOP.

I also indicated that direct acquisition of interests in energy ventures by the State of Alaska would not be quite as radical a departure from traditional tax policy. This observation is based on the time-tested perception, codified in Section 115 of the Internal Revenue Code, that certain ventures in the nature of public utilities are appropriate for state involvement and may be carried on by state or local governments free of tax. Such truly "public" utilities include, for example, local electrical generating facilities and the provision of local sewerage and water service. Because at least some of the ventures for which I understand the GSOP proposal was intended—ventures such as oil or gas pipelines in Alaska—can be likened to public utilities, I pointed out that it would be less of a departure from the policy embodied in Section 115 to permit Alaska to acquire directly some interest in these ventures.

My statement, of course, was no more intended to reflect a general predisposition for state ownership of productive assets than is reflected in current Section 115. I trust that you regard that section as an appropriate provision of the Internal Revenue Code, and that this letter will adequately respond to your concern Please let me know if you desire any additional information.

Best regards.

Sincerely,

Donald C. Lubick,
Assistant Secretary (Tax Policy).

The Chairman. Next we will call a panel of the Honorable Stanley Lundine from New York; the Honorable Peter Kostmayer from Pennsylvania; and the Honorable Matthew F. McHugh of New York, Members of the House of Representatives.

We are pleased to have you gentlemen.

STATEMENT OF HON. PETER H. KOSTMAYER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Representative Kostmayer. Mr. Chairman, thank you very much for the opportunity to testify before your committee this morning. As Members of the House, we appreciate it. We are glad to be on this side of the Capitol.

I will be very brief, just about 5 minutes. I want to explain the basic provisions of our bill, say something in conclusion and then yield to my colleagues from New York.

This legislation was introduced by myself and by Mr. Lundine and Mr. McHugh last March 1. It has over 60 cosponsors to date.

Simply and fundamentally, it establishes a fund of $100 million which would be used as loans to employee and employee community groups to purchase firms and to purchase businesses where a shutdown is imminent. It is important to point out that we need to determine whether or not these plants which are about to close can continue to be operated as viable businesses.

The loan is contingent upon this, and would be determined by the Department of Commerce after the Economic Development Administration has conducted a feasibility study. If the EDA determines that a plant can continue to operate, then the workers who would be laid off and the community which would be so hard hit, would have the opportunity to borrow money from the Federal Government. Funds would be paid back. These are loans, not grants, to be paid back at a rate of interest no higher than that of the prevailing rate within a period of 70 years. Technical assistance would be provided

and these people would have the opportunity to purchase these plants and continue to run them, continue to keep them in their community and continue to work.

Those are, in a very simple and elementary fashion, the basic provisions of this legislation.

Let me say that I think there is a philosophical concept here too, not only an economic notion that we need to keep these plants functioning, particularly in small cities and small towns and rural areas as well as in large cities. This philosophical concept is more controversial. I speak for myself and not for my colleagues. They can address this individually, if they choose to do so.

I think we can improve the quality of life and the quality of working life especially if we provide employees with an opportunity to have some measure of control in the workplace. Our bill would accomplish this by providing employees with funds to purchase stock in their companies, in these plants, which they would buy.

Many studies have been made which have found that there is a rather dramatic increase in productivity and in profits in plants where there is employee participation. We will insert in the record with the committee's consent data showing that this is not an idle notion, or just a romantic notion. We have found that there really is a correlation and a real increase in productivity and in profits as workers have more of a say in their plants and in their workplaces.

I think this legislation would help to do that. With that, Senator, I will stop and yield to my colleague. I think Congressman McHugh is going to go next.

Representative McHugh. Mr. Chairman, I think Representative Lundine would be next, appropriately.

STATEMENT OF HON. STANLEY N. LUNDINE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Representative Lundine. Mr. Chairman, before starting I would like to say that it is a pleasure to be here. You have, no doubt, been America's foremost spokesman for the idea that employees should have the opportunity to own some stock in the corporations they work for. The proposal we are advancing, we believe, is entirely consistent with that.

I know that these hearings are primarily directed at further inducements which you and Senator Gravel and others have proposed and I think they, likewise, are entirely consistent with the specific approach we are advancing.

I understand that this committee has had testimony yesterday by South Bend Lathe and other companies indicating that firms that are in peril of closing and might otherwise have to cease operations have, on occasion, experienced the opportunity to revitalize those companies with an employee-owned enterprise.

I have had personal experience with cases where firms were revitalized and kept in business, improved, and made profitable after employees were given the opportunity for ownership. As the mayor of Jamestown, N.Y., I formed a labor-management committee and dealt with several troubled companies, the most dramatic being Jamestown Metal Products, a very small company. Eighty-seven out

of 120 of that company's employees—production workers as well as managers—took it over in 1973.

Since that time, in spite of some difficulty, Jamestown Metal Products has expanded sales by 65 percent. It has had no layoffs and in fact has increased employment, and the book value of the stock since 1973 is approximately four times what it was when the firm became an employee-owned enterprise.

In another case, in Dunkirk, N.Y., Allegheny-Ludlum was going to close down a specialty steel division, and a new employee-community-owned enterprise called Al Tech Specialty Steel Corp., was formed. Despite the general troubles of the specialty steel industry, Al Tech increased employment to 2,200 full-time workers and made a profit in its very first fiscal year.

I think these are examples which demonstrate not only that there is a potential for saving jobs and improving the enterprise with the participation of the employees but that, as my colleague from Pennsylvania has indicated, productivity is often improved because of the motivation and the interest in the firm. And from my own observations, increased worker participation leads to greater job satisfaction and improves the quality of working life.

The examples, to us, lead all the evidence that is needed to the case for improving the opportunity for employee ownership of troubled firms.

Now I would like to yield to my colleague from New York who will explain how this legislation goes beyond existing authority to meet this particular need.

STATEMENT OF HON. MATTHEW F. McHUGH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Representative McHugh. Mr. Chairman, first I would like to join my colleagues in thanking you for giving us this opportunity to testify, and to congratulate you and the other members of this committee for your great leadership in employee stock ownership plans, something which we are clearly very interested in as well.

It is no accident that we are from the Northeast. We have experienced, in our own areas, the devastation to individuals and their families, and to the tax base of some of our communities, by plants closing or being transferred; and so we have tried, in cooperation with people outside of Congress, to develop some new ideas which can address that very serious problem.

Mr. Lundine has given you some examples where there have been success stories with employees taking over the firm. One may well ask, then, is new legislation really necessary?

I think it is necessary because, in our exploration of this problem, we have found that there are many failures as well. And those failures result not just because the plant could not be continued profitably but because at the critical time, when employees or communities are anxious to purchase, technical assistance and capital was not available.

And so we feel that it would be entirely appropriate for the Federal Government to provide some modest encouragement, information and assistance to those employees or those employee-community groups that are interested in taking over a plant which would otherwise close.

The Economic Development Administration, as I think Mr. Lundine has pointed out, has been of help in certain cases but on an ad hoc basis. It has not had the mandate from Congress to deal with these kinds of situations in a continuing and constructive manner.

At the same time, we have been told by officials in EDA that they have received hundreds of calls from people all across the country who need help and who are anxious to get involved in employee ownership, but to whom EDA has not been able to respond.

We think that this particular legislation would address at least two of the critical problems which we have seen as obstacles to employee ownership. It would provide the information and technical assistance that is necessary at the critical time, and the loans which are necessary in order for them to take over the operation of the plant.

I might also say, Mr. Chairman, that I do not think our bill necessarily addresses every single problem that might be relevant to this situation. For example, I think if there is going to be an adequate transition, the cooperation of the existing ownership is necessary, especially in terms of providing early warning that a plant is going to close.

I also think that disclosure of pertinent business information and financial data would also be important for the transition to take place effectively.

Our bill does not address those problems directly and this committee might want to consider additional legislation to provide incentives to existing ownership to provide early warning to employees, or to provide necessary business information.

But we think our bill, Mr. Chairman, addresses two of the most critical problems, the technical advice and the capital that is necessary to make these kinds of transitions effective, and we certainly hope that your committee will seriously consider our proposal. It may not be perfect in all respects, but we think it is a very important and innovative start.

The CHAIRMAN. Thank you very much, gentlemen.

Of course, as you know, the Finance Committee does not really have the jurisdiction to create any kind of a bank, an employee stock-ownership bank, or any kind. Now, we can cooperate by voting for the tax aspects of it, the revenue parts. It may be that if we are going to do what you would like to do, you will have to go before the Banking Committee over here and also the Banking Committee on the House side.

When you get ready to go before the Banking Committee on this side, I would be inclined to go along with you and do what I can to importune the members on that committee to consider it.

I think that this area of employee stockownership is something that more than just the Finance Committee ought to be involved in and so far as this Senator is concerned, I would try to get all of the committees involved. I would involve the Commerce Committee. That committee has already passed an amendment to that ConRail bill to make ConRail an employee-owned railroad and I have no doubt that if we can make the employees aware of the fact that they have a vested interest in making that railroad succeed, they will do so.

In the last analysis, we need to involve the whole Congress.

I certainly appreciate your imaginative suggestions, gentlemen.
Senator Gravel?

Senator GRAVEL. I, too, am encouraged. It seems we have natural allies for our legislation, from what I can see. I have not had a chance to read your bill, but I can assure you that I will have our staff meet with your staff to work out something. I think that we are philosophically on the same wavelength.

As the chairman said, there are certain of your suggestions such as the loan and banking part of it that deal with another committee.

I would also suggest that if you do begin to lobby, these loan restrictions are quite tight. If we are able to discount these loans with the Federal Reserve System, we could open up a whole new area of being able to finance productive capacity at a very low interest rate of 4 percent without having to go through the budgetary process of the Congress. You would be dealing directly with the money supply to do that.

I would recommend that, since we will be working very closely as to this legislation. In the past, this has always been tacked on to other legislation, but I have recommended to the chairman that with this kind of support over in the House, we can go directly at it.

We have wisdom here and beginnings have been made, and now we can make some giant steps.

Right now we have about 10 million Americans under ESOP's. With the changes that the chairman's bill offers with respect to ESOP's, we will probably put 20, 30, or 40 million very quickly under this program.

Any community can go into this. We had an example yesterday with the South Bend Lathe Co. similar to the example you are talking about. Well, that is wholly-owned ESOP, and they got a loan from the community.

If the community took an equity interest, then the community owns the stock and it is socialistic in character. But there is no reason why the community could not take an equity interest through the individual citizens, which is what we are trying to do in Alaska. It has nothing to do with the State government. The citizens own it directly in addition to the employees.

I think that one of the things we are going to, in theory, is a mix between ESOP's and GSOP's. But we do not have any legislation on the books that can bring this about.

I hope that you gentlemen, as we incorporate your views through this legislation, will give us a hand because it is going to come to your side and we are going to rely upon you to see that it gets passed through the House. You have got to carry the water over on your side.

Again, I just want to join in complimenting you gentlemen for having come to this level of sensitivity regarding the fundamental economic problems of the free enterprise system.

Mr. MCHUGH. We commend the committee for its good sense, Mr. Chairman. Thank you.

The CHAIRMAN. Senator Packwood?

Senator PACKWOOD. No questions.

The CHAIRMAN. Thank you very much, gentlemen.

[The prepared statements of the preceding panel follow:]

STATEMENT OF CONGRESSMAN PETER H. KOSTMAYER

Our social and economic system is in the midst of great stress because of the loss of jobs and the shutdowns of plants and the dislocation in our society all of these factors cause. This leads to greater dependence on government.

Because of the breakdown or absence of many traditional forms of social fellowship and self-help, people want and require more and more support for their economic and social needs, but many people are at the same time against bungling big government. Because of increased concentrations of economic power in conglomerates and government, many citizens are powerless to effect their own economic fate. Now there is a paradox here. People are against high taxes and yet they want the special interest legislation to stop. They dislike impersonal bureaucracies, and yet they want the benefits the bureaucracy bestows. They want their problems solved.

Many, both in and out of government, are seeking alternatives to this dilemma. Voluntary citizen cooperation, local self-reliance, new forms of neighborhood fellowship and social supports, economic independence from big government are the concepts of tomorrow's alternative social policy.

Employee ownership is one of the most proven examples of citizens solving their own problems. Access to property is fundamental to the American economic system and there has been a steady growth of approaches to allow this. Early Homestead Acts, aid to small businesses, credit unions and cooperatives are a few examples of "expanding ownership." Through Senator Long's creative efforts in recent years ESOPs and employee ownership have taken their place as important options for economic development. Let's consider why it works.

First, capital formation is encouraged. A recent New York Times article (July 4, 1978, p. 25) noted that capital raised by stock offerings for small businesses fell $49 million last year while funds generated for large corporations surged. Employee ownership through ESOPs and other forms gives citizens a stake in business and a business a way to raise new capital. But employee ownership not only gives a firm more capital, it can make it function more efficiently.

The lagging productivity of American companies is gaining recognition as a serious threat to our economic growth. There is evidence linking employee-owned firms to increased productivity. For example, employee-owned plywood firms in the Pacific Northwest have consistently outperformed the rest of the industry. Their average output exceeds industry productivity by levels of more than 30 percent. Managers interviewed for the Economic Development Administration's study of employee ownership released last year saw the employee-ownership plan contributing to both productivity and profit. And they were overwhelmingly satisfied with it.

Employee ownership leads to greater profitability. When a sample of 98 such firms was studied in the same EDA project, higher levels of profit were found in the employee-owned firms than in comparable size conventional firms in the same industry. More significantly, however, the more equity the employees had, the more profitable the firm became. This relationship between ownership and profitability is connected with improvements in the quality of working life. The EDA report and others have found increased job satisfaction, lower absenteeism, fewer job grievances, better communication between workers and managers, an increased desire on the part of the employees to perform well and encourage others to work harder, and increased loyalty and commitment to the business in employee-owned firms. This can be a shot in the arm to a business faced with shutdown.

Social effects like lower absenteeism and better labor-management communication seem to be more related to employee participation in developing ideas and making decisions.

Employee ownership favors small business and local business which often knows how to run a firm better that the giant absentee corporations. In examining plant shutdowns a pattern of conglomerate mismanagement and sacrificing of small towns and cities is emerging. In many cases businesses are bought and sold like stock paper in order to keep the overall conglomerate profit levels high and rising. They are then sold off not because they do not make a profit but because profits are not high enough.

But it does not matter if a business shuts down because it is a complete failure or not, there is suffering and havoc for employees, their families and communities or cities.

Shutdowns point exactly to the applicability of employee ownership. As ESOPs and other forms of employee ownership spoke to the crisis of capital formation, they can now speak to the crisis of job formation. Corporate shutdowns are a major national problem affecting the entire domestic economy. Economists Richard Freeman and Robert Frank found a net American job loss overseas between 1966 and 1976 of approximately 1.06 million jobs. The Senate Committee on Small Business has estimated that less than one percent of the 9.5 million jobs added to the United States workforce between 1969 and 1976 was generated by the largest 1,000 corporations. It would appear that the acquisition of small businesses endemic to conglomerates does not encourage employment growth.

The problem touches peoples' lives in every area of the country. According to the United Auto Workers, the state of Michigan lost more than 200,000 jobs to plant shutdowns in approximately the same period. Wayne State University economists estimate that Detroit lost nearly one-fifth of its major manufacturing plants in 1970–75 alone. Since 1960 New England lost nine percent and the Midwest 13 percent of its manufacturing employment. And the problem is not isolated. Concern is at a high point in New York, New Jersey and my own state of Pennsylvania. In Watsontown, Pennsylvania last year Zenith decided to phase out 1,000 jobs at the last United States color TV plant in a community of 5,000 people. Ohio, the scene of another massive shutdown of Youngstown Sheet and Tube affecting 5,000 workers, lost over ten percent of its manufacturing employment in the same period.

The effects of shutdowns spread like a cancer. The United States Chamber of Commerce tells us that every 100 new manufacturing jobs create 68 non-manufacturing jobs for a locality. And as we can expect non-manufacturing unemployment has also spread in the affected areas. It is debilitating in Youngstown where one out of every 30 citizens lost a job in that shutdown.

Strangely enough the notion that the South gets these jobs and the Northeast and Midwest lose may be too simplistic. Some southern economists are now finding that while there is a net increase in jobs in the South, there is a massive problem of shutdowns which is simply covered up by migration from the Northeast and Midwest. One state official from that area wrote me that he supports the concept of employee ownership as one alternative to save shutdown plants because he was sure the problem would eventually reach his state. Indeed, as many conglomerates go overseas for workers and let the technology in southern plants go under, the South may be just a way station on the road to disaster.

Employee ownership is a fresh response to this problem, a way to create jobs without massive governmental expenditures. It relies on citizen initiative, the positive effects on the company induced by increased employee involvement, and loans which are repaid. In contrast, the aftermath of a plant shutdown is a story of increasing federal dependence. Unemployment compensation is just a stop-gap measure. It does not create jobs or help people get jobs or encourage work. The lost seniority, the stability of a familiar working environment that psychologists now tell us is intimately connected to a person's mental health cannot easily be replaced.

Congress is not likely to solve this problem by establishing yet another large bureaucracy or doling out more funds. The creativity of employee ownership is an alternative we shoud apply where it is feasible.

On March 1, 1978 together with Stanley Lundine and Matthew McHugh I introduced the Voluntary Job Preservation and Community Stabilization Act, H.R. 12094. This bill provides for a pilot project of loans to employee and employee-community groups to purchase a firm planning a shutdown where a feasibility study indicates they could realistically save that firm. This legislation now has more than 60 co-sponsors in the House. I believe its emphasis on fiscal conservatism, self-reliance, and practical solutions to problems many of our constituents face makes it an acceptable bipartisan approach. The legislation would require the Secretary of Commerce to identify businesses that are in danger of ceasing operations. Technical assistance would be provided to employee or employee-community groups that decided they wanted to preserve those jobs, to get the loans and to design a program to improve the quality of working life and greater participation in the firm.

This is not a giveaway program. It authorizes loans of two kinds: to the newly constituted firm for technical assistance for initial operating costs and to individual employees for the purpose of enabling them to buy stock in their own enterprise. The broadest use of employee savings, local investment and banking sources would be encouraged to get the funds for the purchase of the shutdown firm.

The government's role here is to encourage voluntary citizen cooperation and community self-reliance. Already the federal government spends hundreds of millions of dollars in grants, loans, credits, and tax breaks to help corporations and businesses stay in business. Employees and communities deserve their chance to save jobs.

Employee ownership is a worthwhile alternative strategy to save jobs. In addition, it is an example of a different kind of dependence, a dependence on the ingenuity, volunteerism, the mutual social and economic support, and the hard work of people who desire to solve national social and economic problems if we only provide the guidance and encouragement. We cannot fund all the programs for all the people. Many of them may not work anyway. Democratic self-reliance and community initiative is the only direction in which we can go. My colleagues, Mr. Lundine and Mr. McHugh will address the success of employee ownership in saving jobs and the reasons why the legislation we have proposed is necessary to encourage this alternative.

STATEMENT OF REPRESENTATIVE STANLEY LUNDINE

I would like to begin with some personal observations about employee ownership. While the approach may sound novel, it has already demonstrated in a number of cases that greater worker participation can dramatically improve industrial performance.

In Jamestown, New York, where I served as mayor before coming to Congress, employee and employee-community ownership arrangements revitalized several failing local firms. In 1973, for example, the Jamestown Metal Products Company was about to be liquidated by its parent company, a conglomerate called AVM. With some help from local investors, 87 of the company's 120 employees—production workers as well as management—purchased the business and made it profitable again.

The new owners took over under pretty adverse conditions. The previous management had committed the plant to an unrealistic pricing policy, forcing the firm to borrow at extremely high interest rates for the first two years. But despite the difficulties, the investment paid off. Between 1973 and 1977, sales expanded by 55 percent, while employment grew by more than 8 percent. Profits rose steadily, enabling the company in 1977 to make a large payment to its employee profit sharing plan. And compared to the 1973 figure, the book value of Jamestown Metal Products' stock has more than tripled.

Rahlstrom Manufacturing, another metal fabricating firm in Jamestown, made a similarly successful transition to employee ownership in 1974. Averting liquidation and the loss of several hundred jobs, the new owners formed and received considerable help from a labor-management committee in reorganizing the aging plant.

Employee ownership arrangements have worked in many places besides Jamestown, and benefitted large firms as well as small ones. As testimony before this committee has already indicated, the South Bend Lathe Company in South Bend, Indiana, achieved stunning improvements in productivity and profits after a 100-percent employee-owned corporation took control in 1975. And in Dunkirk, New York, an employee-community group bought a specialty steel plant that Allegheny-Ludlum had decided to close in 1976. Like South Bend Lathe, the Dunkirk group put together the necessary financing with the help of a low interest loan from the Commerce Department's Economic Development Administration. The new company, Al Tech Specialty Steel Corp., has significantly increased its operating capacity and added more than 400 new jobs, for a total of 2200 full-time workers. Despite the well-known problems of the specialty steel industry, Al Tech reversed a consistent pattern of losses under Allegheny-Ludlum and made a profit in its first fiscal year of operations.

In each of these examples, transition to a form of employee or employee-community ownership proved a constructive way to cope with impending plant shutdowns and save jobs. But the approach need not be limited to cases of economic emergency, and can be viewed as one aspect of a broader effort to encourage worker investment and participation in decisionmaking.

Our evidence supports the theory that employee ownership enhances profitability by strengthening workers' motivation to do a good job. With a new financial stake in their enterprise, both workers and managers are encouraged to explore ways to increase productivity and make the business run better. In many of the cases I'm familiar with, cooperative labor-management efforts to restructure the workplace, develop skills, and generally improve the quality of working life contributed heavily to success.

In Jamestown, the existence of an area-wide labor-management committee gave considerable support to these undertakings. By emphasizing skill development, smoother labor-management relations, better working conditions and the like, the committee created a favorable economic climate which helped ease the transition to employee ownership and sustain the viability of the new firms.

Despite the promise of the concept, transfers to employee ownership have been limited by the availability of financial and technical assistance. Timing has also been a problem—especially in cases where plants will otherwise close. Often, prospective employee and community owners just cannot obtain financing and make all the necessary arrangements quickly enough.

The Federal government can clearly play a more active role. Our bill would begin on a small scale, with a $100 million in loan authority. But it should establish a federal commitment to help interested groups pursue this alternative, and provide new evidence that these ownership arrangements are good practical investments for employees and their communities.

Statement of Representative Matthew F. McHugh

Mr. Chairman, I would like to join in thanking you and the other members of this distinguished committee for holding these hearings, and in particular for providing Congressmen Kostmayer, Ludine and me an opportunity to testify on H.R. 11222. We are encouraged that you have taken an interest in our bill, which we believe would offer some meaningful help in meeting the problem of plant shutdowns.

As you know, employee and employee-community ownership of firms that would otherwise close is becoming an increasingly attractive alternative for coping with a very real problem that many of our communities face in these times of economic hardship. As Congressman Lundine has mentioned, in many communities plants have been kept open and jobs preserved in this way.

This being the case, we may well ask why this legislation is necessary. If employee and employee-community ownership has been emerging as a response to corporate divestitures in recent years, and has proved successful, why do we need new legislation?

The answer is that, despite the success stories, employee and employee-community groups face serious obstacles when they seek to assume ownership of a firm that corporate managers are planning to close down or transfer. At the same time, there is no single agency in the Federal government to which these groups can turn to obtain the help necessary to overcome these obstacles.

This legislation is designed to provide employees and residents of a community with the assistance they need, and to provide that assistance in a timely manner.

As you can appreciate, transfers of ownership to an employee or employee-community group are not easily managed. As we examined those cases where such a transfer has occurred, we found that it took extraordinary efforts and exceptional leadership to keep the firm in operation.

For every successful case, we found many others where employees and residents of a community have tried and failed, not necessarily because the plant could not be operated profitably but because there was no technical assistance available at the critical time or because the prospective purchasers lacked sufficient capital to purchase the firm.

Last year, for example, the New York-based owners of Kasanof's bakery in Boston decided to close the firm down. Although the employees were very interested in purchasing the bakery and keeping it in operation, their efforts failed when they were not able to come up with a $50,000 "buying option" that the owners insisted upon. Thus, one of the largest private employers in Boston's Roxbury section was forced to close down, and both the community and the workers were the losers.

As you know, Mr. Chairman, the Economic Development Administration of the Department of Commerce has done some work in this area. However, even

In those cases where EDA loans were extended to keep a plant in operation, this help was provided only as a last resort and not as part of any permanent mandate.

In short, because there was no other way of stabilizing the community, some officials within EDA were willing to interpret their charge broadly enough to provide the necessary support for the transfer of ownership. However, that support was typically provided in a crisis atmosphere and on an ad hoc basis. It was provided without the benefit of any comprehensive or well developed strategy.

Indeed, we have been told by EDA officials that they have received literally hundreds of telephone calls inquiring about the possibility of its providing financial and technical support for such transfers. However, those same officials have been very frank in informing us that most of these inquiries have never moved beyond this initial stage because the agency lacks the mandate and the funds.

That is likely to remain the case without the enactment of some type of legislation similar to H.R. 11222. Because it has no formal mandate to do so, except where the shutdown results from a marked shift in defense orders or from recently imposed EPA or OSHA regulations, EDA has no plans to help save jobs and stabilize communities through employee or employee-community ownership on a broader scale. Our bill would provide EDA with the mandate and the funds to provide some help on a continuing basis for a broader range of cases.

By establishing a pilot program designed to provide loans and technical assistance to employee and employee-community groups, we would be helping to solve two of the major obstacles these groups face in effecting a successful transfer of ownership.

Other problems would remain, of course, problems that are not addressed directly by our bill. For example, we believe that a transfer to employee or employee-community ownership is most likely to succeed when there is early warning by the owners of a firm of their intention to close down, and when these owners cooperate with the prospective purchasers by making financial and technical information related to the business available to them.

These matters are not addressed directly by our bill, although we have discussed a variety of sanctions and incentives that might be necessary to encourage cooperation. Indeed, this committee may want to consider additional legislation in this connection.

However, our bill addresses two of the most serious obstacles that prospective purchasers face, namely, the need for technical assistance on how to transfer the employee or employee-community ownership and the need for capital to purchase the plant. We believe that, if not a complete answer, it is a good starting point.

As Congressman Kostmayer has suggested, it is our hope that EDA can become a repository of information and assistance to which community residents could turn when faced with a plant shutdown. At the same time, the loan provisions contained in our bill would provide the capital necessary to purchase the firm where it could continue to be operated profitably.

Mr. Chairman, we believe that our bill is in the best tradition of American free enterprise. It would not impose decisions from Washington upon local communities. Rather, it would encourage and support voluntary local initiatives.

It would not require a local community to pursue this alternative when a plant is about to close. Rather, it would provide employees and residents with the necessary assistance should they want to pursue this alternative.

It would not require employees and residents to adopt a particular form of ownership and control. Rather, it would aid them in making an informed choice among all of the options of ownership and control available under the laws of their state.

Finally, the bill would not require the Secretary of Commerce to provide help in cases where a transfer of ownership is not likely to be successful. It would merely give the Secretary the tools and the mandate to provide such help in situations where the Secretary determines there is a reasonable prospect of success, thus saving jobs and stabilizing the community.

For these reasons, then, it is our hope that legislation similar to H.R. 11222 will be enacted as soon as possible. Given the economic impact that a plant closing can have on a community and on the lives of the employees directly affected, we believe that the Federal government has a responsibility to actively search for new approaches for keeping plants in operation.

We hope that our bill, and these hearings, will stimulate a rethinking of the role which employee and employee-community ownership can play in meeting our present economic difficulties.

Thank you, Mr. Chairman. That concludes my prepared statement, a copy of which I would ask to have inserted in the hearing record.

The CHAIRMAN. Next we will hear from Mr. Robert Hamrin of the Rockefeller Foundation.

STATEMENT OF ROBERT HAMRIN, FELLOW, THE ROCKEFELLER FOUNDATION

Mr. HAMRIN. My involvement in this general area of broadened capital ownership stems from my days as an economist at the Joint Economic Committee where I staffed the ESOP hearings held in December 1975 and subsequently, after that, authored the study broadening the ownership of new capital ESOP's and other alternatives.

Broadened capital ownership, I believe, is a goal that should be pursued as vigorously as possible and I wish to focus on this big picture today, and particularly on Senator Gravel's proposal for Alaska.

Because I believe that this is a goal that should be vigorously pursued, I welcome these two days of hearings in furtherance of this goal and the opportunity that I have to participate. I particularly applaud the efforts of the committee chairman, Senator Long, in pursuit of this goal.

I also wish to acknowledge the enthusiastic support and efforts of the late Honorable Senator Hubert Humphrey on behalf of this goal. It was he who sparked the Joint Economic Committee's involvement, and hence my own, in this area.

I appear before you today as an economist who, based upon my analysis of broadening capital ownership for the Joint Economic Committee, enthusiastically supports this general goal.

What, you may ask, do economists in general think about this goal? Unfortunately, I cannot come close to speaking for economists for the very simple reason that about 99 percent of economists have never themselves thought or written on this subject. This was a lesson I learned the hard way in attempting to find economists who could testify at the Joint Economic Committee hearings.

Why have my professional colleagues, not exactly known for their reticence, been so shy and retiring on this particular topic? One can only speculate, but a large part of the reason seems to be that, carried to its full degree, broadened capital ownership constitutes a fundamental structural transformation of the U.S.-economic financial system. Such change is not what most economists, weaned on marginal analysis and focusing on "change at the margin," are accustomed to dealing with.

I could also add that such a perspective characterizes much bureaucratic thinking, as exemplified earlier this morning. The bureaucracy, I would argue, needs some people with vision.

Related to that, Senator Gravel made a very profound point in his earlier question about who in the administration is thinking about the distribution of the $6 trillion of wealth that will be generated over the next 20 years.

The problem is that I am sure no one is, and the reason is that, in

general, the administration does not engage in long-range analysis which is a real critical need.

The change at the margin is what characterizes economists' methods regarding income redistribution. What has been the result of this massive effort?

After 30 years of tinkering and toying in this arena, and the expenditure of hundreds of billions of dollars on income maintenance and transfer programs, the top and the bottom quintiles of the population still hold approximately 40 percent and 5 percent income shares that they held at the end of World War II.

Yet, still today, numerous economists are engaged in attempts to perfect the income redistribution scheme.

The failure of past welfare programs and expenditures to significantly affect what many believe to be a maldistribution of income in the United States has convinced most Americans that nothing can be accomplished here, yet something can be done if the root causes of the problem are recognized. The hard fact which deserves long-overdue priority recognition is that a significantly more equitable distribution of income can only be attained by changing the underlying high concentration of wealth-holdings.

I have some statistics on the distribution of wealth which reemphasize those cited so well by Senator Long earlier this morning. Incidentally, it is not surprising that the Treasury official could not answer your question on the distribution of wealth, since this is one of the most neglected statistical areas in the Federal Government. In fact, while I was with the Joint Economic Committee and looking for statistics on the distribution of wealth, I was astonished to find that the last major survey was done by the Federal Reserve in 1962, 14 years before that time, in 1976, when I was looking.

This committee could provide a valuable service by requiring a biannual report from the Treasury on the distribution of wealth.

The statistics I do have refer to 1972. In that year, the richest 10 percent of the population owned nearly one-fourth of all personally held assets. At the other end of the income spectrum, the majority of American households that year had a financial net worth of less than $10,000 and—and this is the critical point—nearly 1 out of every 8 families had essentially no financial net worth.

The insignificance of capital holdings for low- and middle-income Americans compared to the rich can be seen by looking at what percentage of total income comes from income from dividends, interest, and capital gains.

In the $5,000 to $10,000 income class, 4.7 percent comes from dividends, interest, and capital gains; $10,000 to $15,000 income class, 3.6 percent; $15,000 to $20,000, 4.6 percent.

Then we jump to the $100,000 to $500,000 income class: 46.3 percent. The $500,000 to $1,000,000 income class—79.5 percent comes from dividends, interest, and capital gains.

And finally, the $1 million-plus income class, 86.5 percent.

More generally, of the total income reported in the under-$20,000 income bracket tax returns filed in 1971, about 90 percent came from wages and salaries.

Dominating the assets held by the rich, as we have seen this morning, is corporate stock. In fact, the richest 1 percent held well over one-half of the value of outstanding stock in 1972.

Such concentration in stockholdings means that most Americans are precluded from obtaining a significant ownership share in America's corporations and also that effective control over virtually all corporate assets rest in the hands of a small proportion of the population.

Hence, corporate stock is a logical target asset to choose when pursuing the goal of broadening stock capital ownership.

The Joint Economic Committee, cognizant of such dismal facts, laid the seed in its 1976 annual report for a transformation to begin at the outset of our third century which could be one of the most exciting this country has never experienced: From a capitalist economy in which very few own any capital, and barely even understand what it really is, to a truly capitalist system in which everyone shares a piece of the action by being a capital owner.

The JEC recommendation to Congress in their annual report was—and I quote: "To provide a realistic opportunity for more U.S. citizens to become owners of capital and to provide an expanded source of equity financing for corporations, it should be made national policy to pursue the goal of broadened capital ownership."

Actually, the seeds of such a national policy already existed in the form of the ESOP-related provisions of four congressional bills passed from 1973 to 1975. Much credit goes to Senator Long and this committee for promoting these first bold steps into uncharted territory. These were followed in 1976 with what have become known as the TRASOP provisions of the Tax Reform Act of 1976. The increasingly widespread adoption of these TRASOP's has already been well documented earlier in these hearings.

The important point is that these provisions currently constitute our national policy to broaden capital ownership. The key questions are: How good is it? Is it enough? Could we do even better?

I believe that the merit of TRASOP's, as of other wealth redistribution plans, must be judged by the distribution of benefits. On this score, TRASOP's have serious defects.

First, this gift from the Government to corporate employees is automatically denied to nearly three-fourths of the members of the labor force who do not work for companies that take advantage of the investment tax credit. I am glad to see that the current proposal is tied to compensation so that the labor-intensive companies can benefit more.

Second, within the eligible company, the average employee would not receive significant benefits. More than 90 percent in the recent Hewitt survey were receiving less than $500.

Finally, the intracompany distribution is highly skewed—high salaried executives may receive 10 times the stock benefit of the $10,000 a year worker.

Although TRASOP's have been good in benefiting some employees, in popularizing the concept, and as a first action step, it is obviously not enough. Congressional thinking must now focus on the next best step.

To make any significant advance, we must go beyond the employee-related framework by still retaining some provisions for it, for the obstacles to broadening the ownership of new capital through employee benefits alone are staggering.

First, there is the problem of union opposition because the unions see ESOP's as a threat to their key role in labor-management relations.

Second, there is the fact that less than half of our corporations continue successful operations for a period of 40 years which means that many employees would be left with no benefits from their stock.

In addition, there is the fact that many workers look upon ESOPs' deferred payments disparagingly as promises payable in the hereafter.

Overshadowing all of these problems is the current lack of broad interest and support by the general public, the majority of whom would not benefit from employee-centered plans. The JEC staff study recognized this limitation and suggested the way to gain broad support in one of its major conclusions, and I quote: "Since this is a goal for all Americans and not just employees of corporations, serious consideration should be given to plans that are open to all individuals, so that anyone desiring to purchase stock under special beneficial provisions may do so up to a specified ceiling."

What would be the advantages of a broader based plan—Senator Gravel's GSOP being one example? It does not favor corporate executives or the employees of our most successful or most capital-intensive corporations. It does not come between the worker and his or her union, since it is not based on the employment relationship.

It does not create the opportunity for union leaders to take over control of corporations, since there is no employer-stock channeled to workers or unions as such. It does not depend upon tax subsidies or the loss of tax revenues, except to the extent that dividend payments by corporations would be made tax deductible, a change that is probably coming anyway. And it seems to come closer to a redistribution of income and wealth without disturbing present holdings than any other plan that has been suggested to date.

The case for all citizens having the opportunity to be capital owners has been eloquently expressed by Winnett Boyd, president of Arthur D. Little, Canada, and a leading champion of this goal in Canada. Mr. Boyd says "If a country in which only a few men and women are citizens is political unjust, the remedy is not to abolish citizenship, but to make all men and women citizens. If an industrialized country in which only a few own all the capital is economically unjust, the remedy is not to abolish private capital, but to make it possible for all to become owners of some of it."

Senator Gravel has seen the need for such a broad-scale plan. In his GSOP proposal, he has translated thought into a concrete action proposal. I regard it as an ingenious idea and a logical next step in the broadening capital ownership movement. This movement, as chronicled in Stuart Speiser's book, "A Piece of the Action," has had a lot of thought input.

I personally know the rigorous, conscientious process Senator Gravel has gone through in trying to devise the most effective means to implement broadened capital ownership. I and many others have spent numerous hours in all-day seminars with the Senator to iron out the wrinkles such a new idea inevitably surfaces.

To be sure, some wrinkles still remain. These can only be ironed out in the heat of real life action. The Alaska GSOP idea may not be the only or the ideal vehicle for broadening capital ownership, but it certainly has many compelling features, not the least of which is its potential for firing up public enthusiasm.

When people in Alaska actually begin to see the divident checks and realize that the big energy projects are not just for the benefit of rich outsiders but for them, they will take note, they will like it, and they will wonder how else they can get a piece of the action.

During my 4 years as an economist with the JEC, I saw many learned individuals come before the committee. The vast majority gave sophisticated descriptions and explanations of problems. The more scarce, concrete solutions were often of a shopworn variety, re-appearing for just one more go-around.

Few bold, creative, concrete actions were offered as solutions. I urge this committee and the Congress to seriously consider the merits of Senator Gravel's plan. I always felt, while I was with the JEC, that broadening capital ownership was one of those rare goals that commanded broad, bipartisan support in the Congress. This committee reflects that perspective, I believe.

The only question was what means should be employed to help realize it. The GSOP is a creative means, which should receive whatever congressional support is necessary to implement it.

Thank you.

The CHAIRMAN. Let me just say that your statement is inspiring, Mr. Hamrin, and it makes me think of a story that I have heard several times before. When one of the Wright Brothers succeeded in flying for the first time, he sent a wire home from Kittyhawk and said, "Today I flew 125 feet through the air. I will be home for Christmas."

So his mother took that letter down to the local newspaperman and gave it to him for the items of interest, and the newspaper had a little story on page 4. It said, "Bicycle repairman will be home for Christmas."

Some people do not see the significance of things when it is happening right in front of their eyes. As you indicated in your statement, if this economic system is to survive with all of its competition and all of the things that threaten it throughout the whole world, it is going to have to be a system that does social and economic justice to people.

Now, one alternative would be to try to do all of this by putting about 50 percent of the people either on welfare or social security payments, and paying for it by Government programs. But if we believe in the free enterprise capitalistic system, we ought to make it work, and we ought to have enough groups who support it to where the majority of the people in this country favor the capitalistic system and have a stake in it.

I was disappointed, as you could see today, that the Treasury Department did not sent up Secretary Blumenthal, who seems to believe in this type of thing. They sent up one of the bureaucracy to speak for the bureaucrats who were here before they ever came.

And that type of thing is disconcerting sometimes, when some of us see that this economic system is going to have to be a good deal for everybody and that everyone should participate, and when our efforts

are "bogged down" by the inertia caused by the shortsightedness of others.

I have to run and vote. I will be right back. I will ask Senator Gravel to finish the hearing.

Senator GRAVEL. Thank you.

Mr. Hamrin, I think I left about page 4. Since I think your testimony is important, I will ask you to be redundant and just walk me back through the balance of your testimony.

Mr. HAMRIN. You left actually just before I was making my enthusiastic pitch for your proposal.

Senator GRAVEL. Well, that is what I wanted to hear. I have a good idea you are obviously very bright, and we need everything we can get on the record.

Mr. HAMRIN. The major point I was trying to make is that we need more vision in this country, and we need people who are willing to go beyond marginal changes, and in working with you and some of your ideas, I recognized that you were willing to take such initiative in trying to think of ways in which we could fundamentally alter the income and wealth distribution. I also emphasized that the GSOP proposal was something that was on the table at this point, that was being actively considered, and that we should go forward with it. In this way, we could see what the results are, see what the reactions of the people are when they actually begin receiving fairly substantial dividend checks. I also made the point that this probably would lead to further requests, not only by people in Alaska, but elsewhere, for being part owners of major projects through GSOP mechanisms.

So I would again encourage this committee to do whatever is possible to see that this GSOP proposal does go through, and encourage you to continue your efforts in Alaska to demonstrate the merits of it.

It is at the experimental level, which is something that we talked about at the JEC—we have to start somewhere, and this is a pretty good place to start. So I was primarily encouraging the committee to go forward with it.

Senator GRAVEL. I want to thank you for that, and I might say that you are quite right. The ESOP experience we have had thus far really has not put anything concrete into the hands of individuals. When they retire, they are going to get their stockownership. There is no dividend passthrough at this point in time.

The GSOP, particularly as a result of the opportunity with the Alaska Pipeline, will be able to give individuals a check a year from now for $500. I have suggested that we include in markup as part of passing this legislation the proviso that the GSOP Corporation would tie into a computer, and that all the people in Alaska would report quarterly whenever they received their dividend check. There would be inquiries made as to what has happened to their spending patterns, what has happened to their attitudes toward work, what has happened to their attitude toward corporate enterprise and profits, and what has happened to inflation.

Since we are such an insular economy up there, you could not get a better situation to study all of the possible ramifications with 450,000 people and then build upon the compendium of knowledge we acquire as to what we would do in other parts of the country.

So I appreciate your endorsement.

Mr. HAMRIN. One thing I should raise is that in something that you have written on this—I am not sure exactly what it was—you projected that if a few of the energy projects proposed for Alaska were to be financed by this method, that by the year 2000 the average family of four would receive $40,000 in dividends.

Well, if that is the case, I think you had better think about the massive influx of population that will be coming your way in Alaska.

Senator GRAVEL. I think we could handle that, obviously by definition. It is a major criticism that comes forth, and I would suggest that the stock would be issued after a year's residence. That would take care of the problem.

You could have class A stock for people who have been there, continually, and if you want to issue other stock later on, you could have a class B stock, so you get a progressive reward in that regard.

I might say there are some computations that we have done earlier that I have found most revealing. With a $10 billion capital investment, the dividends would be about $10,000 per person, or $40,000 per family of four by the year 2000. This assumes that the loan is paid off and that the population of Alaska is 785,000 by that time.

That squares with the gift that we now give about 500,000 American families today of $12,000 a year. That is what we gave them last year on the investment tax credit.

That is 500,000 families out of 50 million families. We find it in our hearts to have great largesse for some today, which is the reason why our ownership is skewed the way it is.

I also want to thank you, though, for some new income figures that you had put forth in your testimony. When this staff study was done by the Joint Committee, was the table that was used your work?

Mr. HAMRIN. Yes.

Senator GRAVEL. I want to commend you on that. Because, as you pointed out, nothing had been done since the early 1960's. We have all been deluded, and Treasury was the best example of this. The chamber of commerce spot that talks about how everybody owns Exxon is just a lot of malarkey. Not everybody owns Exxon, and the proof of the pudding is right here. There may have been an increase in positive terms, but in relative terms, there has been no change since the turn of the century.

And your first table here that you developed and have submitted today is the only real source. There is another professor who I came across who has done some work in this area. His very fine work totally confirms your conclusions about the narrowness of the ownership base in this country. We really have been deluding ourselves. We do not have free enterprise. We do not have capitalism. We have it just for the few, and the rest of the people have to live off of these transfer payments that exist.

That is the reason why we are in great difficulty today.

Mr. HAMRIN. I am not sure whether you were here or not when I encouraged this committee, which I believe would have the jurisdiction, to request, or perhaps demand, annual or perhaps biannual reports from the Treasury on the distribution of wealth in this country.

Senator GRAVEL. I would hope the staff would make note of that recommendation. I think that is a very good one.

Mr. HAMRIN. This is a JEC recommendation in its 1976 annual report, which came right after recommending broadening capital ownership, and I hope that this committee could follow up on that.

Senator GRAVEL. You just reminded me that I made that request to the Banking Committee for the Humphrey-Hawkins bill. If they do not do it, let us put in this legislation a requirement that Treasury compile periodical reports on the distribution of wealth. At least they will be a little more glib with the figures the next time they come before us.

Mr. HAMRIN. We have statistics on almost everything—the greatest minutiae of the Consumer Price Index or unemployment—but somehow the distribution of wealth is just a neglected area. It is too touchy, I guess, for us to really get into.

Senator GRAVEL. As an economist, I was also impressed with your reasoning why this never really dawned on the great economists: The Friedmans, the Galbraiths. I once had a meeting with Dr. Galbraith and brought this point up, and he said it was just a tremendous problem, and that was the end of it. No sense or feel of what to do about it.

It is such a big problem that we do not think about it, and I think it is the most fundamental problem that we face in our economic system.

Mr. HAMRIN. It is called vision, and being able to get out from your own tunnel vision to see that the old hackneyed solutions that you put forth, which are still being put forth today to combat stagflation in general, just are not going to cut the mustard any more. The monetary and fiscal policy levers that seemed to work so well in the 1960's were really due to just the confluence of fortuitous economic trends over the past two decades which made those policies look good. But now that we are no longer having long-term trends which are so beneficial to the society, we are really beginning to see that there is no magic within just manipulation of fiscal and monetary levers. Now we have to begin to look at some of the structural problems, one of which is this high concentration of wealth.

So it is all part of a package here, and I hope that eventually my professional colleagues in economics and people in the bureaucracy can begin to see that we have to look for some new solutions, and your GSOP proposal is certainly one.

Senator GRAVEL. I want to wish you well on the book you are writing because that will help develop our literature in this area, and I thank you very much for your testimony.

Mr. HAMRIN. Thank you.

Senator GRAVEL. Our next witness is William Denton, vice president for industrial relations, Southern Pacific Co.

Mr. Denton?

STATEMENT OF WILLIAM DENTON, VICE PRESIDENT FOR INDUSTRIAL RELATIONS, SOUTHERN PACIFIC CO.

Mr. DENTON. Good morning, Senator. I will give you a brief overview of Southern Pacific Co.'s employee stockownership plan and briefly comment on a couple of aspects of S. 3241 that are of concern to us.

I was not here yesterday, but I think that from the remarks this morning that our plan would very much approximate those of the other companies that have testified, and I believe we are very con-

sistent with the philosophy that has been expressed by members of the committee this morning.

Mr. Strauss made the point that everyone should have a piece of the action, and I think our plan maximizes that aspect of the employee stockownership in that every employee of our company is eligible for the plan, and each employee will receive the same share as every other employee.

We have the broadest participation possible. Our requirements for eligibility are 25 years of age and 3 years of employment, and the 3-year provision is essentially to make sure there is some stability and interest on the part of the employee in the company.

We do provide that employees with IRA's—individual retirement accounts—are not eligible, because if they participate in an ESOP, then they are not eligible for an individual retirement account.

There is a provision in S. 3241 that would make these employees eligible in section 3(a)(2)(c) wherein it states that being in an IRA does not disqualify you from the ESOP. We feel that the provision in S. 3241 would very definitely help many of our employees who now have IRA's by making them able to participate in our ESOP.

We also believe it desirable that on final distribution, the employee be able to receive cash, at his option, in lieu of stock, and our plan so provides.

We have found that there are certain administrative problems involved in such a broad-scale employee stockownership plan which will have approximately 40,000 employees participating, and in order to have 40,000 employees participate, we have to review about 55,000 employee files. So this is also adding a tremendous number of stockholders, and therefore, the computer and administrative programs are much larger than we anticipated, and just the cost of administering this program is going to be rather expensive.

We anticipate that the fees will be about $50,000, and for each mailing it will be about $28,000.

Our plan is in its infancy in that it will be submitted to the Internal Revenue Service for approval next week. Our base year will be 1977, and we anticipate that approximately $2 million will be available for distribution, so the share for each employee will be approximately $50.

We also like the credit option that is in S. 3241, wherein it provides that either you can take advantage of your investment tax credit or a percentage of the aggregate compensation of the participants. With our policy of broad participation, that option would definitely increase the amount of the shares.

There is absolutely no earnings test for participation in our plan.

One aspect of S. 3241 that might be troublesome is that it provides for an involvement of collective bargaining representatives in the participation of the employees, and it is certainly my view that the whole concept of employee stockownership would best be kept out of the collective bargaining scene completely.

I have found that our employees are very sophisticated in handling their financial affairs and if they do not want to participate, they do not have to.

But we are just in the process of finding out what the degree of interest is now in distributing the enrollment cards. So I do not see

any real purpose in involving collective bargaining representatives for those employees who are represented by labor unions.

In short, Senator, I believe that our employee stockownership plan very definitely complies with the spirit and intent of the committee's bills, and we are very proud to have this, and we are looking forward to good results from it. Our first distribution, we expect to be after the first part of 1979.

Senator GRAVEL. Do you mean distribution directly——

Mr. DENTON. To the trustee.

Senator GRAVEL. I thank you very much. I appreciate your coming forward and having your views.

Mr. DENTON. Thank you.

[The prepared statement of Mr. Denton follows:]

STATEMENT OF WILLIAM R. DENTON

I am William R. Denton, vice president of Southern Pacific Co., One Market Plaza, San Francisco, Calif. My responsibilities for Southern Pacific include labor relations, personnel, and all other employee-related matters. I am a member of the Southern Pacific ESOP Committee.

Today I would like to tell you a little about our ESOP, our philosophy behind it, some of the complications arising from it, and how we see it working, and I will make some references to the provisions of S. 3241.

Our ESOP has not yet been approved by the IRS. Our plan was approved by our Board of Directors last September, and by the end of this month we will have the complete plan and trust agreement ready to file with the IRS. Our base year for eligibility and our tax year is, therefore, 1977. Our first distribution year will be 1978. We are hopeful of obtaining IRS approval of our plan as a qualified plan by the end of the year.

Our basic policy for our ESOP is that all employees in the company should share equally. Our plan is not limited to management or any other defined group. The amount of each share will be equal to that of every other share. There is no earnings test or criteria. This means that employees throughout our transportation system, from Oregon and Nevada through California and the Southwestern States to Louisiana and Arkansas, will be participating. The plan also includes employees of our Communications Company and all other subsidiaries.

To be eligible to participate in our ESOP, an employee must be 25 years of age and have received compensation in each of three consecutive years. This requirement is to simplify administration and to reward those who have indicated some employment stability and commitment to the Company. Temporary, short-term employees are not eligible.

Employees who have an Individual Retirement Account (IRA) are not eligible under our plan. Many of our employees are able to have and do have IRA's. Under present law, if they then participate in an ESOP, they lose their eligibility for an IRA. As things now stand, their IRA's are more valuable to them than our ESOP will be, so in order not to adversely affect their personal savings programs, we make those employees who have IRA's ineligible to participate in our ESOP.

Section 3(a)(2)(c) of S. 3241 would change the law so that at least in the case of SP employees, participation in our ESOP would not interfere with their continuing to save under an IRA. This section would thus benefit many of our employees.

For our first distribution SP expects to allocate approximately 2 million dollars. We will have over 40,000 employees eligible, so each participant will receive about $50 worth of our stock. We recognize that this is not a large amount per person, but in principle it is clearly a major step in keeping with the ESOP concept of broad employee stock ownership.

The complexities and complications we are experiencing stem from our broad participation approach. We have had to take into account the fact that some of our employees have IRA's as I have mentioned. This would not be a factor if we had limited our participation to management.

Broad participation increases the out-of-pocket cost to the Company. Expenses associated with keeping records, mailing reports to participants, and adminis-

tering the Plan far exceed the amount that may be charged to the Trust. Trustee's fees will exceed $50,000 annually. Mailing costs of quarterly and annual reports to participants are estimated at more than $28,000. These estimates do not include the costs of forms, printing reports, and administrative expenses.

Our broad eligibility approach also creates administrative complexities. We find that because of turnover, retirements, resignations, etc., to identify our approximately 40,000 eligible employees, we will have to deal with about 55,000 employee files. This is both a computer programming problem and an added clerical expense. And as employees leave the Company or otherwise become eligible for receiving their shares, the stock transfer volume and stockholder lists will increase materially. Since we will be adding thousands of new shareholders, there will be much additional paper work to be done.

For the most part each employee will have only a small number of shares—at least for the near future. Since it is expensive to sell a small number of shares on the exchange, an option to convert such shares to cash upon withdrawal from the Plan may be more desirable than requiring that stock be distributed with a subsequent sale. If an employee leaves the Company with only a few shares in his account, it may be more convenient to let him take the cash equivalent if that better suits his financial program.

Because of our broad, Company-wide participation, the option of computing the Company's credit on the basis of the aggregate participants' compensation is logical and desirable as set forth in Section 44C(a)(2) of S. 3241.

Most of our employees are subject to the Railway Labor Act and have representatives who bargain for them under that Act. While as a practical matter one would think unions would encourage and welcome ESOP's, it is oversimplifying the complexities and variables of collective bargaining to assume that. I suggest that ESOP's should be completely outside of the realm of collective bargaining, and, therefore, believe that Section 416(a)(15) on page 14 of S. 3241, giving the bargaining representative the right to decline coverage, is undesirable

We are looking forward to having a qualified ESOP with all of our labor force involved. We believe in the national policy which makes it possible, and the modifications in the law contemplated in S. 3241 which I have mentioned are constructive.

I will be pleased to answer any questions you have about Southern Pacific's Plan.

Senator GRAVEL. Our next witness is Jonathan Conrad, First Pennsylvania Bank.

Mr. Conrad?

STATEMENT OF JONATHAN M. CONRAD, FIRST PENNSYLVANIA BANK, N.A.

Mr. CONRAD. I am a corporate lending officer in the national department of the First Pennsylvania Bank, N.A., which is a major part of the First Pennsylvania Corp., a bank holding company with $8.5 billion worth of assets. My function includes lending money to corporate clients, primarily middle market companies with sales or revenues ranging from $20 million to $200 million, although some clients may range higher in the Fortune 1,000.

This function also includes being the bank's ESOP's corporate lending specialist.

The bank and I appreciate the opportunity to testify before you today on this most important subject. I will summarize my statement at this time and request that my full written statement be included in the record.

The CHAIRMAN. Mr. Conrad, I sure am happy to have you with us today. We very much appreciate your thoughtful suggestions. We will be pleased to hear your statement.

Mr. CONRAD. In regard to the recently introduced S. 3241, Expanded Employee Stock Ownership Act of 1978, I agree that the major incentives provided in this bill are necessary to encourage companies to dis-

tribute stockownership to their employees. I personally support this bill and feel it will be a major step in ESOP legislation.

As an ESOP lending specialist, I have, of course, a direct interest in seeing ESOP's encouraged, but I also feel that the infusion of capital, as well as the formation of capital, for a private market economy is essential, including motivating workers for more productivity.

There are important issues surrounding leveraged ESOP's and ESOP's in general which I will address. In short, they are: The ESOP is a valuable instrument of corporate finance and can be used as an alternate way to raise capital, coupled with employee ownership and motivation. Banks have been reluctant and slow in getting into the area of ESOP financing, but the regulatory environment has improved, and that situation has changed.

The ESOP can improve a company's balance sheet, but further changes and incentives will help ESOP's make more sense to business.

A sense of permanence in ESOP legislation is important in the business community's perspective. Increasing tax incentives, particularly for the contributions to the ESOP, will make ESOP's more flexible for business.

I am sure that the recently introduced Expanded Stock Ownership Act of 1978, under which the tax credit would be increased to 2 percent from the 1 percent presently available, is creating a major incentive for corporations to set up ESOP's in general. It is likely to double the employee's stake in the company.

First, like any employee benefit plan, the tax credit ESOP should become a permanent provision under the code beyond the present 1981 expiration period. The act would make it a permanent provision.

During the past year, I have had the opportunity to develop an ESOP specialization, and as a banker, I have found that the classic leveraged ESOP, where the loan is made to the trust, makes more sense to middle market companies which have revenues from $5 million to $200 million and need to borrow money.

The larger companies—those in the Fortune 500 which range in the $355 million to $55 billion revenues, I have found to be generally more conscious than the middle market companies of the effect ESOP's have on dilution.

Large publicly held companies are particularly concerned with how their public stockholders perceive them. For this reason, I have found that the leveraged ESOP is usually more appropriate to middle market companies and the tax credit ESOP is more suitable for larger companies which have large capital expenditures, enabling them to take advantage of the tax credit for ESOP contributions.

At this time I would like to recommend three changes and additions, one of which is not legislative.

First, the provision in the Expanded Employee Stock Ownership Act of 1978, which would allow tax deductions for dividends paid by corporations on shares of its stock held by an ESOP, unquestionably would provide a major financial incentive. As a banker, I can tell you that this would increase cash flow and, in turn, cash flow is a key to increasing the earnings of the company. That would also minimize dilution and there has been some criticism in that area, but I think we are going to see less of it with that.

Second, dilution would be minimized if the accounting profession could be persuaded to change its approach to the calculation of earnings per share. I recommend that the Senate Committee on Finance open up communications, if possible, with the accounting standards division of the American Institute of Certified Public Accountants. I discuss this in detail in my written testimony.

Further, at present deductions for contributions to an ESOP trust may not be greater than 15 percent of the covered payroll. I feel it is necessary to increase this deduction limit, and I feel that without it, there could be adverse effects on a company's financial position, particularly when the company makes contributions beyond the 15 percent.

It is my understanding that Senator Gravel addresses this problem in his recent bill.

One of the areas which for ESOP provides an excellent opportunity, and a statistic that I came across that I found fascinating, is that there are over 200,000 privately owned corporations in this country with revenues in excess of $1 million. ESOP unquestionably is particularly useful for these companies. On one hand, it creates a market for their stock where no market exists and two, it solves the estate problems for the majority stockholder. And I have found in discussions with management in these companies that they are particularly interested in keeping their companies in the hands of their employees, rather than giving them away to their competition.

Generally, the question has been asked, why have banks been reluctant and slow to get into ESOP financing? I am sure that the initial problem was that the legislation was new and the concept complex. This atmosphere of confusion and mystery has been dispelled. Generally, prior to the 1977 final Internal Revenue Code regulations, it was very difficult, if not impossible, for banks to make ESOP loans.

The final Internal Revenue Code regulations relating to ESOP's should be a major incentive to banks participating in ESOP transactions. They provide definitive rules relating to ESOP loans.

The use of leveraged ESOPs, in my opinion, should increase dramatically. First, in a very difficult regulatory period just discussed, a UCLA survey of employee stockownership plans, dated December 1977, found that of 180 ESOP companies surveyed, 60 percent had leveraged ESOP's and 84 percent were nonleveraged. I feel the percentage of leveraged ESOP's in this study is encouraging, considering the prior regulatory environment.

At present, there are many incentives for establishing ESOP's. However, with the changes recently introduced in the Expanded Employee Stock Ownrship Act of 1978, coupled with other changes mentioned in my testimony, I have no doubt that many more companies will adopt ESOP's and hundreds of thousands of workers in this country will benefit from it. The sense of permanence in ESOP legislation will also be a major step in this direction.

In summary, what makes good sense to business will surely make good sense to banks in this country.

The CHAIRMAN. Thank you very much, Mr. Conrad. Let me ask you about one other thing. Your advice would be helpful.

It occurs to me that we might manage to find a way whereby somebody could insure, at least to some degree, the loss in value of the stock held by employee stock ownership trusts and if that type thing were

done, perhaps encouraged by the tax laws, then perhaps it would be easier to leverage stock ownship plans so as to have a larger share for the employees.

Now, do you have any thoughts along that line?

Mr. CONRAD. Yes; I do. This gets back to my last comment. My experience over the last year in making these loans to ESOP's and my initial problems with my senior management at the bank, who now are convinced, was that traditionally in the early stages of the ESOP legislation, people just looked to the trust and they took stock as collateral, and there were problems in taking that stock because of the fluctuations in value of the stock.

Now, with the regulations—and it is just a matter of time before more banks catch onto this—it is really possible to look directly to the corporation and secure yourself as a senior creditor, just like any other bank does, because with a special guarantee arrangement, I lend to these ESOP's and I take financial covenants. I even can take security, and I am a creditor like any other creditor at the balance sheet level, even though my funds pass through the ESOP.

So, consequently, I really feel that the word is going to get out on the way you can do it right now. I think the legislation is here.

I think it is just the banks sometimes are slow in moving, and I think as the other banks are being more successful, they are going to pick up on this.

The CHAIRMAN. Is that a technique that you are using now to make loans?

Mr. CONRAD. That is correct. An opinion from outside counsel indicated that this is perfectly acceptable with all lending standards. We give it a different name, but essentially it is a guarantee with financial covenants. It is just like any term loan agreement.

The CHAIRMAN. What we need is more people like yourself who show us how the problem can be solved, even without legislation, and we very much appreciate what you are doing in the area and what you have done to finance it.

Thank you very much, sir.

Mr. CONRAD. Thank you.

[The prepared statment of Mr. Conrad follows:]

STATEMENT OF MR. JONATHAN M. CONRAD, CORPORATE BANK LENDER

My name is Jonathan Conrad.* I am a Corporate Lending Officer in the National Department of First Pennsylvania Bank N.A. which is a major part of the First Pennsylvania Corporation, a bank holding company, with $8.5 billion in assets. My function includes lending money in general to corporate clients—primarily middle market companies with sales or revenues ranging from $20–200 million, although some clients may range higher in the Fortune 1000. This function also includes being the bank's ESOP Corporate Lending Specialist.

In regard to the recently introduced S. 3241, Expanded Employee Stock Ownership Act of 1978, I agree that the major incentives provided in the bill are necessary to encourage many more companies to distribute stock ownership to their employees. I personally support this bill and feel it will be a major step in ESOP legislation. As an ESOP pending specialist, I have of course a direct interest in seeing ESOPs encouraged, but I also feel diffusion of capital as well as the formation of capital for a private market economy is essential.

*The views and opinions expressed herein are solely those of the author and do not necessarily represent those of First Pennsylvania Bank N.A.

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HOW APPLICABLE ARE ESOP'S AS A TOOL OF CORPORATE FINANCE?

I will explain how ESOP's are used by companies as an instrument of corporate finance. As a corporate lender, I will attempt to answer the question from a pragmatic vantage point and from my own personal experience of developing an ESOP specialization on the lending side of the bank for the past year. I know of four different uses of leveraged ESOPs and the tax credit ESOP, all of which affect companies financially in different ways and they all, of course, affect employee ownership and motivation.

As a corporate lender, my primary interest is the leveraged ESOP, which usually involves lending to an established Employee Stock Ownership Trust (ESOT). By this mechanism, a company in a new stock situation in effect can borrow money using pretax dollars to amortize the loan. That is, principal payments are tax deductible as well as interest. In any case, the major incentive provided for a corporation establishing ESOPs is the tax incentive.

There are important issues surrounding the leveraged ESOP and ESOPs in general which I will address. In short they are: (1) The ESOP is a valuable instrument of corporate finance and can be used as an alternative to raise capital coupled with employee ownership and motivation. (2) Banks have been reluctant and slow in getting into the area of ESOP financing but the regulatory environment has improved, and that situation has changed. (3) The ESOP can improve a company's balance sheet, but further changes and incentives will help ESOPs make more sense to business. (4) A sense of permanence in ESOP legislation is important from the business community's perspective. (5) Increasing the tax incentives, particularly for the contributions to the ESOT, will make ESOPs more flexible to business.

TAX CREDIT ESOPS

The Tax Reduction Act of 1975, which created the tax credit ESOP or TRASOP, gave ESOPs a tremendous boost and continued to do so through the Tax Reform Act of 1976.

It is important to distinguish this type of ESOP from the leveraged ESOP. The ESOP trust can take advantage both of borrowing money and of tax credits. However, depending on the type and size of the company, one or the other forms of ESOP may be seen by the company as more advantageous. This will be examined later in more detail. As a corporate lender, I foresee many companies benefiting from combining the reinforcing feature of the tax credit with the leveraged ESOP. In this way a company can take advantage of tax deductible loan principal if the ESOP is leveraged, and the tax credit based on the investment tax credit for capital expenditures.

I am sure that the recently introduced "Expanded Employee Stock Ownership Act of 1978", under which the tax credit would be increased to 2 percent from the 1 percent presently available for contributions to the ESOT, and under which the credit would become a permanent provision of the tax code, is creating a major incentive for corporations to set up ESOPs generally.

First, like any employee benefit plan, the tax credit ESOP should become a permanent provision under the Code beyond the present 1981 expiration period. The recently introduced "Expanded Employee Stock Ownership Act of 1978" would make it a permanent provision. Any company making an extended commitment, whether for financial or employee benefit reasons, will look for a sense of permanence in our highly regulated business environment. Under present law, the current tax credit ESOP is available to 1981. This is good in one sense because companies recognize that the government is paying for the earlier contributions. However, this requires a heavy commitment for a company in the future since the company must continue the benefit into the future, beyond 1981.

The second advantage of the increase to 2 percent is illustrated by some facts gathered in a survey Hewitt Associates conducted, in January and February of 1978, of the 1,000 largest U.S. industrial companies. One of the questions directed to 144 companies was the amount each anticipated as a benefit for its average employee. "Of the 115 plans responding to the question, seventy-two plans (62.6 percent) anticipated a benefit for the average employee of less than $200 for 1977, thirty-two plans (27.8 percent) anticipated a benefit of from $200 to $500, and eleven plans (9.6 percent) anticipated a benefit of more than $500."[1] The addi-

[1] Hewitt Associates, "Survey of Tax Reduction Act ESOPs," Highlights Report (January and February 1978) :3.

tional tax credit provided by the new bill will increase the benefit from a motivational point of view. It is likely to double the stake employees have in their companies.

The "Expanded Employee Stock Ownership Act of 1978" also would provide a 1 percent tax credit based on payroll as an alternative for companies which traditionally do not make significant capital expenditures. This should be a major incentive for service companies to establish ESOPs. This tax credit is based on payroll, as service companies presently are, in effect, denied the advantages of the tax credit ESOP simply because they generally do not have large capital expenditures. Although service industries are more labor intensive and, therefore, can take advantage of sheltering more taxes through the 15 percent of covered payroll limitations on contributions, they otfen do not have sufficient hard assets to enable them to obtain the traditional forms of financing. As a banker, most of my experience is with companies, such as manufacturing companies, which have hard assets. However, I can identify with service industries in that my particular job is very people-oriented. Labor intensive service companies are logically interested in motivating their workers, since well motivated employees are likely to contribute much more to a company's profits.

THE LEVERAGE ESOP

There are four uses of leveraged ESOPs, apart from the tax credit ESOP: (1) new stock issue—capital formation; (2) transfer of ownership and creation of a market for the sponsoring company's stock; (3) corporate "spin-offs"; and (4) taking a public company private by repurchase of public shares. I have found the classic leveraged ESOP, where the loan is made to the trust, to make more sense to companies, primarily the middle market companies which have revenues from $5–200 million that need to borrow money.

The larger companies, those in the Fortune 500, which range from $355 million to $55 billion in revenues, I have found to be generally more conscious than the middle market companies of the effect ESOPs have on dilution. The concept of dilution is a complex one, but most commonly it refers to the dilution of earnings per share. In short, this kind of dilution means there are more shares outstanding because of a new issue and consequently less earnings per share, all things equal. This may not necessarily be unwise, provided the company can justify the additional shares with future earnings.

The very large publicly-held companies are particularly concerned with how their public stockholders perceive them. Therefore, dilution may be an important consideration when setting up an ESOP. Very often such companies have access to other inexpensive forms of capital. For that reason I have found that the leveraged ESOP is usually more appropriate to middle market companies, and that the tax credit ESOP is more suitable for the larger companies which have large capital expenditures enabling them to take advantage of the tax credit for ESOP contributions. Middle market companies generally do not have as much access to the equity markets and may find an ESOP to be an excellent alternative means of raising capital.

My experience in lending money to the ESOP trust of a company listed on the American Stock Exchange was very encouraging, mainly because of the assumptions involved in the leveraged ESOP transaction.

The ESOP in this case was replacing a profit sharing plan to provide ownership in the company to employees. With newly issued stock sold to the trust, the company's stockholders' equity will increase over the life of the loan, and the plan will provide funds for the company's expansion.

Moreover, the company's yearly profit sharing expenses were about equivalent to the yearly principal amortization of the term loan so that by substituting stock ownership of the company to employees by way of a leveraged ESOP instead of choosing traditional profit sharing as a benefit, the balance sheet became more favorable. Equity increases with a leveraged ESOP (given the new issuance of stock) as the debt decreases. Furthermore, if one assumes that the new capital generated by the ESOP is being used for "profitable opportunities" as well as generating increased employee productivity, income will also improve. There is still dilution with the new issued stock, but perhaps to a lesser extent.

Dilution possibly can be reduced for ESOP companies by the recently proposed legislation as well as through possible changes by the accounting profession. First, the provision in the "Expanded Employee Stock Ownership Act of

1978" which would allow tax deductions for dividends paid by a corporation on shares of its stock held by an ESOP would provide a major financial incentive for companies to set up an ESOP. For tax reporting purposes (based on new legislation) the company would, of course, reduce its taxes by deducting dividends paid on ESOP stock.

Therefore, the company's cash flow improves while there is no earning reduction for financial reporting purposes. The additional cash flow should improve a company's overall earnings.

Second, dilution could be minimized if the accounting profession could be persuaded to change its approach toward the calculation of earnings per share. I am not an accountant. However, after discussions with associates in the accounting profession, I see possible changes which might further improve the financial effects of leveraged ESOPs. Presently, the accounting profession generally believes that all shares held by an ESOP should be treated as outstanding shares in the determination of earnings per share. However, the American Institute of Certified Public Accountant's Accounting Standards Division has issued a "Statement of Position on Accounting Practices for Certain Employee Stock Ownership Plans" which recognizes an important minority view among the Division. The division stated that:

"The minority within the Division believes that when trust debt proceeds are transferred to the employer corporation, a transaction of a predominantly financing nature has occurred. The minority believes that the shares should be considered outstanding for earnings per share calculations only to the extent that they become constructively unencumbered by repayments of debt principal. To do otherwise according to this minority view, would result in an inconsistent and initially excessive effect on earnings per share in that the total number of shares purchased by the ESOP would be immediately included in the calculation of earnings per share, even though the related compensation expense would be spread over a period of time on the basis of the employer's contribution to the trust." [2]

The recommendation of the American Insttiute of Certified Public Accountants, of which this minority view is a part, has not yet been adopted by the Financial Accounting Standards Board, and no final opinion has been issued. I recommend that the Senate Committee on Finance open communications, if possible, with the Accounting Standards Division, as the adoption of the minority position discussed above would have significant impact in reducing dilution and thereby creating further incentives for companies (particularly publicly-held companies) to adopt leveraged ESOPs.

In addition, I would like to recommend to the Senate Committee on Finance future legislation in respect to Section 404(a)(3) of the Code. Presently, the deductions for contributions to an ESOP trust may not be greater than 15% of the covered payroll. Since interest paid on loans has always been deductible, it is lost when the loan is made to the ESOT. This is due to the fact that interest deductions have been merged into the ESOP contributions. Consequently, there may be adverse effects on a company's financial position after contributions pass 15% of covered payroll. After that point, under present law, neither principal nor interest is deductible. Accordingly, either increasing the deductible contribution as a percentage of payroll, or by allowing the interest on the ESOP loan, over and above presently allowable deductible contributions, would offer greater flexibility to companies establishing ESOPs. It is my understanding that Senator Gravel's recently introduced bill addresses this problem.

Three uses of leveraged ESOPs which I have not discussed specifically have tremendous possibilities as tools of corporate finance. Although the previous discussion related to the new issuance of shares with capital formation, the ESOP also has other practical financial uses.

The ESOP provides excellent opportunities for the closely held companies. It is estimated that there are in this country more than 200,000 privately owned corporations with revenues of $1 million or more. An ESOP can be particularly useful to these companies to create a market for their stock where no market exists and for major owners of a privately owned company when they are concerned with estate planning. Owners of stock in publicly-held companies often can sell their stock on the market to create the necessary liquidity. Private

[2] Accounting Standards Division of the American Institute of Certified Public Accountants, "Statement of Position on Accounting Practices for Certain Employee Stock Ownership Plans," Recommendation to the Financial Accounting Standards Board (December 20, 1976): 5–6.

companies have seen the desirability of their traditional methods of raising capital, such as going-public, decrease in the 1970's as the stock market has become less attractive. On the one hand, an ESOP offers a privately-held company the ability to borrow for an employee benefit with tax deductible dollars. My experience with management of privately-held companies is that they are not as concerned with reducing their companies' financial reporting earnings with ESOP contributions as they are with the need to shelter taxes. On the other hand, the majority shareholders may find an ESOP a better tax option for estate planning. When a corporation purchases stock of a majority shareholder, the transaction may not satisfy the redemption rules of the Internal Revenue Code and the shareholder may be taxed as if the corporation had paid him income; that is, the shareholder may be taxed at ordinary income rates.

However, when an ESOT purchases the stock under certain circumstances, the shareholder can receive capital gains treatment. Finally, I have found in my discussions with owners of privately held companies that they would rather have the ownership of their company in the hands of their employees as opposed to their competition.

The third use of the ESOP which has valuable application as an instrument of corporate finance is to facilitate a corporate spin-off. When spinning off a subsidiary or division, a company may thus create a buyer in lieu of one which otherwise would be difficult to locate or disadvantageous. An example of a corporate spin-off ESOP was seen when 500 employees of South Bend Lathe, Inc. purchased that subsidiary from Amsted Industries for $10 million dollars in cash from a loan by the Federal Economic Development Administration.

The spin-off technique also can make sense from the parent company's perspective, since the divestiture is for cash and the stock issued is from the new company, so that there is no dilution of the parent company's earnings or equity.

Finally, the ESOP which serves as a mechanism to transfer all or most of the ownership of a company to its employees requires a great deal of borrowing by the ESOT. Therefore, it needs to take advantage of greater tax deductible contribuitons to the trust. As mentioned earlier, under present law, there is need to increase the amount of the tax deductive contribution to the trust for more flexibility.

The fourth use enables a public company to go private by repurchase of publicly-held shares. During the 1960's a great wave of middle market companies went public, but many of the companies that went public found that being publicly held created more disadvantages than advantages. In many cases public middle market companies have a worth which is not reflected in the market price of their stock, since the market value is below their book or real value because of the present nature of the stock market. Therefore, even though these companies are public, they find that they do not have real access to the public markets for additional equity offerings. Moreover, there is an increasing cost burden on small public companies to maintain themselves as public companies under the present regulatory environment, in terms of legal and accounting fees. The going-private ESOP, for the reasons just mentioned, would have a great deal of potential for the expansion of employee ownership. However, there are still many problems surrounding this highly specialized area, practical and regulatory, and a great deal will depend on the SEC's treatment of such transactions.

WHY BANKS HAVE RELUCTANT OR SLOW IN GETTING INTO THE AREA OF ESOP FINANCING

The answer to the question of why banks have not been active in ESOP financing is complex. I am sure that the initial problem was that the legislation was new and the concept complex. This atmosphere of confusion and mystery has been dispelled. A great deal of excitement and interest by corporation occurred during the initial stages, when the ESOP concept was included in two very important pieces of legislation, the Employee Retirement Income Security Act of 1974 (EFISA) and the Tax Reduction Act of 1975.

Many lectures and seminars are being given on the subject. The financial and even general press continues to cover the subject. There have been several books written on the subject and more on the way. Moreover, many consultants, lawyers, and some accountants and even fewer bankers have been educating themselves with the ESOP's potential and technical aspects.

However, prior to the late 1977 final Internal Revenue Code regulations, it was very difficult, if not impossible, for banks to lend to ESOPs.

Bank lenders generally look for hard assets and an ability to generate earnings and cash flow to support the proposed loan. The new final Internal Revenue Code regulations relating to ESOPs should be a major incentive for banks participating in ESOP loan transactions, because they provide definitive rules relating to ESOPs. A lender can now look to the corporation for payment

Prior to the final regulations it was hard for banks to make an ESOP loan under traditional lending standards. For example, prior to the final regulations, banks would inappropriately take the ESOP stock as collateral. The lender would then be in danger of violating Regulation U margin requirements.

Moreover, while banks must look to the trust for actual payment of principal and interest of the loan, the cash flow really is generated by the sponsoring company, on which the bank must put its real reliance. Therefore, prior to the final ESOP Regulations, a bank might simply have been relying on the sponsoring company to make contributions to the trust for repayment of the loan, without direct recourse to the company. In general, most bankers and lawyers did not understand how to position themselves as creditors in the traditionally understood lending procedures.

In summary, the final ESOP regulations should enable lending institutions to feel more comfortable from the traditional lending point of view. Now lenders, although lending through the ESOT, can look directly to the company for repayment of the loan though guarantee arrangements which can have the normal financial covenants and default provisions usually found in bank term loan agreements. It is also possible, if necessary, to take hard collateral from the sponsoring ESOP company.

FEDERAL GUARANTEE OF ESOPS

As a corporate lender, one of the common questions I get pertaining to ESOPs is: "Does an ESOP make a company more credit worthy?" The answer is yes, provided the company is continually profitable. That is, the ability of the company to shelter taxes by way of the ESOP occurs, of course, when the company generates taxable earnings. To this extent the company's cash flow improves as well as its ability to pay debt. However, a struggling older company with an uneven earnings record, paying taxes in one year and getting a refund in another, is not a likely loan prospect.

There have been a number of cases where a federal guarantee of the ESOT's debt has encouraged bank participation where a lack of adequate earnings history and other factors, made a loan to the ESOT a high risk transaction by ordinary banking standards. A number of knowledgeable observers, including the former Assistant Secretary of Commerce for Economic Development, William W. Blunt, Jr., have told me that they see a legitimate and useful role for such federal guarantees where necessary to make possible ESOPs which help agencies such as E.D.A. and the Farmers Home Administration to carry out their congressional mandates.

Of course, a broader application of federal guarantees to ESOP transactions where justified by the credit situation could be achieved by extending the mandate of these agencies to include support of ESOPs as such. I assume this would take amending legislation. It would certainly serve to encourage bank involvement in those ESOPs where prospects are good, but the existing credit record does not justify unsupported bank participation. Needless to say, if the transaction simply is not a sound one, the government should not be involved any more than the banks.

SUMMARY

The use of the leveraged ESOP, in my opinion, should increase dramatically. First, in the difficult regulatory period just discussed, a UCLA survey of Employee Stock Ownership Plans in December, 1977 found that of 180 ESOP companies surveyed, 16 percent had leveraged ESOPs and 84 percent were non-leveraged ESOPs.[8] I feel that the percentage of leveraged ESOPs in this study is encouraging considering the prior regulatory environment.

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[8] UCLA Graduate School of Management Field Study Team, "Survey of Employee Stock Ownership Plan," Summary of the Results (December, 1977) : 6.

Second, notwithstanding the perceived motivational advantages of ESOP, the concept must make good business sense to an employer, particularly from the financial perspective. As a banker and ESOP specialist I have found that it is necessary to educate my corporate customers as well as prospective customers to the advantages of ESOP. In discussions with senior management of companies, primarily with chief financial officers and treasurers, I have found the educational process necessary because of the newness of the concept as well as the complexities surrounding the financial impact of ESOP. Presently there are many incentives for establishing ESOPs; however with the changes in the recently introduced "Expanded Employee Stock Ownership Act of 1978" coupled with other changes mentioned in the testimony, I have no doubt that many more companies will adopt ESOPs. The sense of permanence in ESOP legislation will also be a major step in this direction. Accordingly, what makes good sense to business would surely make good sense to the banks in this country.

The CHAIRMAN. Now, next we will hear from Mr. Kenneth R. Cunningham, chairman of the Board of Metropolitan Contract Services.

To all the witnesses remaining, let me just say this. Conducting these hearings while the Senate is in session and voting makes it difficult to have as many members present as we would like to have, but we are going to see to it that this information is made available to all of those who want it and should have it, and I fully anticipate that there be a very broad distribution of all the information made available at the hearings and that it will result in action, both legislatively and perhaps administratively.

Mr. Cunningham, we are pleased to have you, and you may proceed with your statement.

STATEMENT OF KENNETH R. CUNNINGHAM, CHAIRMAN OF THE BOARD OF METROPOLITAN CONTRACT SERVICES, INC.

Mr. CUNNINGHAM. Honorable chairman and members of this distinguished committee, I am indeed pleased to be here to present to you some of the experiences I have had with my employee stock ownership plan. Senator, some of these experiences have been good.

I started out in 1956 as a truck driver with one truck and built the company. I started from scratch, so to speak, and built my company up through the years.

Today, our company has grown to the point where we serve customers now in over 20 cities, major retail customers. We handle their delivery operations.

We run 327 trucks and we employ 730 people. We formed a base maintenance service for NASA at the Langley Research Center.

Early in 1975, I was negotiating with a company to acquire my stock in Metropolitan Contract Services, and it was my desire at that time, for estate planning and other purposes, to receive some cash for my stock. It was at that time that I learned about the employee stock ownership concept through my accountants and my attorneys. It seemed like a real good deal to me. I could receive my money over a period of time. The employees, in effect, would become the owners of the company, and I could see that that would accelerate the growth of the company because, as owners, they would do a better job and help us expand our business.

Well, I think the record will clearly show that that is exactly what happened. After the implementation of the employee stock ownership

plan, once the word spread to the employees that they were, in fact, partial owners of the company, our volume doubled over a 3-year period. We went from a $4 million a year sales volume to over $8 million in 3 years' time.

I think anybody would consider that a significant accomplishment. It was not my accomplishment. It was the accomplishment of the individuals in our company, the company owners.

Senator, I also had another company, Metro Contract Services, and it was basically a Government support service contract company. It performed base maintenance services for NASA at Langley Research Center, Johnson Space Center in Houston, and Huntsville, Ala. As a result of the tremendous results we received as a result of ESOP in Metropolitan, the decision was made that we should afford Metro employees at the Government centers this same opportunity.

So therefore, on January 1, 1977, Metropolitan acquired all the stock in Metro, and those Metro employees also became participants in the employee stock ownership plan. This is where we had our problems.

It seems that was a proven, good business judgment and practice in our commercial business world was received with rejection by the Government itself through NASA and through the DCAA auditors.

They said we had to get our stock valued by an independent appraiser. We hired the most reputable and oldest New York Stock Exchange company in Houston, Tex., to come in and provide an independent evaluation of our stock.

We did the same thing in January 1977—Underwood Newhouse & Co. evaluated our stock. It seems that even though the cost increased to our commercial customers when we put our ESOP program in, our production costs went down to such an extent that they put it in business in Arizona and Nevada and California, because even though it cost the commercial customers the contributions to the trust, what they saved in production costs more than offset that. They were tremendously pleased to have an ESOP participating company handling their trucking and delivery operations.

Well, the Government took a different approach; when auditors come in, the DCAA auditors, they started evaluating the evaluator of our stock, this New York Stock Exchange company, and they said that our stock was going to be valued at 10 percent of what this New York Stock Exchange company said it was worth.

I am not an evaluator, you know, but I know how to add and subtract and I could have closed the doors in that business and written a check to all the people, myself included, and received over $130 a share, and this DCAA auditor said our stock was worth $22 a share. It was the most incredible thing I had ever seen.

We could not reason with him at all. We hired the biggest bank in Texas to handle the trust for the stock of these employees. This man went down there to the bank and talked to those people to make sure they were following every rule and regulation laid down by the IRS and the Department of Labor. The banks did not know that the DCAA had the authority to do this.

During that time, Senator, our company was up for recompetition at our Langley contract, and we had negotiated with the union the benefits of our ESOP trust. NASA went to the Department of Labor

to try to get them to remove the ESOP from the DOL wage determination as a fringe benefit and the Department of Labor twice refused to do that. NASA went down and talked to the union at Langley to try to get them to withdraw from the ESOP. This is unprecedented in my history of over 15 years doing business for the Government.

Needless to say, we did not get the contract. We lost it. There are all kinds of reasons, I guess, why, but we had performed that job for over 3 years in a satisfactory manner. They said we were doing a good job, in writing, during all of our evaluations.

This represents over 30 percent of our volume of our corporation. By taking the contract away from us, NASA is reducing the value of the company and its stock, and hurting the employees.

The other company, Metro Contract Services, I sold to Sal Esparza, a Mexican American individual, and I understand he is having the same problems with the Government, and he can relate his experiences with NASA and the DCAA.

I have had to hire over four different law firms since the implementation of this plan to represent our company, and spent almost $100,000 in legal fees just to defend this program that, Senator, I believed in—and I still believe in. I started out driving a truck, as I said, and I know what it can mean to have ownership of a company. And I know these 730 employees in our organization know what it means, because the record and the success of our company speaks for itself.

I would like to request that my statement be entered into the record, if I might.

Senator, the result of NASA's antagonism toward ESOP is this: we have had to terminate the ESOP for all of our people at the Langley Research Center. We are going to buy that stock back—at the value determined by the New York Stock Exchange, I might add, not the DCAA audit. These people are out of the ESOP program. The ESOP is basically frozen; I do not intend to sell any more stock until we can work this thing out. Nobody has told me that we have violated any regulation or anything.

We have done everything that we knew to do to make this ESOP program go, and make it successful. I can only add that this honorable committee, and you, Senator, could help all ESOP companies if you could just reaffirm that it is a viable vehicle for employee ownership, this ESOP program. I am not asking for any new laws or regulations or anything, but just that the Government itself, through its agencies like DCAA and NASA, could be made to understand that this is a justifiable program.

They say, well, you received money from the sale of your stock. Well, I could have received money from the sale of my stock to the company I originally started negotiating with and not have had any of these problems. It was only when the ESOP got involved that NASA started giving me such a hard time.

Even that, over half of the money that I would receive on the profit of the sale on my stock goes back to the Treasury through taxes.

Senator, I appreciate your letting me appear before this committee. Thank you very much.

The CHAIRMAN. Thank you very much, sir. Does one of your associates wish to say something?

Mr. CUNNINGHAM. Yes, sir. Mr. Personette is our executive vice president and CPA.

STATEMENT OF DAVID PERSONETTE, METROPOLITAN CONTRACT SERVICES, INC.

Mr. PERSONETTE. Yes, sir. I am executive vice president for Metropolitan Contract Services. I came to work April 1, 1978.

One of the most pressing problems Metropolitan had when I went to work for the company was $300,000 in accounts receivable from the Federal Government. I promptly got on an airplane and flew to Langley Research Center at Hampton, Va., to have a conference with the contract officer, with his legal counsel, and with the head of procurement at Langley to discuss that $300,000.

They told me at that time that the best way for me to get that money was to ask them for a token disallowance, but before I could do that, I had to prepare a cash-flow analysis for our cash needs for the coming year to prove to them that we needed that $300,000. They told me that that cash analysis should be submitted to the Defense Contract Audit Agency for their review and comments on it, and after that time I could come back to the people at Langley and ask for our money—again, on a token disallowance basis.

I went back to Houston, Tex., and called the Defense Contract Audit Agency and talked to Mr. Eugene Ballard, who is the head of all of the audits done on Metropolitan through the time-frame period. I asked for an appointment with him, so I could come down. He said I would be wasting his and my time.

He had never questioned who it was who had bought those products and never questioned who was involved in the training programs relating to the project.

As a related point, I got a decision the other day from Judge Dykus, administrative law judge, where those costs were awarded to the contractor.

I have talked to our bankers in Houston, Tex., who administer our employee stock option trust. They tell me that their experience with the DCAA has been that the auditors came out there and conducted their audit in a very unprofessional and unorthodox manner, and that they felt that at times they were being harassed by these auditors.

I feel like the DCAA is biased toward employee stockownership programs, or biased to our company, and I feel that they have conveyed that bias to all of the people at NASA, and anyone else that will give them audience.

I have made a thorough and complete study of NASA's disallowance of our $300,000 and all other costs relating to our employee stock option program. NASA's stated reason for disallowing our money: No. 1, they said that our agreement, our collective bargaining agreement, was not entered into as a result of arm's-length bargaining. Even though the Department of Labor has twice said it was entered into as a result of arm's-length bargaining, they requested a hearing from the Department of Labor. The Department of Labor went to all of the trouble to grant this hearing.

We showed up with our attorneys. The Department of Labor showed up. The labor unions showed up with their attorneys, only to find that NASA did not seem to have time to come to that hearing. NASA, in its continued harassment of our firm, has called a variance hearing on

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our current wage determination with our union. Here we are, spending money since March 25, 1978, based on a new union agreement; we are off the job next Friday, and we do not even know if we are going to get reimbursed for those costs.

I think the NASA's challenge to our wage determination to the Department of Labor is unfounded and frivolous, and it creates a hardship on our company. NASA and the DCAA have challenged the stock value of our company as another reason for disallowing our costs in ESOP.

I personally feel it is outside of the scope of a DCAA auditor to determine—or should even care—what price our employee stockownership trust pays for the stock it buys. I think he should maintain the scope of his audit to whether or not the company actually put the money in trust for those employees on an undiscriminating basis as to other employees.

But, since they did challenge our stock evaluation, I think that that challenge should be answered. They said that our earnings, our PE ratio of 8.9 times as opposed to 5.5 times, and other people in our industry were way in excess of the 5.5.

I personally challenge the qualifications of the DCAA and NASA to say why 8.9 is far in excess of 5.5.

They said our 1976 PE ratio, our 1976 per-share earnings, were only $4.24. What they failed to say in that report was that that earnings per share was $298,000 contribution to the employee stockownership trust. If they had included that contribution back into earnings, our earnings per share would have been $33 per share, much more in line with the stock evaluation by Mosely.

Our DCAA auditor says our stock is worth $22 a share. Well, sir, I can tell you as a certified public accountant that liquidating value of that company was in excess of $100 a share, and I will tell you, that is far in excess of $22 a share.

I think that NASA was biased, and they took that contract away from us because of that bias.

I will not take up any more of your time, sir. I would request that the rest of the discussion be entered as part of the record.

Thank you very much.

Mr. Guild. Senator, we appreciate the opportunity to appear before the committee. I am Tom Page Guild, Jr., counsel for Metropolitan Contract Services.

Even though we are disillusioned at the loss of our contract resulting from an attitude, we feel, of bias by a Government agency, we are enheartened by this committee and its attitude, for the future of ESOP's, and for the future as having employees, such as Mr. Cunningham once was himself, owning his own company and subsequently remembering the other employees of his company and providing them an opportunity to be shareholders, and have a piece of the action.

The Chairman. Well, gentlemen, we can pass laws up here. We have passed several of them now seeking to encourage employee stockownership. It should be clear on the face of it to anybody in the bureaucracy that when Congress passes at least five laws to encourage employee stockownership, the Government policy favors that. The Government looks with favor on it, and seeks to encourage it.

For any Government agency to penalize a company because they have an employee stockownership, or to shape its programs so that it works out that way, seems to clearly be in conflict with the legislative intent of Congress.

Now, most of these laws have a lot of latitude, giving the agency contracting officers some discretion as to what they are going to do and what they are not going to do. You can be sure that insofar as this Senator has any influence, we are not going to have the bureaucracy discriminating against companies because those companies have employee stockownership plans.

I thank you very much for your testimony here today.

Mr. GILL. Thank you, Senator.

[The prepared statements of Messrs. Cunningham and Personette follow:]

STATEMENT OF KENNETH R. CUNNINGHAM METROPOLITAN CONTRACT SERVICES, INC., HOUSTON, TEX.

Honorable Chairman and Members of this distinguished Committee, I am honored and pleased to have this opportunity to appear before you and to present my experiences with the Employee Stock Ownership Plan.

My Company, Metropolitan Contract Services, Inc., started from a trucking and delivery contract with a major retailer in Houston, Texas in 1956. It prospered and grew to its present scope of serving customers in 20 cities and operate 327 trucks and trailers and employs 730 persons, and performs the Base Maintenance services for NASA-Langley Research Center.

Early in 1975, I had entered negotiations with a company to acquire my stock in Metropolitan. It was about this time that I was introduced to the Employee Stock Ownership concept by my Accountants and Attorneys. After careful review and consideration, it seemed that this was a good deal for everyone. I would receive cash for my stock over a period of years, the employees would receive beneficial ownership of the Company, and most important, I believed that the Company would accelerate its growth by better customer service and increased productivity. As the record will clearly show, this was exactly what happened.

I also owned and operated another Company, Metro Contract Services, Inc. Metro was engaged in government support services and served three NASA installations at Johnson Space Center, Houston, Texas, Langley Research Center, Hampton, Virginia, and Marshall Space Flight Center, Huntsville, Alabama. Metro started from a contract at the Johnson Space Center, also in 1965, and grew and prospered along the same lines as Metropolitan.

July 1, 1975, Metropolitan set-up and implemented its Employee Stock Ownership Plan and appointed the Allied Bank & Trust Company, a large Texas chartered bank, to act as Trustee for the stock and the employees. We hired Rotan Mosle, Inc. to perform an independent evaluation of the value of our stock and to present their findings to our Board of Directors for action.

I would like to point out, at his time, that prior to this time I had never had any association, business relationship, or contact whatsoever with Rotan Mosle, Inc. My first experience with them and contact with them was at this time.

I was advised that Rotan Mosle, Inc. was highly professional and competent in their field and Members of the New York Stock Exchange, and therefore, one of the most qualified companies we could find to value our stock.

We also applied for, and received after making negotiations and making certain changes, an Internal Revenue Service determination that our Plan had been approved and was ready for implementation.

Senators, as the news spread that the employees were in fact partial owners of the Company, a marked improvement was noticed by all of our management personnel. We seemed to be getting a sprightful core to the organization, from the truck drivers all the way up to the Managers themselves. I suppose this was so because each one was an owner of the Company on a fair and impartial basis. Metropolitan, in fact, gained new contracts in Arizona, Nevada, major contracts in California. In fact, our volume since the implementation of this Employee

Stock Ownership Plan has more than doubled from approximately $4 million to approximately $8 million. This does not take into consideration any revenue derived from any of the government contracts. I think anyone should acknowledge, that for a Company to double its size from $4 million to $8 million in less than three years is a significant accomplishment. It is my opinion that this accomplishment could not have been made without the total cooperation and positive attitude of all of the employees of the Company and their dedication to seeing their Company grow and prosper.

After reviewing the positive results of Metropolitan's ESOP, it was decided that this same program and benefits should be made available to the employees of Metro Contract Services who worked in the government installations. It was felt that the same attitudes and results could be obtained in Metro as was obtained in Metropolitan. Therefore, on January 1, 1977, Metropolitan acquired all of the issued and outstanding stock of Metro Contract Services, Inc. At that time, we hired Rotan Mosle, Inc. to perform an evaluation of Metro's stock in order to make the exchange. At that same time, Metro and Metropolitan entered into a Joinder Agreement whereby the Metro employees would become participants in the Metropolitan ESOP and receive full value and benefit for their participation, along with the Metropolitan employees.

Sometime in May of 1977, Metropolitan was negotiating with an individual to purchase the shares of Metro Contract Services, Inc. It was at that time that Salvador S. Esparza, a long-time friend and employee, who came up through the Company ranks and was in fact the President, at that time, of Metro Contract Services, approached me to acquire Metro Contract Services, Inc. Since he had been a hard worker and contributed to the success of the Company, I agreed. He is a highly qualified individual who could assume these duties and continue to build Metro into a dynamic organization. One of the considerations was that Metropolitan acquire the Langley Research Center Contract. Therefore, on June 30, 1977, Metropolitan and Metro and the United States entered into an Agreement whereby Metro would transfer its Contract operations and rights to the Langley Research Center Contract to Metropolitan and this was accomplished.

On July 1, 1977, Salvador S. Esparza acquired all of the issued and outstanding stock of Metro Contract Services, Inc. and became a minority-owned Company. Sal can relate to this honorable Committee, the problems and experiences he encountered shortly after July 1, 1977.

As previously stated, the Employee Stock Ownership Plan was incorporated on July 1, 1975, for all of Metropolitan's commercial operations.

On January 1, 1977, Metropolitan included its employees at the Johnson Space Center, Marshall Space Flight Center, and the Langley Research Center in its Employee Stock Ownership Plan coverage. This being accomplished after negotiations with the various trade unions which represented our employees at these locations.

Metropolitan Contract Services, Inc. was in the process of re-competing for the Base Maintenance Contract at the Langley Research Center, the only government contract we had. This Contract amounted to approximately 30 percent of our overall revenue and was very important to the success of Metropolitan. Metropolitan had performed for over a period of three years in a very satisfactory manner and NASA so stated in the quarterly evaluations which they presented us.

Sometime around the first of September, 1977, we became aware that the individuals at NASA who were in charge of selecting the new Contractor were in fact challenging our entire ESOP program that the Chairman of the Source Evaluation Board who was in charge of selecting the new Contractor was also the individual who was trying to influence the Labor Department and the Union to agree to remove the ESOP from our bargaining agreement.

Subsequently, we learned that this individual had approached the Union some two days before our best and final offer in an attempt to secure a statement from him to be used with the Department of Labor to challenge the Arms Length bargaining of our Collective Bargaining Agreement (an unprecedented move, as far as I can determine on the part of NASA). Needless to say, we were not selected as the new Contractor for this Contract. Metropolitan subsequently appealed this decision to the General Accounting Office. We hired an Attorney and went to all of the legal expense to do so. A copy of the basis of our protest is included, along with my statement.

Senators, I would like to add, this is the first and only occasion that Metropolitan has ever filed a protest with the General Accounting Office for a Contract which it had bid on. We have lost many contracts in the past and felt that the

integrity of the system and the reasonableness of the decision did not merit any further action by our Company. But the bias, and prejudice, and extra-ordinary actions taken by NASA, the DCAA, and these individuals with NASA in charge of selecting the new Contractor clearly reflected that Metropolitan, as a result of this ESOP, was downgraded and not awarded this Contract.

At this time, Senators, we found ourselves in a position of having to employ four different law firms to represent our Company before four different agencies of the United States in order to defend and explain our position regarding the Employee Stock Ownership Plan. It seems, what started out to be a good deal for all concerned turned into one of the most disastrous and distasteful experiences which has been my misfortune to encounter.

We weighed our chances of success before the GAO prior to hiring an Attorney and going through the appeal process; however, I felt it was our duty and obligation on the behalf of our Company and our employees to pursue every end to try to right this wrong. I realize that the chances of success at the General Accounting Office to overturn a NASA decision was very unlikely, particularly, in view of the close relationship of the two agencies. I have learned that the former General Counsel of NASA whom I assume assisted in implmenteing the procurement process and system as NASA, is now General Counsel of the GAO that considers appeals on this very process and system. I am not suggesting that anything was not completely proper in our case, but it certainly opens up the feeling of hopelessness and despair when, in effect, you "take on" the federal government as I feel we have been forcd to do in this situation.

Mr. David Personette, I understand, will testify and address some of the problems we have had with the Defense Contract Audit Agency. I would only like to point out that in their Report, they have challenged the valuation of our Company, stock, the credibility of the Rotan Mosle Evaluation and caused undue expense and a hardship on my Company and myself. Their Branch Manager has done what he could to cause our Company untold misery and damage. After receiving the Evaluation Report which he submitted to NASA, just prior to the selection of the new Contractor at the Langley Research Center, we went to the expense of hiring another firm to make an additional, independent evaluation of our Company stock.

The magnitude of the variance between Rotan Mosle and the DCAA was very shocking. It seems DCAA's value of our stock was but 10 percent of Rotan Mosle's, a qualified, New York Stock Exchange Company. The second company, Underwood Neuhaus, Inc., also a Member of the New York Stock Exchange, was hired and submitted their evaluation. I had no business connection whatsoever with this firm either (never done any business with this Company, nor bought any stock) prior to our Company retaining them to conduct an evaluation of Metropolitan stock. Their evaluation reflected that our stock was within 20 percent of the value which Rotan Mosle determined. Mr. Personette will address the difference, but it certainly was no where close to the DCAA's ridiculous value. According to the DCAA Report, this Company which I had been building since 1956, and sold at one time in 1971 for nearly $3.5 million in cash and notes to a company on the American Stock Exchange, was valued at only $400,000 (and this after we had received additional business).

It seems that the DCAA and NASA are up in arms because they feel I made a windfall profit by selling my stock to the Employee Stock Ownership Trust. Had I sold my stock to a third party or to the Company that I was originally negotiating with, I suppose I would have had no problems with the DCAA and NASA.

Our Company would probably still have this Langley Contract, and I would be in the same financial position reasonably that I am now. However, the employees would not own any stock in our Company. In reality, almost half of any profit I secured from my stock would be paid to the U.S. Treasury in taxes. Whereas, had I traded my stock with a listed company, I would have paid no taxes. In retrospect, if I had it to do all over again, I probably would not have entered this Employee Stock Ownership arrangement, because of the undue hardship placed on my Company and the personal worry and problems caused me by this entire transaction. My Company is now in a position of having to acquire new business in order to replace the Contract at Langley. My preference for new business will certainly not be governmental contracts as a result of our experience in dealing with NASA Officials on the level of injustice we have personally witnessed. In order to get any new government contracts, NASA would have to be given as a reference and you can imagine what kind of reference we would get.

As I pointed out earlier, my Company has already retained four law firms to defend for different actions brought by NASA, the Department of Labor, the DCAA, and other governmental agencies.

One action in particular which I find distressing and distasteful was the Arms Length issue at our Langley Contract. After all the numerous procedures followed, NASA obtained a hearing from the Department of Labor on the issue of whether or not we negotiated at arms length with the Union at the Langley Research Center. After much delay and much expense and travel on the part of my Company Officers, our legal staff, and myself, a hearing was scheduled for July 11, 1978, only to find that NASA had attempted to withdraw from this hearing and didn't even show up. I call your attention to a letter from our Legal Counsel which more fully explains this particular instance. But, here is NASA causing a small business to spend money to defend itself against an action to which the accusing party (NASA) did not even bother to appear.

Senators, these aforementioned events are the reasons for the feeling of hopelessness and distress on the part of myself and our Company.

Summarily, I might point out that, at this time, we have been forced to terminate the ESOP program for our employees at the Langley Research Center through Collective Bargaining. Additionally, we have agreed to purchase their shares of stock back at an appropriate and properly evaluated price. I do not intend to sell any further stock to the ESOP, unless and until it is determined that this is a viable vehicle to employee ownership and a company like mine can operate within the laws and regulations laid down by the proper agencies and not be subjected to the abuses and interpretation of some individual who has a personal dislike of a Program.

Senators, I have no illusions of holding on to our Langley Contract or any way receiving special consideration as a result of appearing before you. However, I truly hope that something can be accomplished here by you honorable men to reaffirm that it is still the intent of Congress to foster companies that establish Employee Stock Ownership Plans or at the very least, instruct agencies of the federal government, such as NASA and the DCAA, that they are not to interfere, disrupt and damage companies which have instituted the Employee Stock Ownership Plan in their benefit programs.

Senators, I respectfully appreciate this opportunity to appear before this Committee. I am deeply honored and grateful. Thank you for listening to my "tale of woe."

KENNETH R. CUNNINGHAM,
Chairman.

GILL, LINDSAY & SEAGO,
ATTORNEY AT LAW,
Baton Rouge, La., July 17, 1978.

Re: Metropolitan Contract Services, Inc., Langley Contract No. NAS 1-13700 Service Contract Act.

Mr. KEN CUNNINGHAM,
Metropolitan Contract Services, Inc.,
Houston, Tex.

DEAR MR. CUNNINGHAM: In accordance with your conversation, we herewith include a status report concerning the ongoing attack on Metropolitan Contract Services, Inc., (hereinafter referred to as MCS) Employees Stock Ownership Plan ("ESOP") by the National Aeronautic and Space Administration (hereinafter referred to as NASA).

A brief statement of history and introduction is appropriate. MCS established an ESOP as a stock bonus plan and qualified the same under Sections 401(a) and 4975(e)(7) of the Internal Revenue Code. Subsequently by Internal Revenue Service correspondence dated 21 May 1976, Internal Revenue issued a favorable determination letter regarding the qualification of MCS's ESOP. Upon approval by Internal Revenue, MCS began to incorporate the ESOP into their company structure for the benefit of their employees at over twenty locations. In December of 1976, negotiations between the International Brotherhood of Electrical Workers Local 1340 and MCS resulted in an amendment to the labor agreement between the parties, which provided for the ESOP as an additional fringe benefit

for the employees of MCS working at the NASA Langley Research Center, the only government project held by MCS at the present time. In accordance with normal procedure, the Department of Labor (hereinafter referred to as DOL) included the ESOP in its register of wage determination under the Service Contract Act (Wage Determination No. 73-1627 [Revision 4]). This established the ESOP as a recognized fringe and a cost reimbursable item under its contract to provide maintenance services for NASA at the Langley Research Center. After time had passed and payments were being received by MCS which reflect that the DOL wage determination was the acceptable base for reimbursement, NASA unilaterally ceased paying as a cost reimbursable item all costs related to the ESOP.

In the latter part of August, 1977, NASA by letter to the DOL, Employment Standards Administration, Wage and Hour Division, contested the DOL Wage Determination 73-1627 (Revision 4) on the basis that the inclusion of the ESOP created a wage at substantial variance with the wages of the surrounding locale. Under its authority pursuant to the Service Contract Act, the DOL initiated an investigation and the Administrator, *without the benefit of a hearing*, issued Revision 5 of the Wage Determination 73-1627, which eliminated the ESOP from being included in the wage determination for the purposes of cost reimbursement under the government contract. Further, NASA also attacked the arms-length bargaining between MCS and IBEW Local Union 1340. Thus NASA has utilized every attempt at this point to eliminate the ESOP as a cost reimbursable item for government contracts by invoking all of the exceptions provided and available under the Service Contract Act. In response to NASA's attack on ESOP, MCS supplied a chronology of events to the DOL, relating to the validity of the ESOP under the laws of the United States as well as addressing itself to the issue of arms-length collective bargaining. Based upon this evidence and without a hearing, the Administrator, in October of 1977, issued to NASA its position on the two items of arms-length bargaining and substantial variance from the wage determination. In that position, the DOL issued Wage Determination 73-1627 (Revision 6), which reinstated ESOP as a valid fringe benefit pursuant to the DOL's authority under the Service Contract Act and, further, that it was the determination of the Administrator based on the evidence at hand (presentations of both NASA and MCS) that the amendment to the labor contract establishing the ESOP as a fringe benefit was conducted at arms-length bargaining. Even though there appears to be no argument that the DOL under the Service Contract Act is the authorized governmental agency which is empowered to establish a wage determination for the purposes of cost reimbursment under government contracts, NASA has continued by various disreputable approaches to avoid the end result of acceptance of the jurisdiction and determination of the DOL that the ESOP is a valid fringe benefit, negotiated at arms-length, and thus a cost reimbursable item. Additionally to this end, NASA has refused to recognize and pay funds due to MCS, which exceed $300,000.00, directly related to reimbursement of costs of the ESOP. Further, NASA has even attempted to raise the issue of variance of wage rates and arms-length bargaining before its own Contract Appeals Board even though the law provides that the DOL is the proper agency for such determinations, as specified in the Service Contract Act.

In response to your request to provide you with additional information relating to the most recent status and legal involvement of MCS in the protection of its rights and its employees rights to participate in an ESOP program, NASA, with an attorney from NASA present, insisted upon a meeting with the Business Manager of the IBEW Local 1340. MCS was not notified of this meeting at which NASA began systematically to attempt to elicit from the Business Manager of the Local certain statements which would be provocative and which would lead the DOL to feel that the labor agreement amendment creating the ESOP was not, in fact, bargained for at arms-length. The statement taken from the Business Manager of Local 1340 without the presence of his own counsel nor the presence of any of the contractor's employees or representative was reduced to writing to be notarized and executed by the Business Manager of Local 1340. This statement was then submitted to the DOL as the basis for further denial of arms-length bargaining. Based upon this statement, (as no other evidence was submitted since the DOL determination in October of 1977) the DOL issued a notice for a hearing before the Administrative Law Judge pursuant to its authority under the Service Contract Act. As this hearing approached and even though the hearing was provoked by NASA, NASA attempted in various ways to influence the DOL and place evidence and information before the Adminis-

trative Law Judge prior to the hearing, insisting that this issue was no longer at question. Upon receiving this information, Gill, Landsay and Seago contacted NASA in an effort to receive written concurrence from NASA that the arms-length issue had been settled and that the bargaining had been concluded in accordance with the legal requirements of the Service Contract Act. NASA refused to provide this letter, even though they explained to the DOL that the issue was no longer in question.

At great expense, MCS insisted that the hearing called by the DOL be continued in order that a final determination, in accordance with the Service Contract Act, could be made on the issue of arms-length bargaining. Even to several days before the actual hearing convened on July 11, 1978, NASA attempted to avoid this hearing and to have the hearing terminated. Even though NASA provoked the hearing, even though NASA supplied evidence attempting to have the hearing dismissed, NASA refused both to supply MCS with a letter affirming the arms-length bargaining and, most important, failed to attend the DOL arms-length hearing.

Research indicates that the arms-length hearing in which MCS was involved which was provoked by NASA and which NASA refused to participate, is the first hearing of its kind to be tried concerning the issue of arms-length bargaining under the Service Contract Agreement. Those interested parties present included: MCS, the IBEW (representatives of both Local Union and the International), the counsel for the DOL. At this time, the Administrative Law Judge has the matter under advisement and a decision would be expected within the next five to six weeks. In the meantime, NASA has continued to refuse to recognize and pay costs associated with the ESOP under the contract with MCS and NASA.

Sincerely yours,

JAMES H. GILL, Jr.

ROTAN MOSLE INC.,
Houston, Tex., November 21, 1977.

Mr. KENNETH R. CUNNINGHAM,
Chairman, Metropolitan Contract Services, Inc.,
Houston, Tex.

DEAR MR. CUNNINGHAM: In response to your request, I enclose the following information about our firm and me:

1. Rotan Mosle Financial Corp. Annual Report 1975.
2. Rotan Mosle Inc. 1976 Year End Report. Our latest fiscal year ended about three weeks ago (October 31, 1977), our annual audit is now underway, and our annual report for that fiscal year will be ready in a month or two.
3. Biographical Information on Robert E. Moroney as of 2/1/76. Sorry I haven't had time to update it, but will be glad to do so for you if it is important to you.

When we make appraisals of closely held corporations like Metropolitan Contract Services, Inc. and Metro Contract Services, Inc., our procedure is this:

(a) On the company itself we gather as much information as we can, from any source we deem reliable. Of necessity, most of that information comes from the company itself and its independent Certified Public Accountants.

(b) On the industry, too, we gather as much information as we can from any reliable source. Naturally, we get help from the Company, but we also use additional sources such as trade publications, business magazines, Standard & Poor's Corporation, Moody's Investor's Service and our firm's own research department which enjoys a nationwide reputation for excellence.

(c) Having gathered such information, we then proceed to analyze it carefully, make our own independent decision as to the value of the company's stock, and write our valuation report. We hope the company will consider our valuation reasonable and it usually does. But, in all cases, we must maintain our independence and "call it as we see it."

That's the way we prepared our valuations of Metropolitan Contract Services, Inc. as of June 30, 1975 and our valuation of Metro Contract Services, Inc. as of December 31, 1976. We think both were well done, and we stand behind them.

...We do not consider a corporation's contribution to its Employee Stock Ownership Plan an operating expense in the usual sense of the term because the corporation is under no obligation to continue making such contributions. In that respect such contributions resemble dividends, which the corporation may pay or pass in the discretion of its board of directors.

Yours truly,

ROBERT E. MORONEY,
Vice President—Valuation,
Corporate Finance Department.

Enclosures.

BIOGRAPHICAL INFORMATION ON ROBERT E. MORONEY

Formal education

University of Dallas; Georgetown University (Washington, D.C.); University of Wisconsin (Madison); graduated at Wisconsin in 1923, B.A. degree; major: English, with several electives in law school.

1949: Chairman, Texas Group, Investment Bankers Association of America.

1934: Co-founder, National Security Traders Association, Chicago.

Business experience since college

Worked for Texpolite Building and Loan Association in the Treasury Department of Texas Power & Light Company, Dallas.

Professiona lgroups

Attended Bond School of Guaranty Company of New York, investment banking affiliate of the then Guaranty Trust Company of New York, now Morgan Guaranty Trust Company. Worked as securities analyst in New York and Chicago offices.

Worked successively as salesman, Partner, Vice President, and President of the predecessors of Moroney, Beissner & Co., Inc., Investment Bankers, Houston.

During World War II, negotiated procurement contracts in the Office of the Secretary for the Navy for U.S. Navy at Navy Headquarters in Washington, D.C. and for U.S. Marine Corps at its headquarters across the Potomac in Arlington, Virginia.

Worked as President and Board Chairman of Moroney, Beissner & Co., Inc., Investment Bankers, Houston. Resigned on December 31, 1962.

Worked as Business Manager of St. John the Divine Episcopal Church, Houston. Resigned on December 31, 1964.

Worked as Vice President of Capital National Bank, Houston, Texas, in charge of its investment portfolio.

Practiced as an independent professional financial consultant on corporate financing, Houston.

Rejoined Moroney, Beissner & Co., Inc., Investment Bankers, Houston on April 1, 1968.

Became Vice President—Valuation of Rotan Mosle Inc., Investment Bankers and Brokers, Houston, when Moroney, Beissner & Co., Inc. was merged into Rotan Mosle Inc. on January 15, 1974.

1955: Co-founder, Stock and Bond Club of Houston. Honorary Member Number One.

1961–62: Texas Member of Board of Governors, Investment Bankers Association of America, Washington, D.C.

1968: Member, Houston Society of Financial Analysts, Houston. Fellow, The Financial Analysts Federation.

Scope of experience

Since entering the investment banking business in New York City in 1924, Mr. Moroney has worked in most phases of that industry: analyzing securities; underwriting and selling to the public new and secondary stock and bond issues of business and religious corporations; trading in the secondary market for

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stocks and bonds, listed and unlisted; underwriting and selling to the public new issues of municipal bonds; providing specialized financial consultant services to corporations; managing the investment portfolio of a bank; and making valuation studies of stocks for tax, merger, and property settlement purposes.

In November, 1969, Mr. Moroney served as a panelist at a seminar in Houston on "Going Public" sponsored by the American Institute of Certified Public Accountants.

Mr. Moroney's article entitled, "Most Courts Overvalue Closely Held Stocks" was published in:

Taxes—The Tax Magazine (Commerce Clearing House), March 1973.

The Texas Certified Public Accountants (Texas Society of Certified Public Accountants, April 1973.

Financial Planning Techniques (Aetna Life and Casualty Company, Hartford, Connecticut), June 1973.

The Journal of Business Valuation (The Canadian Association of Business Valuators, Toronto), October 1973.

Tax Law and Practice Course Handbook Series No. 68, The Fourth Annual Employee Benefits Institute, (Practicing Law Institute, New York City, November 1973.

On the subject of valuing closely-held stocks, he addressed:

Texas C.P.A. Tax Institute (sponsored by Texas Society of Certified Public Accountants): Houston, Nov. 20, 1972; Dallas, Nov. 21, 1972.

Houston Business & Estate Planning Council, September 1973.

Houston Estate & Financial Forum, November 1973.

St. Louis Estate Planning Council, December 1973.

Central Texas Estate Planning Council, Austin, February 1975.

Houston Estate & Financial Forum, September 1975.

San Antonio Estate Planning Council, April 1976.

Mr. Moroney has completed valuations of companies in the following industries:

Animal Feed, Automobile and Truck Sales, Cemetery, Commercial Printing, Conglomerate, Cooking Ranges, Diving Contracting, Egg Production, Electrical Contracting, Fertilizer, Funeral Home, Industrial Equipment, Industrial Gas, Magazine Publishing, Manufacturer's Representative, Newspaper Publishing, Oil and Gas Production, Oil Well Service, Oil Well Supply Mfg., Pecan Growing, Professional Sports, Restaurant Chain, Retail Food Store, Shrimping, Television and Radio Broadcasting, Waste Disposal, Wholesale Distributor, Window Cleaning, Wire and Cable Manufacturing.

Testimonies in court as an expert witness

Mr. Moroney has testified as an expert witness in lawsuits involving companies in the following industries:

Telephone Company (Southwestern Bell, State District Court, Houston).

Coal Mining (U.S. Tax Court, Indianapolis).

Variety Store (U.S. Tax Court, Indianapolis).

Conglomerate (U.S. District Court, Minneapolis).

Conglomerate (U.S. District Court, Miami).

Funeral Home (State District Court, Houston).

Solid Waste Disposal (County Court of Domestic Relations, Houston).

Window Cleaning (County Court of Domestic Relations, Houston).

Automobile Distributor (U.S. Tax Court, Lubbock, Texas).

Specialty Wire and Cable Manufacturer (Board of Arbitrators, Boston) scheduled for April–May 1976.

Distributor of Linotype Machines (U.S. Tax Court, Newark, N.J.) scheduled for March 1976.

Pecan Growing and Egg Producing (U.S. Tax Court, Houston) scheduled for February 1976.

STANDARD FORM 30, JULY 1966
GENERAL SERVICES ADMINISTRATION
FED. PROC. REG. (41 CFR) 1-16.101

AMENDMENT OF SOLICITATION/MODIFICATION OF CONTRACT

PAGE 1 OF 1

1. AMENDMENT/MODIFICATION NO.	2. EFFECTIVE DATE	3. REQUISITION/PURCHASE REQUEST NO.	4. PROJECT NO. (If applicable)
19	7/1/77	N/A	N/A

5. ISSUED BY
National Aeronautics and Space Administration
Langley Research Center
Hampton, Virginia 23665

6. ADMINISTERED BY (If other than block 5)

7. CONTRACTOR NAME AND ADDRESS
Metropolitan Contract Services, Inc.
28 Research Road, Suite 107
Hampton, Virginia 23666

8. ☐ AMENDMENT OF SOLICITATION NO. ______ DATED ______ (See block 9)
☒ MODIFICATION OF CONTRACT/ORDER NO. NAS1-13700 DATED 3/24/75 (See block 11)

9. THIS BLOCK APPLIES ONLY TO AMENDMENTS OF SOLICITATIONS

10. ACCOUNTING AND APPROPRIATION DATA (If required)

N/A

11. THIS BLOCK APPLIES ONLY TO MODIFICATIONS OF CONTRACTS/ORDERS

☐ The Change Order is issued pursuant to ______
☐ The above numbered contract/order is modified to reflect the administrative changes
☒ The Supplemental Agreement is entered into pursuant to authority of NASA Procurement Regulation 25.402

12. DESCRIPTION OF AMENDMENT/MODIFICATION

The purpose of this Supplemental Agreement is to recognize the Novation Agreement dated July 1, 1977, between Metro Contract Services, Inc., Metropolitan Contract Services, Inc., and the United States of America.

A. It is hereby acknowledged that the said Novation Agreement effecting recognition of Metropolitan Contract Services, Inc., as a successor in interest to Metro Contract Services, Inc., applies in accordance with all of its terms and conditions to contract NAS1-13700.

B. Except as hereby modified, all the terms, covenants, and conditions of said contract as heretofore modified or amended shall remain in full force and effect.

C. Contract NAS1-13700 is hereby amended to reflect the said agreement by changing the Contractor name in block 8 of page one (1) of the contract to read "Metropolitan Contract Services, Inc." instead of "Metro Contract Services, Inc."

☐ CONTRACTOR/OFFEROR IS NOT REQUIRED TO SIGN THIS DOCUMENT ☒ CONTRACTOR/OFFEROR IS REQUIRED TO SIGN THIS DOCUMENT AND RETURN 3 COPIES TO ISSUING OFFICE

14. NAME OF CONTRACTOR/OFFEROR	17. UNITED STATES OF AMERICA
BY [signature]	BY F. Eden Godfrey [signature]

15. NAME AND TITLE OF SIGNER	16. DATE SIGNED	18. NAME OF CONTRACTING OFFICER	19. DATE SIGNED
N.W. Howard, Vice President		F. Eden Godfrey	AUG 2 1977

CONTRACTOR'S COPY

[Memorandum From Jones, Day, Reavis & Pogue, July 19, 1978]

To: Kenneth Cunningham.
From: Dale H. Oliver.
Subject: Summary of the Metropolitan Contract Services, Inc. protest; B-191162.

The protest at the GAO was brought by Metropolitan Contract Services, Inc. on January 24, 1978. The protest charged that NASA, because of a bias against ESOP programs, discriminated against Metropolitan Contract Services in award of a three-year maintenance services contract at NASA's Langley Research Center.

Metropolitan discovered during the course of the protest that the Chairman of the Source Evaluation Board, the group charged with ranking the offerors, had been also actively working to overturn the ESOP implemented by Metropolitan. Metropolitan believes that NASA's predisposition against ESOP's led it into several procurement errors. For example, NASA disregarded a $400,000 price savings offered by Metropolitan in a proposed ceiling for ESOP costs. NASA also failed to seek clarification during the "negotiations" of aspects of the Metropolitan offer which NASA later said were ambiguous.

The General Accounting Office did find that NASA incorrectly interpreted Metropolitan's offer, but concluded that the $400,000 savings could be considered as only hypothetical. The GAO also opined that Metropolitan had not been prejudiced by other noted defects in the NASA evaluation. As a result of these conclusions, the GAO did not recommend corrective action. Metropolitan sought reconsideration of the decision. That reconsideration was denied yesterday.

DECISION OF THE COMPTROLLER GENERAL OF THE UNITED STATES

File: B-191162.
Date: July 18, 1978.
Matter of: Metropolitan Contract Services, Inc.—Reconsideration.

DIGEST

Prior decision is affirmed upon request for reconsideration where GAO finds Board of Contract Appeals decision cited by protester not to be controlling on facts and 4-percent cost ceiling only applied to Employee Stock Ownership Plan costs and not to all labor costs.

Metropolitan Contract Services, Inc. (Metropolitan), has requested reconsideration of our decision of June 14, 1978 (B-191162), in which we denied Metropolitan's protest of the proposed award of a contract by the National Aeronautics and Space Administration (NASA) under request for proposals (RFP) No. 1-101-5700.0120.

Metropolitan's request for reconsideration is grounded on the belief that our Office has misinterpreted the legal effect of a 4-percent cost ceiling which Metropolitan offered on the costs of its Employee Stock Ownership Plan (ESOP). The Service Contract Act wage determination applicable to this procurement contained as a fringe benefit an 8-percent ESOP. In our decision of June 14, 1978, we found that Metropolitan in its best and final offer had placed a firm, unconditional 4-percent cost ceiling on the ESOP costs NASA would have to reimburse Metropolitan under the contract. However, we held that NASA could properly refuse to evaluate Metropolitan's proposal with the 4-percent ceiling. We agreed with NASA that:

"* * * as only Metropolitan of the three offerors had an ESOP, Metropolitan was the only offeror in a position to manipulate the cost level or contribution rate of the ESOP because, according to NASA's counsel, the Metropolitan Board of Directors could unilaterally change the plan at any time. Also, as the wage determination required an 8-percent ESOP or its equivalent, if Metropolitan unilaterally reduced its ESOP costs to 4 percent, it would be required to provide some additional fringe benefit, which, when coupled with the 4-percent ESOP, would yield the equivalent of 8-percent ESOP costs. Thus, while ESOP costs were reduced to 4 percent, the total fringe benefit package costs would remain unchanged."

In denying this basis of protest, we stated:

"However, as noted by NASA, altering the 8-percent ESOP would most likely require raising another fringe benefit. NASA was given no protection regarding other fringe benefit costs. It is clear from Metropolitan's best and final offer that the 4-percent ceiling only applied to the ESOP. If the ESOP contribution was reduced or the ESOP abolished altogether and an equivalent increase given the employees in another portion of the wage determination, NASA would not receive any of the cost savings Metropolitan attributes to its 4-percent ceiling. In passing, we note that Metropolitan has renegotiated its labor agreement with the union involved and, effective July 1978, the ESOP has been deleted and a 7-percent increase made in the pension fund for employees. Therefore, there will be no ESOP to which to apply a ceiling and NASA would have to reimburse the full 7-percent pension fund cost.

"Accordingly, we find nothing improper in NASA's cost projections for the offerors."

Metropolitan contends that its 4-percent ceiling would have applied to any equivalent increase in another fringe benefit to which the 8-percent ESOP costs, if the ESOP was abolished, were transferred.

Metropolitan cites *Reynolds Metals Co.*, ASBCA No. 7686, 1974 BCA 4312, *reconsideration*, 1964 BCA 4477, for the proposition that a contractor cannot recover the increased costs of changing the allocation of fringe benefits, after contract award, even though the contractor could not have foreseen the change in circumstances leading to the reallocation.

We do not find *Reynolds* controlling in this situation. The Armed Services Board of Contract Appeals held that Reynolds' allocation of a Supplemental Unemployment Benefit Plan contribution to 16 plants as overhead charges on the basis of direct labor hours worked at each plant could not be changed to reflect the benefits actually paid to workers at one plant which had been closed on the completion of the contract. The retroactive reclassification of this one item of overhead cost, at one plant, was inconsistent with Reynolds' accounting system and contrary to generally accepted accounting practices. The original decision and the reconsideration make clear that it was the retroactive nature of the change which the Board found objectionable.

Here, if there was a shift of costs from the ESOP to another fringe benefit, there would be no retroactive revision and, therefore, we do not find the reasoning of *Reynolds* to require altering our prior decision of June 14, 1978.

While Metropolitan also makes the argument that its 4-percent ceiling applied to labor costs and not just ESOP costs, we believe the following statement in its best and final offer clearly shows the ceiling only applied to the ESOP:

"* * * Too, although the ESOP costs remain the same as required by the Wage Determination Act of September 22, 1977, we would like to inform the SEB that management has reviewed the impact of amortizing of the ESOP costs over the longer five-year contract period and if Metropolitan is awarded this contract, our costs will be 4 percent, 4 percent and 4 percent, respectively. We are confident these amounts can be negotiated with IBEW Local 1340; however, in the event they cannot, Metropolitan would agree to a ceiling of 4 percent, 4 percent and 4 percent, respectively, for the ESOP costs under contract. Accordingly, we feel NASA should consider this as a cost savings under Metropolitan's revised proposal. * * *"

Accordingly, our decision of June 14, 1978, is affirmed.

R. F. KELLER,
Deputy Comptroller General of the United States.

STATEMENT OF DAVID PERSONETTE

I, David Personette, am the Executive Vice President of Metropolitan Contract Services, Inc. of Houston, Texas. I came to work for Metropolitan on April 1, 1978. One of the most significant problems facing Metropolitan at that time was the overdue status of approximately $300,000 of accounts receivable from the Federal Government. That money was and is being held up by NASA as the result of an audit report by Mr. U. G. Ballard, an auditor for the Defense Contract Audit Agency. I contacted Mr. Nolan Jones, the Contract Officer in charge of our contract and asked him the procedures necessary for me to try to collect the money in question. He told me that I should prepare an analysis of Metropolitan's cash needs and submit that analysis to the DCAA in Houston for their review.

Subsequently, the DSAA would make a report on that analysis to Nolan Jones and at such time NASA would consider our request for the money on a token disallowance basis. I then called Mr. Ballard of the DCAA in Houston, Texas and requested an appointment with him for the purpose of discussing his views on Metropolitan, his report to the DCAA regarding the disallowance money and his upcoming review of our cash flow projections. Mr. Ballard then told me that if I wanted him to talk to me about helping Metropolitan in any way. I was wasting his time and mine. He said that Mr. Ken Cunningham, the major shareholder and board chairman of Metropolitan, was dishonest and that as far as he was concerned, Mr. Cunningham or any company controlled by him was not entitled to consideration. He told me that if I wanted to work

for Metropolitan, that was my business, but he thought I should know that Mr. Cunningham was a cheat and that he would control anything he could to his own best advantage, even if it meant taking actions detrimental to others.

Being quite concerned about the statements he was making, I asked Mr. Ballard when and why he had developed his opinions about Mr. Cunningham and Metropolitan. He told me that his thinking along those lines began four years ago when he, as an auditor, disallowed certain contract costs relating to the Job 70 program. He said that those costs had been included in the contract costs and had also been reimbursed by the Department of Labor, a procedure that he felt was fradulent. At that time, I told him of my experience in the past in the commercial sector with Job 70 credits and that commercial customers had in the past paid for products manufactured using Job 70 employees at the same price they paid for products made using non-Job 70 employees. I asked him why the Government sector should be any different than the private sector. As a matter of interest, it is my information that the matter of the Job 70 disallowance has finally been determined by an administrative law judge who awarded most of the disallowed costs to the contractor.

I have had various discussions with the bankers for Metropolitan Contract Services, Inc. Some of those discussions have related to the actions of the DCAA and Mr. Ballard during DCAA audit procedures involving the bank. The people at our bank tell us uniformly that they felt the audit was conducted in a very unorthodox and unprofessional manner and that at times they were made to feel that they were being harassed.

Everyone that I talked to who has come in contact with Mr. Ballard of the DCAA tells me that his story to them about Kenneth Cunningham and Metropolitan is the same as it was to me. In talking with the people at NASA, it is obvious to me by their indirect comments that they have also heard the same story from Mr. Ballard.

I have made a thorough and complete study of NASA's disallowance of our $300,000 relating to ESOP and of the DCAA report by Mr. Ballard upon which the disallowance is based. Attached to this statement as Exhibit 1 is a copy of NASA's disallowance statement and a copy of Mr. Ballard's audit report relating to ESOP. NASA's stated reasons for disallowing our $300,000 are as follows: (1) that the ESOP benefit was not the result of arms-length bargaining; (2) that the ESOP benefit is at variance with wages and benefits in the area; and (3) that the stock that was purchased by the ESOP trust was over-valued by Rotan Mosle and that the trust paid too much for the stock. NASA in its continuing harassment of Metropolitan Contract Services and its Employee Stock Option Plan requested a hearing from the Department of Labor regarding the arms-length issue after the Department of Labor had twice already given a ruling that the ESOP was indeed the result of arms-length bargaining.

The Department of Labor finally did go to all the trouble to set up a hearing. Representatives and attorneys from Metropolitan Contract Services, from the International Brotherhood of Electrical Workers and from the Department of Labor came to that hearing, only to find that no one from NASA showed up. NASA has now requested another hearing with the Department of Labor to determine whether or not the existing wage determination between Metropolitan and the IBEW is at variance with wages paid in the area. We negotiated the very best deal we could with the IBEW and the Department of Labor granted a wage determination. NASA, in its continued harassment of our firm, has put us in the untenable position of having paid many thousands of dollars of wages since March 25, 1978 through our last day on the job without really knowing whether or not we will be reimbursed for those costs. I feel that NASA's challenge of the wage determination is unfounded and frivolous, and is just another one of their tactics to make life as miserable as possible for Metropolitan because of their bias and prejudice toward our Employee Stock Option Plan.

NASA and the DCAA have spent hundreds of man hours making great fanfare of the valuation of Metropolitan stock by Rotan Mosle. Rotan Mosle's stock evaluation is attached as Exhibit 2. They have said many times that the primary reason for disallowing our $300,000 is that the stock that our Employee Stock Ownership Trust bought was over-valued and the trust paid too much for it. Metropolitan Contract Services has contributed faithfully to that Employee Stock Ownership Trust on a percentage to the wages paid to its employees. The value of the stock bought by the trust has absolutely nothing to do with the amount of money Metropolitan puts into that trust. I was dumbfounded when I read

NASA's long, involved statement about the valuation of the stock purchased by the trust.

Admittedly, the Department of Labor and the Internal Revenue Service are quite interested in the prices paid for company stock by the Employee Stock Ownership Trust, but it is totally outside the scope of NASA and the DCAA to question stock valuations. Their only question should relate to whether or not Metropolitan actually made the contributions to the trust on the same basis it made contributions for other employees throughout the company.

However, since NASA and the DCAA have taken it upon themselves to directly challenge the stock evaluations made by some of the most talented investment banking firms in the world, I feel that it is necessary to show the Senate Finance Committee the incredible lack of professionalism and independence displayed in NASA's ridiculous evaluation of Metropolitan's stock value. First, NASA has attacked the earnings per share of Metropolitan Contract Services. They say that actual 1975 earnings were only $22.36 a share, which at 8.9 times earnings is far in excess of the composite ratio of 5.5 of comparable companies used in the stock appraisal.

I personally challenge the qualifications of the DCAA and NASA to determine what would constitute one P/E ratio being "far in excess" of another. NASA also challenged the 1976 projected P/E ratio of $39.60 per share saying that 1976 actual earnings per share were only $4.24. What NASA neglected to say was that in the year of 1976, there was a $289,000 contribution to the Employee Stock Ownership Trust. If that contribution had not been made, earnings would have been $33.00 a share. NASA and the DCAA knew this, but as a result of their prejudice and bias, neglected to mention it in their report.

At the time Mr. Ballard was making his own appraisal of the value of Metropolitan Contract Services, he made no attempt to determine the value of Metropolitan's assets less liabilities. If he had, he would have found that Metropolitan could have been liquidated at any time for in excess of $100 per share. Mr. Ballard, in his audit report, set a value on Metropolitan stock of $22.00 per share. As a Certified Public Accountant, I can tell you without reservation that I am qualified to say that the net liquidating value of the company at that time was indeed "far in excess" of Mr. Ballard's appraisal. A copy of his $22.00 per share evaluation is included with this statement as Exhibit 3. I do not know all of the procedures and techniques used by Rotan Mosle and by Underwood Neuhaus in their separate, independent evaluations of our stock, but I do know that they are eminently more qualified to appraise the value of going concerns than is an auditor with the DCAA, especially one who is auditing something completely outside the scope of his duties.

It is my personal conviction that Mr. Ballard is strongly biased against Metropolitan Contract Services, Inc. and Mr. Kenneth R. Cunningham and that he conveys his prejudices to anyone that will give him audience. I believe that he has influenced the people at NASA to the extent that they have disallowed over $300,000 of our money and that they have awarded our contract to another contractor for reasons other than prudent business evaluation. NASA, in its haste to select another contractor, did so without regard to a $400,000 cost differential saying that the cost differential was nebulous and there were ways for Metropolitan to avoid giving that cost savings. However, at no time during contract negotiations or orals was Metropolitan asked by NASA to clarify or explain the $400,000 differential. In their haste to select another contractor, by 12 points out of 1,000 possible, they ignored the $400,000 and they ignored the cost of phasing us out and the cost of phasing a new contractor in. All the people at NASA say that the selection was a result of normal, prudent business judgment and even though Metropolitan was only beat out by 12 selection points out of 1,000, "the chips just fell that way".

I personally feel that it will be an outrageous affront to Congress, to the taxpayers of the United States, and to all systems of ethics in Government procurement if the DCAA and NASA are allowed to act in the neglectful, abusive, and irresponsible fashion they have demonstrated on this issue.

EXHIBIT 1

NATIONAL AERONAUTICS AND SPACE ADMINISTRATION
NOTICE OF CONTRACT COSTS SUSPENDED AND/OR DISAPPROVED

PAGE 1 OF 7 PAGES

TO: *(Name and address of contractor)*
Metropolitan Contract Services, Inc.
9225 Katy Freeway, Suite 110
Houston, Texas 77024

CONTRACT NUMBER: NAS1-13700
NOTICE NUMBER: PSCB 78-5
VOUCHER NUMBER: 28 thru 38, 40, 42, 44, 46, 48
DATE OF NOTICE: APR 24 1978

1. This notice is issued pursuant to the authority of the NASA Procurement Regulation. It constitutes advice of costs suspended and/or disapproved incident to the audit of the above referenced voucher. Description of items and reasons for action are shown below.
2. Suspended costs, as referred to herein, are costs which, for the reasons shown below, appear questionable but on which final determination has not been made.
3. Disapproved costs, as referred to herein, are costs which, for the reasons shown below, have been determined by the undersigned to be unallowable.
4. As to any disapproved costs identified herein, this Notice constitutes a final decision of the contracting officer, effective sixty days after the date of its receipt by the Contractor, unless the Contractor mails or furnishes to the cognizant contracting officer a written appeal before the expiration of such sixty-day period. If this Notice becomes a final decision of the contracting officer by virtue of expiration of the sixty-day period, it may be appealed in accordance with the provisions of the "Disputes" clause of the contract identified above. If the Contractor decides to make such an appeal, written notice thereof *(in triplicate)* must be mailed or otherwise furnished to the contracting officer within thirty days from the date this decision becomes effective. Such notice should indicate that an appeal is intended and should reference this decision and identify the contract number. The NASA Board of Contract Appeals is the authorized representative of the Administrator for hearing and determining such disputes. The NASA Contract Appeal procedures are set forth in Appendix A of the NASA Procurement Regulation.

	DATE	ADDRESS	SIGNATURE
GOVERNMENT AUDITOR			
CONTRACTING OFFICER	APR 24 1978	NASA, Langley Research Center, Mail Stop 139 Hampton, VA 23665	Nolan Jones NOLAN E. JONES

CONTRACTOR'S ACKNOWLEDGMENT OF RECEIPT *(The Contractor or his authorized representative shall acknowledge receipt of this notice to the Government auditor. One copy of the acknowledged notice will be submitted to the cognizant contracting officer.)*

DATE OF RECEIPT	TYPED NAME AND TITLE OF AUTHORIZED OFFICIAL	SIGNATURE

ITEM NO.	DESCRIPTION OF ITEMS AND REASONS FOR ACTION	AMOUNT OF COSTS SUSPENDED	AMOUNT OF COSTS DISAPPROVED
	This Form 456, Notice Number PSCB 78-5, supersedes Forms 456, Notice Numbers PSCB 77-1, -2; 78-1, -2, -3 and -4.		$261,261.61
I.	Pursuant to NASA PR 15.201-3, 15.205-6(a)(2) and 15.205-6(f)(2), Employee Stock Ownership Plan (ESOP) costs incurred from January 1, 1977, through March 29, 1978 are unreasonable and disallowed for reasons as follows:		
	a. ESOP costs were initially reimbursed under the contract upon the presumption that the ESOP had been agreed upon by the Contractor and the Union pursuant to arm's-length bargaining. The presumption of arm's-length bargaining was and is incorrect, and the cost of ESOP is therefore unreasonable and disapproved pursuant to NASA PR 15.201-3(ii). The foregoing decision is based upon the deposition of Mr. Steven Stump, President of Local 1340, International Brotherhood of Electrical Workers (IBEW) and Assistant Business Manager. A copy of the deposition has been provided to the Contractor under the Freedom of Information Act.		
	b. The employees who perform the work required by NAS1-13700 are covered under a Collective Bargaining Agreement (CBA) between IBEW Local 1340 and the		

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NATIONAL AERONAUTICS AND SPACE ADMINISTRATION
NOTICE OF CONTRACT COSTS SUSPENDED AND/OR DISAPPROVED-Continuation Sheet

PAGE 2 OF 7 PAGES

TO: (Name and address of contractor)	CONTRACT NUMBER	VOUCHER NUMBER
Metropolitan Contract Services, Inc. 9225 Katy Freeway, Suite 110 Houston, Texas 77024	NAS1-13700	28 thru 38, 40, 42, 44, 46, 48
	NOTICE NUMBER: PSCB 78-5	DATE OF NOTICE:

ITEM NO.	DESCRIPTION OF ITEMS AND REASONS FOR ACTION	AMOUNT OF COSTS SUSPENDED	AMOUNT OF COSTS DISAPPROVED
	Contractor. According to the Contractor, the CBA contains a Statement of Understanding which incorporates the Contractor's ESOP as a fringe benefit. The Department of Labor (DOL) has concurred in the Contractor's position and has included the ESOP as a fringe benefit in the Wage Determination applicable to the first year of the follow-on contract, formerly scheduled to commence on March 25, 1978.		
	c. It is clear from the deposition (page 6) that the Union does not consider Statements of Understanding to be a part of the CBA or binding in any way to a follow-on contractor (page 19). Therefore they do not consider ESOP to be a fringe benefit under the CBA. On this point it should be noted that on page 20 of the deposition Mr. Stump was asked if he would have accepted ESOP within his CBA if it were presented to him and as has been accepted under the Statement of Understanding. His answer is: "No sir, no way in the world. My members had no protection, we've got no trustees. Any man negotiating for a Union, there is no way he could accept it, no way in the world. Any Union agreement I have ever been involved in or I have read, any fringe benefits are set up with trustees from labor and management, equally divided. Provisions so if they can't arrive at an answer then they bring in an impartial party or arbitrator type person. I would never sign an agreement like that".		
II.	Pursuant to NASA PR 15.201-3(ii), the ESOP-associated costs are further deemed unreasonable and are disallowed because the ESOP benefit is substantially at variance with benefits which prevail for services of a similar character within the locality of contract performance, i.e., Hampton, Virginia. Section 4(c) of the Service Contract Act, added by amendment enacted October 9, 1972, provides that wage rates and fringe benefits agreed upon and set forth in a collective bargaining agreement must be paid unless found upon a hearing to be substantially at variance with those wage rates and fringe benefits prevailing in the locality. Prima facie evidence is available, showing that the ESOP benefit is substantially at variance with that which prevails for services of a similar character in the Hampton, Virginia locality.		
III.	Costs claimed are also disapproved because they are based on an excessive valuation placed on the shares		

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NATIONAL AERONAUTICS AND SPACE ADMINISTRATION NOTICE OF CONTRACT COSTS SUSPENDED AND/OR DISAPPROVED-Continuation Sheet		PAGE 3 OF 7 PAGES
TO: (Name and address of contractor) Metropolitan Contract Services, Inc. 9225 Katy Freeway, Suite 110 Houston, Texas 77024	CONTRACT NUMBER NAS1-13700 NOTICE NUMBER PSCB 78-5	VOUCHER NUMBER 28 thru 38, 40, 42, 44, 46, 48 DATE OF NOTICE

ITEM NO.	DESCRIPTION OF ITEMS AND REASONS FOR ACTION	AMOUNT OF COSTS SUSPENDED	AMOUNT OF COSTS DISAPPROVED

of Metropolitan stock sold to the ESOP trust. Costs in excess of the fair market value of the stock are determined to be unallowable per NASA PR 15.201-3, 15.201-4, 15.205-6(d) and 15.205-6(f)(2)(ii)(A).

a. Metropolitan adopted an ESOP in December 1975 for its employees. In January 1977 Metro was made a wholly owned subsidiary of Metropolitan, and one month later (February 1977) the Metropolitan ESOP was extended by Joinder Agreement to apply to Metro employees, retroactive to July 1976, the beginning of the plan year. Metro at this time had all Government work consisting of three NASA cost reimbursement contracts (NAS 8-31028, 9-14991 and 1-13700); Metropolitan had only commercial business. The Metropolitan ESOP requires Metropolitan and Metro to make cash contributions to the ESOP trust which uses the money to invest in securities on behalf of the plan participants. Currently, the trust has invested solely in Metropolitan stock. Prior to the Joinder Agreement, the Metropolitan ESOP trust owned 1440 shares of Metropolitan stock valued at $288,000, which the trust had purchased from Mr. K. R. Cunningham, Chairman of the Board and Chief Executive Officer of Metropolitan, in August 1976 for $200 a share. In February 1977, after the Joinder Agreement, Mr. Cunningham sold another 5000 shares of his Metropolitan stock to the ESOP trust, again at $200 a share, for $1,000,000.

b. Since all of the stock of Metropolitan was owned exclusively by Mr. Cunningham, it was not publicly traded. Rotan Mosle, Inc., a securities investment firm, appraised the value of the stock as of June 30, 1975, at $200 a share and this price has been used for all stock sold to the ESOP trust by Mr. Cunningham. In their valuation of the stock, Rotan Mosle used financial data and information which included (i) actual 1975 earnings per share of $22.36, (ii) projected 1976 earnings per share of $39.60 and (iii) an analysis of comparable companies' financial and stock marketing structures. The Rotan Mosle appraisal is unacceptable for the following reasons:

(1) The price of $200 per share is 8.9 times actual 1975 earnings per share of $22.36. This price earnings (PE) ratio is far in excess of the composite 5.5 PE ratio of comparable companies used

NATIONAL AERONAUTICS AND SPACE ADMINISTRATION
NOTICE OF CONTRACT COSTS SUSPENDED AND/OR DISAPPROVED-Continuation Sheet

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TO: (Name and address of contractor)
Metropolitan Contract Services, Inc.
9225 Katy Freeway, Suite 110
Houston, Texas 77024

CONTRACT NUMBER: NAS1-13700

NOTICE NUMBER: PSCB 78-5

VOUCHER NUMBER: 28 thru 38, 40, 42, 44, 46, 48

DATE OF NOTICE:

ITEM NO.	DESCRIPTION OF ITEMS AND REASONS FOR ACTION	AMOUNT OF COSTS SUSPENDED	AMOUNT OF COSTS DISAPPROVED

in the appraisal; i.e., Leaseway Transportation, Retail Merchants, Flexi-Van and United Truck Leasing.

(2) Neither Metropolitan nor Rotan Mosle could provide the original documentation supporting the projected 1976 earnings per share of $39.60. Both Metropolitan and Rotan Mosle advised that the documentation supporting the projection had been lost. Although certain other financial data and information were available at the time of the Rotan Mosle appraisal, including Metropolitan's financial statement as of September 30, 1975, showing that the projected earnings for 1976 were not being achieved, apparently, none of these data and information were used in the Rotan Mosle appraisal which was not completed until November 12, 1975.

(3) The projected earnings per share did not take into consideration the impact of the cost of ESOP in reducing the amount of future earnings.

(4) The 1976 earnings projection of $39.60 per share was highly inaccurate in relation to the actual 1976 earnings per share of $4.24.

c. On January 3, 1977, Mr. Cunningham, who also owned all of the stock in Metro, agreed to sell Metro to Metropolitan in exchange for additional shares of Metropolitan stock. Since Metro stock was not publicly traded, it was necessary to have an appraisal made of the Metro stock for purposes of this transaction. This appraisal was also obtained from Rotan Mosle, who issued an appraised value of $1,800,000 for the 25,000 outstanding shares of Metro stock, or $72 a share. The $1,800,000 value placed on the Metro stock was based on 1977 estimated earnings of $300,000. Metro stock of 25,000 shares was exchanged for 6,000 shares of Metropolitan stock using the $200 per share value established by Rotan Mosle as of June 30, 1975. The Rotan Mosle $1,800,000 valuation of Metro is unacceptable for the following reasons:

(1) The $300,000 projected 1977 earnings, after taxes, was based in part on the exclusion of $183,425, before taxes, of certain costs categorized as non-recurring expenses. Rotan Mosle was asked if this was a consistent practice in the valuation of stock and they advised it was not. This inconsistency

NASA FORM 456-1 NOV 68 PREVIOUS EDITIONS ARE OBSOLETE. NASA-HQ

NATIONAL AERONAUTICS AND SPACE ADMINISTRATION

NOTICE OF CONTRACT COSTS SUSPENDED AND/OR DISAPPROVED-Continuation Sheet

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TO: (Name and address of contractor)	CONTRACT NUMBER	VOUCHER NUMBER
Metropolitan Contract Services, Inc. 9225 Katy Freeway, Suite 110 Houston, Texas 77024	NAS1-13700	28 thru 38, 40, 42, 44, 46, 48
	NOTICE NUMBER PSCB 78-5	DATE OF NOTICE

ITEM NO.	DESCRIPTION OF ITEMS AND REASONS FOR ACTION	AMOUNT OF COSTS SUSPENDED	AMOUNT OF COSTS DISAPPROVED
	substantially overstated the value of Metro. (2) The assumption that lower costs, i.e., the absence of non-recurring expenses, will automatically increase profits in a cost reimbursement environment, such as in the case of Metro's business, is invalid. Reduction of costs by any means results in a reduction of sales and costs with little impact on profits. (3) Rotan Mosle used a PE ratio of six times earnings to value Metro. The PE ratio appears to be too high. The company is not a growth company as demonstrated by its equity growth since its beginning in 1972. Although there have been no cash dividends to reduce company equity, the equity account only amounts to $213,595 at June 30, 1977. Furthermore, the non-recurring expenses mentioned above are identified as marketing expenses which means that in the valuation Rotan Mosle used a PE ratio of a growth company but projected that such growth would not continue or be needed as evidence by their elimination. Such valuation practices are questionable and could result in an inaccurate stock or company appraisal. d. Although Metropolitan obtained an appraised value of $200 a share for its stock as of June 30, 1975, it used that price to sell stock to the ESOP trust on August 11, 1976 (1440 shares) and on February 18, 1977 (5000 shares). At the time of the latter sale of stock, the 1976 actual earnings of $4.34 a share had been available for several months and this figure differed significantly from the 1976 projected earnings of $39.60 a share used in the original Rotan Mosle appraisal upon which the $200 per share was based. At the time of the February 1977 stock sale, Metropolitan's issued shares of common stock had increased from 10,100 to 19,100 shares. Additional earnings information was also available for the first six months of 1977, ending December 1977. All of this information was available before February 18, 1977, and a more current valuation of the stocks should have been obtained. e. The purchase of Metropolitan stock on August 11, 1976, by the ESOP trust was based on the current needs of the ESOP as determined by the amount of company contributions. The February 18, 1977, sale		

NATIONAL AERONAUTICS AND SPACE ADMINISTRATION NOTICE OF CONTRACT COSTS SUSPENDED AND/OR DISAPPROVED-Continuation Sheet		PAGE 6 OF 7 PAGES	
TO: (Name and address of contractor) Metropolitan Contract Services, Inc. 9225 Katy Freeway, Suite 110 Houston, Texas 77024	CONTRACT NUMBER NAS1-13700 NOTICE NUMBER PSCB 78-5	VOUCHER NUMBER 28 thru 38, 40, 42, 44, 46, 48 DATE OF NOTICE	
ITEM NO.	DESCRIPTION OF ITEMS AND REASONS FOR ACTION	AMOUNT OF COSTS SUSPENDED	DISAPPROVED
	of stock to the ESOP trust was made after the purchase of Metro by Metropolitan. However, at the time of the February sale the ESOP did not have a requirement to allocate shares of stock to the employees and would not have such a requirement until August or September of 1977. While an ESOP trust has the right to buy stock at any time it is desirable, such transactions must be prudent and in the interest of participating employees. Inasmuch as Mr. Cunningham during the period January through June 1977 was selling and reorganizing his corporate holdings, it would appear that a more prudent course of action would have been to delay the February 1977 sale of stock to the ESOP trust, especially since the stock was not needed until August or September of 1977. Mr. Cunningham, the seller of the stock and a member of the ESOP Administrative Committee which made the decision to buy the stock in February 1977, has declined to explain the rationale for the February 1977 stock purchase.		
IV.	Costs claimed are further disapproved because they include interest charges on the leveraged portion of the Metropolitan ESOP which were unnecessary under the prevailing circumstances and served to dilute the value of the ESOP benefits to the plan participants. Costs claimed in this category are determined to be unallowable per NASA PR 15.201-3 and 15.205-6 (f)(2)(ii)(A).		
	a. On February 18, 1977, the ESOP trust bought 5000 shares of stock for $1 million from Mr. K. R. Cunningham, who was also a member of the ESOP committee which approved the purchase. To buy the stock in advance of ESOP contributions and allocation to employees, the ESOP trust borrowed $1 million from the Allied Bank of Texas which is the Trustee of the Metropolitan ESOP. While an ESOP may purchase stock at any time, the transaction should accrue to the benefit of participating employees. Since Mr. Cunningham was the sole owner of the other Metropolitan shares of stock which could have been bought at any time, there is no evidence that the ESOP had to be advanced stock with Metropolitan shares of stock. Metropolitan was asked to provide the rationale for the ESOP's buying of stock on February 18, 1977; however, this was not provided. During the year ended June 30, 1977, the Trust incurred interest expense on the borrowed funds and also held		

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NATIONAL AERONAUTICS AND SPACE ADMINISTRATION

NOTICE OF CONTRACT COSTS SUSPENDED AND/OR DISAPPROVED-Continuation Sheet

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TO: (Name and address of contractor)
Metropolitan Contract Services, Inc.
9225 Katy Freeway, Suite 110
Houston, Texas 77024

CONTRACT NUMBER: NAS1-13700

NOTICE NUMBER: PSCB 78-5

VOUCHER NUMBER: 28 thru 38, 40, 42, 44, 46, 48

DATE OF NOTICE:

ITEM NO.	DESCRIPTION OF ITEMS AND REASONS FOR ACTION	AMOUNT OF COSTS SUSPENDED	AMOUNT OF COSTS DISAPPROVED

back unallocated cash to pay future interest expense as shown below:

	Metropolitan ESOP		
	Total	Metro Contracts	Metropolitan Contracts
Interest Expense	$25,236	$12,062	$13,174
Unallocated Cash	34,355	16,125	18,230
Total	$59,591	$28,187	$31,404

b. Because of the lack of evidence that the February 18, 1977, stock purchase was a prudent business transaction and made in the interests of the ESOP and participating employees, related interest expenses are deemed to be unreasonable and unallowable in accordance with NASA PR 15.201-3 and 15.205-6(f)(2)(ii)(A). Had the ESOP not bought the stock in advance of contributions and allocations to employees interest would not have accrued, and therefore more money would have been available to purchase additional shares of stock for participating employees.

c. Metropolitan advised that the unallocated cash represents money held in the ESOP trust at June 30, 1977, to pay future interest which accrues on the loan subsequent to June 30, 1977. This future interest was allocated to Metro and Metropolitan. However, subsequent to June 30, 1977, Metro (NASA contracts NAS 8-31028 and 9-14991) was not a part of the Metropolitan ESOP and therefore, the interest should not have been allocated to Metro. Since Metro established its own ESOP effective July 1, 1977, and is incurring interest on that plan, the charging or allocating of Metropolitan ESOP interest after June 30, 1977, is a double charge to Metro and its NASA contracts.

EXHIBIT 2

APPRAISAL OF MARKET VALUE OF METROPOLITAN CONTRACT SERVICES, INC., HOUSTON TEX.

PURPOSE AND SCOPE OF REPORT

We have been asked by the management of Metropolitan Contract Services, Inc. ("MCS" or the "Company") to estimate the fair market value of 100 percent of the common stock of the Company on June 30, 1975. Our report has been prepared solely to assist management in determining an appropriate common stock value for establishing an Employee Stock Ownership Trust.

Our evaluation is based primarily upon information contained herein furnished by the management of Metropolitan Contract Services, Inc., and we have relied upon such management for the accuracy and completeness of such information. We have made no independent verification of the information contained herein, and make no representation as to its accuracy and completeness.

For the purpose of this report, fair market value is defined as "the price agreed upon between a willing buyer and a willing seller with each having full knowledge of all pertinent facts and with neither being under any compulsion to act."

CONCLUSION

Considering all pertinent factors, we estimate the fair market value of 100 percent of the common stock of Metropolitan Contract Services, Inc. on June 30, 1975 to be $2,020,000 or $200.00 per share (based on 10,100 shares outstanding). This value is 8.9 times fiscal 1975 earnings before extraordinary loss of $22.36 per share, 5.1 times estimated 1976 earnings per share of $39.60, and 5.7 times tangible book value per share of $35.19 on June 30, 1975.

ROTAN MOSLE INC.,
By G. CLYDE BUCK,
Senior Vice President.
MARK ANDREWS,
Corporate Finance Associate.

[Following in the report are 43 more pages of analytical material in report form. Due to the volume involved, those pages were not copied.]

EXHIBIT 3

Audit Report No. 1181-02-8-0114.

* * * us to discuss with the IRS the value IRS would assign to the stock and the amount the IRS would allow as a tax deduction. If Metropolitan officials agreed, DCAA would abide by the assessment of the stock value as determined by IRS. The contractor did not agree at the present time but would give it further consideration. We recommend that the NASA contracting officer obtain an independent appraisal of the Metropolitan stock. With respect to an independent evaluation, our office, with the support of Headquarters, DCAA, will provide the necessary assistance in obtaining this type of appraisal. After the stock appraisal is obtained, if HASA and Metropolitan cannot agree on the appropriate stock value, we recommend that NASA contact IRS to obtain their assistance in settling this issue. Because the Department of Labor (DOL) has the responsibility of assuring that the ESOP fiduciary responsibilities comply with the employee exclusive benefit rule, we recommend that DOL's assistance also be requested at the time of the contact with IRS. In the interim we recommend a suspension of the ESOP contributions based on a stock value of $22 per share as computed in Paragraph 4.a.(1)(f) above. The amount of the suspension is computed below:

1. Total ESOP contribution by Metro to Metropolitan ESOP	$290,987
2. Shares of stock allocated at $200 per share from above contributions after expenses	1,314
3. Suspended cost of $178 per share ($200 minus $22) times 1,314 shares for fiscal year 1977	233,892
4. Metropoltan ESOP contribution from July 1, 1977, through Nov. 30, 1977	89,148
5. Suspended costs of ($178 divided by $200). 89 percent of contributions (89 percent times $89,148)	79,342
6. Total ESOP costs suspended (3 and 5)	313,234

The CHAIRMAN. Next, we will hear from Mr. Stuart J. Evans, Director of Procurement of the National Aeronautics and Space Administration.

We would like to hear your statement, Mr. Evans. Would you proceed, sir?

STATEMENT OF STUART J. EVANS, DIRECTOR OF PROCUREMENT, NATIONAL AERONAUTICS AND SPACE ADMINISTRATION

Mr. EVANS. Mr. Chairman and members of the committee, I have with me today Mr. John E. O'Brien, NASA's Assistant General Counsel; Mr. Robert E. King, Director of Industrial Relations; and Mr. Joseph Garcia of the Contract Pricing and Finance Office. We are here at your request to address various matters of interest to the committee relating to NASA's views regarding employee stock ownership plans in general and the problems encountered by NASA with two particular plans.

As you may be aware, Mr. Chairman, the Department of Defense has been considering, for some time, various approaches to specific regulatory coverage on ESOP costs. NASA was asked to comment on one of the earlier DOD proposals, and on February 25, 1977, we forwarded our comments to the Chairman of the Armed Services Procurement Regulations Committee.

We believe it clearly demonstrates that NASA fully understands the intent of Congress regarding ESOP and to this end I should like to quote one relevant paragraph:

> Recent legislation would indicate that ESOPs are an appropriate, and even preferred, form of deferred compensation. Moreover, we believe that it is the clear intent of this legislation to foster ESOPs as a financial tool as well as a means of acquiring employee ownership in a corporation.

Our experience since that letter was written does indicate that there are complex cost issues involved which bear upon the overall cost of Government contracts. As a matter of interest, the General Accounting Office, by letter dated June 23, 1978, to the Department of Defense, stated the following:

> The concept of ESOP costs is relatively new and the entire area of cost allowance for this type of program requires close surveillance on the part of Government cost analysts. It has recently come to our attention that there is considerable potential for contractor abuse in this area, especially in the case of small contractors almost entirely involved with Government contracts or grants and whose stock has no established market.

We are aware of the concerns expressed by the GOA. The basis of our problems involve events which transpired during the last year. We have encountered problems with two particular ESOP's, one with Metropolitan Contract Services, Inc., the other with Metro Contract Services, Inc.

Our Marshall Space Flight Center in Huntsville first learned of the application of the Metropolitan ESOP to their contract with Metro in connection with a notice of substantial projected cost overrun from the company in the spring of 1977. Marshall officials promptly expressed their concern to the company and subsequently suspended payment on ESOP's costs allocated to their contract pending further understanding of their nature and determination of their reasonableness.

Marshall also asked the Defense Contract Auditing Agency, upon whom we rely for audit service, to make a complete evaluation of the Metropolitan and Metro ESOP's to determine the extent to which related costs were reasonable and allowable.

Since the Metropolitan ESOP had also been implemented by Metropolitan under a contract with Langley Research Center, that Center subsequently suspended such costs. This suspension also included a significant additional issue concerning whether the ESOP had been included in the Metropolitan-IBEW labor agreement as a result of arms-length bargaining.

This matter was originally brought to the attention of Langley officials by local IBEW officials representing employees of Metro at Langley.

The DCAA submitted their report to Marshall in January 1978. The central question raised by the DCAA in both audits related to the pricing of the stock sold to both ESOP trusts and to the possimility of stock overpricing in violation of the exclusive benefit rule under IRC section 401(a).

On January 18, 1978, within days of receipt of these reports, NASA representatives met with representatives of Metropolitan. Mindful of the fact that a further suspension of costs would prolong the withholding of reimbursement to the two companies of their billed ESOP costs, we agreed with Metropolitan that such costs would be formally disallowed to permit both Metropolitan and Metro to appeal the disallowance under the provisions of the contracts.

We also discussed means of alleviating any financial hardship that such action might have on both companies, and gave assurance that we would give conscientious consideration to meaningful representation on the part of both companies.

In the case of Metro, immediate action was initiated by NASA to review the financial impact. On February 24, 1978, a token disallowance decision on Metropolitan ESOP costs was executed permitting the flow of some $152,000 of $168,000 of disallowed costs to Metro.

With respect to Metropolitan, the issue was further compounded by the competition for follow-on support services at Langley subsequently addressed in this statement. Notwithstanding this matter, we moved incrementally to fulfill the understanding we had reached.

To this end, on April 24, a similar disallowance was made of Metropolitan ESOP costs, and a request for assessment of financial impact was also made with DCAA. In March and May 1978, in discussions with Metropolitan officials, Langley indicated a complete willingness to consider any token disallowance proposals that Metropolitan might offer. None, however, were made.

On June 28 of this year, representatives of Metropolitan met with the NASA Administrator and indicated for the first time to us at headquarters the nature of their financial hardship.

The Administrator directed that immediate action be taken to accelerate whatever relief equity dictated.

On July 12, Metropolitan provided confirming information; and on July 11, DCAA reported their evaluation.

As of today, we are proceeding with an appropriate agreement with Metropolitan to assure a reasonable flow of these disputed costs to alleviate the stated hardship.

Mr. Chairman, NASA is fully aware of and sensitive to the fact that ESOP's are relatively new in Government contracts and that our agency has no authority or responsibility for the regulation of these plans. We also recognize that the regulation of ESOP's is in the province of the Treasury Department and the Department of Labor.

Accordigly, shortly after the receipt and analysis of the DCAA reports, we briefed personnel from the Department of Labor and personnel from the Internal Revenue Service. We advised those offices of our disallowance action and of the fact we would conform to whatever decisions or actions they determined were appropirate in the circumstances.

I understand also, Mr. Chairman, the committee has expressed an interest in the recompetition of the Langley contract that was lost by Metropolitan. We are pleased to provide the committee with the decision of the Comptroller General of the United States on a protest filed by Metropolitan against the selection of the company in Houston, Tex., for this work.

The Comptroller General, upon consideration of all the materials submitted in this case, denied the protest of Metropolitan on June 14, 1978. On the 28th of June, Metropolitan filed a request for reconsideration of the decision by the Comptroller General, and on July 7, 1978, filed a complaint in the U.S. District Court, Southern District of Texas.

On the 18th of June, the Comptroller General affirmed his decision. In view of pending legislation between the parties, it is inappropriate for NASA to address this matter further at this time.

Lastly, Mr. Chairman, I would like to bring one more aspect of the Metropolitan ESOP to the committee's attention. Earlier I alluded to a significant problem which was brought to NASA's attention by local IBEW officials at Langley. On August 3, 1977, the assistant business manager for the IBEW local called Langley officials expressing concern over the inclusion of ESOP's in a wage determination issued by the Department of Labor. He asked for a meeting.

In response to this request, the meeting was held on August 4, 1977. At that meeting, the union advised NASA that, one, the union was never told initially of the basis or the amount of ESOP funding, and assumed, based upon their discussions with the company, that it would be a profit-sharing plan.

Second, the union did not initiate a demand for ESOP or a request for opening of the labor agreement.

Third, the company initiated its first request to the union to accept ESOP some time in September 1976, although the collective bargaining agreement did not expire until March 24, 1978.

Fourth, the union did not consider ESOP a part of the collective bargaining agreement.

Fifth, ESOP should not be included in the wage determination.

The issues raised by NASA to the Department of Labor with respect to the ESOP were: one, was the inclusion of ESOP by the company during the midterm collective bargaining agreement arrived at through arm's-length bargaining; and second, are the ESOP costs to the Government when combined with other fringe benefits and wages

at substantial variance with what is prevailing in that locality.

The Department of Labor has not made a determination on these issues.

In summary, Mr. Chairman, we believe we have acted responsively as procurement officials on this matter. We have challenged costs for what we believe are good and sufficient reasons in accordance with well-established procedure. We have advised both the Department of Labor and t' e Internal Revenue Service of our actions in this matter as they may relate to those agencies' statutory interest.

In our view, the administrative process will settle the ESOP reimbursement issue in a manner similar to any other cost issue in dispute between the Government and one of its contractors. Meanwhile, we are working toward a sensible solution of our withholding of funds from Metropolitan pending resolution of the dispute.

This concludes my summarized comments, Mr. Chairman. Thank you.

The CHAIRMAN. I am not thoroughly familiar with this controversy, and it appears to be a matter that is somewhat complicated and which requires some study. But as one who is very much interested in employee stockownership, I would certainly be disappointed to find that, after we have worked hard to pass laws to encourage corporations to adopt programs which permit the workers to own stock in their companies, the Government agencies are killing the program while we are working to try to make it work.

You have made your statement here, and I think it speaks for itself. We will have other statements on it, and I assume you will be hearing more from us about this matter.

We definitely want the concept of employee stockownership to work. Sometimes we have problems with labor unions. Sometimes we have problems with Government agencies. It seems like we have a lot more problems with these two interest groups than we do with management as far as employee stockownership is concerned.

Thank you very much, gentlemen.

[The prepared statement of Mr. Evans follows:]

STATEMENT OF STUART J. EVANS, DIRECTOR OF PROCUREMENT, NATIONAL AERONAUTICS AND SPACE ADMINISTRATION

Mr. Chairman and members of the committee, I am Stuart J. Evans, NASA Director of Procurement, and with me is John E. O'Brien, NASA's Assistant General Counsel for Procurement Matters, Robert E. King, NASA's Director of Industrial Relations, and Joseph Garcia, the Director of my Contract Pricing and Finance Office. We are here at your request to address various matters of interest to the committee relating to NASA's views regarding Employee Stock Ownership Plans (ESOP's) in general and the problems encountered by NASA with two particular plans of two particular companies with whom we do business.

Mr. Chairman, we appreciate this opportunity to appear today to express our views and position on these matters. We have previously corresponded with various members of Congress on the same subject and submitted a staff report to you on the same subject and submitted a staff report to you on February 1, 1978. In the interests of full disclosure, we are providing to the Committee a copy of this staff report and copies of three Disallowance Notices referred to later in this Statement. Since these documents may contain information falling within Restrictions in Disclosure contained in Title 18, United States Code, Section 1905, this material is being furnished separately and not as part of this Statement.

NASA Procurement Regulations, like other agencies' procurement regulations, do not specifically address the reimbursability of ESOP costs, although the regulations do address various other forms of deferred compensation. As you may be aware, Mr. Chairman, the Department of Defense has been considering for some time various approaches to specific regulatory coverage of ESOP costs. NASA was asked to comment on one of the earlier DOD proposals and on February 25, 1977, we forwarded our comments to the Chairman of the then Armed Services Procurement Regulation Committee. We are providing a copy of this letter for the record and believe it clearly demonstrates that NASA fully understands the intent of Congress regarding ESOPs and is prepared to accept its allocable share of reasonable costs of these plans. To this end, I quote one relevant paragraph:

"Recent legislation would indicate that ESOPs are an appropriate and even a preferred form of deferred compensation. Moreover, we believe it is the clear intent of this legislation to foster the use of ESOPs as a financing tool as well as a means of encouraging employee ownership in the corporation. We note, for example, that ERISA specifically permits an ESOP trust to borrow money from a bank or lending institution to purchase company stock, have the loan guaranteed by the company, and repay the loan out of company contributions to the trust. Congressional preference we believe can be seen in the extra 1 percent investment tax credit included in the Tax Reduction Act of 1975 for companies which agree to invest the tax savings in an ESOP trust. We understand that additional legislation designed to encourage the use of ESOPs is pending."

Mr. Chairman, NASA supports the principles and objectives of ESOPs as instruments of national policy. We are also sensitive to our responsibilities as a procurement agency for the prudent and responsible expenditure of public funds. Our experience since the above letter was written does indicate that there are complex cost issues involved which bear upon the overall cost of Government contracts. As a matter of interest, the General Accounting Office, by letter dated June 23, 1978, to the Department of Defense stated the following:

"The concept of ESOP costs is relatively new, and the entire area of cost allowance for this type of program requires close surveillance on the part of Government cost analysts. It has recently come to our attention that there is considerable potential for contractor abuse in this area especially in the case of small contractors almost entirely involved with Government contracts or grants and whose stock has no established market."

We share the concern expressed by the GAO.

The basis for our concern involves events which have transpired during the last year. We have encountered serious problems with two particular ESOPs—one with Metropolitan Contract Services, Inc. and the other with Metro Contract Services, Inc. These problems arose from the following circumstances:

Both Metropolitan and Metro were originally owned and controlled by Mr. Kenneth R. Cunningham, now Chairman of the Board and Chief Executive Officer of Metropolitan. Metro was a Government contractor whose business consisted of three NASA cost reimbursement contracts being performed at three of our centers—the Langley Research Center, Hampton, Virginia, the Johnson Space Center, Houston, Texas, and the George C. Marshall Space Flight Center, Huntsville, Alabama. Metropolitan had only commercial business and had adopted an ESOP in December 1975. In August 1976 the Metropolitan ESOP purchased 1,440 shares of Metropolitan stock from Mr. Cunningham, the sole stockholder, at $200 per share. In January 1977, Mr. Cunningham sold Metro to Metropolitan. With the acquisition of Metro by Metropolitan, the Metropolitan ESOP was extended by Joinder Agreement to apply to Metro employees at all three NASA centers retroactive to July 1976. After the sale of Metro to Metropolitan and the extension of the plan to Metro employees, the Metropolitan ESOP trust purchased another 5,000 shares of Metropolitan stock from Mr. Cunningham in February 1977, again at $200 a share for $1,000,000. In July 1977, Metropolitan sold Metro, less the Langley contract, to Mr. Salvador Esparza, then President of Metro. Mr. Esparza immediately established his own ESOP by selling 45% of his newly purchased stock in the company to the Metro ESOP trust. It is estimated that the combined effect of these transactions, all occurring within a six or seven month period, would serve to increase costs under the three NASA contracts by about $800,000.

Our Marshall Center first learned of the application of the Metropolitan ESOP to their contract with Metro in connection with a notice of a substantial projected cost overrun from the company in the spring of 1977. Marshall officials promptly expressed their concern to the company, particularly with regard to the applica-

tion of ESOP to Davis-Bacon employees which at the time constituted about half the work force on the Marshall contract. When Metro was sold by Metropolitan in July 1977 and Metro immediately established its own ESOP, Marshall suspended payment on all ESOP costs allocated to their contract pending further understanding of their nature and determination of reasonableness. Marshall also asked the Defense Contract Audit Agency (DCAA), upon whom we rely for professional audit service, to make a complete evaluation of the Metropolitan and Metro ESOPs to determine the extent to which related costs were reasonable and allowable.

Since the Metropolitan ESOP had also been implemented by Metropolitan under the contract being performed at Langley, that Center likewise became concerned about the cost increases being billed under its contract for ESOP charges. Subsequently, Langley suspended such costs. This suspension generally was for the same circumstances pertaining at Marshall but, also, included a significant and an additional issue concerning whether the ESOP had been included in the Metropolitan/IBEW Labor Agreement as a result of arms-length bargaining. This matter was initially brought to the attention of Langley officials by local IBEW union officials, representing employees of Metropolitan employed at Langley.

The DCAA submitted their report to Marshall in January 1978. In the same month Marshall received a similar report from DCAA with respect to its audit of the Metro ESOP then in effect at Marshall and Johnson. The central question raised by the DCAA in both audits related to the pricing of the stock to both ESOP trusts and to the possibility of stock overpricing in violation of the "Exclusive Benefit Rule" under IRC section 401(a). In substance, DCAA recommended that, pending further assessment of the stock value, costs relating to these plans under NASA contracts in excess of $22 per share of Metropolitan stock and $8.54 per share of Metro stock be suspended.

On January 18, 1978, within days of the receipt of these reports, NASA representatives met with representatives of Metropolitan. During the course of that meeting we discussed the results of the DCAA audit report which were known to both parties. Mindful of the fact that a further suspension of ESOP costs could prolong a withholding of reimbursement to the two companies of their billed ESOP costs, we agreed with Metropolitan that such costs would be formally disallowed to permit both Metropolitan and Metro to appeal the disallowance under the Disputes provisions of the contracts and proceed with due process administrative hearings. We also discussed means of alleviating any financial hardship that such action might have on both companies and gave assurances that we would give conscientious consideration to meaningful representations from both companies that disallowance of ESOP costs during the period involved in determination of the issue would work a hardship on the firms. At that time we further recognized that any financial hardship which might flow from this action would in all probability, impact Metro to a greater extent than Metropolitan. As a result of this meeting an exchange of correspondence between NASA and both companies took place confirming such discussions.

In the case of Metro immediate action was initiated by NASA to review the financial impact of the disallowance action. On February 24, 1978, a "token disallowance" decision on Metropolitan ESOP costs was executed permitting the flow of some $152,000 of $168,812 disallowed costs from Marshall to Metro. On April 3, 1978, similar action was taken with respect to the token disallowance on the Metro ESOP costs. Copies of these disallowance notices are provided to the Committee as previously stated.

With respect to Metropolitan, the issue was further compounded by virtue of the competition for follow-on support services at Langley subsequently addressed in this statement. Notwithstanding this matter, we moved incrementally to fulfill the understanding we had reached with the above representatives of Metropolitan on January 18, 1978. To this end, on April 24, 1978, a similar disallowance was made by Langley of Metropolitan ESOP costs. A request for assessment of financial impact on Metropolitan of this disallowance was also made to the DCAA. On two occasions, in March and May 1978, in discussions with Metropolitan officials, Langley indicated a complete willingness to consider any "token disallowance" proposals that Metropolitan might offer. None, however, were made. On June 28, 1978, representatives of Metropolitan met with the NASA Administrator and indicated for the first time to NASA Head-

quarters, the nature of the financial hardship that might flow from disallowance of ESOP costs under the Langley contract. The Administrator directed that immediate action be taken to accelerate whatever relief equity dictated. The President of Metropolitan was asked to furnish in writing to NASA a detailed statement of the company's immediate need for the money being withheld by NASA, together with Metropolitan's recommendations regarding adequate security to assure the Government of recovery in the event the Government prevails after litigation.

On July 12, 1978, Metropolitan provided the requested information and on July 11, 1978, the DCAA reported their evaluation of the effect of the disallowance action on Metropolitan's financial posture. As of today we are proceeding with an appropriate agreement with Metropolitan to ensure a reasonable flow of these disputed costs to that company to alleviate the stated hardship pending resolution of the issues. In the meantime, both Metro and Metropolitan have appealed the disallowances to the NASA Board of Contract Appeals in accordance with established administrative procedures.

Mr. Chairman, NASA is fully aware of and sensitive to the fact that ESOPs are relatively new in Government contracts and that our agency has no authority or responsibility for the regulation of these plans. We also recognize that the regulation of ESOPs is in the province of the Treasury Department (Internal Revenue Service) and the Department of Labor.

Accordingly, shortly after receipt and analysis of the DCAA reports on the Metropolitan and Metro ESOP cost evaluations, we briefed personnel of the Labor-Management Services Administration of the Department of Labor and personnel of the Employee Plans Operations Branch and the Prohibited Transaction Staff of the Employee Plans Division of the Internal Revenue Service. We advised those offices of our disallowance action and of the fact that we would conform to whatever conclusions, decisions or action they determined were appropriate in the circumstances. On April 25, 1978 we were advised by the Director of Enforcement, Labor-Management Services Administration, Department of Labor, that a case had been opened by them for investigation of the administration of these ESOPs and that we would be informed of the results of their investigation. A copy of the confirming letter, dated April 25, 1978, is enclosed. We are unable to inform the Committee of what, if any, action has been taken by the IRS on this matter. We have been advised by IRS representatives that they are precluded from release of such information to us.

Mr. Chairman, I understand that the Committee has also expressed an interest in the recompetition of the Langley contract which was lost by Metropolitan. We are pleased to provide the Committee with the decision of the Comptroller General of the U.S. on a protest filed by Metropolitan against the selection of Klate Holt Company of Houston, Texas. Briefly, this selection resulted from a 1977 competition among seven firms, including Metropolitan, for performance of services at Langley following expiration of the present contract on March 24, 1978.

Selection of the Klate Holt Company was made by Langley on November 30, 1977 and unsuccessful offerors were afforded a full debriefing on the selection prior to the award of a contract in order to permit them a meaningful opportunity to protest or otherwise object to their non-selection. Metropolitan was so debriefed, and on January 24, 1978, elected to protest the selection of the Klate Holt Company to the Comptroller General of the U.S. The Comptroller General reviewed all submitted material relevant to the positions of the parties, held a conference on this protest attended by representatives of Metropolitan and NASA to sharpen the issues and received amplifying material from both parties arising from this conference. Subsequently, the Comptroller General, upon consideration of all material submitted, denied the protest of Metropolitan on June 14, 1978. During the period of this protest, Langley has successively extended the existing contract with the unsuccessful competing incumbent, Metropolitan, on a sole source basis through July 21, 1978 pending the decision by the Comptroller General. This action was taken to protect the position of Metropolitan throughout the period of protest resolution. On the basis of the Comptroller General decision on June 14, 1978, Langley awarded a contract to the Klate Holt Company on June 29, 1978 for performance of services for which they were selected in November 1977. On June 28, 1978, Metropolitan filed a request for reconsideration of the decision with the Comptroller General and on July 7, 1978, filed a complaint in the U.S. District Court, Southern District of

Texas, Houston Division, seeking a Mandamus order directing Government officials to withdraw the award of the contract with the Klate Holt Company and a preliminary injunction to maintain Metropolitan and its employees on site at Langley pending review of the above Comptroller General decision. In view of the pending litigation between the parties, it is inappropriate for NASA to address this matter further at this time.

Lastly, Mr. Chairman, I would like to bring one more aspect of the Metropolitan ESOP to the Committee's attention. Earlier in my statement, I alluded to a significant problem which was brought to NASA's attention by local IBEW officials at Langley. This problem involved the manner in which Metropolitan instituted the ESOP with the local union in the first place, and which subsequently provided the basis upon which the company began to charge ESOP costs under the Langley contract.

In the summer of 1977 Langley commenced a scheduled procurement competition for the performance of facility and equipment maintenance, rigging and hauling support services leading to the award of a contract in early 1978 upon expiration of the then current contract with Metropolitan. To this end, that Center issued a Request for Proposals (RFP) for such services to commence March 25, 1978 and, pursuant to the Service Contract Act of 1965, as amended, included therein a wage determination issued by the Department of Labor in March 1977.

This wage determination contained the wage rates and fringe benefits of the collective bargaining agreement between Metropolitan and Local Union 1340 of the International Brotherhood of Electrical Workers, AFL/CIO, but did not include ESOP since it was not a part of the collective bargaining agreement. Subsequent to the issuance of the RFP, Metropolitan advised NASA of a Letter of Understanding between the company and the union on ESOP and requested that NASA obtain from the Department of Labor a revised wage determination. A revised wage determination including ESOP was issued by the Labor Department on August 1, 1977. Although the Letter of Understanding was not dated, we later learned that it was signed by the parties in the latter part of December 1976 or early January 1977. The collective bargaining agreement became effective January 1, 1976 and had an expiration date of March 24, 1978.

On August 3, 1977, the Assistant Business Manager for the IBEW local called Langley expressing concern over the inclusion of ESOP in this wage determination and surprise that the company was charging the 8% ESOP costs to the Langley contract. He asked for a meeting to discuss the possibility of having ESOP removed from the wage determination.

In response to this request, a meeting was held August 4, 1977. At this meeting, NASA learned, among other things, that although the Letter of Understanding had been signed by the parties in late December 1976 or early January 1977 and the company began billing ESOP charges in January 1977, the union was unaware of the 8% funding until the Assistant Business Agent saw the Department of Labor wage determination in early August 1977.

The Union also advised NASA that: (1) the union was never told initially the basis or the amount of ESOP funding, and the union assumed, based on their discussions with the company, that it would be a profit-sharing plan; (2) the union did not initiate a demand for ESOP or request an opening of the labor agreement to discuss any fringe benefits at the time ESOP was discussed; (3) the company initiated its first request to the union to accept ESOP sometime in September 1976, even though the collective bargaining agreement did not expire until March 24, 1978; (4) the union did not consider ESOP as a part of the collective bargaining agreement and (5) ESOP should not be included in the wage determination. Based on the timing and the sequence of events leading to the Letter of Understanding between the company and union on ESOP, NASA requested that the Department of Labor remove ESOP from the wage determination.

The issues raised by NASA to the Department of Labor with respect to ESOP were: (1) Was the inclusion of ESOP by the company during the mid-term of the collective bargaining agreement and the events leading to the Letter of Understanding with the union arrived at through arms-length bargaining; and (2) Are the ESOP costs to the Government when combined with the costs of other fringe benefits and wage rates at substantial variance with what is pre-

vailing in the locality for the same or similar work. The Department of Labor, as of this date, has not made a determination on these issues.

In summation, Mr. Chairman, we believe we have acted responsibly as procurement officials on this matter. We have challenged the costs for what we think are good and sufficient reasons in accordance with well established procedures. We have advised both the Department of Labor and the Internal Revenue Service of our actions in this matter as they may relate to those agencies' statutory interests. In our view, the administrative process will ultimately settle the ESOP reimbursement issue in a manner similar to any other cost issue in dispute between the Government and one of its contractors. Meanwhile, we are working toward a sensible solution of our withholding of funds from Metropolitan pending resolution of the dispute.

This includes my prepared comments, Mr. Chairman, thank you.

FEBRUARY 25, 1977.

Col. THOMAS F. BLAKE, Jr.,
Chairman, ASPR Committee, Office of the Assistant Secretary of Defense, Installations and Logistics, The Pentagon, Washington, D.C.

DEAR COLONEL BLAKE: Reference is made to your letter, dated December 10, 1976, forwarding for our review and comment an issue paper dealing with the allowability of employer contributions to an Employee Stock Ownership Plan (ESOP).

In our opinion, ASPR should not be revised to impose any additional restrictions or prohibitions on the allowability of these costs. We take this position for the following reasons:

a. Recent legislation would indicate that ESOPs are an appropriate and even a preferred form of deferred compensation. Moreover, we believe it is the clear intent of this legislation to foster the use of ESOPs as a financing tool as well as a means of encouraging employee ownership in the corporation. We note, for example, that ERISA specifically permits an ESOP trust to borrow money from a bank or lending institution to purchase company stock, have the loan guaranteed by the company, and repay the loan out of company contributions to the trust. Congressional preference we believe can be seen in the extra 1% investment tax credit included in the Tax Reduction Act of 1975 for companies which agree to invest the tax savings in an ESOP trust. We understand that additional legislation designed to encourage the use of ESOPs is pending.

b. We believe the present cost principles, particularly the requirement that deferred compensation be deductible for income tax purposes as a condition of allowability, are adequate in terms of preventing any serious abuses in this area. In this regard, it is unlikely that ESOP contributions would qualify as a tax deductible expense if the primary purpose of the plan is intended to acquire new capital. See the exclusive benefit rule of Section 401 of the Internal Revenue Code.

c. While the ESOP concept has been around for a number of years, we know of no major defense contractor that has chosen to adopt such a plan. Perhaps the reason for this, as some authorities have suggested, is that the use of ESOP as a financing tool has limited applicability, and is not as attractive as it might seem over other, more conventional forms of raising new capital. For example, it has been pointed out that ESOP borrowing as opposed to a regular loan entails the issuance of new stock which tends to dilute owners' equity and earnings per share of stock. Also, because an ESOP transaction only results in saving the cash that would have been paid in tax dollars, the amount of capital available to a company through ESOP borrowing is only about half that available from the normal sale of stock to third parties.

In view of the foregoing, we recommend that no action be taken to amend ASPR at this time to impose any special limitations or restrictions on the allowability and treatment of employer contributions to ESOPs. Such action, in our opinion, is unnecessary and could be interpreted as being inconsistent with current economic policy.

Sincerely,

EDMOND J. GOLDEN,
(For S. J. Evans, Assistant
Administrator for Procurement).

U.S. DEPARTMENT OF LABOR,
LABOR-MANAGEMENT SERVICES ADMINISTRATION,
Washington, D.C., April 25, 1978.

Re Metropolitan Contract Services, Inc., and Metro Contract Services, Inc., employee stock ownership plans.

Mr. JOHN E. O'BRIEN,
Assistant General Counsel for Procurement Matters, National Aeronautics and Space Administration, Washington, D.C.

DEAR MR. O'BRIEN: For your information, in follow-up of the meeting held on March 7, 1978, attended by representatives of NASA and this Department, please be advised that we have requested our Dallas Area Office to open a case and make appropriate inquiries to determine whether the Employees Stock Ownership Plans (ESOPs) of subject organizations were instituted and are being managed consistent with the provisions of the Employee Retirement Income Security Act of 1974 (ERISA).

We will be in further contact with you when the investigation has been completed. In the meantime, if you have any questions, please contact Mr. Edward C. Kennelly of this Office, telephone number 523-8845.

EDWARD F. DALY,
Director, Office of Enforcement.

DECISION OF THE COMPTROLLER GENERAL OF THE UNITED STATES

File: B-191138.
Date: July 5, 1978.
Matter of: Metro Contract Services, Inc.

DIGEST

1. Protest that applicant screening techniques should have been considered under listed evaluation factor of "Initial Staffing and Phase-In" is denied because major evaluation criteria is RFP need not be broken down to reflect each specific factor actually considered where, as here, there is sufficient correlation between stated criteria and factors actually used.

2. Offeror was not prejudiced by failure of agency to reduce cost proposal by $9,000 cost of computerized work order system, which source evaluation panel found to be more than needed, where total contract price is $2.5 million, $9,000 reduction would not have made offeror low in cost nor made cost a discriminator in contractor selection.

3. Review of protestor's proposal and source selection statement reveals nothing improper in downgrading of proposal in three areas which were not discussed or not discussed adequately in proposal, contrary to contentions of protester. Further, scoring of protestor's and successful offeror's proposals in area of past experience was not improper.

4. Where RFP contains no provision regarding minority status of offerors, it would be improper to give competitive advantage to firm based on fact it was minority contractor.

Metro Contract Services, Inc (Metro), has protested the award of a contract to S.F. & G. Inc., d.b.a. Mercury, by the National Aeronautics and Space Administration (NASA), Langley Research Center, Hampton, Virginia, under request for proposals (RFP) No. 1-105-5715.0550.

The contract is for support services for the steam and compressed air facilities at Langley. The cost-plus-fixed-fee contract was for a 2-year base period plus 1-year priced option period and two additional 1-year unpriced options.

The RFP was issued on September 2, 1977, and seven proposals were received on the due date of October 17, 1977. Following an initial evaluation, written discussions were conducted with the five offerors determined to be in the competitive range. Award was made to Mercury on January 16, 1978.

Metro's initial basis of protest is that the Source Evaluation Panel (SEP) improperly downgraded Metro's proposal for allegedly containing a major weakness in applicant screening techniques. Metro argues that the RFP's evaluation criteria contained no mention of applicant screening techniques and, therefore, the action by the SEP was inappropriate.

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Subfactor 1 under REP Evaluation Factor 1.0, Management and Operations Plan, reads as follows:

"*Initial Staffing and Phase-In.*—Provide detailed plans for initial staffing of the entire complement, for making fully operational all Contractor-Furnished Equipment, and Government-Furnished Equipment by contract start, and for other facets ensuring maximum continuity of service to the Government. The initial staffing plans shall include recruiting methods to be utilized, commitments assuring availability of all personnel including the degree of incumbent personnel retention, and planned phasing-in of personnel including initial orientation and training."

NASA contends that the consideration of an offeror's proposed method of applicant screening was not the imposition of a new, unpublished evaluation criterion, as argued by Metro, but rather was an inherent part of the published criteria.

Our Office has held that the major evaluation criteria listed in an RFP need not be broken down to reflect each specific factor actually considered in the detailed evaluation of proposals, so long as there is sufficient correlation between the stated criteria and the factors actually used. See *Checchi and Company*, B-187982, April 4, 1977, 77-1 CPD 232, and *AEL Service Corporation, et al.*, 53 Comp. Gen. 800 (1974), 74-1 CPD 217.

Based upon our review of the record, including Subfactor 1, the entire RFP and the argument of Metro, we believe that applicant screening is within the purview of "Initial Staffing and Phase-In" and, therefore, find nothing improper in the SEP's evaluation of the matter.

Secondly, Metro contends that while the SEP downgraded Metro's computerized work order system as being too complicated and more than was needed to perform the contract properly, the SEP did not reduce Metro's cost proposal by the $9,000 proposed cost for the system.

The contracting officer has responded to the above argument by stating that the $9,000 cost ($3,000 per year for the initial 2-year contract plus the 1-year priced option) was nominal, some other type of system would have been necessary to replace the system at some cost and the difference in cost would be inconsequential.

We note that the Source Selection Statement (SSS) finds that cost was not discriminatory in the contractor selection as there was only nominal difference in cost between all five offerors. All offerors' proposed costs were roughly $2.5 million for the 3-year period which was evaluated. Accordingly, even if Metro's costs for its work order system should have been reduced by some amount, even the full $9,000, such cost savings would have been insignificant compared to the total evaluated costs and would not have been sufficient to make cost a discriminator. In addition, it would not have made Metro the low cost offeror, as it alleges.

Thirdly, Metro challenges a finding in the SSS that Metro's technical operations plan did not address the reporting of technical problems which Metro argues was discussed in detail in its proposal. The contracting officer states that, while Metro's proposal did discuss the handling of technical problems, there was no plan as to the notification of NASA personnel when a serious technical problem arose. We have reviewed Metro's proposal and agree that it did not contain such a plan. In view of paragraph 1.2.9 of the Statement of Work in the RFP, which stated, "In the event of probable or actual equipment failure the Contractor shall immediately report to the Government orally and/or in writing specifying possible causes and estimated time for repair," we have no objection to the SEP's criticism of this area of Metro's proposal.

Next, Metro states that it was unfairly criticized in the SSS under the evaluation criteria "Continuing Plan" because it failed to adequately discuss turnover replacement, which portion of its proposal Metro contends it clarified and amplified in response to the following question posed by the SEP:

"Explain specifically your plan for replacement personnel for Stationary Steam Engineers and Steam Plant Operators to maintain continuous service coverage during absences of the regular personnel."

Metro alleges that its original proposal and its 6-page submission in response to the above question were more than adequate and that the fact that the SEP continued to downgrade Metro in this area shows that the SEP was sepcifically looking for something upon which to downgrade Merto.

The contracting officer states that Metro was not downgraded for its proposed short-term personnel replacement which was clarified and expanded in its revised

proposal in response to the above question but for a weakness in its permanent personnel replacement plan. Metro treats these two areas as one in its protest, according to the contracting officer, when they were actually two distinct evaluation subcriteria. Metro's short-term personnel replacement plan was unclear in its original proposal and, therefore, the SEP posed the above question to clarify it. However, its permanent replacement plan was clear in its original proposal but contained a weakness in the judgment of the SEP because Merto planned to obtain the advice of the contracting officer's technical representative on potential employees prior to hiring, which was a matter the SEP considered to be the sole responsibility of the contractor.

Our Office has recognized that while an ambiquity or a portion of a proposal which is unclear should be clarified with the offeror, there is no requirement under NASA's negotiation procedures, contained in NASA Procurement Directive 70-15, to point out a weakness or deficiency. *Management Services, Inc.*, 55 Comp. Gen 715, 729 (1976), 76-1 CPD 74.

Accordingly, as Metro was downgraded for an area of its proposal which it did not strengthen in its revised proposal (permanent personnel replacement), not the short-term personnel replacement which it was under the mistaken impression it was downgraded for, our Office has no objection to the evaluation in this area.

Metro also contends that it was improperly penalized in the evaluation process for failing to discuss the relative authority of critical personnel, when its proposal contained a detailed discussion of the relative authority of key personnel, which, by definition, would include critical personnel. Metro argues that it was downgraded solely because of its choice of terms (key vs. critical).

The REP listed the Contract Manager, Steam Plant Foreman and Air Compressor Plant Foreman as key personnel and the four each Stationary Steam Engineers and Senior Air Plant Technicians as critical personnel. Metro's proposal contained a chart describing the authority and responsibility of the key personnel. There was no corresponding infromation regarding the critical personnel. While Merto states that its choice of terms determined its score in this area, under the terms of the RFP, both phrases had certain meanings and we note that the remaining portion of Metro's proposal employed the terms consistent with the REP. Therefore, as Metro's proposal did not discuss the relative authority of critical personnel, there was nothing improper in NASA's actions.

Metro states that its rating of satisfactory plus under Factor 1.0, Subfactor 1 (Initial Staffing and Phase-In), is inconsistent with the good plus rating it received under Factor 2.0 (Key and Critical Personnel). Factor 2.0 was an evaluation of the actual people proposed for the contract based on their resumes, while Factor 1.0, Subfactor 1, as quoted above, included the manner in which an offeror would start up performance. Therefore, as two different areas were being evaluated, there was no need for the rating to be the same. Upon our review, we find no inconsistency.

Metro also takes exception to the SSS, concluding that Mercury was graded too high on past experience whole Metro was downgraded and not given enough credit for its experience. NASA responds that Metro was given credit for its past performance of the Langley Base maintenance contract but that Mercury was given more points for steam plan and air compressor station facilities services being performed for the Environmental Protection Agency at Research Triangle Park, North Carolina, the same type contract under consideration here. We find nothing improper in this point allocation.

Additionally, Metro argues that it did not receive full consideration as a minority contractor in contravention of various Executive orders and congressional policy. The procurement was a small business set-aside and contained no evaluation factors relating to the minority status of an offeror. Therefore, since an award must be based on the evaluation criteria contained in a solicitation, it would have been improper for NASA to give Metro a competitive advantage due to its minority status.

Metro also questions NASA's award to Mercury during the 10-day period following the debriefing when NASA was aware of a probable protest being filed. Our Bid Protest Procedures only prohibit on award after a protest has been filed with our Office unless certain determinations are made. See 4 C.F.R. § 20.4 (1977). Therefore, as the protest was filed on January 20, 1978, and the award was made on January 16, 1978, our Office finds nothing improper in the action of NASA.

Finally, Metro states that it should have received the SSS substantially in advance of its debriefing instead of obtaining it only 1 hour prior to the debriefing. However, Metro was not prejudiced by its late receipt of the SSS as it did not affect the contractor selection process or the evaluation of the proposals.

For the foregoing reasons, the protest is denied.

R. F. KELLY,
Deputy Comptroller General of the United States.

The CHAIRMAN. If Congressman Wilson is here, I would appreciate it if you would stick around to hear his statement.

Mr. EVANS. Thank you, Mr. Chairman.

The CHAIRMAN. I call the Honorable Charles Wilson, a Representative from Texas, as the next witness. I hope the others will pardon me for calling him out of schedule, but Mr. Wilson is a very busy man these days, and we understand that.

STATEMENT OF HON. CHARLES WILSON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Representative WILSON. Mr. Chairman, I wish to thank you for allowing me to come before your committee today to testify regarding employee stock ownership plans (ESOP).

I became interested in ESOP's last December, and what I have observed over the past 7 months is, in my judgment, the kind of situation that we are faced with so often in which it is so difficult to nail down proof of bureaucratic malfeasance. Metropolitan Contract Services, Inc., a NASA contractor with a proven record of performance at a savings to Government, was denied a contract renewal because they had an ESOP as urged by Congress. There are three important points that I would like to bring out, and about which I think you should be aware.

No. 1, I was told in December by NASA that there was absolutely no complaint whatsoever with the performance of Metropolitan, that the performance had been good, that they had lived up to their contract and had, indeed, in some instances saved money. Second, during our conversation, I was told that NASA had questions about the value of the stock of this company. They questioned whether or not the stock was really worth as much as the employees were paying for it. I asked NASA whether they were prejudiced basically against the ESOP program or whether they thought somebody might be making too much money, which was really none of their business in my judgment, and I further asked if there were other contractors or subcontractors that had ESOP programs. This is the definitive part of my testimony—they told me there were many, many more. I say, OK, how many are there? And they say, we will write you a letter.

Third, my impression has always been that the intent of Congress was to encourage the use of ESOP's by companies contracting with the Federal Government. The Defense Contract Audit Agency determined in a recent survey that only 15 National Aeronautics and Space Administration contractors out of a total of 2,419 have ESOP's. I have been advised that the number of contractors with ESOP's will soon be reduced, totally disregarding the intent of Congress.

NASA did, in fact, send me a letter as they said they would. They listed 15 of their contractors that had ESOP's and in the past 2 days before I came here to testify, we checked with the treasurers of those 15 companies and found that only 7 of them actually had ESOP's. The others have some sort of a stock option program, which practically every corporation in the United States has, but not an ESOP.

And so, of the 15 that NASA told me had ESOP's out of the 2,419 contractors, there are only 7. And I would just represent to you, that this is, again, a classic example of bureaucrats overstepping their authority, deliberately trying to thwart the will of Congress, nitpicking, and the very thing about which I believe most of the American public is very concerned.

If the bureaucrats do not like a program, or they think somebody is making too much money, they can thwart the will, not only of the people, but of the Congress, and I think that is precisely what has hapened in this case, I believe there is an obvious prima facie prejudice on their part, and I think that any contractor that has an ESOP and tries to do business with NASA is going to have a very, very difficult time.

The CHAIRMAN. The NASA testimony raises the issue of whether the IBEW local played a part in the NASA decision. Do you know anything about that matter?

Does that local have members just working with just one company, or do they have members working with a lot of other competitors in the same area?

Representative WILSON. Oh, IBEW is one of the biggest unions in the country. They, of course, have them everywhere.

The CHAIRMAN. The thought occurred to me that it may be that some of the union officers may have some negative feelings regarding employee stockownership—I just would not know about that. If that had something to do with it, maybe we ought to find out something about that, too.

Representative WILSON. I think so. I would be happy to pursue that.

The CHAIRMAN. I do not know. I just wondered if you knew anything about it.

Thank you very much. We will do the best we can to get to the bottom of it, Congressman Wilson.

Representative WILSON. Thank you.

The CHAIRMAN. Next we will call Mr. Frederick Neumann, Director of the Defense Contract Audit Agency.

STATEMENT OF FREDERICK NEUMAN, DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY

Mr. NEUMAN. Mr. Chariman, I am Frederick Neuman, the Director of the Defense Contract Audit Agency. With me are Mr. Irving Sandler, on my right here, who is our Assistant Director for Policies and Plans; and on my left is Mr. John Quill, our counsel.

We are here at your invitation to tell you about the Defense Contract Audit Agency and to relate to you some of our views and the work

we perform in connection with the cost of employee stockownership plans.

First, a few words to describe the Agency and its mission.

The Defense Contract Audit Agency was established by the Department of Defense to perform all contract auditing for the Department of Defense and to provide accounting and financial services to contract negotiators and administrators. Our work is advisory to these officials who hold warrants authorizing them to bind the Government.

We do several major things in the course of our advisory services. We evaluate the reasonableness and allocability of estimated costs which are contained on contractor's proposals as they are furnished to the Government for purposes of negotiating Government contracts.

We verify the propriety and acceptability of costs charged or allocated to flexibly priced contracts. These are contracts where the final price is based on a cost determination.

And, finally, we do look to detect any inefficient or uneconomical operations requiring correction by contractors in order to avoid the incurrence of excess costs on Government contracts.

In performing our audits, we use standards which are essentially the same as those governing audits performed by the major public accounting firms; that is, those prescribed by the American Institute of Certified Public Accountants. Our audits also conform to the Standards of Audits for Government Agencies, Programs, Activities and Functions which were promulgated in 1972 by the General Accounting Office and applied to the Agency's work by DOD implementation of the OMB Circular No. A-73.

We are a small organization with some 2,800 profesional accountants, many of whom are certified public accountants in the various States, and we are dedicated to assure, as best as we can, that the taxpayers of this country get a dollar's worth of value for a dollar spent in contracting for goods and services.

In performing our reviews, we determine the allowability of costs incurred, or to be incurred, under Government contracts by applying the applicable parts of Defense Acquisition Regulations, formerly called the Armed Services Procurment Regulations. Specifically dealing with ESOP, paragraph 15-205.6 deals with compensation for personal services and it provides the primary acquisition policy to determine the allowability of ESOP's for the Department of Defense.

Additionally, DAR paragraph 15-201 stresses such factors as reasonableness of these costs and whether or not they are allocable to Government contracts.

I might add that Public Law 91-379, under which cost accounting standards are developed, is likewise applicable to this set of circumstances to determine what costs are properly assignable to defense contracts.

OMB Circular No. A-73 requires all audit organizations to perform audit services for other executive branch activities wherever that would be the most economical and efficient way to obtain the needed audit. Accordingly, and as authorized in our own charter, which is DOD Directive 5105.36, we provide contract audit services to about 25 other Federal agencies at those contractor locations where DOD has a continuing audit interest, or where it is economical from a Government-wide point of view.

NASA is one of our principal non-DOD agencies for which we perform these services. The NASA cost principles are essentially the same as those contained in the Defense Acquisition Regulations.

The CHAIRMAN. If you will pardon me, sir, I have read your statement, and it sounds to me—or, at least, it looks to me from having read your statement—as though the whole issue turns on the valuation of that stock. Is that correct?

Mr. NEUMAN. Yes, sir.

The CHAIRMAN. And your view is that the stock is not worth, I take it, nearly as much as the price at which the employer sold it to the ESOP?

Mr. NEUMAN. That is the view of the people who did the audit, Senator. They looked at the activities of the independent appraiser and the only thing they did differently was to use more current and more accurate information than the independent appraiser, which, of course, looks to the company to furnish data. They rely on the data furnished by the company.

If all the data furnished is not accurate or if less than complete information is furnished to the appraiser, obviously any decision reached by that appraiser could not be considered valid. In this particular instance we believe there was data available which the appraiser did not use at the time. We did not make our own independent evaluation.

As a result, we advised the contracting officer to get an independent evaluation. We did not make one, sir. We suggested that he get an independent evaluation, or that he look to the Internal Revenue Service or the Department of Labor both of which have the authority under the statute to make these determinations. This is our part in this particular issue.

The CHAIRMAN. I will appreciate your statement. Frankly, I wonder whether a determination of this sort is your responsibility or whether this should have been left to the normal IRS audit procedures. I think we will probably wind up making our own independent study. Thank you very much.

Mr. NEUMAN. Thank you.

[The prepared statement of Mr. Neuman follows:]

STATEMENT OF FREDERICK NEUMAN, DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY BEFORE THE SENATE FINANCE COMMITTEE 20 JULY 1978

Mr. Chairman, and Members of the Committee: I am Frederick Neuman, Director of the Defense Contract Audi Agency, and with me are Mr. Irving J. Sandler, DCAA's Assistant Director for Policy and Plans, and Mr. John J. Quill, DCAA's Counsel. We are here at your invitation to tell you about the Defense Contract Audit Agency (DCAA) and to relate to you some of our views and the work we perform in connection with the cost of Employee Stock Ownership Plans (ESOP) allocated to Government contracts.

First, a few words to describe our Agency and its mission.

AGENCY MISSION

The Defense Contract Audit Agency was established by the Department of Defense to perform all contract auditing for DoD and to provide accounting and financial services to contract negotiators and administrators. Our work is advisory to the officials holding warrants authorizing them to bind the Government.

We (1) evaluate the reasonableness and allowability of estimated costs contained on contractors' proposals for Government contracts, (2) verify the propriety and acceptability of costs charged or allocated to flexibly priced Govern-

ment contracts, and (3) review major contractors' practices which, if inefficient and not corrected, lead to excessive costs and contract prices.

AUDITING STANDARDS

In performing our audits we use standards which are essentially the same as those governing audits performed by the major public accounting firms; those prescribed by the American Institute of Certified Public Accountants. Our audits also conform to the Standards for Audit of Governmental Organizations, Programs, Activities and Functions promulgated by the General Accounting Office and applied to our Agency through DoD implementation of Office of Management and Budget (OMB) Circular No. A-73.

We are relatively a small organization with some 2800 professional accountants, dedicated to assuring, as best we can, the taxpayers of this country get a dollars worth of value for a dollar spent.

APPROACH TO AUDITING

In performing our reviews, we determine the allowability of costs incurred or to be incurred under Government contracts by applying the applicable parts of the Defense Acquisition Regulation (DAR), formerly called the Armed Services Procurement Regulation. DAR paragraph 15-205.6—Compensation for Personal Services, provides the primary acquisition policy for determining the allowability of ESOP's for the Department of Defense. Additionally paragraph 15-201 stresses reasonableness, allocability and other factors as overall criteria for allowability of costs charged to Government contracts.

OMB Circular No. A-73 also requires all audit organizations to perform audit services for other Executive Branch activities wherever that would be the most economical and efficient way to obtain the needed audit effort. Accordingly and as authorized in our DoD charter (DoD Directive 5105.36), we provide contract audit services to about 25 other Federal agencies at those contractor locations where DoD has a continuing audit interest, or where it is economical from a Government-wide point of view. NASA is one of the principal non-DoD agencies for which we perform these audit services. The NASA cost principles are essentially the same as those contained in the Defense Acquisition Regulation.

ESOP COSTS

While there is no specific mention of ESOPs in the current DoD or NASA contract cost principles or employee compensation, it is recognized that contributions to an Employee Stock Owner Trust is a form of allowable deferred compensation subject only to a review for reasonableness and compliance with IRS rules. Such allowable contributions would include the reasonable cost of stock acquired and related interest incurred by the employee trust to borrow funds for this purpose. At our request, DoD is revising its cost principles to provide specific coverage on ESOPs.

We have had a few problems in applying these cost principles, but these problems relate to unusual contractor arrangements in their ESOPs. For example, a contractor recently asked for reimbursement of contributions made to an employee trust which were then returned to the contractor as payment of interest on its promissory notes. This transaction actually results in no cost to the contractor and such would be the case on its tax return.

The governing DAR cost principle I referred to before—Compensation for Personal Services—requires our auditors to assure that allowable compensation does not exceed Internal Revenue Service Rules. One such rule is that a qualified ESOP be for the exclusive benefit of the employee. An important test for this condition is that the transfer or purchase price of the employer corporation stock acquired by the trust not be more than the fair market value at the time of the transaction. This requires special consideration when the company stock is closely held and a fair market value cannot be readily determined.

For companies where the stock shares are closely held, it may be necessary for the employer to have its stock valued by a reputable, independent, outside organization. Such independent evaluations are reviewed to assure that the data used in making the valuation study is current, accurate, and complete. The valuation expert will generally assume that all data supplied by the company is accurate. In addition, the expert will normally ask corporate management if it knows of any facts that the valuation expert hasn't covered which

might affect the value of the corporation's stock. The expert must rely on the corporation for accurate and complete data. To the extent that the data is wrong or incomplete in any material respect, the derived value of the company's stock loses validity. While our auditors may compute a rough order of magnitude of the impact of such data they are not expected to develop a new appraisal. They would, however, disclose findings of this nature to contracting officers. In a few cases involving such findings they suggested that the contracting officers obtain an independent valuation of what the company's stock is worth.

The valuation of common stock of a closely-held corporation is a complex process and no formula can be devised that will apply in all circumstances. Relatively few problems with ESOPs have surfaced to date. However, in view of complexities involved we have asked our auditors to be alert to the need for assistance in this area. We are exploring the possibility of retaining an independent expert to assist us with stock valuation cases should the problems become more widespread.

That completes my brief overview of our organization and the considerations employed in auditing the cost of ESOPs allocated to Government contracts. I would be pleased to answer any questions you may have.

ADDITIONAL STATEMENT OF FREDERICK NEUMAN, DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY

Mr. Chairman and Members of the Committee: I would like to express my appreciation for this opportunity to supplement my testimony given before your Committee on 20 July 1978. At the time of my original testimony, I was not aware that allegations would be put on the record concerning the personal behavior of one of our auditors. After reading the testimony furnished to you by Mr. David Personette, Executive Vice President, Metropolitan Contact Services, Inc., I feel obligated to state for the record that we believe these allegations to be unfounded.

Mr. Ballard, the manager of our Houston Texas branch office reviewed the testimony of Mr. Personette and denies any conversation concerning the honesty and integrity of Mr. Cunningham; he further denies that he made any statements relative to whether the contractor's procedure under the job–70 program were fraudulant. Additionally, Mr. Ballard strongly asserts that Mr. Personette's comments concerning his personal and professional behavior were completely without merit.

The record will show that the audit actions were completed well before Mr. Personette came to work for the contractor. Additionally, in late 1977 Mr. Cunningham, Chairman of the Board of Metropolitan, called our attention to certain problems perceived by him during the audit. Our Atlanta Region looked into the matter in some depth; our Headquarters staff worked closely with the field auditors and NASA procurement officials to resolve the points of issue. They found Mr. Ballard's conduct to be wholly professional and above reproach.

Mr. Ballard's audit experience extends back over a period of 23 years; his record is unblemished and he has been given a number of commendations. His supervisors know him to be a dedicated professional who is mature in outlook and honest in his dealings.

I believe his actions in this matter in no way contravene his professional responsibilities or the legislative intent of encouraging employers to establish ESOPs. Quite to the contrary, it could be viewed that Mr. Ballard's actions foster the goal of ESOPs to enhance the welfare of employees by assuring that full and fair value is received by the employees for the expenditure of amounts held in trust for them.

The Agency is convinced Mr. Ballard acted within the scope of his authority and maintained conduct well within the bounds of professional propriety and generally accepted auditing standards. Additionally, I believe the audit reports issued by our Houston branch office were designed to produce fair and reasonable contract costs that are borne by the taxpaying public and at the same time achieve the objectives contemplated by ESOP legislation.

The CHAIRMAN. We are now favored with the presence of Hon. Jim Mattox who is a Representative from Texas. I would be happy to hear from Congressman Mattox.

STATEMENT OF HON. JIM MATTOX, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Representative MATTOX. Mr. Chairman, I am honored to be here before you. I think that my testimony will be relatively brief. I know you have had prior testimony, and I think pretty comprehensive testimony, so I will try to be brief about the matter.

I would like to speak from the perspective of being a member of the House Budget Committee. I have been following this entire case that relates to Metropolitan and its dealings with NASA, I think probably since last year. In the course of looking at the documents, I think there is something important here that you would be interested in, because I know how tightfisted you have to be with the dollars of this country.

In the haste in which NASA selected a contractor on this contract, they overruled Metropolitan, despite the fact that Metropolitan's bid was 400,000 lower than the next closest bid. They have now explained that they did not understand that the bid was $400,000 lower and they made a selection, even though Metropolitan was, in effect, outranked by their ranking—which is pretty nebulous in itself—by 12 points out of a possible 1,000.

During the course of the oral and the course of written information, they never once asked Metropolitan to clarify the fact that they were willing to, in effect, eat $400,000 worth of Government costs and take $400,000 out of the profit. They never even considered that.

And it seems to me from a congressional viewpoint, and frankly, from a taxpayers' viewpoint, that that is a pretty shortsighted-type approach. I think that they took that approach, frankly, because of their interest in destroying Metropolitan contracts and, in effect, doing away with that contract and in effect, striking at the heart of the ESOP-type concept, in effect, knocking the ESOP concept out of Government contracting. Because it is my viewpoint that if companies like Metropolitan are knocked out, that means that other Government contractors are not going to be real happy to step forward and establish ESOP's for their employees.

The CHAIRMAN. I am trying to understand what you are saying. Here is a contractor who bid $400,000 less than the next low bidder.

Representative MATTOX. That is right.

The CHAIRMAN. So it will cost the Government $400,000 to throw out that contract.

Representative MATTOX. That is right.

The CHAIRMAN. Well, are you saying that this company set up a stockownership plan for the benefit of their employees and a question arose whether there was something wrong about that stockownership plan, and NASA then cost the Government $400,000 by throwing that bid out because of the employees stockownership plan?

Representative MATTOX. That is, in effect, what happened.

The CHAIRMAN. Now, the fact that the employer has a stockownership plan means that those employees get a little better break than they do in some other company, even if the stock is not worth what they think it ought to be worth.

Is that a fair conclusion?

Representative MATTOX. I think that that is a fair conclusion, Mr. Chairman, and I honestly believe that the reason the Government, on this contract, would be losing $400,000 was because of the interest in destroying the ESOP concept in Government contracting.

The CHAIRMAN. That may be it. That may be it. Maybe the Agency's negative feelings about ESOP were a major factor in their hostility toward this company.

Representative MATTOX. You may very well be right, and you have a lot more experience than I have, but it is obvious to me that Metropolitan got a raw deal out of the whole matter.

The CHAIRMAN. Well, my impression is that where the Government suffers that badly by that kind of decision it has to be somebody making a purely selfish decision.

Representative MATTOX. I think that is probably right.

The CHAIRMAN. And, frankly, if you follow it closely enough you will probably find he places his personal prejudices above the good of the Agency.

Representative MATTOX. You may be right there, too.

The thing that impressed me was this. I have listened to some presentation by NASA and the thing that impressed me is that they said they did not understand that you were actually offering us a $400,000 savings and we did not understand that you were going to eat that $400,000. But I tell you one thing: Had they granted the contract to Metropolitan, you can bet that they would be standing right there, with no misunderstanding, and had been willing to say, listen, you are not going to get to pocket that $400,000. We get that.

Let me tell you, there would have been no misunderstanding had they granted the contract to Metropolitan. And it is a pure abuse not to have taken that kind of action. It makes the other companies very leery, because the other companies in the contracting area, I am sure, feel that the reason that Metropolitan lost it was that they established this ESOP-type concept and contracted for it.

I think that from my viewpoint, if NASA has got that kind of money to waste, perhaps we should take a little closer look at their budget the next time and be a little more cautious about granting their money, and they might be a little more cautious in applying the entire overall process.

I have been most displeased with the overall defense that the Government has offered. I do not think that there is anything wrong with the second bidder, Senator. I would not want to impune the integrity of anybody in that organization, but I will——

The CHAIRMAN. I do not know who the second bidder was. All I know is that I have seen mischief like that before and it usually is something like I said. But I am not here to say obviously. I would not know that.

Representative MATTOX. I think there is one other point that we ought to make. This is a contract that Metropolitan already had, and Metropolitan was already carrying out the contract and doing an acceptable job on it.

Despite that fact, Metropolitan, recognizing that they were in trouble with NASA, were willing to grant the $400,000 savings. What Metropolitan said was, look, we will do this job with a whole lot

less profit, because we want to keep our contract, even though, we know, we might be able to do it at a more expensive price, we want to keep it.

And even with that fact, as I say, it makes it entirely and completely suspicious, Senator, when they make those kinds of decisions. And I appreciate your allowing me to come on over here and visit with you and I hope you will allow me to come back sometime.

The CHAIRMAN. It seems to me that the answer is fairly obvious. But if Metropolitan in this case had put the stock in for the employees at an inflated price, that should have just been corrected by an IRS audit.

Representative MATTOX. The IRS should have done that.

The CHAIRMAN. The Internal Revenue Service should have simply imposed its "prohibited transaction" rules insofar as the value of the stock exceeded what IRS decided what the stock was worth.

But for NASA to take the contract away from them, in my judgment, would be an utter outrage when it is the low bid.

Representative MATTOX. That is right.

The CHAIRMAN. And that is something that I think we need to get into.

Now, if every time a company bids on a piece of Government bid, the company with the low bid—if they are afraid that NASA is prejudiced against companies which establish an employee stock ownership plan and give their employees a piece of the action—then I would see why they would be afraid to have a stock ownership plan.

That really places the thing in a light that, minus your testimony, I would not have understood, and I want to thank you very much for bringing that to our attention.

Representative MATTOX. Thank you.

The CHAIRMAN. I regret that there is nothing that we can do at this point to rehabilitate the company for what they have lost by this conduct, but maybe—assuming that they are right about the matter after we further study it—that we can prevent that same mischief from happening in the future.

Representative MATTOX. I think we can prevent that. I think that NASA has an obligation to this company now to take a little closer look and see if they had better not reevaluate some of the bids that have taken place on some of these other jobs and I think, frankly, that you and I have a responsibility to take a closer look at NASA's budget, too, if they can afford to waste this $400,000.

The CHAIRMAN. Well, now, I am familiar, Mr. Mattox, with situations where corporations who did not think that the employee stock ownership idea was a good thing at all, but who decided that since the Government was providing a tax credit to encourage it, they would go along and give it a try, where they were not enthusiastic.

You heard, at least yesterday we have testimony by Mr. Reed Thompson testifying for the utility companies and stating that they like the idea of employee stockownership plans. They think it is good. It is a constructive forward movement and it improves relationships between management and labor.

Now, with all of the support employee stockownership has received in the past 2 days, it is very discouraging to find a Government agency like NASA sitting there and saying they can throw people's bids out because they have a stockownership plan—they don't admit

it is because of the plan, mind you, but they look at the plan to see if they can find some minor technicality to quarrel about and justify a decision to throw the bid out because they do not like the plan, or the way it is being administered, and that was never intended by Congress.

I appreciate your testimony.

Representative MATTOX. Thank you.

The CHAIRMAN. Next, we will hear from Mr. Jim Rice, president of Oklahoma Aerotronics, Inc.

STATEMENT OF JIM RICE, PRESIDENT, OKLAHOMA AEROTRONICS, INC.

Mr. RICE. Mr. Chairman, I very much appreciate the opportunity to appear before you this morning. I would like to introduce, if I may, Mr. Art Miller at my right who is the President of MetFab of Texas, Inc., and he has seen fit to associate his company with ours.

Our use of the ESOP over the past 7 years, I think, demonstrates quite well the very special use of the ESOP and its value to a small company which is owned and controlled by disadvantaged people—by people who are socially and economically disadvantaged.

Oklahoma Aerotronics was founded in 1964 with experienced management working within a total community effort to try to overcome the chronic social and economic deprivation of our entire area. This area had been spiraling downward socially and economically ever since our once very-prosperous coal mines closed down in 1929 to 1932 and a big depression that hit about that same period.

We have had, toward this effort, $280,000 of local equity, capital. We had $512,000 of loans and loan guarantees through the Economic Development Administration—which, incidentally, is paid off in full this year—and we have had the absolutely vital and essential assistance of the Small Business Administration in their 8(a) program.

From the introduction of the ESOP in 1971 up to the present, our company has shown a change in total asset increased from $750,000 to $4 million. Net worth has gone from $500,000 negative to $2.5 million positive.

Retained earnings from $1 million negative to $1.25 million positive. Long-term debt from $1.25 million reduced now to less than $50,000.

In 1971, we were a marginal operation. Today, the operation is profitable. We have gone from 35 employees in 1971 with a quarter of a million payroll to 340 employee-owners today with approximately $3.3 million payroll.

If we are given the necessary 2 more years to complete the Small Business Administration's approved 8(a) business plan that we have, we will then have a $5 million payroll into 500 employee-owners. That is 500 families who will no longer be disadvantaged. They will be in the American mainstream of our economy.

Our employee ownership, exercised through the ESOP, has grown from 55 percent over the fiscal years 1971 to 1976 period to 61 percent in fiscal year 1977, 68 percent in fiscal year 1978, and, the Lord and SBA being willing, it will be approximately 100 percent before 1987.

Like every developing company, whether it is disadvantaged or not, Oklahoma Aerotronics has had to recognize and to cope with some real hard, solid facts. For example, No. 1, it normally requires 10 to 20 years

to develop a competent manager. He is hard to find. He can ask for and get good jobs at good pay and by any generally accepted definition, a presently competent manager is not presently disadvantaged.

No. 2, a presently competent management is prerequisite to the future success of every company. Again, disadvantaged or not.

So this means, No. 3, that the disadvantaged 8(a) company, owned and controlled by socially and economically disadvantaged people must, just like every other company, have presently competent, hence, presently nondisdavantaged management before it has any hope of future success.

Now, SBA has failed to really understand these facts, I think. And this, in considerable measure, may account for the less than one-half of 1 percent success rate which has been experienced by disadvantaged companies in the 8(a) program. I think that SBA's recognition of the problem is indicated by its report to the Congress in 1975 that "The few 8(a) companies meeting with success are precisely those owned and controlled by 'disadvantaged' persons having characteristics, attributes, and economic and social backgrounds found among the nondisadvantaged."

Further, by the statement in the same report, that any attempt to limit ownership in the 8(a) companies to persons who were both socially and economically disadvantaged would "tend to limit the participation in the 8(a) program to those with little, if any, true possibility of success in the marketplace."

But this observation apparently merely suggested to SBA that the 8(a) eligibility requirements be changed to include enough "affluent disadvantaged." That is, enough so-called disadvantaged people who actually have the characteristics of the nondisadvantaged.

And this, hopefully, would raise the 8(a)'s success rate.

Well, it has not worked of course, and on the other hand, I think it has contributed, in part at least, to the abuses so widely criticised and publicized by the Subcommittee on Federal Spending Practices.

But SBA's response to these criticisms again seems, I think, largely cosmetic. For example, to increase business development expense, to strengthen management assistance—all very good, of course, but it does not change the harsh fact that management actually requires a 10- to 20-year incubation period before you can have a company with any hope of success.

And of course, again, the renewal of the old efforts to change eligibility requirements, this time by setting up some hereditary post hoc categories of disadvantaged which are labeled presumptive disadvantaged, such as black, female, veteran.

Now, such categorization by group violates the dignity and the integrity of an individual, and historically there simply is no other political action that is no divisive. It splits splinter group against group in bitter fratricidal quarrels and, meantime, the ESOP concept offers a perfectly valid, widely applicable and now a proved methodology—proved by Oklahoma Aerotronics—for dealing with this precise problem.

Disadvantaged ownership and control as exercised through the ESOP allows for competent, nondisadvantaged management while, at the same time, providing full opportunity for the disadvantaged employee-owners to acquire management skills at affordable com-

pany costs and then to compete on an equal footing for the management jobs in their own company.

In Oklahoma Aerotronics for example, 38 percent of our management and professional jobs today are held by people who have come up from the hourly paid ranks in Oklahoma Aerotronics.

Now, certainly this pilot project staged by us over this last 7 years, I think it demonstrates the powerful leverage of a carefully designed ESOP. However, Oklahoma Aerotronics had highly vocal opposition from a minority in the Small Business Administration when we first introduced the SBA to this concept back in 1970.

This opposition has subsequently increased. It has increased in direct proportion, actually, to the increasing success of our demonstration.

Really, I suppose that this is not surprising, bcause the ESOP is innovative and it is a characteristic of every bureaucracy, I think, to oppose to the death anything which is contrary to preconceived conventional notions or different, or upsetting to habitual routine. As a matter of fact, the more ineffectual a given program, as unfortunately 8(a) has been so far, the more violent and more vocal the opposition to any change. And, most especially, also, if any suggestion for change originates outside the bureaucracy.

Oklahoma Aerotronics' successful demonstration of the ESOP has actually placed its own survival now in dire jeopardy. This foreshadows a tragedy for our 340 families and a tragedy for the hopes and plans, the initial progress, of our entire community. Our people in Oklahoma simply cannot understand it. Oklahoma Aerotronics is theirs—it is their company. It is their hope for the future.

This action, SBA, truly it is the taking and the slaughter of the poor man's only lamb for the rich man's table and it is not right.

Perhaps even more, the implications of this attitude, of this mindset for future ESOP applications for the entire 8(a) program and most especially for the newly proposed, and I think extremely vital and important Minority Business Enterprise Act, these implications, in the long-run, may be even more tragic.

Mr. Chairman, I do deeply appreciate the opportunity to appear before you and I will try to answer any questions which you may have.

The CHAIRMAN. It just occurs to me that there may be some reason why SBA is antagonistic toward your company and want to get rid of it and might see the ESOP as an excuse to do it. But I must say that, if that is the case, I am simply not in sympathy with SBA on that. I thought I liked SBA and thought it was doing some good work. As a matter of fact, I helped establish the Small Business Administration.

But what you are trying to do with your employee stock ownership plan is inspiring—the idea of trying to give disadvantaged people an opportunity to be productive and to participate fully in this economy of ours is inspirational and we ought to be helping you. We should not be doing anything to make life more difficult for you. I am one Senator who is going to continue to push for employee stock ownership and prevent agencies like SBA from negating our efforts in this regard.

Mr. RICE. We cannot understand it, Senator, but of course, we have appealed this SBA action, but unfortunately, regulatory law is a

little different from criminal law. A criminal, you know, if he appeals his case, there is a stay of execution until the appeal takes place. However, under the regulatory law, you are executed first, and then if the court appeal is in your favor, this is a legal justification then for an attempt to resuscitate you.

The CHAIRMAN. Thank you very much, sir. We will look into this and try to be as helpful as we can.

Mr. RICE. Thanks a lot.

[The prepared statement of Mr. Rice follows:]

STATEMENT OF JIM RICE, PRESIDENT, OKLAHOMA AEROTRONICS, INC.

Utilization of an Employee Stock Ownership Program by a "Disadvantaged" Business Concern

DIGEST

1. This report discusses the role of the Employee Stock Ownership Program (ESOP) in helping disadvantaged firms—i.e., firms majority owned and controlled, by socially and economically disadvantaged people—to become self-supporting and competitive. The experience of Oklahoma Aerotronics, Inc. (OAI) is cited, a 7-year pilot project demonstrating: (a) The advantages which the ESOP offers for this purpose. (b) The opposition to the ESOP concept within some Government agencies.

2. OAI was founded in 1964, with competent professional management coopted into a total-community effort to overcome the chronic (since 1930) social and economic deprivation of the area.

3. The OAI Employee Trust was established in 1971. Employee ownership through the ESOP has grown from 55% for FY 71–76 to 61% for FY 77; it will be 68% for FY 78, substantially 100% before 1987.

4. Since 1971, OAI has grown from a marginal to a profitable operation: from 35 employees to 340 employee/owners; from $0.25 to $3.30 million payroll. Given two more years, it will have a $5.0 million payroll, into 500 employer/owners and their families who are no longer disadvantaged, having joined the advantaged main stream.

5. The ESOP is uniquely designed to provide, for employee/owners having adequate drive and ability, an inside fast-track-up in management. To date, 38% of OAI management and professionals have moved up from OAI hourly ranks. Increasingly, employee/owners at all levels accept individual responsibility for company performance.

6. Disadvantaged companies, like all others, must face these hard and unavoidable facts:

(a) It normally takes a minimum of 10–20 years beyond high school to make a competent general manager. By generally accepted definition, *presently* competent managers are *presently* nondisadvantaged.

(b) *Presently* competent management is prerequisite to *future* success.

(c) Therefore, a company owned and controlled by the disadvantaged, must have non-disadvantaged management *before* having any hope of success.

7. Disadvantaged ownership, exercised through an ESOP, allows for competent non-disadvantaged management from the beginning, while providing full opportunity for willing and able disadvantaged employee/owners to acquire management skills and compete for management jobs *in their own company*.

8. SBA failure to cope with (6) above largely accounts for the less-than-½-of-1% success rate of the 8(a) Program. It explains the limitations for 8(a) of short term "management assistance". I projects the futility of current efforts to diddle the 8(a) eligibility requirements.

9. OAI has demonstrated the value of the ESOP to a disadvantaged firm. But the concept is innovative, upsets routines, hence is anathema to the bureaucratic mind-set.

10. SBA has elected to reject the ESOP concept and to "terminate with extreme prejudice" the ESOP demonstrator. The consequences, for OAI and for Hartshorne, Oklahoma, are tragic. The implications for the entire 8(a) Program, and for the newly proposed Minority Business Enterprise Act, are equally serious.

STATEMENT

Mr. Chairman and members of the Committee, I appreciate the opportunity to offer an account of our company's experience with the Employee Stock Ownership Plan (ESOP), demonstrating the role of an ESOP in helping disadvantaged firms—i.e., firms majority owned, and controlled, by socially and economically disadvantaged people—to become self-supporting and competitive.

Oklahoma Aerotronics, Inc. (OAI) was founded in 1964, with experienced and competent professional management joining into a total-community effort to overcome the chronic social and economic deprivation of our area. The community—Hartshorne, Pittsburg County, Oklahoma—was once a prosperous coal mining center. The mines closed in 1929–32 and this, together with the great depression of that same period, brought the area below social and economic break-even operation, setting off a viciously declining cycle of eroding industrial base and reduced employment—out migration, leaving an aging and less productive population—diminishing tax base with higher welfare costs—less money for schools, health and community facilities—flight of capital—continuing erosion of industrial base.

With $512,000 of financial assistance through the Economic Development Administration (repaid in full in 1978), with Small Business Administration assistance under the 8(a) Program, and with use of the ESOP, OAI has initiated a reversal of this downward spiral. From 1971 to the present, OAI has grown from a marginal to a profitable operation; from 35 employees to 340 employee/owners; from $0.25 million to $3.30 million payroll. Given two more years to complete the approved Business Plan under 8(a), OAI will have a $5.0 million payroll, into 500 families who are no longer disadvantaged, having joined the advantaged main stream. Meanwhile, for the community as a whole, net migration flow is reversing and the employment trend is upward. The tax base is increasing slightly (even with adjustment for inflation), while welfare needs are decreasing.

The OAI adaptation of the ESOP is detailed in Appendix I, and an over view of the ESOP operation is given in Appendix II. Employee ownership, exercised through the ESOP, has grown from 55 percent for FY 71–76 to 61 percent for FY 77; it will be 68 percent for FY 78, substantially 100 percent before FY 87—at no cash outlay by any employee.

Under the ESOP, OAI employee/owners at all levels tend increasingly to accept individual responsibility for their company's performance. Many are following the inside-fast-track provided by the ESOP, and competing for OAI management and professional jobs: 38 percent of these jobs are currently held by formerly hourly paid personnel.

OAI, like all companies disadvantaged and non-disadvantaged, must face these hard and unescapable facts:

1. It normally takes a minimum of 10, more likely 15–20 years, beyond high school to develop a competent general manager. He is in short supply, demands and gets good jobs at high pay. By any generally accepted definition of terms, a *presently* competent manager is *presently* non-disadvantaged.

2. *Presently* competent management is prerequisite to *future* success.

3. Therefore, the 8(a) company, if owned and controlled by truly disadvantaged people, must have presently competent, hence *presently non-disadvantaged* management *before* having any hope of future success.

An ESOP, properly designed, is uniquely suited to this situation. Disadvantaged ownership and control through the ESOP allows for competent non-disadvantaged management from the beginning, while providing full and equal opportunity for disadvantaged employee/owners—those willing and able—to acquire management skills at affordable company expense, and to compete on an equal footing for the management jobs *in their own company*.

The SBA has never understood, hence has been unable to cope with this problem. This largely accounts for the less-than-½ of 1 percent-success rate of disadvantaged firms in 8(a). SBA recognized and reported to the Congress in 1975 that "the few 8(a) companies meeting with success are precisely those owned and controlled by 'disadvantaged' persons having characteristics, attributes, and economic and social background found among the non-disadvantaged". SBA stated further that any attempt to limit ownership to persons who are both socially *and* economically disadvantaged would "tend to limit participation

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in the 8(a) Program to those with litte if any true possibility of success in the marketplace'.

This suggested, and apparently justified, the novel solution of setting up de facto definitions of disadvantage which would include enough "affluent disadvantaged", and enough so-called disadvantaged who, actually, had the essential characteristics of the non-disadvantaged, thus raising the 8(a) success rate to acceptable level. Of course, this policy has not worked; it *has* contributed to the abuses so widely publicized and criticized in 1977-78 by, for example, the Sub-Committee on Federal Spending Practices and Open Government.

The SBA 1977-78 response to this criticism seems largely cosmetic: The advocacy of increased spending for "business development expense" and strengthening of short term "management assistance" programs, which ignores the harsh fact of the 10-20 year incubation period normally required for competent management; and a renewed effort to diddle the 8(a) eligibility requirements, this time by setting up arbitrary post hoc and hereditary categories labeled "presumptive disadvantaged"—such as "Black", "Female", "Veteran"—categories from which escape by individual volition is impossible. Such categorizing by group violates the dignity and integrity of the individual and, historically, no other form of political action is more divisive—pitting splintering group against group in unending, bitter, fratricidal quarrel. (Categories such as poor-rich, or advantaged-disadvantaged, are *not* hereditary in our society, and their use need *not* be divisive. Persons *can*, and many *do*, move from one category to the other by individual volition, and categorization is by individual, not by immutable group).

The ESOP offers a widely applicable methodology for disadvantaged firms. Certainly the "pilot project" staged by OAI over the past 7 years has demonstrated the powerful leverage which a carefully designed ESOP offers to this purpose. But OAI met with highly vocal opposition from a minority in SBA, upon first introducing SBA to the ESOP concept in 1970; and this opposition has increased in direct proportion to the increasing success of the demonstration. Of course, this should not be surprising. The ESOP concept is innovative and upsetting to the status quo; it is characterstic of all bureaucracy to oppose to the death anything contrary to preconceived conventional notions, or different, or requiring change in habitual routine; and the more ineffectual and unsuccessful a given program (as, for example, 8(a)), the more violent and vocal the bureaucratic opposition to any change—especially if the change makes the program more effectual—most especially if the suggestion for change originated outside the bureaucracy.

In this case, OAI's successful demonstration of the ESOP has placed its own survival in dire jeopardy. This foreshadows tragedy for our immediate 340 families, and for the hopes and plans and progress of the whole community. Our people do not understand. It seems another example of the taking and slaughter of the poor man's only limb for the rich man's table.

However, the implications of this SBA attitude and mind-set for the entire 8(a) Program, and for the newly proposed Minority Business Enterprise Act—these implications, long run, may be equally tragic.

Mr. Chairman, Gentlemen, I deeply appreciate this opportunity to appear before you. I will try to respond to any questions.

APPENDIX I

Outline of the Employee Stock Ownership Program (ESOP), as Adapted by Oklahoma Aerotronics, Inc.

The OAI Employee Stock Onwership Trust comprises all present and future OAI employees with one or more years service. Voting members are those on the active payroll at the time of any vote. Each member has one vote, regardless of his job, seniority, or status inside or outside our Local 1679 bargaining unit of the UAW.

The ESOP is managed by a Committee consisting of the OAI President, ex-officio, and 3 elected members: One being from outside and two from inside the bargaining unit, but each being elected by simple majority vote, and recallable by ⅓ petition followed by simple majority vote, of all voting members.

At stockholder meetings, the four ESOP Committee members each votes ¼ of the shareholdings of the Trust: except that, while OAI is in the 8(a) Program, the President's vote is proxied to the 3 elected members.

The annual stockholder meeting elects 4 Directors, each by simple majority stock vote. These, together with the ESOP committeemen, form an 8-member Board of Directors on which each member has a single vote. Five votes constitute a quorum, and five votes are required to pass any action, except to adjourn.

In each fiscal year, OAI may contribute to the ESOP up to 25% of aggregate W-2 earnings of ESOP members. This contribution is exempt from corporate income taxes. The contribution may be made in any combination of cash, treasury stock and/or new stock. The Trust may, in turn, use any part of cash contributions to buy out private stockholdings on a non-discriminatory basis. All stock transactions are at "fair market value", established by arms-length appraisal and subject to critical IRS review.

The company contributions to the ESOP are allocated annually to member accounts, pro rata to W-2 earnings. These allocations, and all earnings thereon, are nonforfeitable—100% vested.

Distributions from individual accounts to individual members are made upon termination of employment due to death, permanent disability, or normal retirement; or, if an employee terminates for other reason, upon death or 62nd birthday. Provision will be made in the future for a further annual distribution of certain benefits. For example, to permit a pass-through of dividends on trust shareholdings. To date, the OAI Trust has paid out $70,000 in retirement or death benefits, to the accounts of four members.

Appendix II

Overview of the ESOP in Operation in OAI

1. Changes in Operational Management

With the first major distribution of cash benefits, employees become aware that they, in fact, own the company—that company cash-in and cash-out is actually in and out of their own pockets. Hence, they begin asking questions. Just how much does that new piece of equipment cost? How expensive is it to maintain? They demand more effective supervision, they object to "goof-offs", they become intolerant of petty theft. With improved morale production goes up, scrap goes down, quality is improved. The over-all operation is more alert, faster paced, yet surprisingly relaxed. Operational management is certainly and refreshingly different: More difficult and challenging, and also more rewarding and much more fun.

2. Changes in General Management

General management likewise acquires a new set of dimensions, harking back to two basic but sometimes forgotten American ideals:

First, that the optimum *attainable* wisdom in worldly affairs derives from the consensus opinion of plain ordinary people—under a system of checks and balances which does not impede necessary executive action, but does delay controversial policy decisions long enough to damp out waves of hysteria and permit a true consensus to form. The Oklahoma Aerotronics, Inc. Employee Stock Ownership Program rests firmly on this ideal.

Second, just as most of us recognize our own personal inadequacies to be President of the United States, but nevertheless insist upon the right to work toward and try for the job if we do desire; and, in any case, we insist upon our prerogative and competence to select and judge the man who does take the job; just so, most of the employees of OAI neither exect nor would want to be its chief executive officer—although, unquestionably, some few are aiming toward it. But each one, as a member of the ownership family, is in a position to insist upon a hearing and fair consideration for each step-by-step promotion, which he works for and considers merited. He has an "inside fast track"—to the extent that he wants and is able to work it. For example, at this date 38% of our management and professional personnel have promoted themselves to present positions from the hourly-paid ranks of OAI (and OAI standards for these jobs are exceptionally high).

OAI people know that *they*, as the ultimate owners of OAI, have final control. They can hire professional management from both inside and outside the company, as needed to optimize results *in their own company*. And the employee/owner who achieves advancement is keenly aware that his performance is under the constant scrutiny of his peers within the company.

3. PURPOSE AND GOAL

The purpose toward which the OAI adaptation of the Employee Stock Ownership Program is directed is the creation and building of a profitably operating employee-owned company, in which:

(a) Each employee/owner has freedom to determine his own goals—just what and how much of value he wants to develop of himself, and to invest in his company.

(b) Each employee/owner has equal opportunity to grow, to develop "that of value" which he has determined to invest in his company—and then has equal opportunity to actually make that investment.

(c) Each employee/owner receives a just return for his contribution: In wages, and in accumulating ownership of the productive capital of his company, and in the earnings of that owned capital.

(d) Finally, some employee/owners will earn, in lesser or greater measure, the privilege to lead others and the opportunity to fulfill the second great commandment, as recorded for us by Matthew.

STATEMENT OF JOHN M. TRASK, JR., ASSOCIATE ADMINISTRATOR FOR FINANCE AND INVESTMENT, SMALL BUSINESS ADMINISTRATION

Mr. TRASK. Mr. Chairman, my name is John M. Trask, Jr. I am the Associate Administrator of Finance and Investment and with me is Alan Hiebein, an attorney in SBA's legal department. We appreciate this opportunity to appear here today to discuss the Small Business Administration's policy regarding loans to employee stock option plans.

We at SBA do, indeed, recognize the value of ESOP's, both for employers and employees alike. We also recognize the fact that it is the intent of Congress to encourage ESOP's.

As you know, it is our policy not to make loans to ESOP's, but we do, as you know, make direct loans and guaranteed loans, to qualified small businesses.

We did give the issue serious consideration and concluded that it is neither necessary nor desirable to structure loans to small businesses through ESOP's.

First of all, ESOP's are not considered small businesses. We ask ourselves if entities which are not small businesses should be eligible for SBA loans. We concluded that the eligibility of ESOP's for small business loans is questionable.

We also ask ourselves if we would be denying loans to qualified small businesses by denying them to ESOP. We determined that we would not be denying loans to small businesses.

Additional considerations were taken into account during our deliberations. The issue has been raised that structuring the loan through the ESOP would enable the company to receive a beneficial tax treatment on the loan repayment. We looked into this and determined that the same tax benefit can be obtained through a regular loan to a small business which maintains an ESOP.

An employer's contribution to an ESOP can be made in three forms: Cash, employer's stock, or property. Any of these will create a tax deduction for the corporation equal to the fair market value of the assets transferred.

To obtain a tax deduction which would at least equal that available if the loan had been made to the ESOP itself, the company could transfer, each year, shares of the company's stock to the trust in an amount equal in value to the loan payments. The employer would thereby have the same tax deduction treatment on debt repayment.

There is no greater tax advantage to the company if the loan is made to the ESOP rather than to the company, as SBA preferred.

The issue has also been raised that the transaction that I just described would work to the financial detriment of the employees, since the employee would benefit from subsequent stock value increases only if he or she received all of the stock immediately.

This argument is valid only if the company is immediately profitable, and if the value of its stock increases immediately.

The chances of this happening in the type of businesses SBA makes loans to are very small. The point does not hold, of course, if the stock value decreases.

In addition, even if SBA changed its policy, the small business would always have the option of choosing either method.

The issue also has been raised that our policy regarding ESOP financing would, in effect, deny employees many of the protections provided by ERISA. Both the Department of Labor and the Internal Revenue Service have established regulations to protect employee rights and benefits under various types of employee benefit plans, including ESOP's.

Additionally, the IRS has established specific rules to protect plan participants when the ESOP borrows funds, since plan assets are at risk in such situations.

When the employer is the borrower, plan assets are not at risk. In any event, plan participants receive continuing protection by the general regulations of IRS and the Department of Labor, no matter who is the borrower.

We feel at SBA that our usual method of making loans to the small business is preferable, since we are able to identify the eligible small business concern within the true borrower-lender relationship.

In addition loan approval and disbursement procedures would probably be delayed if the loan is to be made to the ESOP instead of to the company, because to assure repayment by the company with its assets and guarantors, SBA would probably have to become involved in the relationship between the ESOP and its company.

Therefore, Mr. Chairman, for these reasons, we have decided not to make loans to ESOP.

This concludes my prepared statement. I will be happy to answer any questions you may have.

The CHAIRMAN. I think that it is a subject that will address itself to legislation. We did not think that we had to specifically state in the law that you could make a loan to the employee stock ownership plan or not. However, it was clearly an intention that you do so.

To this Senator, it would seem that there would be situations where the company would be eligible for loans and you could make the loans to the employee stock ownership trust if you wanted to, and you would

make it for the benefit of all the employees in that firm through the employee stock ownership plan.

It just seems to me that if you take the view that you are just not going to make any loans to any employee stock ownership trusts or employee stock ownership plans, no matter how they go about applying for it, I just do not think it is in the Nation's interest. It may be that you can justify it by the statements that you have made here, but my inclination would be to say that if you think that is how you ought to do business, then we ought to make you change it by law.

Surely you would recognize that there are situations where you would benefit a lot more people if you made it to the employee stock ownership trust, is that not right?

Mr. TRASK. I think a change in the law would certainly be the simple way to clear up the matter?

The CHAIRMAN. I did not hear you.

Mr. TRASK. I said a change in the law would be the simple way to clear up the matter.

The CHAIRMAN. Well, we will look into this more thoroughly and I wish you would reconsider your position, because greater employee participation in companies, as of now, that seems to be the wave of the future. That is the way we are moving.

We would like to work it so that more people could get in on the action. It would be nice to see that the employees get a nice hefty share of the benefits as well, and your people could help to move it that way. Instead, you seem determined to get in the way. I think I need to look at possible legislation to keep this from happening.

Thank you, gentlemen.

Mr. TRASK. Thank you, sir.

The CHAIRMAN. The committee stands in recess.

[Thereupon, at 12:50 p.m., the committee recessed, to reconvene, subject to the call of the Chair.]

APPENDIX A

MATERIAL SUBMITTED FOR THE RECORD BY SENATOR LONG

95th Congress } COMMITTEE PRINT
2d Session }

ESOPs

An Explanation for Employees

Prepared by the Staff of the

COMMITTEE ON FINANCE
UNITED STATES SENATE

RUSSELL B. LONG, *Chairman*

MARCH 1978

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ESOPs—An Explanation for Employees

Introduction

An Employee Stock Ownership Plan, or "ESOP" as it is usually called, is designed to give employees the chance to acquire a stock ownership in their company. More importantly, the ESOP usually does this without requiring the employee to spend any of his own money; his investment is the time and effort he puts into his job to make his employer profitable. Although some ESOPs permit or require employees to put money into the ESOP, most provide that the employer will make all necessary ESOP payments.

What Is An ESOP?

An ESOP is an employee benefit plan which is "qualified" under the Internal Revenue Code. That is, it has been written in such a way that it satisfies the requirements of the Internal Revenue Code. As a qualified plan, the ESOP is required to be operated for the "exclusive benefit" of participating employees (and their beneficiaries).

How Does an ESOP Work?

The ESOP is designed to acquire stock of an employer for the benefit of employees. To do so, the ESOP may borrow money from a bank or other lender (including the employer). The stock is bought directly from the employer or from shareholders. When the ESOP borrows money, the employer guarantees to the lender that the ESOP will repay the loan. Employees are never required to assume any obligation for the repayment of the money borrowed by the ESOP. The employer is required to make annual payments to the ESOP in an amount at least equal to the amount the ESOP must pay on the money it borrowed. These amounts are then paid by the ESOP to the lender each year.

The employer is also permitted to make additional payments of cash or stock to the ESOP each year. The amount of these additional payments is usually decided by the board of directors of the employer. Because the ESOP is "qualified," the employer gets a tax deduction for all payments to the ESOP, up to a maximum limitation established by the Internal Revenue Code. This tax deduction is available for the required employer payments and any additional payments, and its effect is to reduce the annual cost of the ESOP to the employer. Cash put into the ESOP by the employer will be used primarily to purchase employer stock. In addition, this cash may be invested temporarily in savings accounts or certain other permitted investments.

What Do Employees Get as Part of the ESOP?

Each year, all amounts of cash and employer stock paid by the employer to the ESOP, and employer stock bought with cash held in the ESOP, are allocated among the accounts of employees who are participating in the ESOP. This allocation is usually done on a formula related to each employee's salary or wages as compared to the salaries or wages of all other participating employees. Take as an example an employee who earns $10,000 per year from a company where the total salaries of all participating employees equal $500,000. That employee's salary or wages is 2 percent of the total, and so his share of allocations of cash and employer stock under the ESOP for that year would be 2 percent. If the employer contributed $100,000 to the ESOP during the year, the employee's share would be $2,000.

A trust will be established (under the ESOP) to hold the cash and employer stock paid to the ESOP for the benefit of employees (and their beneficiaries). It is created by a separate written trust agreement and will be administered by a trustee. This is done to assure that each employee's interest in ESOP assets will be protected.

What Do I Own in the ESOP?

An ESOP, like most employee benefit plans, is designed to benefit employees who remain with the employer the longest and contribute most to the employer's success. Therefore, an employee's ownership interest in cash and employer stock held in the ESOP is usually based on his number of years of employment with the employer. The employee's ownership interest in the ESOP is called his "vested interest," and the language in the ESOP which determines his vested interest is called a "vesting schedule." Although there are many vesting schedules which may be used by an ESOP, most vesting schedules are set up so that the longer an employee stays with the employer, the greater his vested interest becomes.

If an employee terminates employment with the employer for any reason other than his retirement, or, in some cases his death, his vested interest will be determined by looking at the vesting schedule and measuring how many years he has worked for the employer. All cash and employer stock in which he does not have a vested interest because he has not worked for the employer for enough years will be treated as a "forfeiture," to which the former

employee will not be entitled. Forfeitures are usually allocated among the ESOP accounts of the remaining employees on the same basis as employer payments to the ESOP are allocated.

The vesting schedule applies only where an employee does not end his employment because of retirement or, in some cases death. If an employee retires, or, in some cases if he dies, he will immediately have a 100-percent vested interest in all ESOP assets held for him.

When Do I Receive What I Own From the ESOP?

Even though employer stock and cash are usually put into the ESOP for an employee each year, and put into a special account under his name, he will normally not be able to actually get any employer stock and cash from the ESOP until after his employment with the employer terminates and he ceases to be a participant in the ESOP.

After an employee's participation in the ESOP ends, he (or his beneficiary) will be eligible to receive a payment of his vested interest. There are many permissible times and methods for making the payment to him from the ESOP. For example, an ESOP may provide that payment will be made as soon as possible after an employee's termination of employment. On the other hand, the ESOP may require that any payment be deferred until some later time, such as the normal retirement date set forth in the ESOP or the employee's death. However, payment of a former employee's vested benefit under the ESOP must start soon after his death or attainment of age 65. Payment may be made to a former employee (or his beneficiary) in a lump sum, or it may be made in installments.

Payment of an employee's vested interest from an ESOP must normally be made in as many whole shares of employer stock as possible, with the value of any fractional share being paid in cash. Occasionally, depending upon how the ESOP is set up, the ESOP may pay a portion of an employee's vested interest in cash. However, this is not the usual case.

What Can I Do With My Shares of Employer Stock From the ESOP?

Once a former employee (or his beneficiary) gets his shares of employer stock from the ESOP, they are his property and he can do what he wants with them. He can vote the shares of employer stock at shareholders' meetings, receive any dividends paid on the stock by the employer, and he may keep the stock as long as he wishes.

However, if he wishes to sell or otherwise transfer ownership of the stock to a third party, he may be required by the terms of the ESOP to first offer to sell the stock to the employer and the ESOP. This requirement is called a "right of first refusal" for the employer and the ESOP; they can exercise this right and purchase the employer stock at its fair market value. Generally, the price offered by the prospective buyer would establish the fair market value for the stock. However, if an independent party hired by the employer decides that the fair market value is higher than the offering price, then that would be the fair market value of the stock when it is sold to the employer or the ESOP. The purpose of this right of first refusal is to protect the employees of a closely held employer by preventing the stock from being acquired by outside parties who have no interest in the employer or the ESOP and to protect the employer from violating any Federal law as a result of having its stock sold when it does not no satisfy certain Government rules.

In addition, at the time the former employee (or his beneficiary) receives his employer stock from the ESOP, he may be given a "put option," the right to demand that the employer buy his shares of employer stock at their fair market value. In such a case, the ESOP may provide that the ESOP may buy the employer stock, although the ESOP may not be required to buy the stock under the put option. The purpose for including a put option in the ESOP is to assure that each former employee (or his beneficiary) will have someone available to buy his shares of employer stock if he wishes to sell.

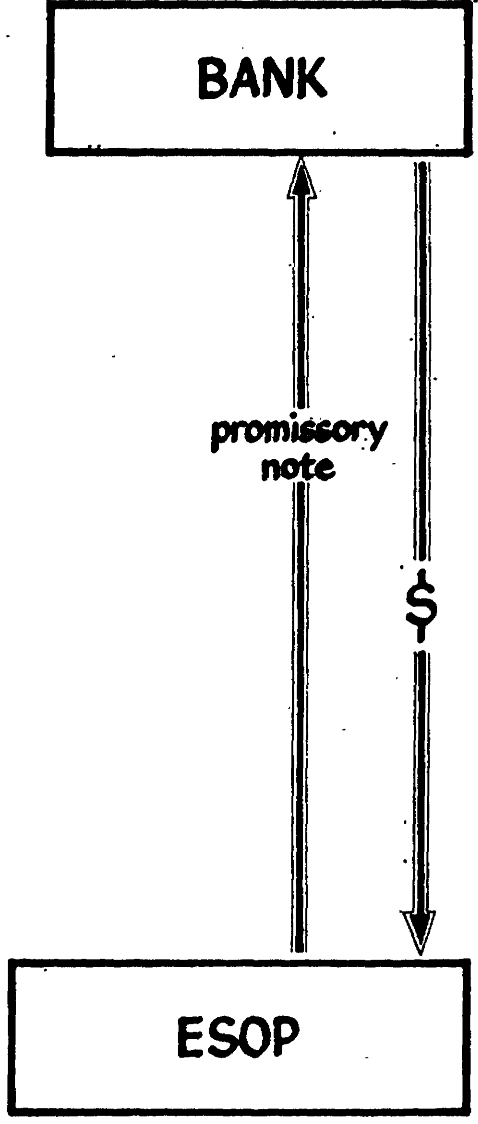
How Does the ESOP Help My Employer?

The employer benefits primarily from the favorable tax treatment it receives for all payments made to the ESOP. This is very important when the employer uses the ESOP as a means of borrowing money. In order to understand how the use of the ESOP to raise money benefits the employer, a comparison must be made with the usual method of borrowing money.

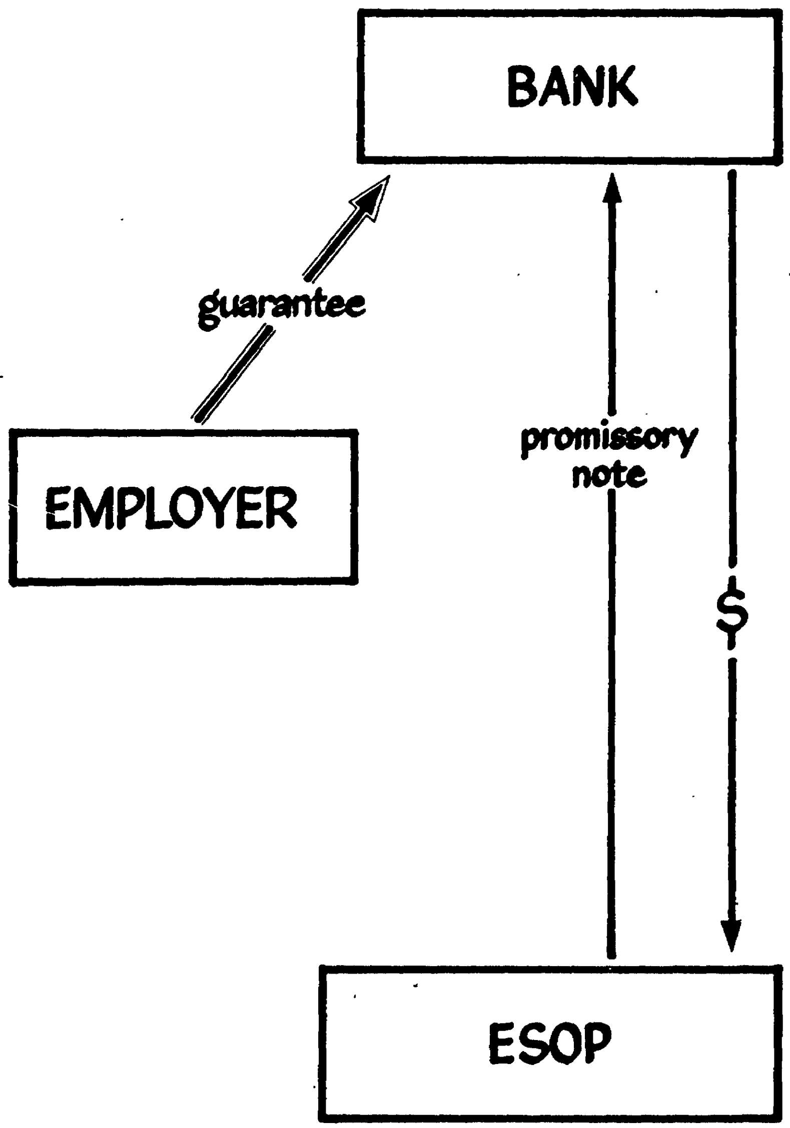
If an employer which does not have an ESOP wishes to borrow money to build a new building, expand production, or for any other reason, the employer would go to a bank to borrow money. When the employer repays the loan, it will also pay interest on the loan, just like an individual person would do with a charge account. Although the interest payments would be tax deductible, the principal payments on the loan would not. This means that the employer would first figure its taxable income, then pay its income taxes, and then make its payment on the loan.

The use of an ESOP for this purpose greatly helps the employer because of the effect it has on the employer's taxes.

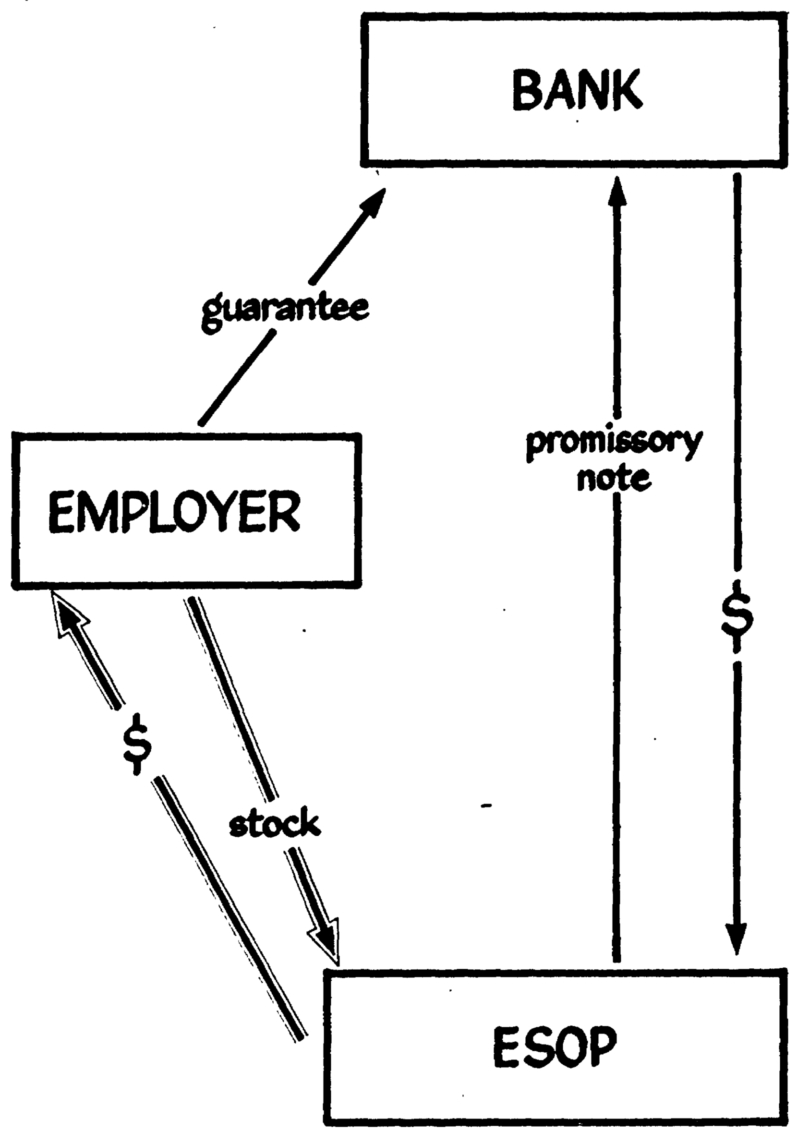
In this situation, the ESOP borrows the money from a bank, and signs a promissory note for the money:



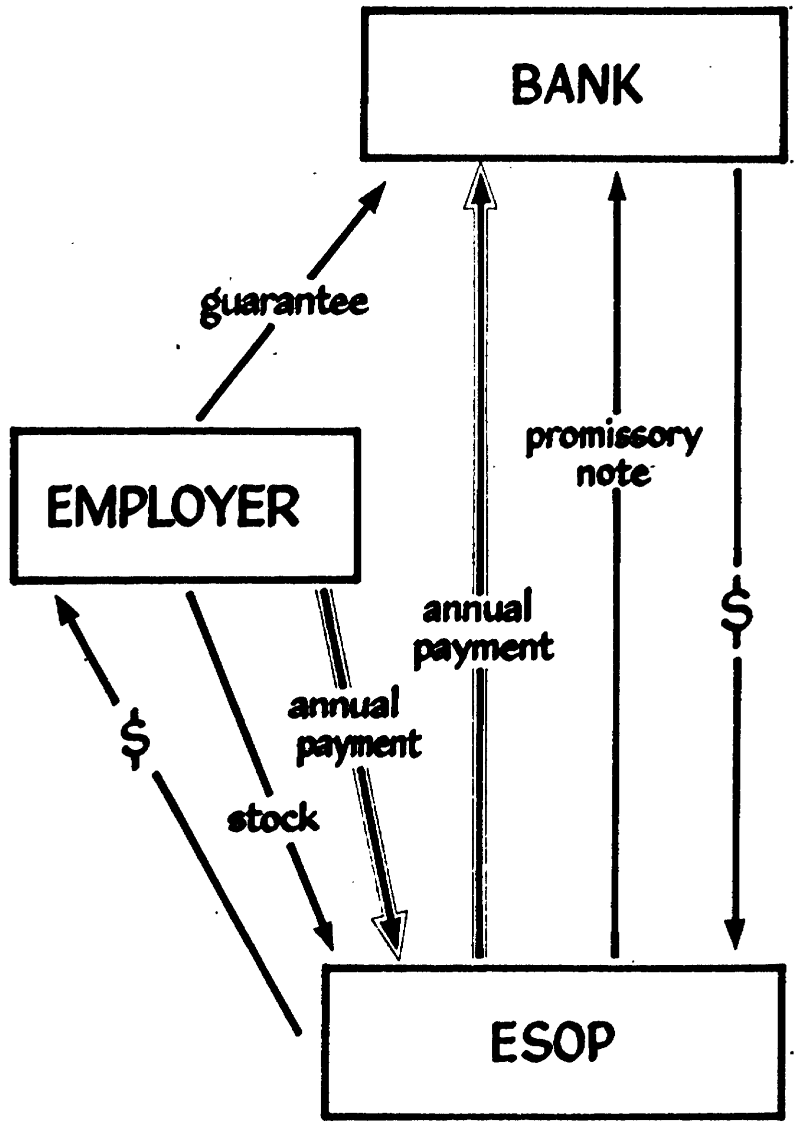
As part of the ESOP loan, the employer gives a written guarantee to the bank, promising that the ESOP will repay the loan and that each year the employer will pay to the ESOP enough money to permit the ESOP to make its annual repayment of the loan:



The ESOP then uses the money from the loan to buy stock from the employer:



Each year, the employer makes a tax-deductible payment to the ESOP, sufficient to let the ESOP make its annual debt repayment to the bank:



The effect of this transaction is to allow the employer to borrow money from a lender and repay the loan with tax-deductible dollars. Since the principal and interest repayments are deducted before the employer's taxable income is determined, the taxable income is lower than through regular borrowing and the employer's taxes are reduced.

Since the major portion of the ESOP assets are used to buy employer stock, the value of each employee's ESOP benefit is directly tied to the financial success of the employer. Also, the employer, as a result of the use of an ESOP, benefits because employees understand that their work performance directly affects the financial success of the employer and the value of ESOP assets. After all, they now own part of the company.

Another benefit to the employer is that the ESOP provides its shareholders with a buyer for their stock if they wish to sell. For stockholders of a small employer, this is a tremendous advantage, and it could also assist the employer in attracting additional investors.

Summary

The adoption of an ESOP provides benefits for the employer, its shareholders and its employees. Our tax laws encourage the establishment and use of ESOPs. Congress has passed five laws in the past 5 years to encourage employers to consider ESOP. Will it continue? Senator Russell B. Long, chairman of the Senate Finance Committee, has repeatedly stated: "Just as in 1862, when Congress passed a law to allow Americans who had very little money to own and develop up to 160 acres of land, we should now give Americans the opportunity to become owners of our growing frontier of new capital (stock). The way to do this is through laws which encourage the development of programs like ESOP."

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[COMMITTEE PRINT]

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

RELATING TO

TAX INCENTIVES FOR STOCK OWNERSHIP PLANS

LISTED FOR A HEARING

BY THE

COMMITTEE ON FINANCE
ON JULY 19 AND 20, 1978

PREPARED FOR THE USE OF THE

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BY THE STAFFS OF THE

COMMITTEE ON FINANCE AND THE
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I. INTRODUCTION

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

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

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

Present law

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

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

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

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

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

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

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

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

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

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

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

[5] This limitation is adjusted for inflation.

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

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

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

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

S. 3241

Description of the bill

General

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

Deductions

Under the bill, a deduction would be allowed to an employer for dividends paid on employer stock held by an ESOP (including a TRASOP), if the dividends are passed through to the participants currently. In addition, taxpayers in general would be allowed an income tax, gift tax, or estate tax deduction for a contribution (or bequest) made to an ESOP if (1) the contribution is allocated to ESOP participants in a manner which does not discriminate in favor of employees who are officers, shareholders, or highly compensated, and (2) no part of the contribution is allocated to the donor, a relative

of the donor, or any person who owns more than 25 percent of the stock of the employer. The dividend deduction and the contribution deduction would be allowed in addition to the usual limits on deductions for contributions to tax-qualified employee plans.

Voting rights

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

Lump sum distributions

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

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

Individual retirement accounts (IRAs)

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

Put options

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

Minimum tax

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

Effective date

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

Revenue effect

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

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

S. 3291

Description of the bill

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

Effective date

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

Revenue effect

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

III. GENERAL STOCK OWNERSHIP TRUSTS—S. 3223

Present law

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

Description of the bill

General

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

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

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

Participating in the GSOT

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

Corporate deduction for payment to a GSOT

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

Tax treatment of the GSOT

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

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

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

Tax treatment of participants

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

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

Eligibility for industrial development bonds

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

Effective date

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

Revenue effect

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

EMPLOYEE OWNERSHIP

(Report to the Economic Development Administration, United States Department of Commerce, Project Number 99-6-09433, by the Survey Research Center, Institute for Social Research, University of Michigan)

This technical assistance project was accomplished under a grant with the Economic Development Administration. The statements, findings, conclusions, recommendations, and other data in this report are solely those of the grantee and/or its consultants and do not necessarily reflect the views of the EDA.

Broad access to property is fundamental to the American economic system. Throughout our history, there has been a steady growth of institutions especially designed to help the average citizen acquire and safeguard property of one sort or another. The early Homestead Acts, Federal Deposit Insurance Corporation, credit unions, cooperatives, aid to small business, and more recently minority enterprise ownership assistance are just a few examples of broadening the property base of "expanding ownership."

One of the most recent variations to emerge is the Employee Stock Ownership Plan, or ESOP, which permits employees to acquire up to 100 percent of the equity of the firm for which they work. This plan not only affords a real increase in property ownership for the workers as individuals, but also serves as an instrument for new corporate capital formation.

The transfer of ownership is accomplished by an ESOT (Employee Stock Ownership Trust), a separate entity designed to receive the stock, or give it to the employees, repay such loans as have been made to acquire the stock, and to act as agent for the corporation.

The ESOP/ESOT may have any number of objectives apart from stock transfer and management. It can raise new capital, enhance current pension trusts. develop second incomes for stockholder-workers, or pursue any other set of legitimate corporate objectives. The ESOP principle finds both interest and support among a wide variety of disciplines, from investment bankers to social scientists. Many students of the quality of working life perceive positive correlations between worker participation and productivity, between job satisfaction and the sharing of decision-making responsibilities.

Despite growing interest in expanded ownership in general, and ESOPs in particular, little organized research has been done. There are several success stories, to be sure, but appearances do not define casualty.

EDA is the Federal agency most directly responsible for economic development in areas which suffer unemployment, underemployment, or sudden economic downturn. The Public Works and Economic Development Act of 1965, as amended, authorizes the use of various economic stimulants—public works assistance, business development and loan guarantees, research and development, technical assistance, and other special impact forms of aid.

The question has arisen whether newer forms of employee ownership, such as the ESOP-ESOT models, are reliable tools for redevelopment. Can failing business firms be saved? Will areas which have resisted other forms of development incentives be stimulated into growth and new work opportunities by expanded ownership devices?

EDA put these and other related questions to the Institute for Social Research of the University of Michigan. This report is their response and represents, we believe, a pioneer effort. The study is divided into two parts. The first is a general overview and analysis of a variety of employee participation expanded ownership programs—including many ESOPs. The second part is a study of one specific ESOP, 100 percent of whose stock is owned by the employees.

The overall findings are necessarily tentative, particularly in the case of ESOPs included in the sample, whose history is too short for absolute conclusions to be drawn. Nevertheless, it appears that optimism would not be inappropriate, and further study of long-term performance is warranted.

I. EMPLOYEE OWNERSHIP

This section concerns firms that have adopted a plan of employee ownership. Employees at all levels in these firms own stock varying from a very small percent of the company's equity in some cases to as much as 100 percent in other cases. We have located 472 such firms. Ninety-eight were identified through information in newspapers, magazines, and professional journals, as well as through information provided by persons who are familiar with employee owned companies. In some of these companies employees own stock through

an employee stock ownership trust (ESOT); in others employees own stock directly. The remaining 374 firms were identified through information provided by the Internal Revenue Service from applications by these firms for ESOT status.

We have collected detailed information in the first 98 of the above firms, including such information as industry type, number of employees, magnitude of sales volume, the percent of employees who participate in the ownership plan, the percent of equity owned by non-managerial as well as managerial persons, whether ownership is direct or through a trust, whether ownership implies voting rights and whether employee representatives are on the board of directors. We also measured the attitudes of managers toward the ownership plan and their judgment about the effect of the plan on productivity and profit. In thirty of the companies we were able to obtain actual data about profit, and we therefore analyzed for this sub set of companies the relationship between profit and some of the above aspects of ownership.

The data that we have collected along with the analyses that we have performed offer preliminary evidence concerning the possible impact of expanded ownership on the economic viability of firms and on their ability to save jobs.

Summary of findings[1]

We estimate that more than a thousand firms in this country have some form of employee ownership plan (not including profit sharing and pension trusts), although in most of these firms the percent of equity owned by employees, particularly by non-managerial employees is small. We were able to identify and to collect data from 68 firms in which at least 50 percent of the equity is owned by employees. In 20 of these firms, non-managerial employees themselves own at least 50 percent of the equity either directly or through an employee stock ownership trust.

Managers offer a number of reasons for having established an employee ownership plan. The incentive that it provides to employees and the tax advantages that it affords the company were among the prominent reasons given by managers in firms with employee stock ownership trusts. Reasons that are related to the creation or maintenance of employment were also mentioned by some of the managers of ESOT firms, but these employment-related reasons were offered more frequently by managers of firms in which employees own stock directly.

Managers in both types of firms are in general very supportive of the ownership plan and they see the plan as contributing to the productivity and profit of the firm. In fact, the thirty firms in our sample for which data about profit are available do show a higher level of profit than do similar conventional firms in their industry, although it is not possible to assert on the basis of this comparison that employee owned firms in general are more profitable than conventional firms, since the firms in our sample may be selected with respect to profit. It is clear, nonetheless, that employee owned firms can function efficiently and profitably. Furthermore, analyses concerning the possible determinants of profitability of these thirty companies indicate that the single most important correlate of profitability among the aspects of ownership that we measured is the percent of the company's equity owned by non-managerial employees. The greater this percent, the greater the profitability of the firm.

Introduction

Examples of expanded ownership can be found throughout the history of the United States. An unpublished survey, for example, has found that 389 firms in which a large proportion of the stock is directly owned by employees were established in this country between 1791 and 1940.[2]

Employee ownership can take two forms: direct, in which employees own shares in the company as would any shareholder in a joint-stock company; or "beneficial," in which employees own shares through a trust. Since the passage of the Employee Retirement and Income Security Act of 1975 (ERISA), the only type of trust which may legally accommodate large amounts of investment by employees in their company's stock is the Employee Stock Ownership Trust (ESOT).

[1] This section of the report was prepared by Michael Conte and Arnold Tannenbaum.

[2] Jones. D. The economics and industrial relations of producer cooperatives in the United States, 1790–1940, n.d.

Contributions to an Employee Stock Ownership Trust are governed by an Employee Stock Ownership Plan (ESOP) which requires that the trust invest primarily in employer securities, unlike a normal pension trust or profit-sharing trust which must diversify its holdings. The plan may leave the method of contribution entirely to the discretion of a single party or parties or it may specify one of several methods of contribution. Contributions may be made on the basis of a profit-sharing principle (whereby some fixed percentage of company profits is annually transferred to the trust), a cost principle (whereby a fixed percentage of labor costs is annually transferred to the ESOT), or a fixed contribution principle (whereby a fixed dollar amount is transferred to the trust). The central requirement, however, is that the ESOT invest "primarily" in employer securities, and that disbursements from the ESOT be made in employer securities. Dividends that may be declared are not usually distributed immediately to employees but rather are held in trust. Nonetheless, the financial well-being of the "beneficiaries" of stock in the ESOT is tied to the success of the company.

We include in this study data from both these types of plans but not from other types of stock ownership trust, such as profit-sharing and pension trusts. Under present law these latter trusts are not permitted to hold large blocks of employer's securities.[3]

Method of selecting companies for study

We compiled a list of 148 companies in the United States and Canada that we thought might have some degree of employee ownership. This list was culled from articles in newspapers, magazines and professional journals, from conversations with colleagues, and finally, from references given by persons in employee-owned companies whom we contacted. A letter was written to the president of each of these companies, asking permission to conduct a fifteen to twenty minute telephone interview. These persons were generally willing to participate in our survey, although many of them delegated responsibility for the interview to another officer, usually a financial officer. Interviews were finally conducted in 132 companies, of which 98 actually proved to have some component of worker ownership. These 98 cases, seven of which are in Canada, serve as the main basis for the analysis of this section.

In addition to information about the above 98 companies, we obtained copies of recent applications to the Internal Revenue Service from 374 firms for ESOT status. These applications represent the work in progress in the 13 IRS key districts at the time of our request to the IRS. Some of the information included in the IRS records overlaps with information obtained through interviews with the 98 firms and a limited comparison can therefore be made between the two sets of firms. For example, 41 percent of the employees in the average firm of the IRS set participate in the ownership plan compared to 77 percent of the employees in the average firm of our first set. Our initial selection procedures, which were designed to locate firms with "substantial" employee ownership have understandably led to firms that have a higher participation rate for employees in ownership than the norm. The plants in this set, however, are comparable in size to those of the IRS set, the average number of employees in the former case being 1,448 compared to 1,334 in the latter.

Description of the companies

Data from the IRS records.—Table 1 presents data from the IRS applications that describe several features of ESOPs and that illustrate how ownership through an ESOT may differ from direct ownership. The vesting period is one such feature. Stock that is held in trust but is not yet vested to an employee may be forfeited if the employee leaves the company for reasons other than sickness or death. This condition, which applies to ESOPs, does not apply to direct ownership and, as the first two columns of Table 1 show, the vesting period in the average ESOT begins about three years after the employee has joined the plan and is completed seven years later. Large firms, however, may commence and complete the vesting process faster than small firms. (In some companies, the vesting period may be as long as 20 years.)

A second feature of ESOPs concerns the right of employees to sell their shares, which right they do not have until the shares have been "distributed" to the employees. Column 3 of Table 1 indicates that in 72 percent of the firms in the

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[3] For an analysis of some firms that have substantial profit sharing programs, see Profit sharing in 38 large companies, piece of action for 1,000,000 participants. Vols. 1 and 2. Evanston, Ill.: Profit Sharing Research Foundation.

IRS "sample" distribution does not ocur until after the employee leaves the company. This prevailing feature of ESOPs may not differ in principle from that in cases of direct ownership, where ownership of stock is a condition of employment.

Column 4 of Table 1 provides information about the basis upon which stock is allocated to employees. In 82 percent of the cases the amount of stock an employee receives is proportional to the employee's wage or salary, although the allocation formula need not be linear, and it may take into account other considerations, such as seniority.

Column 5 indicates that in some ESOP firms employees themselves must make a contribution toward the purchase of their stock, but this feature occurs in only seven percent of the ESOP firms in the IRS set. It may be somewhat more frequent in larger than in smaller firms.

Column 6 presents information concerning the percent of employees in each firm who participate in the plan. A larger proportion of employees participate in small firms compared to large ones.

Data from telephone interviews.—Of the 98 companies where we interviewed a managerial representative, 68 have ESOPs and 30 have direct ownership. The firms differ a good deal from one another in number of employees, as shown in Table 2, although in general they are relatively large by conventional standards. Furthermore, ESOP firms in this set are larger than directly owned firms, even though both types include a broad distribution of size.

Size as measured by sales is presented in Table 3. Forty-five percent of the firms in our set had sales of at least $25,000,000.

Table 4 indicates that as many as 50 percent of the ESOP firms in our set are *wholly* owned by employees including managers while only 19 percent of the directly owned firms are wholly owned by employees. However, in 78 percent of the directly owned firms *at least half* of the equity is owned by employees. Table 5 shows the percent of equity owned by the ESOT. The percent of stock owned by workers themselves is, of course, lower than the above figures, as Table 6 indicates.

TABLE 1.—SOME CHARACTERISTICS OF ESOP FIRMS IN THE IRS SET

	Average number years—		Percent cases where—			Average percent of employees participating in ESOP
	Till vesting begins	Till fully vested	"Distribution" not allowed before termination of empolyment	Allocations are made on basis of total compensation	Employees must contribute	
Size of firm (number of employees):						
14 to 74 (N equals 100)[1]	3.5	10.8	75	86	0	77
75 to 149 (N equals 79)	3.2	10.2	71	90	2	68
150 to 424 (N equals 101)	3.2	10.2	81	82	2	58
425 to 46,842 (N equals 94)	2.2	7.6	60	72	25	49
All (N equals 374)	3.0	9.7	72	82	7	62

[1] Number of cases.

TABLE 2.—NUMBER OF EMPLOYEES IN ESOP AND DIRECTLY OWNED FIRMS

	Percent of firms		
	ESOP (N-68)	Direct ownership (N-30)	All firms (N-98)
Number of employees:			
4 to 99	18	20	18
100 to 249	18	37	23
250 to 999	38	23	34
Over 1,000	26	20	25
Total	100	100	100

TABLE 3.—SALES VOLUME OF ESOP AND DIRECTLY OWNED FIRMS

	Percent of firms		
	ESOP (N-€8)	Direct ownership (N-31)	All firms (N-97)
Sales (in millions of dollars):			
Less than 1	6	10	8
1 to 10	22	24	22
10 to 25	20	35	24
25 to 100	32	17	28
Over 100	20	14	18
Total	100	100	10

TABLE 4.—DISTRIBUTION OF PERCENT TOTAL EQUITY OWNED BY EMPLOYEES (INCLUDING MANAGERS)

	Percent of firms		
	ESOP (N=60)	Direct ownership (N=27)	All firms (N=87)
Percent total equity owned by employees:			
Less than 9.9	4	4	4
10 to 49.9	18	18	18
50 to 99.9	28	59	38
100	50	19	40
Total [1]	100	100	100

[1] 11 firms did not provide sufficient data to determine the percent of equity owned internally. They are eliminated from this table.

TABLE 5.—PERCENT OF THE FIRM'S EQUITY OWNED BY THE EMPLOYEE STOCK OWNERSHIP TRUST

	Number	Percent of firms
Percent of equity owned by trust:		
0 to 9.9	15	26
10 to 24.9	20	34
25 to 49.9	11	19
50 to 100	12	21
Total [1]	58	100

[1] 10 firms did not provide data on the percent of equity owned by the trust.

TABLE 6.—PERCENT TOTAL EQUITY OWNED BY WORKERS

	Percent of firms		
	ESOP (N=58)	Direct ownership (N=25)	All firms (N=83)
Percent total equity owned by workers:			
Less than 3	34	8	27
3 to 9.9	16	8	13
10 to 49.9	43	20	36
50 to 100	7	64	24
Total [1]	100	100	100

[1] 15 firms did not provide data relevant to the percent of equity owned by workers. They are eliminated from this table.

A measure of equity owned by workers in each ESOP firm was obtained by multiplying the percent of the company's equity owned by the ESOP times the percent of the ESOP's equity owned by the workers. Because of the way records are kept in most of the ESOP firms, we found it necessary to rely on the distinction between salaried and non-salaried personnel as the basis for distinguishing rank-and-file workers from managers in these firms. Furthermore, while all of the respondents in the directly owned firms were able to provide information about the allocation of ownership between managers and non-managerial personnel, only about half of the respondents in the ESOP firms were able to provide precise information concerning the allocation of stock within the ESOP. In these firms, 54 percent of the ESOP stock on the average is owned by non-salaried employees and we assume that this average defines the amount of stock belonging to workers within each ESOP of the remaining cases.[4] The percent of total equity owned by workers in these remaining cases, as we estimate it, is therefore directly proportional to (i.e., 54 percent times) the percent of the company's equity in the ESOP itself.

Table 7, based on the above assumptions, provides information about the amount of equity owned by workers in firms of different size. Substantial ownership by workers occurs predominantly in firms of moderate size rather than in the very small or the very large ones. For example, workers own at least half of the equity in 42 percent of the firms having between 100 and 249 employees. By way of contrast, workers own this much equity in only 12 percent of the firms of under 100 employees and in 16 percent of the firms of over 1,000 employees.

TABLE 7.—DISTRIBUTION OF PERCENT TOTAL EQUITY OWNED BY WORKERS IN FIRMS OF DIFFERENT SIZE

	Percent equity owned by workers				
	0 to 2.9	3 to 9.9	10 to 49.9	50 to 99.9	Total
Number employees:					
4 to 99	31	13	44	12	100
100 to 249	24	15	29	42	100
250 to 999	22	19	37	22	100
1,000 to 18,000	31	16	37	16	100
Total	27	13	36	24	100

Reasons for adopting employee ownership

Respondents were asked their reasons for adopting an employee ownership plan. Answers were classified as follows:

Incentive: e.g., "Ownership provides an incentive for employees to work harder" or Employees will be "more conscientious about their work."

Financial: e.g., "ESOP provides us with a tax advantage" or "ESOP permitted our company to raise needed capital."

Moral: e.g., "Employees should own part of the company that they work in."

Employment: e.g., "The company would have closed down if the employees had not bought it" or "It [employee ownership] is a good way to start a business."

Miscellaneous.

Each respondent was permitted to indicate three reasons and Table 8 gives the percent who mentioned each of the above categories as one of their responses. While the "incentive" and "financial" motives appear to be the more prominent ones among the ESOP firms, "employment" stands out as a reason for the creation of the direct ownership plans.

The relative importance attached to financial reasons for the adoption of an ESOP undoubtedly reflects the tax incentives associated with ESOPs as well as other features of an ESOP that might prove advantageous under some circumstances. For example, the principal owners of a business may wish to divest themselves of their holdings while retaining control of the business. The owners can accomplish this through an ESOP in two ways: by passage of nonvoting

[4] The definition of "worker" implicit in the above procedure differs somewhat in the two types of firms. "Worker" may include foremen and salaried clerical workers in some directly owned firms. but not in the ESOP firms. Table 6 may. therefore, overstate the difference in worker ownership between ESOP and directly owned firms, although we do not believe that the definitional inconsistency accounts for the entire difference shown in the table. Furthermore, we "control" for this variation in definition in the regression analyses shown below.

stock to the ESOP or by passage of voting stock but not permitting "pass through" voting. In the latter case, the trustee of the ESOT, who may be accountable to the board of directors of the company rather than to the employees, may be entitled to vote the shares in the ESOT. By making one of these two arrangements, the principal stock holder in a closely held company can retain control over the company without actually holding a "controlling interest."

TABLE 8.—REASONS FOR ADOPTING EMPLOYEE OWNERSHIP PLAN

	Percent of firms[1]		
	ESOP (N=68)	Direct ownership (N=30)	All firms (N=98)
Incentive	41	13	32
Financial	37	0	25
Moral	12	7	10
Employment	12	53	24
Miscellaneous	53	43	50

[1] Percents are based on the total number of firms represented in each column and these percents add to more than 100 since respondents might provide more than 1 reason.

Ownership and control

We asked two questions of respondents in ESOP firms in order to determine the extent to which voting rights are included along with ownership. (1) "Do the shares in the ESOT have a voting right which may be exercised by either the employee owner or the trustee, that is, does the ESOT hold voting stock?" (2) "Does the ESOT have pass-through voting, i.e., can the employees direct the trustees on how to vote the shares in the trust?" One question was asked about voting rights in directly owned firms: "Are employees entitled to vote if they own a share in the company?" The answers in response to these questions show a marked contrast between ESOP and directly owned firms. Of the 64 ESOPs which responded to the first question, 17 indicated that the stock in the ESOT is voting stock. On the other hand, of the 30 cases of direct ownership for which we obtained an answer to the relevant question 29 companies indicated that employees who own shares in the company could vote their stock. In 28 of these cases, the vote is direct; on one, it is by proxy. Table 9 presents some of these data.

The large disparity between the answers from ESOP and directly owned companies indicates the complexity of the ownership concept. Ownership is essentially a set of rights. In legal terminology, two basic ownership rights are "right to *corpus*" and "right to control." Right to *corpus* permits the owner to sell the property that he or she owns and is usually associated with a claim to all the profits generated by the property. Owners in an ESOT share in the capital gains and losses of their stock and are entitled to dispose of their stock once it has been distributed to them. Their ownership rights, however, generally do not include the right to vote their stock. Nonetheless, some control may be exercised by employees in other ways, such as through a union. Workers on the board of directors of the company, which is becoming increasingly popular in some European countries, is a further way in which employees might exercise influence in employee owned firms.

TABLE 9.—VOTING RIGHTS

[In percent]

	ESOP (N=64)	Direct (N=30)	All firms (N=93)
Can employees themselves vote, or direct the voting of the stock that they own:			
Yes	27	97	50
No	73	3	50
Total	100	100	100

Companies with ESOPs and those with direct ownership do not differ greatly in the extent to which employees are unionized, as Table 10 indicates. About one third of the companies in both groups have some employees who are unionized. (We did not inquire about the extent of unionization within the company. It is

our impression that directly owned companies have significantly fewer unionized employees than do comparable ESOP companies.) Large differences are apparent in the table, however, when it comes to other measures of employee influence over company decisions. For example, 36 percent of the respondents in companies with ESOPs report that worker representatives sit on the board of directors, while 77 percent of the companies with direct ownership report the presence of workers on the board. Similarly, 51 percent of the respondents in companies with ESOPs compared to 77 percent in companies with direct ownership indicate that employees influence "important" decisions in the company. In some of the companies, according to our respondents, this influence extends to such decisions as whether or not to make major capital acquisitions.

TABLE 10.—RESPONSES TO QUESTIONS RELEVANT TO EMPLOYEE PARTICIPATION IN DECISIONS

[In percent]

	ESOP (N=66-68)	Direct (N=30)	All firms (N=96-98)
Are employees in your company represented by a union:			
Yes	32	33	32
No	68	67	68
Total	100	100	100
Is there employee representation on the board of directors of your company:			
Yes	36	77	49
No	64	23	51
Total	100	100	100
Do employees have any direct input into any important decisions besides through a union:			
Yes	51	77	56
No	49	23	44
Total	100	100	100

Employee ownership and profitability

Thirty of the companies provided data about profit and we rely on this subset of companies for the analysis of profitability. We employ the ratio of pre-tax net profits to sales as a basis for gauging profitability. Furthermore, the ratio for each firm is divided by the ratio in 1976 for the industry as a whole to which the firm belongs.[5] This final ratio is the primary measure of pre-tax profitability of a firm. We made one further adjustment, however, for five firms in our subset: because these firms are directly and wholly owned by employees, the firms follow the practice of distributing a part of their "profit" to employees in the form of wages. This allocation of funds has the effect of depressing the conventional statement of profit, although it has the corresponding advantage of reducing the base upon which tax on profits is computed. The firms justify this adjustment as a cost to the firms of the additional effort and productivity that presumably characterize them.[6] Nonetheless, these monies should be considered part of the profit of the firm for purposes of comparison with the other firms in our set. We therefore took the wage differential between the worker-owners of the firms in questoin and non-owner-workers (who perform essentially the same jobs as the owners and who receive the union wage rate) as a basis for calculating the amount of money that was diverted from profits to wages. This differential was added to the formally stated profit figure for each of the five firms in question and this final value is taken as the basis for computing the profitability of these firms. While this adjustment seems appropriate as a way of maintaining comparability among firms that employ different accounting procedures, we have also retained, for purpose of analysis, the unadjusted statement of profit. This unadjusted value, we believe, is an overly conservative statement for these firms, but there may be some utility, nonetheless, in examining profitability defined in this way as well as through the adjusted figure.

[5] Robert Morris Associates. Annual statement studies. (1976 ed.) Philadelphia: Credit Division. 1976.

[6] Berman, K. V. Comparative productivity in worker-managed cooperative plywood plants and conventionally run plants. Mimeo, 1976.

The average adjusted profit ratio for the firms in our subset is 1.7; the unadjusted ratio is 1.5. In either case, these values, which are greater than 1.0, indicate that the profitability of the firms in our subset is greater than that of comparable size firms in their respective industries—although we are not able to claim statistical significance for these figures since the variance in profitability among firms is relatively large and the number of cases is small. It is also possible that our "sample" of firms may be select with respect to profitability. We take these figures as suggestive, nonetheless, that employee ownership, in one form or another, may be associated with the profitability of a firm.[7]

Table 11 helps to elaborate this implication. In this table we present the results of a regression analysis in which each of the two indices of profitability (adjusted and unadjusted) is predicted by several aspects of employee ownership. The predictors include:

1. The form of employee ownership, whether direct or through an ESOT (ESOT is scored "0"; direct ownership is scored "1").
2. The percent of employees who participate in the plan.
3. The percent of company equity owned by employees (by managers and workers).
4. The percent of company equity owned by the workers themselves.
5. Whether employees have representatives on the board of directors.
6. Whether employee stockholders have voting rights.

These predictors jointly explain a substantial amount of the variance in "adjusted" profitability, but only one of the predictors, the amount of equity owned by the workers themselves, proves statistically significant ($p<.02$); the more equity the workers own, the more profitable the firm, other things being equal (beta=1.02).[8]

TABLE 11.—REGRESSION COEFFICIENTS FOR THE PREDICTORS OF "ADJUSTED" AND "UNADJUSTED" PROFITABILITY

	Adjusted (N=20)[1]	Unadjusted (N=25)[1]
Multiple	r=0.72	0.47
Predictor:		
ESOT (=0) versus direct ownership (=1)	−0.22	−0.34
Percent employees participating in plan	−0.30	−0.31
Percent equity owned internally	−0.31	−0.19
Percent equity owned by workers	[2]1.02	0.78
Worker representativesness on board of directors	−0.18	−0.18
Percent stockholders vote	−0.05	−0.24

[1] The data necessary to calculate the adjusted profitability ratio are unavailable in 5 firms of the subset and 5 firms did not provide information concerning all of the predictors in this regression. The number of cases in the adjusted and unadjusted cells are therefore 20 and 25 respectively.
[2] $p<.02$.

The second variable of importance in this analysis, the amount of equity owned internally, has, if anything, a negative relationship with profitability (beta= −.31) but the statistical significance of this variable is marginal, at best, a coefficient of this size occurring about one out of four times by chance. Variation in "internal ownership" in this context is really variation in ownership by *managerial personnel* since ownership by the workers themselves is controlled in the analysis. The possible implication, therefore, is that increases in the amount of equity owned by managers may have a negative effect *if this increase is not accompanied by an increase in the equity owned by the workers.* This result is not strong statistically, but it may be worth considering as a hypothesis.

The impact of the remaining variable can easily be attributed to chance but it is nonetheless tantalizing to see that they, too, imply, if anything, negative rela-

[7] For other studies in which the performance of worker owned plywood firms is compared to that of conventional firms, see Bellas, C., "Industrial Democracy and the Worker-Owned Firm." Praeger Publishers: New York, 1972; Berman, K., "Worker-Owned Plywood Companies: An Economic Analysis." Pullman, Wash., Washington State University Press, 1967; Comparative productivity in worker-managed cooperative plywood plants and conventionally run plants. Unpublished, 1976. Bernstein, P., "Democratization of Organization: Theory, Practice and Further Possibilities," Ph.D. dissertation, Stanford University, 1972. See also Melman, S., Managerial versus cooperative decision making in Israel. "Studies in Comparative International Development," 1970–71, 6, 3, who compares the performance of kibbutz firms with conventional firms in Israel.

[8] "Beta" refers to a standard regression coefficient.

tionships in the regression. Direct ownership (rather than through an ESOT), the percent of employees who participate in the plan, the existence of worker representatives on the board, and the existence of voting rights show a negative relationship (if anything to profitability *when the percent of equity owned by the workers themselves is controlled.*

Prediction of the unadjusted profitability index (second column in Table 11) is not as good as the prediction of the adjusted index, the multiple correlation being .47, and none of the predictors meet the usual criterion of significance. The pattern of results, however, is similar to that for the analysis of the adjusted profitability index, and the one predictor that approaches a marginal level of statistical significance in the analysis is the percent of equity owned by the workers (beta=.78, p=.11).

The negative signs associated with several of the variables in Table 11 do not imply (or they would not imply even if they were statistically significant) that these characteristics are associated with *low* profitability; they imply (or would imply) such a negative association only under the conditions of the regression analysis where, for example, the amount of equity owned by the workers is controlled statistically. In fact, because firms where workers hold a high percent of the equity are likely also to be directly owned, direct ownership, like the amount of worker ownership itself, is positively associated with profitability.

Table 12 helps to illustrate these associations. This table shows the simple, zero order correlations among the variables presented in the regression analysis. Asterisks indicate correlations that are significant at the .05 level or better. We see in this table not only how the predictors may be associaed with profitability, but also how the predictors relate to one another. For example, firms in which workers hold a high proportion of the equity tend to be directly owned (r=.68), to have worker representatives on the board (r=.36), and to provide voting rights to employee owners (r=.68). On the other hand, the correlation between the percent of equity owned by the workers and that owned internally (by workers and managers) is not as high as one might expect, in view of the fact that internal ownership includes ownership by workers (r=.34). The proportion of equity owned by *managers* in many of these firms is relatively large and "internal ownership," therefore, reflects managerial ownership more than worker ownership.

Direct ownership in this table is significantly and positively related to adjusted profitability (r=.48)—unlike the relationship indicated in the regression analysis—because direct ownership is associated with the percent of equity owned by workers, which appears from the regression analysis to be the more basic correlate of profitability. Voting rights is also associated with the percent of equity owned by workers and it, too, shows a positive relationship with adjusted profitability (unlike the relationship in the regression analysis), although the magnitude of the correlation does not meet the criteria of statistical significance, given the small number of cases.

The percent of employees who participate in the ownership plan, however, does *not* show the relationship to profitability that one might expect from the hypothesis that employee ownership has a positive effect on profitability (r=—.33). The explanation may hinge on the association, or rather lack of association, between the percent of employees who participate and the percent of equity owned by workers (r=.14). Apparently, many firms that have relatively widespread employee ownership in fact involve only a small proportion of the companies' equity in such ownership. Many members, in other words, own very little.

TABLE 12.—CORRELATIONS AMONG ASPECTS OF EMPLOYEE OWNERSHIP AND PROFITABILITY

	Profit (adjusted) (N=20)	Profit (unadjusted) (N=25)	ESOT vs. direct ownship (N=75)	Percent employees participating (N=75)	Percent of equity owned internally (N=75)	Percent of equity owned by workers (N=75)	Workers on board (N=75)
ESOT (=0) vs. direct ownership (=1)	[1]0.48	0.27					
Percent employees participating	—.33	—.29	—[1]0.23				
Percent of equity owned internally	—.02	—.06	—.10	[1]0.25			
Percent of equity owned by workers	[1].60	.31	[1].68	.14	[1]0.34		
Workers on board	.24	.08	[1].36	.08	.04	[1]0.43	
Employee stockholders vote	.30	.18	[1].68	—.11	—.11	[1]0.47	[1]0.22

[1] $p<.05$.

Managers' estimates of the effect of employee ownership on productivity and profit

In an earlier analysis, we found substantial sentiment on the part of managers as well as of workers in favor of the employee ownership plan in a firm that had recently adopted such a plan.[9] According to members of that firm, employee ownership contributed substantially to the satisfaction of all employees as well as to the motivation of workers and ultimately to the productivity and profitability of the company. Records of the firm also indicated that grievances and waste (in the form of expendable tools) declined and that productivity and profitability increased during a period immediately following the introduction of the plan (although profitability was higher during one period a number of years earlier).

In the present analysis, a management representative in each firm was asked two questions about the effect of employee ownership on productivity and profit. "Do you think that employee ownership affects profits? Does it increase profits, decrease them, or have no effect?" A similar question was asked concerning productivity. The average response to these questions, 2.6 on a three-point scale, indicates substantial support for employee ownership in the judgment of these managers. Furthermore, the analyses presented in the previous section, which suggest that the employee owned firms are above average in profitability for their respective industries, lend some credence to the claim of these managers. But the managers who are more likely to credit employee ownership for high levels of profit are not necessarily in the more profitable firms of our subset.

Table 13 shows the results of a regression analysis designed to determine which aspects of ownership are associated with the judgment by managers that employee ownership has a positive effect on profit and productivity. Managers in firms in which workers own a high proportion of the equity are no more likely to ascribe positive effects to employee ownership than are managers in firms in which workers own a small proportion of the equity—even though this aspect of employee ownership appears to be the more important correlate of profitability in our analysis (Table 11). On the other hand, employee ownership is more likely to be reported to have positive effects on profit where such ownership is direct, rather than through an ESOT (beta=.46, $p.=.06$) and where workers do not have representatives on the board (beta= −.22 $p=.10$).

These results do not explain profit and productivity so much as they explain the attitude of managers concerning the possible impact of employee ownership on profit and productivity, and we see in Table 13 some indication (which we shall see repeated below) that the existence of employee representatives on the board may sometimes be associated with negative attitudes on the part of managers. Other things being equal, managers appear to react less positively in firms that have worker representatives on the board than in firms that do not have such representatives.

Employee ownership and attitudes of workers toward their job, as judged by managers

Each managerial respondent was asked whether employee ownership affected the attitudes of workers toward their job. The average response was .84 on a scale from 0 to 1, where "1" means that work attitudes are better and "0" that they are worse as a result of the ownership plan. The score of .84, therefore, implies that these managers on the average perceive the employee ownership plan to have a substantially positive effect on the attitudes of employees. But as Table 14 suggests, this judgment by managers differs from firm to firm, and it may be less positive where workers have representatives on the board of directors than where they do not. The beta, −.39, which is associated with a provision in the plan for such representation is the only one that proves statistically significant ($p<.01$).

Managers' satisfaction with the employee ownership plan

The managerial respondent in each firm was asked, "Are you satisfied with the way employee ownership is working?" The average response to this question is 2.8, which implies in general a high degree of satisfaction—"3" being the highest possible score. Table 15 shows how aspects of employee ownership are associated with this satisfaction.

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[9] An employee owned firm. Survey Research Center, Institute for Social Research, The University of Michigan, January 17, 1977.

TABLE 13.—*Regression coefficients for the predictors of managers' estimate of the effect of employee ownership on productivity and profit*

[N=71]

Predictor:	Multiple r=.35
ESOT (=0) vs. direct ownership (=1)	[1].46
Percent employees participating in plan	.12
Percent equity owned by employees	−.12
Percent equity owned by workers	−.06
Worker representatives on the board (no=0; yes=1)	−[2].22
Employee owners vote (no=0; yes=1)	−.07

[1] $p=.10$.
[2] $p=.06$.

TABLE 14.—*Regression Coefficients for the predictors of workers' attitudes toward their job, as judged by managers*

[N=70]

Predictor:	Multiple r=.44
ESOT (=0) vs. direct ownership (=1)	.35
Percent employees participating in plan	.15
Percent equity owned by employees	−.13
Percent equity owned by workers	−.05
Worker representatives on the board (no=0; yes=1)	[1].39
Employee owners vote (no=0; yes=1)	.08

[1] $p=.004$.

TABLE 15.—*Regression coefficients for the predictors of manager's satisfaction with the employee ownership plan*

[N=70]

Predictor:	Multiple r=.48
ESOT (=0) vs. direct ownership (=1)	[1].69
Percent employees participating in plan	[2].28
Percent equity owned by employees	.17
Percent equity owned by workers	−.24
Worker representatives on the board (no=0; yes=1)	−.12
Employee owners vote (no=0; yes=1)	−.22

[1] $p<.004$.
[2] $p<.05$.

Two variables prove significant in this regression. Managers are more satisfied with the plan where ownership is direct rather than through an ESOT (beta=.69, $p<.004$) and where the percent of employees who participate in the plan is relatively large (beta=.28, $p.<05$). It seems reasonable that managers should think well of the plan where participation is widespread. On the other hand, we have seen that widespread ownership is not associated with profitability; such ownership may very well mean that many employees own only a very small fraction of the equity—and it is the amount of equity owned by workers that appears to be the most important correlate of profitability.

Employee ownership and employee influence

Each managerial respondent was asked, "Do employees have any direct input into any important decisions besides through a union?" Simple, zero order correlations indicate that managers judge worker influence to be relatively high in firms where the percent of equity owned by workers is relatively great ($r=.42$[10]), ownership is direct ($r=.25$[10]), employees have representatives on the board ($r=.25$[10]), and employee-owners have voting rights ($r=.22$[10]). One of these variables, the percent of equity owned by workers is the relatively more important one in a regression analysis, as can be seen in Table 16.

[10] $p<.05$.

TABLE 16.—*Regression coefficients for the predictors of employee influence, as judged by managers* [N=68]

Predictor:	Multiplier=.50
ESOT (=0) vs. direct ownership (=1)	−.08
Percent employees participating in plan	−.05
Percent equity owned by employees	−.03
Percent equity owned by workers	[1].44
Workers representatives on the board (no=0; yes=1)	.12
Employee owners vote (no=0; yes=1)	.09

[1] $p=.04$.

Table 17 provides the simple, zero order correlations between managers' satisfaction with the plan and their estimates of (1) the influence that workers have, (2) the plan's effect on productivity and profit, and (3) the plan's effect on workers' job attitudes. All of these variables, with the exception of the one concerning worker influence, relate positively to one another, again indicating that while managers tend to be consistent in appraising the implications of employee ownership, they do not include worker influence as part of their positive conception of such ownership.

TABLE 17.—CORRELATIONS AMONG RESPONSES OF MANAGERS CONCERNING ASPECTS OF EMPLOYEE OWNERSHIP

[N=90]

	Managers satisfied with plan	Positive effect on profit and productivity	Employees have influence
Positive effect on workers attitudes	[1]0.45	[1]0.54	0.11
Managers satisfied with plan		[1].34	.07
Positive effect on profit and productivity			−.01

[1] P less than 0.01.

Conclusions

Some degree of employee ownership of firms is not uncommon in this country, although examples in which non-managerial employees own a substantial part of the equity of the company are rare. Nonetheless, data about such companies offer preliminary evidence concerning the possible impact of expanded ownership on the economic viability of firms and on their ability to save jobs. We are led on the basis of these data to the following tentative conclusions.

First, the industrial relations climate in employee owned firms appears to be good, in the judgement of managerial respondents. Second, managerial respondents in these firms see employee ownership as having a positive effect on productivity and profit in the firm. Third, the employee owned firms that we have studied do appear to be profitable—perhaps more profitable than comparable. conventionally owned firms. Fourth, the single most important correlate of profitability among the aspects of ownership that we have studied is the percent of the company's equity owned by the workers themselves. Fifth, while the influence that workers have in the firm, as judged by managers, is a function of the amount of equity that the workers own, managers' evaluation of the ownership plan is not affected in a positive way by either the amount of ownership held by the workers or the amount of influence exercised by the workers. Managers appear to be more favorably disposed toward the plan where participation is widespread among employees, even though widespread participation may involve only a small fraction of the company's equity.

Several of the firms we studied adopted their ownership plan specifically as a way of saving the plant from economic collapse and saving the jobs in the plant. Some adopted the ownership plan for other financial reasons or for moral reasons. But in either case, the data of this report, indicate that employee ownership may contribute to the economic viability of a firm and to the economic well being of members as well as to the quality of working life within the firm.

The data suggest that the impact of employee ownership on unemployment in specific firms might be viewed from the point of view of prevention as well as from the point of view of cure. In the latter case, a firm in which the threat of un-

employment is imminent might be bought by employees as a way of saving their jobs. We have examples in our data of this form of "cure." On the other hand, a healthy firm might move into employee ownership as a way of strengthening its performance so that the loss of jobs will not be threatened in the first place. Our data also include firms of this type.

We offer the above conclusions as tentative. The firms for which we have measures of profit may be select and our analyses are based on correlations that illustrate association among variables; they do not prove causation. The results of these analyses, however, are sufficiently encouraging to justify a detailed longitudinal (historical) study of a number of firms over a period of years. Such a study should include measures of the attitudes and motivations of all employees within the firms as well as measures of the performance of the firms.

II. AN EMPLOYEE OWNED FIRM [11]

This section concerns one firm that was acquired by its employees through an employee stock owners trust. The company was acquired by its employees following a decision by the original owner to liquidate because of a poor profitability picture. The plant's closing would have meant the loss of jobs for its 500 employees as well as an estimated 100 to 200 others whose jobs depended indirectly on the plant. Several of the company's officers, with the backing of the employees arranged to borrow $10,000,000 to purchase the company and to keep it in operation. Half of the borrowed sum came from a revolving account established in the community by the Economic Development Administration as a means of helping to provide employment in the community. The remaining portion was borrowed from other, conventional sources.

Summary

The data that we report in this section were collected approximately 18 months after the acquisition and they came from two sources. First, are data concerning the attitudes and perceptions of company personnel obtained through interviews with 51 randomly selected persons in the company. Second, are data from company records that provide information about profit, worker productivity, absences, grievances, injuries, and other indicators of company performance.

The data from these diverse sources are in large measure consistent in their implication that performance has improved at the company in recent years and that the level of morale and worker motivation has increased since the change in ownership. The causes of improvement cannot be determined with certainty from the preliminary analysis presented here, although the reports of many company personnel, including workers and managers indicate that at least some of the improvement is attributable to the change in ownership and to the employee stock ownership plan. We hope to be able to answer the question of causality with more certainty as additional data become available to us and as more detailed analyses are undertaken.

Employee attitudes and perceptions

Changes in the company since the employee stock ownership plan

Practically all the workers and managers whom we interviewed indicated that the company had changed for the better since the employee stock ownership plan was introduced. (See Table 1.) Improvements in the company described by the respondents fell primarily into several categories (see Table 2.) First, about half of the workers and managers mentioned that the relationships between people had improved and that people worked better together now that they all owned the company. For instance, one worker stated that:

"You have everyone more united . . . and you have a better outlook on coming to work. It seems as if you're working for yourself. You just don't come in and put in your eight hours. It's kind of a psychological thing. You work

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[11] This section was prepared by Michael Conte, Fred Leech, Donna McCulloch, and Arnold Tannenbaum. We thank R. J. Bullock for his help in planning the analysis of the financial data provided by the company. We also very much appreciate the substantial help provided by the officers and employees of the company in making this report possible.

like any other job but it's psychological thing where you are working for yourself like you're in business for yourself."

Another remarked that, "I feel it's more of a family now, more homey. It's a pleasure to work here." One manager put it this way:

"I think we're a closer knit family. There's more feeling of ownership among the employees. Naturally, we still have a few employees we still have got to get that word to, that final convincing that they are owners. Overall, it's been a very healthy change."

Another manager pointed out that a problem that might have been considered a managemet problem, "Now it's everyone's problem."

Second, nearly three-quarters of the managers and close to half of the workers felt that morale had improved and that people were more conscientious about their jobs. For example, one manager stated that, "I think the morale is a lot better than it was before—you've got more of a feeling of personal pride among the workers," and another claimed "the interest of the employees is more noteworthy. Everyone is trying a little harder." One worker felt that:

"The guys are more conscientious about their work. They feel they got to put out a much better product now because that's what's going to make more business for us. They do a little better work now than they did before."

A third category of comments, noted somewhat more by the workers than by the managers, concerns benefits and working conditions. For example, one worker was pleased with the new benefits even though he felt that working conditions had not changed appreciably.

"Yes, now workwise it's about the same in our department, but in benefits it's changed a lot. Really good, really good. I've never had it so good. We get raises more often and bonuses; week's pay; we get turkeys at Thanksgiving and things like that we never had before."

Another worker stated, "Well, I think it has changed drastically because [the former owner], we weren't getting what we're getting now. It's a different ballgame now. It's our company and they're treating us good. They give us bonuses; they us extra checks, you know like vacation. They give us a couple of weeks vacation added in. [The former owner] never did that to us. They took all the money and they claimed they weren't making a profit. So far as the employee-owned is, in my opinion, I like it."

Reduction in waste and absenteeism were mentioned specifically by a number of respondents. For example, one worker said, "Everybody is not so willing to throw a part away anymore which was one of the first signs they cared about the company. Scrap is held to a minimum. A ten minute break is not a 15 minute break where it used to be a half hour or 45 minute break. They're a little more conscious of a lot of small things."

Another person proclaimed, "My particular job is taking care of the scrap and since this last year I noticed the scrap off the machines I picked up as a lesser amount than previously."

A fifth category concerns the future of the company, which according to several workers and managers looks promising. As one worker put it, "There's much more confidence in the future. This is one of main things we have today that we didn't have before."

Finally, a small number of respondents mentioned that employees had more of a voice in the company, and a few indicated that some workers were still suspicious or the communications were not good. Negative comments of this kind were rare.

TABLE I.—QUESTION: HAVE THINGS CHANGED AT THE COMPANY SINCE THE EMPLOYEE STOCK OWNERSHIP PLAN HAS BEEN INTRODUCED . . . ARE THEY BETTER, WORSE, OR ABOUT THE SAME AS BEFORE?

[In percent]

	Workers (N=40)	Managers (N=11)	Total (N=51)
Better	93	82	90
Better in some ways	2	9	4
Worse	0	0	0
No different	5	9	6
Total	100	100	100

TABLE 2.—QUESTION: IN WHAT WAYS HAVE THINGS CHANGED?

[In percent]

	Workers [1] (N=40)	Managers [1] (N=11)	Total [1] (N=51)
More of a united effort; more of a family; it's our company; better relations and cooperation between people and departments; better communications; more shared responsibility	58	45	55
Better attitudes and morale; more interest in work and company affairs; more conscientious; better effort	45	73	51
Better benefits; more bonuses; more pay; improved working conditions; more vacation; holiday turkey	48	27	43
Less waste; less absenteeism	10	18	12
More promising future; more confidence in the future; business is picking up; orders are better; fewer layoffs; in future we should be able to catch up to other plants in wages	13	9	12
Some workers still suspicious; poor communications in some cases	3	9	4
We have more of a voice in the company; participating more	8	0	6

[1] Percentages need not add to 100 because of multiple responses.

Attitude of management toward employees

Managers and workers were asked about the attitude of management toward employees. Nearly three-quarters of the managers interviewed and about half of the workers felt that the attitude of management had changed for the better. About one-fifth of the managers and nearly half of the workers felt that no change had occurred, and small percentages of both groups felt that managerial attitudes were better in some ways but worse in others. None of the respondents felt that attitudes were worse. (Table 3.)

Change in the attitudes of management reported by respondents fall into several categories (Table 4). A fairly high proportion of both groups (64 percent of the managers and 43 percent of the workers) felt that workers were treated better by managers and more like owners and that communication was better. Thus, one worker felt that management was more considerate of him and described some of the consequences of this:

"They listen to our problems more readily. The people on the floor have to work with certain problems all day, week in and week out, year in and year out, and management is beginning to realize that and starting to listen to us where they didn't before, and it's good employee-employer relationships because if you know someone will listen to your problems, you feel more like a human and when you take the dehumanization out of the job, there's more productivity, you're more responsible, you're more willing to work more overtime, and less tension, and it's a pretty good deal all around."

TABLE 3.—QUESTION: HAS THE ATTITUDE OF MANAGERS TOWARD EMPLOYEES CHANGED . . . FOR BETTER OR FOR WORSE?

[In percent]

	Workers (N=40)	Managers (N=11)	Total (N=51)
Better	53	73	57
Better in some ways, worse in others	2	9	4
Worse	0	0	0
No different	45	18	39
Total	100	100	100

TABLE 4.—QUESTION: IN WHAT WAY HAS ATTITUDE OF MANAGERS TOWARD EMPLOYEES CHANGED?

[In percent]

	Workers[1] (N=40)	Managers[1] (N=11)	Total[1] (N=51)
Better communications; workers treated as owners; more consideration; we work better together; more cooperation	43	64	47
Workers have more of a voice in decisionmaking; management doesn't give "orders" anymore; management goes to workers for ideas	3	36	10
Management has given worker better benefits, working conditions, and equipment	10	0	8
No change: we've always gotten along; it was always good and still is	8	9	8
No change: management has not improved in attitudes toward workers; management is management and workers are workers; the hierarchy is still the same	8	9	8
Management is tighter/stricter around the shop	3	0	2
Workers can be too assertive	0	9	2

[1] See footnote, table 2.

to say because they've always been nice and cared about the employees. . . ." The other group made comments suggesting that the old hierarchy was still there and that management was management and labor was labor. One worker expressed his dismay with this, stating:

"No, I don't believe so, it's still the same. That's one thing that disappoints me. Because there seems to be still that dividing line where I don't think it should be. Well, it should be to an extent, but not the same as it was. Well, like they're still working for the conglomerate, and we're still more or less union."

On the negative side, one manager suggested that workers were getting too assertive and one worker complained that managers were stricter around the shop and wouldn't give him everything he wanted anymore.

Attitude of employees toward management

Respondents were invited to comment about changes in the attitude of employees toward management. A majority of both groups felt that employee attitudes had improved. (Table 5.)

Table 6 provides a categorization of the changes indicated by respondents. 45 percent of workers and managers felt that working relationships between the two groups were improved in that better communication, more confidence and respect for managers and improved teamwork prevailed. One worker stated:

"The attitude of employees toward management now is not so negative, not so resentful of the authority they have. They figure whatever they're doing is for our success as a whole rather than money in the pockets of the higher-ups."

Another worker commented, "They think we're more human, at least to do the right thing . . . we feel like we're partners now and want to keep it that way." One manager saw a change in employee attitudes in this way:

"Morally speaking or philosophically, they realize that we can all see we're working together and the distinction between the two—i.e., "they're the bad guys and we're the good guys'—that's been changing."

TABLE 5.—QUESTION: HAS THE ATTITUDE OF EMPLOYEES TOWARD MANAGEMENT CHANGED—FOR BETTER OR FOR WORSE?

[In percent]

	Workers (N=40)	Managers (N=11)	Total (N=51)
Better	58	55	57
Better in some ways, worse in others	5	0	4
Worse	2	18	6
No different	35	27	33
Total	100	100	100

TABLE 6.—QUESTION: IN WHAT WAYS HAS THE ATTITUDE OF EMPLOYEES TOWARD MANAGEMENT CHANGED?

[In percent]

	Workers[1] (N=40)	Managers[1] (N=11)	Total (N=51)
We work better together, more of a team; better communication; better, friendlier relations; more confidence and respect; better cooperation	45	45	45
Workers take on increased responsibility; they try to solve things before they go to managers; management is more conscientious; trying harder	8	18	10
Workers have more say in decisions; workers can get results from their decisions	5	9	6
No layoffs	3	0	2
Some workers are still suspicious of management; fear that management is getting a bigger cut of the shares; management is still management and workers are still workers	10	27	14
Miscellaneous	15	27	18

[1] See footnote, table 2.

Another manager stated: "We seem like we're working more as a team, where before it was always union and management, now it's almost like all owners. It's all teamwork, and I notice that people go over and help each other now where in the old days they used to say, 'hey, find somebody to help that guy.' Now, a man has a problem, three or four fellows come over and help him."

Another group of respondents (18 percent of the managers and 8 percent of the workers) felt that workers were taking on increased responsibilities or that management was more conscientious. One manager proclaimed that, "They're willing to accept some of our problems, and they're trying to help solve these problems before they even come to us." A worker remarked, "Oh yeah. They're trying to make the product better so they can sell it. Before it was like [the conglomerate] was in charge."

Some of those who felt that employees' attitudes toward management had remained the same or worsened expressed the opinion that workers were suspicious of management or that workers felt that management would come out with most of the shares. One manager elaborated upon this problem, stating: ". . . there is the suspicion of empire building. The prime thing is the way the shares are being divided by salary and they have the idea that the higher positions and management will come out with the majority of the shares. We've proved that management will come out with 33 percent and that the union will come out with 66 percent, but it's very difficult to convince these guys and they're still very suspicious. But I think this will change—you will change them when they receive two or three bonuses, etc., i.e., something they've never had before."

A worker confirmed this manager's opinion, stating, "Well, some of them think that management gets a little better deal out of ESOP than they are. They're thinking moneywise to theirself. They figure that because management makes better wages, they're gonna get a big cut out of the share, I guess."

Other causes for suspicion included the union problem and the fact that many workers lost their pension when the ownership changed from conglomerate to workers. This was especially problematic for some senior employees who had accumulated substantial equity in the pension plan under the former owners, but who did not have quite enough seniority to claim their pension rights at the time of the transfer of ownership—but they would have lost those rights in any case had the company been liquidated. One worker described some of these problems:

"It's still a little bit suspicious. They don't know how far management will go. We still have a union problem here and we don't know how it will go. These older persons who lost out on the pension are in bad shape. We don't know how that is going to go."

Attitude of employees toward their work

When asked whether employees' attitudes toward their work had changed most respondents, workers and managers alike, reported an improvement. (Table 7.) A high percentage of both groups (36 percent of the managers and 50 percent of the workers) mentioned that workers were interested in their jobs because they felt they were working for themselves or that company success was a

result of their efforts (Table 8). Thus, one manager claimed, "They feel a little bit more responsibility for quality workmanship, being it is their own company." Another manager described how reward depends on performance, stating:

"We know what we sell it [the product] for, and we can say, 'okay, fellows, every time one of those go out it's $8,000 profit,' and you're back to dollars again and you're talking language they can understand and by doing this, you can get a little more enthusiasm out of the guys."

Some of the workers made similar comments. Regarding the feeling of ownership, one stated, "I seem to think I want to get it out better than I did because I know it's for me." And another remarked, "I think we're getting a little better work out of people now. Now we got something to work for. Before we were working for a company. Now we're working for ourselves."

In the same fashion, another claimed, "Well, now everybody is more or less in making money for themselves. It's their work, not just the company's. Before the money was going into somebody else's pocket. Now it's our own."

TABLE 7.—QUESTION: HAS THE ATTITUDE OF EMPLOYEES TOWARD THEIR WORK CHANGED . . . FOR BETTER OR WORSE?

[In percent]

	Workers (N=40)	Managers (N=11)	Total (N=51)
Better	83	91	84
Better in some ways, worse in others	0	0	0
Worse	2	0	2
No difference	13	9	12
Not ascertained	2	0	2
Total	100	100	100

TABLE 8.—QUESTION: IN WHAT WAYS HAS THE ATTITUDE OF EMPLOYEES TOWARD THEIR WORK CHANGED?

[In percent]

	Workers[1] (N=40)	Managers[1] (N=11)	Total[1] (N=51)
Workers feel that they are working for themselves; realize that their salary is contingent upon their performance; workers have more interest in their jobs; company success is a result of their effort; better atmosphere	50	36	47
More conscientious; trying harder; putting more time in; not as much goofing off; less absenteeism	35	27	33
More precision; better quality of work; less waste	25	36	27
Worker making more money; getting ahead better	8	0	6
Greater quantity of work; higher productivity	3	9	4
More teamwork; workers help each other more	0	9	2

[1] See footnote, table 2.

About a quarter of the managers and a third of the workers mentioned that employees were more conscientious and were putting in a greater effort. One manager stated that "They're more conscientious in what they do and how they perform." The workers expressed much the same opinion with one stating, "There isn't as much goofing off as there used to be" and another commenting, "As far as I can see, I'd say I know my attitude has changed. I feel more conscientious about my job and I want to do my job to the best of my ability. I can't really speak for a whole lot of other people but the ones I talk to seem to be more conscientious about their jobs. I'd say yes, their attitudes have changed for the better."

About one-third of the managers and one-fourth of the workers felt that this extra effort was paying off in terms of better quality of work and decreased waste. One manager replied, "The large percentage of the employees are more cost conscious, more scrap conscious, and are trying harder not to run scrap and still maintain a high level of earnings."

One worker put it bluntly, stating, 'We're a little more careful about what we do and how much [we] waste. It's our money now." and another made a similar remark, "They're trying to put out good parts. If we don't run good parts, it's going to hurt us, come right out of our pocket." A third stated, "They're doing a better job all around now, Like piece work jobs—they're not rushing right through because they don't want to get it back."

Smaller numbers of managers and workers mentioned other changes in the attitudes of employees toward their work. Some felt that "their production was on the better side." Others thought that there was more of a team spirit and that workers were helping each other out more. Thus one manager commented:

"They're working more as a team now . . . If a guy's got a problem, everybody used to sit back, and say 'I'm glad it's not me.' Now they feel just the other way around. It's us now."

Some workers felt that employee attitudes toward work had improved because the employees were making more money and getting ahead better.

Change in the way decisions are made

While the employee stock ownership plan had strong effects on the attitudes of the respondents, it appears that the decision-making structure has not changed very much, according to most respondents. When respondents were asked whether there had been any change in the way decisions that affected them were made, a majority felt that there had been no change. (Table 9.)

Eighteen percent of the respondents, however, felt that they had more say, and that they were consulted about major decisions, that they were not given orders, or that formal channels, such as representation on the board of directors or employee votes, provided a means of participation in decision-making. One supervisor expresses this sentiment well, stating:

"As far as major decisions, I think we have more of a say as far as suggesting what might be done. We're allowed to put in our suggestions and they're heard, and management, upper management, is not afraid to listen to us, and they're willing to sit down and listen to an idea if we've got one. I know that if we go back and say this is the way it should be done, well, they come back and say, 'Well, you show us how it should be done.' It's a lot different than it was before. I think before, upper management just did it and that was it and I've been in all the way from the union up to management and I think it's changed. I think we have more of a say."

A worker felt there was a change in his foreman's order-giving behavior:

"I'm working as a fork lifter now. Instead of telling the guys, they ask the guys, they ask the guys in a sort of round about way that they're not forcing the person to do something and I feel it helps us in better relations between the management or even the forman and the driver. I'll be walking around and one of the foreman may ask me to do something and he'll say when you get time and I'll say I got time now. I'll do it. I got that attitude. I like to do it. It's good."

TABLE 9.—QUESTION: HAS THERE BEEN ANY CHANGE IN THE WAY DECISIONS THAT AFFECT YOU ARE MADE?

[In percent]

	Workers[1] (N=40)	Managers[1] (N=11)	Total[1] (N=51)
No change	63	55	65
We have more say; they ask for our opinion before making major decisions; they listen to us more; more equality; they don't give orders; we have representatives on the board of directors; they take employee votes	18	18	18
Attitudes of management better; they are for the worker	10	0	8
Decisions made by local personnel, not conglomerate	0	9	2
We may have more say in the future; will have more say when we own more stock; drastic changes take time	5	9	6
Decisions that were made by me are now made higher up; management used to set the pay scale, now the board does it	0	18	4
Workers have less say now, before we had a union even if it was weak	3	0	2

[1] See footnote, table 2.

Another worker concentrated on the more formal aspects, stating:

"Now, if we've got something major, more or less, they come to us and get our opinion first and see how the guys feel about it around here. Some things they don't ask us, but most of the major stuff they ask us first. Well, they ask us like if we wanted to change the incentive program around a little bit on piece work and they sent out pamphlets and explained everything and asked our opinion of it and we could either vote yes or no or leave some other kind of answer. It was left up to us what we wanted to do with it."

A small number of managers and workers felt that although there were no changes now, they would have more say in the future, especially when they owned more stock and had some experience with participation. In this fashion, one manager stated:

"Again, I think it will be a certain period of time. They want to make certain changes but you have to learn to walk before you can run. This is the wisest move. This is what the Board of Directors is trying to do."

One of the workers gave his viewpoint, stating:

"Well, I don't think there is [a change] yet. There supposedly is supposed to be within the next three years I think it is. Well, they might listen to certain ones more now than they did about ideas and ways of doing things better. But in time, it's supposed to be to the point where we all have a say-so, if we have an improvement to make or something."

Another worker explained this in terms of percentage of stock owned:

"I'm looking at it from long range. Right now we really don't have any input, and say, because at this point, I feel we have a small percentage of the stock. Until we are in 100 percent of control then we will have more input and can have more control."

A small number of managers indicated that they had more say because decisions were currently made by local personnel rather than by the conglomerate. Others, however, felt that decisions were made at a higher level than before and that some of the decisions that were previously made by them were made higher up. One such manager commented, "Well, now in our pay scale and like that, where it used to be a management problem, now the board settles it."

A small number of workers remarked that they might have more say now than before because the attitude of their managers was better and that they were for the workers. Others stated that workers have less say now because they no longer have their union. One of these workers stated:

"No, they're still made the same; management makes them. Sometimes I think we got less say now. Well, before they had a union, but we didn't feel we was getting much out of it, but we could hide behind them, for all the good it did. . . There would be like one or two guys from the union, which maybe tended to go the other way from the worker's point of view, would try to help, see what they could get out of it, which wasn't usually too much. But now since we just about don't have one, it's not that much to hide behind, so that they just take over."

General opinions of the stock ownership plan

When asked how they felt about the stock ownership plan, most respondents reacted favorably. Many of them commented specifically upon the benefits they had received and the feeling of togetherness and ownership it had created and expressed a favorable outlook for the future. Of the small group who gave negative or mixed answers, some complained that the money was divided up unfairly, that they did not have the influence that they should have or that they lost their pension in the change of ownership.

Again the answers of managers and workers were similar to one another. (Table 10.) Respondents (82 percent of the managers and 77 percent of the workers) made positive statements about employee stock ownership. As far as specific remarks are concerned nearly three-quarters of the managers and one-third of the workers drew attention to the improved benefits and working conditions that accompanied the plan. As one worker put it, "It feels okay. We do get bonuses we didn't get before. I worked for 27 years and never even got a turkey at Thanksgiving. Now we get bonuses and vacations, we never got those things before. It's okay now. I like it."

TABLE 10.—QUESTION: HOW DO YOU FEEL ABOUT THE STOCK OWNERSHIP PLAN?

[In percent]

	Workers (N=40)	Managers (N=11)	Total (N=51)
General tone of comments:			
Positive—I like it, a good idea, an improvement, things are better	77	82	78
Mixed—I like some things about it but not others; better in some ways, worse in others	10	0	8
Negative—I don't like it, it doesn't really give you influence, unfair, things are worse	13	18	14
Total	100	100	100
Specific remarks:			
Better benefits; better retirement provision; bonuses; better pension; more vacation; holiday turkey; improved working conditions; shares divided up fairly	[1] 35	[1] 73	[1] 43
We're all working together; it's good to be a part of something; working for yourself, you work harder and care about what goes on; better relations; better atmosphere	23	45	27
It has real possibilities; it will get even better in the future; they will improve it; will be more of a feeling of ownership in the future when employees get more stock	20	36	24
I have a job now because of it; it's worth it to stay with the company rather than to get another job	10	9	10
Financial gains for the company	3	9	4
Contingent answers: depends on business and outlook; if everyone is behind it, it will work; if problems get worked out, will be good; if it stays solvent as long as we make money	15	0	12
I lost my pension in the changeover; lost my seniority	10	9	10
Stock ownership does not necessarily give one influence; workers don't feel they have influence	0	18	4
Don't like the way the stock is divided/money handled; shouldn't have to put $1,000 in; stocks should be equally shared—not based on your salary; shouldn't have to wait 10 years to take money out	13	[illegible]	10

[1] See footnote, table 2.

Another worker commented, "I like it. In the first year what I've gained it took me 21 years on the previous pension plan and I contributed to that and look what I got in one year plus all the other benefits—bonuses two years in a row, turkey for Christmas, an extra week for vacation and an extra week at Christmas."

A manager felt that the pension plan provided was superior to ones he had previously encountered:

"If it works out like it's supposed to, I think it's a pretty good deal. It gives a guy, where normally he has to work 30 years to draw a pension, he can now work 10 or 15 years and [if he] left, he would at least still get something."

Another fairly large group of respondents (45 percent of the managers and 23 percent of the workers) made remarks about the change in atmosphere at the company, and how the feeling of ownership created a spirit of togetherness and a desire to work harder. Thus, one worker commented, "I think stock ownership makes a person want to do the best he can because it's for his own good. When you're treated right, you want to do right."

In a similar fashion, another worker commented, "I feel as though it's something new when I come through the door. It's something I do for me. Everyone else is working for me too. We, as employees, were so fortunate to have a man like [the president.] He worked real hard and seemed to care about us all here."

One of the managers gave a somewhat more elaborate description of the effects of the feeling of ownership:

"Let's assume that somebody locally just bought us out. I don't think that the morale would be as high as it is now. I would still be of that opinion, that I'm working for somebody else, [that] I'm not working for myself . . . [but] right now you're working for yourself really. With ESOP, for instance, if I were working for [another company] down the street here, they had bought us, we really wouldn't be worried too much about how much we spent for this and how much overtime we put in here, but now being ESOP you start looking at your watch and say, 'gee, I'm working too much overtime and that's taken out of my over-all, that's taken off the top of the cream there and I don't like that.' So you have a little more pride and you're a little more conscious of what happens whereas if somebody else owns you, you're just not conscious of it. You just don't have that feeling. It's their money."

Other respondents (36 percent of the managers and 20 percent of the workers) focused upon the favorable outlook for the future and expressed their conviction that the plan will be improved even more. One worker briefly stated, "I'm in favor of it. In the long run it will pay off for us. Say ten years from now. So far we've been doing pretty good." Similarly, one manager remarked, "I think it will snowball as it improves and it will improve more." And another stated:

"After three years when employees actually have in their possession shares of stock that they know is their's and a percentage of it that even if they leave the company and they can figure out what that percentage will be, that's when your real feeling of ownership will be there. I'm certainly hoping for it."

Smaller numbers of managers and workers cited the fact that they still had jobs (9 percent of managers and 10 percent of workers) or that the company was making financial gains (9 percent of the managers and 3 percent of workers) as evidence of the plan's success. As one worker commented:

"I'm very glad we got it or otherwise we'd be out of a job. I don't know how it will affect us in the future or anything like that, but we do have jobs. Otherwise we wouldn't have jobs. We'd be looking for jobs."

In addition, a number of workers (15 percent) gave contingent answers, i.e., they would like the plan if it succeeded and if certain conditions are met. As one commented, "I think it's a good idea. If everybody gets together on this thing and puts 100 percent into it, it's all going to come back on us. It will work out for us people, if it works out, but it's got to be a 100 percent deal, You can't have 80 percent for it and 20 percent not."

On the negative side, some respondents commented on their hard feelings over losing their pensions or that they were not as influential as they felt they should be or that they felt that the money was unfairly divided.

A small percentage of both workers and managers expressed bitterness over the loss of their pensions when ownership changed hands. One worker stated, "Of course the only thing I can complain about is the pension. I got 25 years and no pension. They tell me I'm too young to get a pension. I can't go back 25 years and start again . . ."

A manager echoed this statement: "I lost my pension on the old plan and I'd like to see it work because it means a lot to me. I was here 22 years. I know it's a selfish reason but everybody's in the same way."

Some managers and supervisory personnel (18 percent) pointed out that stock ownership and increased influence do not necessarily go hand-in-hand. As one stated, "Stock ownership does not really give stock owners influence in the company. Today it's a one man corporation—the president. He appoints the board of directors. The board of directors appoints the employee trust committee. It's one continuous circle. After 15–18 years when voting rights are vested, the shareholders will have appreciable influence. I am a bit skeptical of the ability of management to change. The Bank will not make management change. This is not a criticism of ESOP; it's a comment about the company."

Some workers (13 percent) were critical of the actual financial operation of the plan and felt that management and certain types of workers were getting a disproportionate number of shares. One worker had a number of complaints:

"I don't like the way it's set up. You got to put $1000 in before you're eligible to participate, plus stock shares are based on the amount of money you make, which I don't think is a fair way of doing it. I'd rather set it up for amount of hours at work rather than amount of money—i.e., it should be an equal sharing. If you are a lower paid day worker rather than a piece worker, it's not fair. You got the same amount of responsibility. It takes everybody to do a job. I don't think it's a fair way of doing it. Also, at the age of 65, you can't call it profit sharing. All it amounts to is a retirement plan at 65. You retire or don't live to see it. It should be after 10 years, it should be 100 percent vested and you should be able to take that money out. After all, it is your money."

This worker may be revealing a misunderstanding of one aspect of the plan when he states that $1000 is required for eligibility. According to company officers, the plan prohibits that persons can "buy into" the plan. Another worker also complained about the way the stock is distributed, but he acknowledged that he did not really understand the plan:

"I feel all right about it, if we could make sense out of it. The way they spell it out, we don't know how much money we got, how much stock we got, or what they do with our stock after they have got it, which I suppose they do send us some machinery and different things, but how that works don't make too much sense to me. They don't spell it out clearly like an ordinary person could make

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sense of it. To them it probably does. To us it don't make sense. Unless we take it to a lawyer and have him figure it out and they cost you money. Well, I'm dissatisfied in a few ways. Like they said there's 12 people gets two-thirds of it. Well, that is wrong, because they're getting the highest wages to begin with. I still say, whatever profit come in through the back door should be split equally among the men plus the supervision. Not that they get a bigger share than the rest of us, and not to go by wages because wages vary, fluctuate quite a bit. Now, like me, I'm mostly on day work. All right, I'd be the one that would collect the smallest amount and I put out the same production as the other guys. That's where it hurts the smaller man with smaller wages. Where you're on piece work you can make your $60 a day and that's what they go by, the average of it. So where I make maybe $35, $40 a day, so I'm losing money."

This reaction may illustrate how some misunderstanding can arise when complex information is communicated to a large number of persons. It may also illustrate a real difference in point of view between at least some persons within the plant.

Company performance

The morale and motivation of company personnel has improved as a result of the ownership plan, according to employees. According to these persons, employees are working more efficiently and more carefully because of the plan and they are contributing in this way to the success of the company. In fact, a number of measures of company performance based on company records to indicate improvement in recent years, although we are not able to determine from the available data how much of the improvement is attributable to the ESOP itself. The purchase of the company by employees was attended by other significant changes, including the establishment of an independent corporate identity, and some turnover in high level personnel. Each of these changes may have had an effect on corporate performance, quite apart from the ESOP itself. For example, according to some company officers, decision making has been facilitated and made more effective because decisions that had heretofore been centralized at conglomerate headquarters are now made within the plant itself. Furthermore, a number of significant changes in company strategy regarding marketing, production, and accounting were introduced along with the change in ownership. These strategies and some of their implications include:

Reduction in the backlog of orders which the company was having difficulty meeting efficiently and the elimination in that backlog of under-priced items.

Stabilization of monthly sales.

Decrease in the average collection time for accounts receivable.

Reduction in annual insurance premiums (for the same degree of coverage).

Purchase of a small new division.

Profit is one index of company performance. The years 1970 through 1975 were periods of loss for the company. The earlier years in this period, however, were difficult for the industry as a whole. Domestic new orders fell drastically in 1969 and did not rise to their previous level until the early part of 1973. The company did not do much worse than average for its class in 1972. In 1973, however, the industry in general returned to previous levels of profitability, while the company did not. The company did not move into the black until after the employee takeover. Monthly profit (net income before taxes) since that time has been consistently positive and the flow of profits has been stable.

The productivity of workers on jobs that have time standards appears also to have increased since the change in ownership and this increase in the amount of work turned out by each employee has not occurred at the expense of the quality of that work as measured by the rate of returns of the product from customers. The rate of these returns has gone down compared to the pre-ESOP period. Furthermore the expense associated with the use of perishable tools per sales dollar has also shown improvement, although labor costs per sales dollar has not changed noticeably since the initiation of the ESOP, perhaps because increased productive efficiency is partially compensated by increased pay for those employees who are working on incentives.

Two indices of employee behavior that are relevant to company performance, the rate of grievances and the turnover rate of salaried employees,[13] have also shown favorable change since the ESOP was installed, but absenteeism and accident rates have not changed one way or the other. The available measure of

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[13] Data concerning non-salaried employees are unavailable from company records.

absenteeism may be problematic, however, since it is based on person-days lost rather than on the number of absences that have occurred. The former is heavily influenced by a few persons who have serious long term illnesses and it is not sufficiently sensitive to the effect of "problem" employees who are absent often but for very short periods of time. Data concerning the latter type of absenteeism are not available in the records.

Conclusion

The company appears to have experienced a recovery in recent years according to a number of attitudinal, behavioral, and economic indicators. It is not possible in this preliminary analysis, however, to provide a definitive explanation of this recovery or to attach specific weight to the ownership plan itself. Some of the data do indicate that the plan is having positive effects, both direct and indirect. Yet the company has operated during earlier periods (prior to 1969) at levels of profitability as high if not higher than current levels. Furthermore, we cannot say on the basis of this limited analysis that the company is performing better (or worse) than other, traditionally owned companies in its industry.

Perhaps the most unequivocal support for the effectiveness of the plan comes from the employees themselves, who indicate through interviews an unusually high level of morale, motivation, and commitment to the success of the company. The transition to employee ownership is not yet complete (the passing on of voting rights is scheduled to occur in several years) and the effects of employee ownership whether positive or negative are therefore not yet fully realized. Nonetheless, given the very positive attitudinal and motivational climate, and the demonstrable success of the company at present, there is reason to expect that performance will continue at present levels at least, barring a serious decline in the market for the company's product.

The Final ESOP Regulations— A Return to Certainty

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The Final ESOP Regulations—A Return To Certainty

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[¶ 1073] On the third anniversary of the enactment of ERISA, the Internal Revenue Service and the Department of Labor released their final regulations relating to the definition of "employee stock ownership plan" and the requirements for ESOP loans.[1]

In their proposed form, the ESOP regulations were extremely restrictive.[2] Interest in the ESOP concept dropped off accordingly. However, between the issuance of the regulations in proposed form on July 30, 1976 and their final publication on September 2, 1977, the regulations underwent substantial revision. With the most troublesome provisions now either deleted or greatly modified, it is safe to predict that there will be a renewed interest in the ESOP.

The change of heart by the IRS and the Labor Department reflects the strongly adverse Congressional reaction to the ESOP regulations in their proposed form. After the passage of four pieces of legislation favoring the ESOP and "ESOP financing," it was hardly surprising to find the Congress highly displeased by the extreme restrictions that the agencies had proposed for the "leveraged ESOP." Section 803(h) was inserted in the Tax Reform Act of 1976 as a statement of Congressional concern ". . . that the objectives sought by this series of laws will be made unattainable by regulations and rulings which treat employee stock ownership plans as conventional retirement plans, which reduce the freedom of the employee trusts and employers to take the necessary steps to implement the plans, and which otherwise block the establishment and success of these plans."[3]

In an unprecedented commentary on administrative policy, the underlying Conference Committee report specifically dealt with twelve areas of particular concern and provided a detailed outline of "instructions" for the redrafting of the regulations that would otherwise "frustrate Congressional intent." For the most part, the final regulations closely follow the suggestions made by the Conference Committee.

The significance of the final regulations is that they bring a more certain and a more realistic approach to the ESOP concept. The ESOP may now clearly take advantage of ERISA's "ESOP loan exemption"[4] to finance the purchase of employer stock for the benefit of employees. With Congress strongly supportive of the underlying purposes of the ESOP, it's clear that an ESOP may now be used with confidence as a technique of corporate finance to accomplish certain corporate objectives, while granting employees access to the ownership of employer stock.

The History of the ESOP: Although the past five years have witnessed a steadily growing interest in the ESOP, the history of the ESOP as a financing concept goes back much further. The stock bonus plan, the basic nucleus of the ESOP, first received Congressional recognition for tax exemption under the Revenue Act of 1921.[5] In 1953, the Internal Revenue Service, through its publication of Revenue Ruling 46, first recognized the use of a qualified employee trust to borrow funds for investment in

the sponsoring employer corporation.[6]

Congressional legislative recognition of the ESOP is first found in the Regional Rail Reorganization Act of 1973,[7] which defined the ESOP as "a technique of corporate finance." ERISA provided further definitional criteria[8], thereby encouraging the ESOP's use, as did the Trade Act of 1974.[9] More recently, the ESOP concept has evolved into a close cousin, the TRASOP, through expansion of the investment tax credit provisions under the Tax Reduction Act of 1975 and the Tax Reform Act of 1976.[10]

It is the underlying purpose of the ESOP that best distinguishes it from other types of deferred compensation plans. Thus, any practitioner in this field should have some sense of the ESOP's underlying philosophy as a financing vehicle if he is to ably and confidently advise clients regarding its use.[11] Under ERISA, the ESOP is defined as a plan "designed to invest primarily in qualifying employer securities."[12] And, as the IRS had earlier pointed out in Revenue Ruling 69-65, the purpose of a stock bonus plan is ". . . to give the employee-participants an interest in the ownership and growth of the employer's business."

Thus, a stock bonus plan is exempt from the requirement for a "fair rate of return" with respect to an obligatory investment in employer stock. Indeed, ERISA specifically recognizes that certain types of "employee pension benefit plans" may have objectives other than that of providing employees with retirement income.[13] Further, as opposed to a pension plan, the Income Tax regulations do not require that a stock bonus plan (or a profit-sharing plan) be designed to provide retirement benefits; rather, retirement is merely one of the events that can trigger the distribution of benefits to participants.[14]

The Proposed & Final Regulations: In their proposed form, the regulations would have had a "chilling effect" on the use of the leveraged ESOP. The proposed regulations failed to adequately reflect the intent of Congress that the ESOP retain its usefulness as a "technique of corporate finance." Under both the Trade Act of 1974 and the Tax Reduction Act of 1975, the Senate Committee on Finance had clearly indicated that the ESOP could be used by a corporation to finance new capital growth and transfers of ownership by incurring loans (or other extensions of credit) secured primarily by the credit of the corporation. The very purpose of ERISA's ESOP loan exemption was to permit the debt-financed acquisition of employer stock from the employer (or from existing stockholders) while building beneficial ownership of such stock into employee participants.

The Conference Committee report accompanying the Tax Reform Act of 1976 indicated Congressional concern that the proposed restrictive regulations would ". . . make it virtually impossible for ESOPs, and especially leveraged ESOPs, to be established and function effectively . . ."

Included among the strict requirements which led one Senator to refer to the proposed regulations as "bureaucratic frustration,"[15] were a prohibition against rights of first refusal, a requirement that voting rights be exercised by employees, the requirement of approval of an ESOP loan by an "independent fiduciary," stringent limitations on the classes of employer stock acquired by an ESOP, complex release and allocation provisions, burdensome requirements for put options, strict limitations on repayment terms and default provisions of ESOP loans, and an expansion of the situations in which the sale of employer stock to an ESOP would be characterized as a corporate redemption.

The response of the agencies to the Congressional criticism was slow, but sure. The final regulations, issued more than thirteen months after

they were proposed, accept the underlying concept of using the ESOP as a special type of employee benefit plan designed to be utilized also as a financing device for the benefit of both employees and the employer corporation (as well as its shareholders). The final regulations focus on two primary areas: (1) the ESOP definition and the requirements of "ESOP" status: and (2) the requirements and conditions under which the ESOP will satisfy ERISA's "ESOP loan exemption."

The Requirements of "ESOP" Status: The stock bonus plan is defined in the Income Tax regulations as ". . . a plan established . . . to provide benefits similar to those of a profit-sharing plan, except that the contributions . . . are not necessarily dependent upon profits and the benefits are distributable in stock of the employer company."[16] The regulations require that an ESOP be formally designated as such in the plan document.[17] In addition, the ESOP must specifically provide that it is "designed to invest primarily in qualifying employer securities."[18] When one considers that an ESOP has the special purpose (as an employee benefit plan) of providing the benefits of stock ownership to participating employees, the "primarily" language of the ESOP makes sense.

The requirement that an ESOP be invested "primarily" in employer securities appears to be more of a qualitative standard than a strict, percentage-oriented quantitative test. The regulations fail to specify any minimum portion of the ESOP's assets that must be so invested. In fact, to require any such investment in employer stock would raise potential fiduciary problems under ERISA Section 404 regarding the prudence of such acquisitions. It appears that the "primarily" requirement relates to the purpose and objective of acquiring stock ownership for employees and is not a requirement of a specific percentage investment in employer stock at all times.

The ESOP, as defined under Section 4975(e)(7) of the Code and Section 407(d)(6) of ERISA, is a qualified stock bonus plan (by itself or in combination with a qualified money purchase pension plan) and which otherwise meets the regulatory requirements. The ESOP (including the money purchase plan portion) is included in the definition of "eligible individual account plan"[19] for purposes of ERISA's exemptions from the general diversification requirement[20] and the ten percent limitation on the holding by a plan of qualifying employer securities.[21] Under section 407(d)(3)(B) of ERISA, an ESOP must specifically state the extent to which plan assets may be invested in qualifying employer securities.

The exemption of the ESOP from the diversification requirement (to the extent that it invests in employer stock) does not, however, imply a waiver of other elements of the prudence requirement. However, the prudent man rule is measured by keeping in mind the ESOP's special purpose. Thus, prudence is evaluated in the context of the "conduct of an enterprise of a like character and with like aims."[22] This view finds substantial support both in ERISA and in Section 803(h) of the 1976 Tax Reform Act.

The final regulations add very little to the ESOP definition that is not already required for conventional stock bonus plans (with several exceptions that will be noted below). It should be remembered that the final regulations do not apply to stock bonus plans which are not ESOPs. Consequently, there appear to be but three reasons for a plan to be designated as an "ESOP":

1. To utilize the financial advantages of ERISA's "ESOP loan exemption" for acquiring employer stock.

2. To enable a money purchase pension plan (combined with a stock bonus plan) to invest more than ten percent of its assets in qualifying employer securities (unless the plan was so invested prior to ERISA.)[23]

3. To take advantage of the special increased dollar limitation on annual additions under Code Section 415(c)(6).

Combinations and Conversions: The final regulations specifically provide that an ESOP may be combined with a qualified pension, profit-sharing or stock bonus plan which is not an ESOP.[24] Such a combination can be advantageous for ease of administration and for consolidating the reporting and disclosure requirements of ERISA, as well as for presenting participants with a single plan providing various types of benefits.

In combination with a profit-sharing plan, the ESOP attains greater flexibility both in its investments and in the form in which distributions can be made. When combined with a conventional stock bonus plan, the stock bonus plan which is not an ESOP will not be subject to the ESOP requirements of the regulations.

The regulations permit an existing pension, profit-sharing or stock bonus plan to be converted into an ESOP. However, the fiduciary rules of ERISA and the "exclusive benefit of employees" requirement of the Code will apply to any such conversion.[25]

As the regulations point out, one must also be cautious lest a conversion constitute a termination of an existing plan.[26] Where the assets of an existing plan are comprised of a diversified portfolio of investments, conversion to a portfolio invested primarily in employer stock may present serious problems under ERISA's fiduciary rules. One should proceed with great caution in this area.[27]

The regulations prohibit an ESOP from being considered together with another plan for purposes of satisfying the nondiscrimination requirements of the Code, unless both plans were in existence on November 1, 1977.[28] An exception is also provided where both plans are ESOPs which include substantially the same proportion of various classes of employer stock. The Conference Committee report under the 1976 Tax Reform Act specifically endorsed this approach.

Allocations: The regulations indicate that the requirements applicable to profit-sharing plans and stock bonus plans are generally to be followed when making allocations to the accounts of ESOP participants.[29] Thus, the ESOP must include a definite allocation formula that does not result in the discrimination prohibited by Code Section 401(a)(4).[30] The regulations further provide that the cost basis of employer securities under the ESOP be accounted for (in order to determine the net unrealized appreciation attributable to such securities).[31]

As proposed, the regulations attempted to provide for allocation of debt financed stock under a leveraged ESOP as provided in Section 273(f)(4) of the Trade Act of 1974. In simple terms, the Trade Act formula provides for the annual "release" of stock from the suspense account for allocation purposes based upon the ratio that the current year's payments of principal *and* interest bear to the total payments of principal *and* interest over the duration of the loan (i.e., the interest element of the loan payments is "capitalized"). The purpose of the Trade Act method is to counteract the inequitable effect of the relatively high proportion of early debt payments used to pay interest and the relatively high proportion of later payments utilized to retire principal.

The proposed regulations would have required that leveraged stock be "released" and allocated in equal annual amounts over the term of the

loan. The Conference Committee report under the 1976 Tax Reform Act noted that the proposed method was "not in accordance with common business practice" and suggested that the allocations should be permitted by "a formula more similar to that provided for ESOPs in the Trade Act of 1974."

In their final form, the regulations provide two methods for allocating debt financed stock to participants' accounts.[32] Both methods provide for the creation of a "suspense account" for debt financed stock, with stock to be "released" from the suspense account and allocated as loan payments are made by the ESOP. Such stock is thusly allocated regardless of whether or not it has actually been pledged to the lender as security for the extension of credit to the ESOP.

The first release method follows the Trade Act formula whereby stock is allocated only as principal and interest on the loan are actually paid by the ESOP. This method takes into account that loan payments may vary for a number of reasons (including variable interest rates, which are now permitted under the final regulations). This method also permits the "refinancing" of an ESOP loan without an acceleration of stock allocations. Once "released," shares are to be allocated among the accounts of participants under a definite, predetermined allocation formula.[33]

Under the alternative allocation "release" method, one looks solely to principal payments on the ESOP loan. In order to use this method, the terms of the loan must meet three special criteria:

1. The loan must provide for annual payments of principal and interest at a cumulative rate that is not less rapid at any time than level annual payments for ten years;

2. Interest included in any payment can be disregarded (for "release" purposes) only to the extent that it would be determined to be interest under standard loan amortization tables; and

3. The alternative method cannot be used if the term of the loan exceeds ten years by reason of a renewal, extension or other refinancing of the loan.

This second method can be used for ESOP loans of ten years or less which provide for repayment on a level (or faster) annual basis. Where interest only is payable in early years, or where earlier year payments total less than 10% of the total payments of principal and interest over the term of the loan, this formula cannot be used. However, the ESOP can provide for the use of either method, depending on the terms of each particular ESOP loan.

ESOPs have generally used a dual account system for the accounting of allocations. One account is used to reflect shares of employer stock while another reflects each participant's interest in ESOP assets other than employer stock. Under the provisions of the final regulations, this dual account system may be the only appropriate means of allocating for a leveraged ESOP.

The final regulations also require that income and forfeitures under the ESOP be allocated to participants' accounts.[34] And if income is applied to repay an ESOP loan, the stock "released" from the suspense account will be allocated in lieu of the income itself. The regulations further provide that forfeitures under the ESOP first be applied against assets other than employer stock allocated to the participant. And if there is more than one class of employer stock allocated to the participant, the forfeiture must be applied proportionately to each class of stock.

In the event of unequal annual "release" of shares for allocation purposes, the regulations caution against possible plan disqualification, based upon the allocation limitations under Code section 415 and the requirement for "substantial and recurring" contributions. ESOPs that "release" stock in varying annual amounts (particularly where there is a provision for a deferral of payments or for "balloon" payments) will be closely observed by the IRS. So long as the ESOP loan is actually repaid over a "reasonable" period, there appears to be no need for concern. This caution apparently found its way into the regulations due to comments in the Conference Committee report indicating that an ESOP loan need not be amortized (and stock need not be allocated) in equal annual amounts.

The section 415 warning should likewise be of little concern in a properly planned ESOP loan. Clearly, no ESOP loan should be structured to require contributions exceeding the deductible limits of Code section 404(a) or which would result in exceeding the section 415 allocation limits. This reference in the regulations to section 415 indicates one point worthy of note; namely, that the annual additions to accounts are based upon employer contributions made to the ESOP (tc service the loan) and not on the value of employer stock "released" and allocated to participants' accounts.

The caution regarding the failure to make "substantial and recurring" contributions should likewise be of little concern in the context of a leveraged ESOP. First, no greater requirement is imposed on an employer making contributions to an ESOP than would be imposed should that employer have a discretionary contribution profit-sharing plan or stock bonus plan.[35] [Of course, the inclusion of a money purchase pension plan in the ESOP will require a definite contribution formula.] Second, the very existence of an ESOP loan will generally bring with it a fixed commitment for employer contributions when the loan itself is (presumably) guaranteed by the employer.

Voting Rights: In their proposed form, the ESOP regulations required that voting rights (and other shareholder rights) with respect to employer stock held by an ESOP be directed by the participants in the ESOP.[36] The Conference Committee report suggested that the regulations "should not distinguish between leveraged ESOPs and other employee plans in this regard." In their final form, the regulations withdrew the provision requiring that voting rights be "passed through" to employees.

The ESOP fiduciaries (the Trustee or an administrative committee) appointed by the employer may exercise the voting rights on employer stock held by the ESOP. However, it should be kept in mind that the fiduciaries are serving to protect the ESOP participants' interests as beneficial shareholders of the sponsoring corporation. Thus, under ERISA section 404(a)(1), the fiduciaries must discharge their responsibility "solely in the interest of participants."

The pass-through of voting rights to participants is clearly permissible. In fact, such a feature is common in the ESOPs of publicly traded corporations and could prove to be a signficant feature in the stimulation of employee motivation through the ESOP. One of the distinguishing features of the TRASOP is its requirement that voting rights be passed through to participants.[37]

Treatment of Sale as a Redemption: Included in the proposed regulations was an amendment to the regulations under Code section 301 relating to corporate distributions to shareholders.[38] That provision would have characterized a shareholder's sale of employer stock to an ESOP as a corporate redemption in some situations, thereby possibly resulting in the

imposition of dividend treatment on the selling shareholder. Whether the IRS was correct in so characterizing such a transaction is highly questionable.[39] In commenting on this provision, the Congress questioned its validity while also suggesting ". . . if such a rule is authorized and proper, its application should not be restricted to ESOPs and should be applied only where the stock sold by the shareholder inures to his benefit (or the benefit of related parties) under the plan."

In withdrawing this proposed amendment, the Service commented in the preamble to the regulations that guidance on this matter would be given in the context of shareholder transactions with employee plans in general.

Within two weeks after publication of the final regulations, the IRS issued Revenue Procedure 77-30, which sets forth the circumstances under which it will issue an advance ruling on the sale of employer stock to an employee plan for purposes of Code section 301.

In order to receive a ruling that such a sale will not be treated as a distribution by the corporation, the following three conditions must be satisfied:

1. The combined beneficial interest in the employee plan of the selling shareholder and his immediate relatives does not exceed 20% of the total, based upon both annual allocations and total account balances;

2. Any restrictions on stock held by the plan and distributed from the plan must be "no more onerous than the disposition restrictions on at least a majority of the shares of employer stock held by other shareholders of the employer." Restrictions imposed by Federal or state securities laws are disregarded for this purpose; and

3. It must be represented that there is no intention or understanding for the employer to redeem any of the stock from the employee plan.

The Revenue Procedure specifically states that these operating rules are merely guidelines for the issuance of advance rulings and do not, as a matter of law, define the circumstances under which a sale of stock can be treated as a corporate distribution under Code section 301.

The 20% limitation on plan interests stems from a floor statement by Senator Russell Long when the Conference Report on the 1976 Tax Reform Act was presented to the Senate.[40] The Senator noted that redemption treatment would be appropriate ". . . where the selling shareholder has such a large beneficial interest as an ESOP participant that a substantial portion of the stock he sells to the ESOP will inure to his benefit —that is, to a large extent, the shareholder is selling to himself." The Senator felt that dividend treatment might be appropriate ". . . only in those rare situations when the transaction does not result in a substantial change in beneficial ownership of the stock acquired by the plan." Thus, the 20% limitation seems reasonable in response to Senator Long's comments.

The conditions relating to restrictions on disposition of employer stock should not preclude the use of a right of first refusal with respect to stock distributed from the ESOP of a closely-held corporation. If such a "restriction" satisfies the requirements of the ESOP regulations on the rights of first refusal (discussed below), it should not affect the value of the stock.

The requirement of a representation of no redemption intention by the employer should likewise pose no problem. This representation would not preclude an employer redemption of stock pursuant to the exercise of a put

option granted by the employer to a plan participant receiving a distribution of stock from the plan (discussed below).

With the publication of Revenue Procedure 77-30, shareholders may now proceed to sell their employer stock to an ESOP with confidence that the transaction will receive treatment as a sale and not as a dividend.

Integration with Social Security: In their temporary and proposed form,[41] the regulations provide that ESOPs established after November 1, 1977 may not be integrated with Social Security and that a previously integrated ESOP must not be amended after that date to increase the extent of integration. The integration level may, however, continue to rise by reason of automatic adjustments for increases in the Social Security taxable wage base. This anti-integration rule stems from statements in the Conference Committee report under the 1976 Tax Reform Act; these statements, in turn, are the result of past definitions of ESOPs by the Senate Committee on Finance which note that an ESOP is designed "to build equity ownership of shares in the employer corporation into its employees substantially in proportion to their relative incomes."[42]

Distributions: The regulations indicate that distribution of benefits from an ESOP are governed by the rules normally applicable to qualified plans.[43] Where the proceeds of an ESOP loan are used to acquire various classes of employer stock, a distributee must receive substantially the same proportion of each such class (to the extent allocated to the account).

In their temporary and proposed form, the regulations provide that income received by the ESOP on employer stock may be "passed through" as current income to participants.[44] Section 803(h) of the 1976 Tax Reform Act specifically recognized this pass-through option as another way to provide the benefits of stock ownership to employees. This "current" distribution of income is limited to the two-year period after such dividends are received by the ESOP.

Life Insurance: As proposed, the regulations contained strict limitations on the purchase of keyman or buy-sell life insurance by an ESOP.[45] In deleting these limitations, the final regulations provide that the general rules applicable to the purchase of life insurance by qualified plans will apply to ESOPs. The sole remaining limitation is that the proceeds of an ESOP loan may not be used to fund life insurance premiums.

> **CAUTION→** The fiduciary rules of ERISA must be carefully considered by anyone planning to use an ESOP purchase of life insurance for keyman or buy-sell purposes. The payment of premiums for such purposes must be considered in the context of ERISA's prohibited transaction rules.[46] In addition, a life insurance investment must be evaluated under the general requirements of prudence and exclusive purpose.[47]

Consequently, it is suggested that such life insurance would more appropriately be purchased by the employer corporation, with buy-sell agreements coordinated with purchases of stock by the ESOP, as discussed below. Any death proceeds under corporate-owned insurance policies will be received tax-free by the corporation[48] and may be contributed or lent to the ESOP for the "pre-tax" financing of the purchase of stock. Also, the payment of non-deductible insurance premiums[49] by the corporation may be "tax-sheltered" by annual stock contributions to the ESOP.

Buy-Sell Agreements: Under the regulations, an ESOP is prohibited from obligating itself to purchase stock ". . . from a particular security holder at an indefinite time determined upon the happening of an event such as the death of the holder."[50] This prohibition seems appropriate in

light of the fact that such a transaction may prove to be imprudent when the time comes for the ESOP to honor its obligation.

The fact that an ESOP may not be bound to a future purchase of employer stock does not preclude the ESOP's use in connection with corporate buy-sell agreements. Such an agreement may contain an option to effect the purchase through the ESOP; it is only the *binding* commitment that is prohibited by the regulations.

ESOP Loan Requirements

The "ESOP loan exemption" from the prohibted transaction rules is provided by ERISA section 408(b)(3) and Code section 4975(d)(3). This exemption acknowledges the concept of "ESOP financing" contemplated by the Senate Committee on Finance. The ESOP loan regulations[51] essentially provide guidelines for the requirement that the loan be "primarily for the benefit of participants."

The ESOP loan exemption applies solely to loans (or other extensions of credit) to the ESOP from a party in interest.[52] Such a "loan" could be structured in a number of ways, including a loan from an independent party guaranteed by the employer or another party in interest (such as a major shareholder), a direct loan by the employer, the trustee or other party in interest, an installment sale of employer stock to the ESOP by a party in interest, or a pledge of assets by a party in interest as security for a third-party loan to the ESOP.

Use of the ESOP as a financing technique permits the use of corporate credit to enable the employees of a company to debt finance their acquisitions of employer stock. Such purchases will be used to finance new capital formation to the extent the stock is purchased from the sponsoring corporation. To the extent stock is purchased from existing shareholders, the ESOP is used to finance transfers of ownership by creating a market for employer stock.

Self-dealing: In order to preclude fiduciary self-dealing, the proposed regulations required that an ESOP loan be arranged and approved by an "independent" fiduciary.[53] The Conference Committee report characterized this requirement as "unduly burdensome" in light of the other protective rules applicable to the ESOP loan exemption. Congress suggested that the regulations should "deal directly with possible abuses."

As issued in their final form, the regulations delete the requirement for an independent fiduciary in connection with an ESOP loan.[54] In addition, the final regulations expanded the ESOP loan exemption to include exemption not only from the party in interest prohibitions under ERISA section 406(a)(1), but also from the fiduciary self-dealing prohibitions under ERISA section 406(b), except for the "kick back" prohibition of section 406(b)(3).

In order to protect against potential abuses resulting from fiduciary self-dealing (e.g., where the interests of fiduciaries may conflict with those of ESOP participants), the regulations warn that both the IRS and the Labor Department will subject ESOP financing transactions to "special scrutiny" to ensure that the ESOP loan is "primarily for the benefit of participants." This special scrutiny had been expressly directed by the ERISA Conference Report.

The Primary Benefit Tests: In following the directive of the Conference Committee to "deal directly with possible abuses which may occur" in connection with ESOP financing, the regulations adopt two tests to illustrate how a determination will be made as to whether an ESOP is "primarily

for the benefit of ESOP participants and their beneficiaries."[55]

The first test, the "net effect on plan assets" test, [56]focuses on the interest rate of the loan and the price of the employer stock acquired with the loan proceeds. They should be such that plan assets are not "drained off." This first test simply adopts language directly from the ERISA Conference Report. Both elements of the test appear to be requirements for satisfying both the ESOP loan exemption and the "sale exemption" of ERISA section 408(e) and do not provide much additional guidance.

The "arm's-length standards" test[57] provides the second measure of acceptability of the terms of an ESOP loan. Basically, this test requires that the terms of an ESOP loan, whether or not between independent parties, must be at least as favorable to the ESOP as the terms of a comparable loan resulting from arm's-length negotiations between independent parties. The general fiduciary requirements of ERISA appear to already encompass the substance of this second test.

The primary benefit requirement of the regulations also mandates compliance with the rules concerning the use of loan proceeds, the ESOP's liability and collateral for the loan, default and interest. These provisions are discussed below.

The Application of Loan Proceeds: Under the regulations, the proceeds of an ESOP loan must be utilized within a "reasonable time" to acquire qualifying employer securities, to repay such loan, or to "refinance" a prior ESOP loan. As proposed, the regulations would have limited employer stock purchases to voting common stock with unrestricted dividend rights.[58] The Conference Committe felt that the usual rules applicable to employee plans should properly protect the participants' interests and, therefore, the final regulations permit loan proceeds to be used to purchase any qualifying employer securities, as defined in ERISA section 407(d)(5). Thus, a leveraged ESOP may purchase any class of stock and, in certain limited situations, marketable debt securities of an employer corporation (or its affiliates),[59] subject to ERISA's fiduciary rules.

As proposed, the regulations did not allow an ESOP loan to be used to "refinance" an existing loan. The final regulations acknowledge that such a transaction may benefit the ESOP's participants.

With the exception of rights of first refusal and the mandatory put options (discussed below), the regulations prohibit acquisition of employer stock with an ESOP's loan proceeds if it is subject to puts, calls, other options or buy-sell arrangements.[60] In response to comments of the Conference Committee report, the regulations now permit restrictions on stock which are required by applicable law (e.g., to comply with Federal and state securities law).

Loan Liability of the ESOP and Collateral: Discussions by the Senate Committee on Finance indicate that ESOP loans are to be "secured primarily by a commitment by the employer to make future payments to the ESOP in amounts sufficient to enable such loans to be repaid."[61] The proposed regulations likewise provided that an ESOP loan must be made without recourse to the existing assets of the ESOP, except with respect to any employer stock remaining subject to pledge as collateral for the loan. The ESOP's loan payments were limited to amounts received by the ESOP as employer contributions (other than contributions of employer stock) made for the purpose of repaying the ESOP's debt obligations plus earnings attributable to such contributions. Separate accounting was required for such contributions and earnings thereon. Such limitations are consistent with the general concept that an ESOP loan be essentially nonrecourse as to ESOP assets which have already been "paid for."

These provisions are basically a restatement of the requirements of

Q.&A. F-10 of T.I.R.-1413, the initial guidelines for ESOPs published by the Internal Revenue Service on November 4, 1975. The Conference Committee report raised no objection with regard to these proposed requirements, and the final regulations restate essentially the same limitations on the extent of the ESOP's liability on a loan.[62]

Q.&A. F-10 of T.I.R.-1413 required that the employer make contributions to the ESOP adequate to service the ESOP's debt obligation. This requirement was deleted from both the proposed and final regulations. This deletion is significant only where the employer has not guaranteed the repayment of the ESOP loan. The only loan transaction in which this would seem to make any difference is the situation in which the ESOP "loan" takes the form of an installment purchase of stock (or other loan) from a major shareholder (or other party in interest). In such a case, the selling shareholder (or other party in interest lender) would do well to require an employer guarantee (or a pledge of the stock sold to the ESOP) in order to ensure that the employer has an obligation to make ESOP contributions sufficient to enable the ESOP to service the "loan."

Because an ESOP loan from an outside lender is generally secured by an employer guarantee, a pledge of stock is usually not necessary. In fact, in the event of default on the loan, the employer stock would be of questionable value to the lender, who would probably far prefer the status of a corporate creditor to that of a stockholder with unsellable shares. And in the case of a publicly traded company, such a pledge of stock may raise problems under the margin rules of the Federal Reserve Board.[63] A pledge of stock often unnecessarily complicates the loan transaction and is generally no more necessary than in a direct loan to the sponsoring employer from an outside lender.

Default on an ESOP loan: Both the proposed and final regulations provide a limitation on the transfer of plan assets to the lender in the event of default on an ESOP loan.[64] The regulations provide that the value of ESOP assets transferred in satisfaction of the loan must not exceed the amount of the default.

In the case in which the lender is a party in interest, the regulations provide that plan assets may be transferred to that party in interest upon default "only upon and to the extent of the failure . . . to meet the payment schedule of the loan." This rule does not apply where the lender is not a party in interest (where, that is, the "extension of credit" by the party in interest consists solely of a guarantee of the ESOP loan).

The special default rule of the proposed regulations limited the events of default on *any* ESOP loan to the failure to meet loan payments due. This inability of the ESOP to negotiate events of default which are common in commercial loan transactions would have resulted in the ESOP having great difficulty obtaining loans from banks or insurance companies. The final regulations permit an ESOP loan to be structured in conformity with common loan practices and, unless the lender is the party in interest, normal provisions for the acceleration of the debt in event of default may be included in the provisions of an ESOP loan.

In the case in which the lender is a party in interest, the loan provisions may still include events of default other than nonpayment, as well as provisions for acceleration of the ESOP loan. However, plan assets may be transferred to the party in interest only to the extent of the failure to meet loan payments currently due. Of course, this provision of the regulations does not limit the rights of the lender against the employer (or shareholder) who has guaranteed the ESOP loan.

Terms of repayment: Under the requirements of the final regulations,[65] an ESOP loan must be for a specific term and may not be payable on demand, except in the event of default (as discussed above). Thus, an ESOP loan must be amortized over a reasonable period of time and cannot be used, for example, to finance an employer's "open line of credit."

Under the provisions of the proposed regulations, the terms of an ESOP required that the ESOP be permitted to make prepayments at any time without penalty. The Conference Committee report felt "that the question of such penalties should be a matter of negotiation between the ESOP and the lender" (subject to the prudence restrictions of ERISA). This is in line with the overall tenor of the Conference Committee report which stressed that ESOP loans should be judged in the context of their utilization in a business financing transaction. Thus, the terms of an ESOP loan transaction will clearly be judged based on all the surrounding facts and circumstances. The "primary benefit" standard, with its two tests ("net effect on plan assets" and "arm's-length standard") will provide the primary measure of compliance.

Reasonable Interest: The "ESOP loan exemption" of ERISA mandates that the interest rate not be in excess of a reasonable rate. Likewise, both the proposed and the final regulations[66] require that all relevant factors be considered in evaluating what is reasonable, including the amount and duration of the loan, the security and guarantee (if any) involved, the credit standing of the ESOP and the guarantor (if any) and the prevailing interest rate for comparable loans. The final regulations contain a significant provision that (when all these factors are considered) a variable interest rate may be reasonable.

The regulations don't explain how the ESOP itself could have a credit standing. In the vast majority of the cases, the ESOP itself has no credit standing but, rather, is primarily dependent upon the credit of the employer and its ability to make contributions to the ESOP adequate to repay the ESOP loan. If the ESOP had such a credit standing and could borrow without the guarantee of a party in interest, the loan would not be an "ESOP loan" under ERISA and need not satisfy the requirements of the ESOP regulations.[67]

NOTE→ The interest rate on ESOP loans is most often negotiated with an independent lender who is not a party in interest. However, with the deletion of the requirement for an "independent fiduciary" to approve the transaction, caution must be exercised in setting an interest rate where the lender is a party in interest.

Right of First Refusal: In their proposed form, the regulations prohibited subjecting employer stock acquired by an ESOP to a right of first refusal.[68] The Conference Committee felt that such a prohibition would have a "chilling effect" upon the establishment of ESOPs by failing to recognize that such a right is necessary for smaller businesses to protect their interests.

The preamble to the final regulations acknowledges the many comments protesting the proposed prohibition. The regulations now recognize "... the necessity of a right of first refusal to protect small, closely held corporations, whose securities are not publicly traded, from dilution of control, takeovers by competitors and inadvertent 'going public'."

Thus, the regulations permit a right of first refusal in favor of the employer corporation, the ESOP or both. Shareholders other than the ESOP may not have a right of first refusal with respect to "leveraged" stock. The right must be exercised within a fourteen-day period after written notice is given of the intent to transfer such stock. The selling

price and other terms under the right must be not less favorable to the seller than the terms of a good faith offer to purchase the shares made by a buyer other than the employer or the ESOP.

The regulations appear also to require that the selling price must be at least equal to the valuation of employer stock determined under the ESOP. If the ESOP documents expressly provide that a good faith offer will be "deemed to be fair market value" for purposes of the right, that price should control. Indeed, such an offer represents the best evidence of fair market value for that stock at that time under generally accepted guidelines for valuation.

For stock that is publicly traded, the regulations forbid the use of a right. For the purposes of the regulations, "publicly traded" refers to stock that is listed on a national securities exchange or is quoted on a system sponsored by a national securities association (NASDAQ).

Put Option: With the exception of publicly traded stock not subject to a trading limitation under applicable Federal and state securities laws, all employer stock acquired with the proceeds of an ESOP loan after September 30, 1976 must be subject to a put option to the employer when distributed to a participant (or beneficiary).[69] Stock subject to resale restrictions under Rule 144 of the Securities and Exchange Commission must also be subject to the put option requirement when distributed by an ESOP.

Under the put, the participant must have the right to sell the stock received back to the employer for at least 15 months after distribution from the ESOP.[70] The 15-month period excludes any time when the employer is prohibited from buying the stock due to prohibitions under applicable law. For example, this would include any period during which an employer has insufficient surplus available to redeem its stock. If publicly traded stock should cease to be publicly traded within 15 months after distribution by the ESOP, the stock must be subjected to the put option requirement for the balance of the 15-month period.

The fair market value of the stock as determined under the ESOP is the price to be paid in connection with the exercise of such a put option. If the put option is exercised by a party in interest, the fair market value is to be determined on the date of the transaction. Otherwise, the latest valuation date under the ESOP will suffice for determining fair market value.[71]

Payment under the put may be made in either a lump sum or in installments, starting within 30 days after the put is exercised. In the case of installment purchases, the payment provisions must be for substantially equal installments, with reasonable interest, over a period of up to five years. If, when the put is exercised, the ESOP loan used to purchase such stock has not yet been repaid, the installment payments may be extended to the earlier of the date ten years after the put is exercised or the date the loan is entirely repaid by the ESOP.[72]

The final regulations also require that any installment payment under a put option be provided with "adequate security" for the credit extended by the employee to the sponsoring employer. The regulations provide no guidance as to what constitutes "adequate security." It's conceivable that this requirement may preclude the use of installment payments under a put option in numerous situations. Should lump-sum payments under a put become the only feasible means of complying with the regulations, employers may resort to making installment distributions of stock from the ESOP in order to solve their liquidity problem. In that case, participants would be denied the favorable tax treatment allowed under Code section 402(e) for lump-sum distributions of employer stock.

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The ESOP itself cannot be bound to honor the put but may, under the regulations, actually purchase the stock under the option once the put is exercised to the employer. In the case of an employer, such as a bank, which is forbidden by federal or state law from purchasing its own stock, there must be a third party (such as a shareholder or an affiliate) other than the ESOP who is bound to honor the put if one is required. This requirement may make it impossible for a bank to utilize a leveraged ESOP where their stock is not publicly traded. It is hoped that the agencies will revise this requirement to comply with Congressional intent to encourage ESOP financing.

Transitional Rules: As proposed, the regulations would have required that any leveraged ESOP loan be amended to conform to all applicable requirements. The issue of retroactivity was not addressed by the Conference Committee report. However, the Senate version of the Tax Reform Act of 1976 contained the language of what became section 803(h) of the Act. Following the implicit directive of this section, the final regulations contain transitional rules applicable to ESOP loans incurred prior to November 1, 1977.[73]

ESOP loans incurred prior to January 1, 1976 are not subject to the requirements of the regulations relating to puts, calls or other options, or buy-sell arrangements; the provisions for ESOP liability, default, release from encumbrance; rights of first refusal, put options and other loan terms. Such ESOP loans are, however, subject to the requirements relating to the "primary benefit" provision, use of loan proceeds and reasonable rate of interest, inasmuch as such requirements could be "reasonably anticipated" from the statutory provisions of the ESOP loan exemption. The special "default rule" also applies to such a loan if made to the ESOP by a party in interest, and must have been complied with before November 1, 1977. A leveraged ESOP in effect on July 1, 1974 is not subject to any provisions of the ESOP regulations until June 30, 1984, due to the effective date provisions of ERISA section 414(c)(1).

ESOP loans incurred after December 31, 1975, but before November 1, 1977 are generally subject to the rules applicable to pre-1976 loans, plus the ESOP guidelines of T.I.R.-1413. Such a loan is subject to the "default rule" requirements only in the case of a party in interest lender. Such a loan is not subject to the right of first refusal rule and the three special rules relating to "release" and allocation of shares under the level annual payment method. However, the other "release" rules are applicable to stock acquired by the ESOP after November 1, 1977, with the proceeds of a loan incurred prior to that date.

The mandatory put option is required for employer stock acquired with ESOP loan proceeds after September 30, 1976, regardless of the date the loan was taken out (or refinanced). For such stock distributed by an ESOP prior to November 1, 1977, the put option must be complied with by December 31, 1977.

There are undoubtedly many unamended ESOPs. And it's hoped that retroactive compliance can be effected so long as the provisions of the plan not in compliance have not operated to the detriment of participants.

Conclusion: The final ESOP resolutions represent a new approach to employee benefits. Rather than focusing on employee retirement income security, the ESOP's primary goal is to enable employees to derive the benefit of ownership of employer stock. Although ERISA is replete with references to "primary" and "exclusive" benefit language regarding qualified plans, it appears that the ESOP is intended to operate for the mutual benefit of the employer and its employees.[74]

For the employer, the leveraged ESOP provides a tax-favored method

of financing its capital requirements. And for the employee it represents a measure of Congressional concern with the recurrent pattern of concentrated capital ownership in the United States.[75]

In answer to the common criticism that ESOPs put plan participants in an unacceptedly risky posture, Senator Russell Long, the legislative patron saint of employee ownership, responds,

> "Detractors have argued that there is an unacceptable risk to an employee's future security if his retirement fund is invested entirely in his employer. They claim that the financial failure of an employer inflicts double damage because it means the loss of both job and retirement income. To that argument one must respond that there are no devices today other than employee stock ownership plans which are capable of widespread application within the U.S. economy and which can make significant holders of capital out of the vast majority of consumer units who own no significant productive capital of any kind. Fifty years of intensive application of the principles of conventional fixed-benefit pension and profit-sharing plans have not created this opportunity. In fact, as mentioned earlier, fewer and fewer persons own capital today; the capital ownership base was ten times larger at the turn of the century than it is today. One can only conclude that the argument regarding the excessive risk an ESOP creates for an employee's future should not be heeded when balanced against the tremendous financial gain an ESOP avails to an employee."[76]

Thus, the ESOP brings a populist perspective to the employee benefits field. Because its purpose differs, the tests by which its acceptability will be measured are likewise different. Although the ESOP operates within the general framework of ERISA, its underlying ownership ethic brings to ERISA a slightly different measure of plan acceptability.

The final ESOP regulations bring both a more reasonable and a more realistic approach to the establishment and administration of ESOPs. Prior to the publication of the final regulations, the ESOP was plagued with uncertainty regarding its treatment at the hands of the IRS and the Labor Department. However, it is now quite clear that Congress fully intends to carve out an ESOP exception from ERISA in order to bring about the debt financed purchase of employer stock for the benefit of employees.

The regulations appropriately caution fiduciaries to "excise scrupulously their discretion in approving ESOP loans."[77] The ESOP is intended to grant employees access to ownership while also giving the employer a less expensive means to finance capital growth and transfers in ownership. The ESOP concept represents an attempt to build a financial structure that will benefit both the employee and the employer. The ESOP should be used only when appropriate and only when it can serve the valid objectives of the employer corporation and its shareholders while also providing for employee stock ownership in a manner consistent with the fiduciary requirements of ERISA.

TABLE OF CITATIONS

Footnote **Reference**

(1) T.D. 7506, Reg. §§ 54.4975-7(b), ¶ 85,177* & 54.4975-11, ¶ 85,177*. D.O.L. Reg. §§ 2550.408b-3, ¶ 90,297* & 2550.407d-6, ¶ 90,297*. Following footnotes will cite only the IRS Regulations.

(2) Prop. Reg. §§ 54.4975-11, ¶ 94,169* & 54.4975-7(b), finalized 9-2-77, ¶ 85,-177,* and D.O.L. Prop. Reg. §§ 2550.407d-6, ¶ 90,297 & 2550.408b-3, ¶ 90,297 appearing at 41 FR 31833 & 41 FR 31870 respectively.

Footnote Reference

(3) P.L. 94-455 (10/4/76), ¶ 93,476*.

(4) ERISA § 408(b)(3), ¶ 80,408* & I.R.C. § 4975(d)(3), ¶ 77,565*.

(5) § 219(f) of 1921 Revenue Act exempted from the income tax laws income from a trust created by an employer as part of a "stock bonus or profit-sharing plan for the exclusive benefit of some or all of his employees." A similar tax exemption was not provided to pension plans until the Revenue Act of 1926.

(6) Rev. Rul. 46, 1953-1 C.B. 287, ¶ 69,308*, updated by Rev. Rul. 71-311, 1971-2 C.B. 184, ¶ 65,780.*

(7) P.L. 93-236 (1/2/74) ESOP defined in § 102(5) thereof.

(8) I.R.C. § 4975(e)(7), ¶ 77,565*. See also ERISA § 407(d)(6), ¶ 80,407*.

(9) P.L. 93-618 (1/3/75). In granting loan guarantees in connection with projects in trade impacted areas, the Trade Act gives preference to a corporation which agrees to finance 25 percent of the principal through an ESOP. 19 USC § 2373(d) and (e).

(10) A corporation is allowed an additional 1% investment tax credit (through 1980) if the amount of that 1% is contributed to a TRASOP. Under § 301(e) of the 1975 Act, as added by § 803(d) of the 1976 Tax Reform Act ¶ 80,983*, a further additional ½% investment tax credit is allowed for TRASOP contributions if that ½% is matched by employee contributions. Special restrictive requirements apply to TRASOPs. The ESOP regulations finalized on 9/2/77 did not include the TRASOP regulations.

(11) Long, "Employee Stock Ownership Plans: Spreading the Wealth to the Average American Worker", 26 Am. U.L. Rev. 515 (1977); Kurland, "Beyond ESOP: Steps Toward Tax Justice", 29 *The Tax Executive*, 187 and 386 (1977); Speiser, "ESOP, Kelso and Economic Justice", N.Y. State L.J. 552 (November, 1975); O'Hara and Crawford, "Will Every Corporation Have an E.S.O.P.? Senator Long Makes It Hard to Say No", 61 A.B.A.J. 1287 (1975).

(12) ERISA § 407(d)(6)(A), ¶ 80,407*. See also I.R.C. § 4975(e)(7)(A), ¶ 77,-565*.

(13) ERISA § 3(2), ¶ 80,021*, includes as an "employee pension benefit plan" a plan which either (a) provides retirement income to employees, *or* (b) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond. See also ERISA § 402(b)(1), ¶ 80,402*, which requires a funding policy consistent with the objectives of the plan.

(14) Reg. § 1.401-1(b)(1)(ii) & (iii), ¶ 63,069*. Compare to Reg. § 1.401-1(b)(1)(i), ¶ 63,069*.

(15) Comments of Senator Ted Stevens of Alaska. 122 Cong. Rec. § 13429-30 (daily ed. Aug. 4, 1976).

(16) Reg. § 1.401-1(a)(2)(iii) & (b)(1)(iii), ¶ 63,069*.

(17) Reg. § 54.4975-11(a)(2), ¶ 85,177*.

(18) Reg. § 54.4975-11(b), ¶ 85,177*.

(19) ERISA § 407(d)(3)(A)(ii), ¶ 80,407*.

(20) ERISA § 404(a)(1)(C) & (2), ¶ 80,404*.

(21) ERISA § 407(a) & (b), ¶ 80,407*.

(22) The ERISA Conference Report, H. Rept. 93-1280 (8/12/74), states that the "conferees expect that the courts will interpret this prudent man rule (and the other fiduciary standards) bearing in mind the special nature and purpose of employee benefit plans" and notes the "special purpose" of eligible individual account plans which "commonly provide for substantial investments in employer securities."

(23) ERISA §§ 406(a)(2), ¶ 80,406* & 407, ¶ 80,407*.

(24) Reg. § 54.4975-11(a)(5), ¶ 85,177*.

(25) Reg. § 54.4975-11(a)(6), ¶ 85,177*. "Conversion" is generally effected through an amendment of the existing plan.

(26) Reg. § 54.4975-11(a)(6), ¶ 85,177*. See I.R.C. § 411(d)(3), ¶ 80,411* &

Footnote **Reference**

Reg. § 1.411(d)-2(c), ¶ 85,176*. See also Reg. § 1.401-6(b)(1), ¶ 63,074* and ERISA § 4041(f), ¶ 80,941*.

(27) See Eaves v. Penn, 426 F. Supp. 830 (1976), where rescission of a profit-sharing plan conversion to an ESOP was ordered by reason of a finding of violations of ERISA § 404(a)(1), ¶ 80,404*. See also Ludwig, "Conversion of Existing Plans to Employee Stock Ownership Plans," 26 Am.U.L. Rev. 632.

(28) Reg. § 54.4975-11(e), ¶ 85,177* & Prop. Reg. § 54.4975-11(e)(2) & (3), ¶ 94,169*.

(29) Reg. § 54.4975-11(d)(1), ¶ 85,177*.

(30) Reg. §§ 1.401-1(a)(2)(ii), (b)(1)(ii) & (iii), (3), ¶ 63,069* & 1.401-4 (a), ¶ 63,072*

(31) Reg. ¶ 1.402(a)-1(b)(2)(ii), ¶ 63,085*

(32) Reg. § 54.4975-11(c) & (d)(2), ¶ 85,177* See also Reg. § 54.4975-7(b) (8), ¶ 85,177*

(33) Reg. § 54.4975-11(c) & (d)(2), ¶ 85,177* I.R.C. § 401(a)(4), ¶ 75,401* & Reg. § 1.401-4(a)(1) & (2)(iii), ¶ 63,072*, Reg. § 1.401-1(b)(1)(ii) & (iii), ¶ 63,-072*. Compare Rev. Rul. 70-125, 1970-1 C.B. 87, ¶ 65,642*.

(34) Reg. § 54.4975-11(d)(3) & (4), ¶ 85,177*.

(35) Reg. § 1.401-1(b)(2), ¶ 63,072*.

(36) Prop. Reg. § 54-4975-11(d), withdrawn 9/2/77, ¶ 94,169*.

(37) § 301(d)(5) of 1975 Tax Reduction Act, ¶ 80,903. See also Prop. Reg. § 1.46-8(d)(7), ¶ 94,129*.

(38) Prop. Reg. § 1.301-1(1), withdrawn 9/2/77.

(39) I.R.C. § 317(b) provides that a redemption is the acquisition by a corporation of its stock from a shareholder in exchange for property. I.R.C. § 318(a)(2) (B)(i) & (3)(B)(i) preclude attribution of ownership from or to an employees' trust qualified under § 401(a), ¶ 80,401.

(40) 122 Cong. Rec. § 16015 (daily ed. September 16, 1976).

(41) Prop. Reg. § 54.4975-11(a)(7)(ii), ¶ 94,169* & Reg. § 54.4975—11(a)(7) (ii), ¶ 85,177*.

(42) S. Rep. No. 93-1298 on H.R. 10712 (Trade Reform Act of 1974); S. Rep. No. 94-36 on H.R. 2166 (Tax Reduction Act of 1975); S. Rep. No. 94-938 on H.R. 10612 (Tax Reform Act of 1976).

(43) Reg. § 54.4975-11(f)(1) & (2), ¶ 85,177*.

(44) Prop. Reg. § 54.4975-11(a)(8)(iii), ¶ 94,169*, (d)(3) & (f)(3) & Reg. § 54.4975-11, ¶ 85,177*.

(45) Prop. Reg. § 54.4975-11(b)(2), ¶ 94,169*, withdrawn 9/2/77. The proposed regulations also covered the purchase of life insurance to fund death benefits for participants.

(46) ERISA § 406(a)(1)(D), ¶ 80,406*, prohibits the direct or indirect ". . . use by or for the benefit of, a party in interest, of any assets of the plan . . ." See also I.R.C. § 4975(c)(1)(D), ¶ 77,565*.

(47) ERISA § 404(a)(1)(A) & (B), ¶ 80,404*. Also, the "exclusive benefit of employees" requirement of I.R.C. § 401(a), ¶ 75,401*.

(48) I.R.C. § 101(a)(1), ¶ 75,101*.

(49) I.R.C. § 264(a)(1), ¶ 75,264*.

(50) Reg. § 54.4975-11(a)(7)(i), ¶ 85,177*.

(51) Reg. § 54.4975-7(b), ¶ 85,177*.

(52) The scope of ERISA's prohibited transactions provisions and exemptions thereunder will relate only to the "lending of money or other extension of credit between the plan and a party in interest." See ERISA § 406(a)(1)(B), ¶ 80,406* and I.R.C. § 4975(c)(1)(B), ¶ 77,565. The guarantee of a loan (direct or indirect) constitutes an "extension of credit." See Reg. § 54.4975-7(b)(1)(ii), ¶ 85,177*.

Footnote Reference

(53) Prop. Reg. § 54.4975-7(b)(1)(i), ¶ 85,177*. See also ERISA § 406(b), ¶ 80,-406 & I.R.C. § 4975(c)(1)(E), ¶ 75,565.

(54) Reg. § 54.4975-7(b)(2), ¶ 85,177*.

(55) Reg. § 54.4975-7(b)(3)(i), ¶ 85,177*.

(56) Reg. § 54.4975-7(b)(3)(ii), ¶ 85,177*.

(57) Reg. § 54.4975-7(b)(3)(iii), ¶ 85,177*.

(58) Prop. Reg. § 54.4975-7(b)(2)(i)(B), withdrawn 9/2/77.

(59) See ERISA § 407(d)(1), (5), (7) & (e), ¶ 80,407*. See also I.R.C. §§ 4975 (e)(8), ¶ 77,565* & 503(e), ¶ 75,503*. Regulations relating to the definition of "qualifying employer security" were published with the final ESOP regulations as Reg. § 54.4975-12, ¶ 85,177* & D.O.L. Reg. § 2550.407d-5, ¶ 90,297*. Compare to I.R.C. § 402(a)(3), ¶ 75.402*.

(60) Reg. § 54.4975-7(b)(4), ¶ 85,177*.

(61) S. Rep. No. 93-1298 (11/26/74) on H.R. 10710 (Trade Reform Act of 1974); S. Rep. No. 94-36 (3/17/75) on H.R. 2166 (Tax Reduction Act of 1975).

(62) Reg. § 54.4975-7(b)(5), ¶ 85,177*.

(63) Section 7 of the Securities Exchange Act of 1934 grants power to the Federal Reserve Board to prescribe regulations governing the amount of credit extended or maintained on any nonexempt security. Under this authority, the Board has adopted Regulation U (banks), Regulation T (brokers and dealers) and Regulation X (borrowers).

(64) Reg. § 54.4975-7(b)(6), ¶ 85,177*.

(65) Reg. § 54.4975-7(b)(13), ¶ 85,177*.

(66) Reg. § 54.4975-7(b)(7), ¶ 85,177*. See also ERISA § 408(b)(3)(B), ¶ 80,-408 & I.R.C. § 4975(d)(3)(B), ¶ 77,565*.

(67) See Footnote No. 52.

(68) Reg. § 54.4975-7(b)(9), ¶ 85,177*.

(69) Reg. § 54.4975-7(b)(10), ¶ 85,177*.

(70) Reg. § 54.4975-7(b)(11) & (12)(ii), ¶ 85,177*.

(71) Reg. §§ 54.4975-7(b)(12)(iii), ¶ 85,177* & 54.4975-11(d)(5), ¶ 85,177*.

(72) Reg. § 54.4975-7(b)(12)(iv) & (v), ¶ 85,177*.

(73) Reg. § 54.4975-7(b)(15), ¶ 85,177*.

(74) See, for example, the floor statement of Senator Ted Stevens in opposition to the proposed ESOP regulations. 122 Cong. Rec. § 13429-30 (daily ed. Aug. 4, 1976).

(75) Staff of the Joint Economic Committee, Congress of the United States, 94th Cong., 2d Sess., Broadening The Ownership of New Capital: ESOPs And Other Alternatives (Joint Comm. Print 1976)

(76) Long, supra note 11, at 518.

(77) Reg. § 54.4975-7(b)(2)(ii), ¶ 85,177*. See also Rev. Rul. 69-494, 1969-2 C.B. 88, ¶ 65,610*, which discusses the "exclusive benefit" rule of I.R.C. § 401(a), ¶ 75,401*, in the context of the sale of employer securities to an employees' trust. It appears that an ESOP creates a certain "unity of interests" between employer and employees.

* P-H Pension and Profit Sharing.

ESOP: Is It for Your Bank?

By

Pete M. Drexler

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ESOP: Is It for Your Bank?

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[¶ 160] Employee Stock Ownership Plans (ESOPs) lend new horizons to the control of banks. One must, however, carefully analyze the characteristics of this increasingly popular profit-sharing vehicle before venturing into its adoption. The obligation is to ascertan the flexibilities and advantages; the challenge is to avoid the pitfalls .

The projections here will show the effects an ESOP would have on a typical $50 million bank. They are accompanied with a discussion of the influence that bankers have over their corporations.

ESOPs have been gaining in popularity throughout the United States especially in the non-banking segment of our economy. The growing acceptability of ESOPs is attributable to certain advantages which conventional profit-sharing plans do not offer such as: (1) the creation of working capital through the deductibility of stock contributions; (2) adaptability to growth-oriented companies whose taxable income exceeds $50,000, and (3) their ability to increase employee morale through participation with and ownership of the employer.

But why is an ESOP preferable to other conventional profit-sharing plans? Cash flow immediately becomes a factor. Conventional profit-sharing plans, in order to qualify under the Employee Retirement Income Security Act (ERISA) and tax deductibility, must be funded in cash contributions. A corporation contributing $100,000 to a cash profit-sharing plan will experience a deduction, reducing taxes $50,000 (assuming 50% tax rates). The net cost of the contribution is $50,000. On the other hand, the contribution of employer corporation stock worth $100,000 to an ESOP does not require cash while still availing the corporation of a $100,000 deduction. So, instead of costing $50,000, an ESOP creates $50,000: a net saving to the corporation of $100,000 working capital (capital which can be used for expansion, inventory, or reduction of debt).

> **FLEXIBILITY OF STOCK TRANSACTIONS especially for the closed held corporation, is a consideration. ERISA and Internal Revenue Code regulations specify restrictions over the investments which can comprise profit-sharing plans. For example, there are prohibitions against the ownership of large concentrations of employer securities such as stock within profit-sharing plans The purchase of significant blocks of employer stock from key stockholders may lead to the disallowance of a qualified plan.**

Yet, such transactions are actually encouraged for ESOPs as long as all transactions are conducted at "Fair Market Value." This presents a complication for the closely held corporation, but once solved, enables the ESOP to actually create a market place for such stock where one did not exist before. An ESOP can actually contribute to the capital adequacy of banks. Bank regulatory bodies have been increasing their awareness of capital adequacy (usually requested to be 8% of total assets) due to recent trends of declining capital. For example, major New York banks have allowed capital to decline as low as 3.5% of total assets while the Federal Reserve Board has made it clear that this process cannot continue.

What has caused this alarming trend? Primarily, the answer can be found in the inconsistent growth rate of deposits (the primary source of bank operations). Between 1952-1962, the average annual growth of deposits was 4.3%, 9.33% during 1962-1967 and 5.6% the year ended March 1976.

As deposits grow, at whatever pace, a banker will be compelled to invest the resultant funds in order to minimize idle bank assets. Capital inadequacy results when the growth of deposits (and the resultant investment in loans or securities) exceeds the growth in bank capital (through the combination of retained earnings and the sale of new equity issues less dividends). Equity capital resources may have limitations. Banks with assets less than $25 million may sell common stock while those between $25 and $100 million may also find favorable markets for capital notes. Normally, however, investors seek such senior securities of the larger regional banks. Bank regulators normally discourage the sale of capital notes if they will exceed 33⅓% of total capital. Common stock markets for banks may be unreceptive to new issues due to low dividend policies or slow growth trends. Controlling stockholders may not approve new public stock sales which could cause dilution.

All this reveals an undesirable combination of events which will be confronting more banks if present trends within the industry continue. This is where the Employee Stock Ownership Plan offers a feature unique to profit-sharing plans.

→PURPOSE OF THE ESOP→ is to acquire employer common stock to be distributed to employees through their long-term employment. The ESOP trustees may decide to acquire a large block of employer stock at today's price as a hedge against higher prices in the future. The ESOP in guaranteeing its future vesting requirements through the purchase of a large block of stock may coincidentally help solve the employer-bank's capital inadequacy problems.

This is a desirable set of circumstances because employees, in this regard, are afforded the opportunity to aid in the operations of their employer. The stock purchase loan can be financed by the ESOP borrowing funds from a third-party institution (the loan guaranteed by the employer corporation's pledge to annually contribute cash to the ESOP). This arrangement creates the circumstances in which a corporation's debt is deductible both as to interest and principal since the cash flow is actually cash contributed to a qualified profit-sharing plan. The relative advantages and disadvantages to the leveraged ESOP transaction are discussed later. The above features of an ESOP can lead to its adoption but projections of simulated activity can be highly useful in determining the advisability of use.

Once the advantages of an ESOP are ascertained, other questions must be answered. For example, the controlling shareholder(s) will want to know when ESOP contributions will dilute control of the corporation. Other inquiries can be directed to the potential tax effects, if any, or the future cash flow requirements in order that the ESOP may repurchase shares of stock from retired employees as they tender them for sale.

A hypothetical $50 million bank was simulated in order to ascertain the effects a typical ESOP would have [see page 299]. Presumptions of 10% annual growth rate, profits amounting to 1.01% of assets, and salaries amounting to 15.6% of expenses which in turn amount to 6.10% of beginning assets, were presumed. In order to test the effects on stockholder control through dilution resulting from ESOP stock contributions, it was further assumed that at the beginning of year one, there were 50,000 shares of common stock outstanding and the controlling shareholder held 75% or 37,500 shares.

The operating percentage assumptions above were abstracted from national averages of banks in this size category, for illustrative purposes. The following describes the calculation techniques which were used for the simulation for year one:

(1) Net income of $505,000 was calculated as 1.01% of beginning assets of $50 million.

(2) Salaries resulted from multiplying total assets times 6.10% then taking 15.6% as the salary proportion of total expenses. This amount was further reduced 25% to allow for fringe benefits to net out qualifying wages of, in this case, $356,850. (It is important to note that the projected operating percentages for one's own bank would be substituted in the above calculations when evaluating the feasibility of actual ESOP situations.)

(3) At this point, the potential ESOP contribution may be computed by multiplying wages of $356,850 times 15%. Once the ESOP contribution of $53,528 is calculated, the beginning net income of $505,000 can be adjusted (net of tax effect) and ending capital ascertained.

A multi-columnar workpaper providing a column for each of the above calculated amounts should be utilized. The above calculations were repeated for ten years in this simulation to assess the effects of such a prolonged period of time.

The determination of quantity of stock shares to be contributed once the qualifying deduction has been calculated can be the most difficult aspect of ESOP administration.

If the subject stock is frequently traded at "arms length" by unrelated parties or is listed in a public market place the prevailing price may be the basis for the stock contributions. The contribution is divided by the market price to determine the number of shares to be issued to the ESOP.

There are relatively few regulations within the Internal Revenue Code to guide the ESOP administrator other than the "prudent man" rule which, among other things, calls for all stock transactions to be predicated on "fair market value". When there is no ready market for a closely held corporation's stock, periodic fair market evaluations by consultants are recommended.

This simulation utilized what was considered to be a valid stock valuation method in combining earnings per share with per-share book value calculations in estimating fair market values as follows:

Book value per share—ending capital $4,412,205 divided by shares outstanding (50,000) equals $88.24.

Earnings per share—adjusted net income ($478,236) divided by shares outstanding (50,000) equals $9.56. The multiplication of earnings per share times a valid, relevant price/earnings ratio can approximate fair market value.

Local banking conditions or evaluation of similar banking institutions may aid in the determination of a reasonable price/earnings ratio. This simulation assumed a price/earnings ratio of 11 to 1 which calculated a value of $105.21 (11 × $9.76).

The Louisiana Ad Valorem Tax Commission utilizes a formula similar to the following in establishing fair market values of Louisiana banks for the purpose of assessing taxes:

Book value per share × 3)
Expanded earnings per share × 1) divided by 4

Utilizing the above formula, fair market value at the end of year one was calculated:

$88.24 × 3 = $264.72
$105.21 × 1 = $105.21
$369.93 ÷ 4 = $92.48

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Then, the stock contribution was calculated as 578 shares ($53,528 ÷ $92.48). The shares of stock presumed to be outstanding in year two were 50,578 and so forth.

When calculating stock values, it is important to remember that generally accepted accounting principles do not necessarily reflect market values of fixed assets. The book value of the bank building for the hypothetical bank may have been $500,000.00 while it was worth $2 million. This would necessitate the following calculations in order to determine stock value:

Capital at end of year	$4,412,205
Plus: unrecorded value of bank assets	1,500,000
Adjusted capital	$5,912,205

Book value per share—
$5,912,205 ÷ 50,000 = $118.24
$118.24 × 3 = $354.72
$105.21 × 1 = 105.21
$459.93 ÷ 4 = $114.99

Thus, fair market value of the subject stock was increased from $92.48 to $114.99. The qualifying contribution of $53,528 when divided by $114.99 would indicate a stock contribution of 466 shares. This reduction of stock contributed from 578 to 466 shares in order to qualify for the same tax-deductible contribution clearly demonstrates how a highly valuable stock will reduce the dilutive effect of ESOP stock contributions.

The ten-year simulation of the hypothetical bank ESOP revealed the following information:

Deductible contributions were estimated to be $853,072 or 6,056 shares and tax savings, assuming 50% taxes, amounted to $426,536.

Since 6,056 shares of stock were issued to the ESOP, the controlling shareholder's percent of outstanding stock was reduced from 75% to 66.9%.

Other details such as growth in total capital and dividends issued to stock held by the ESOP during the ten years may be determined.

The preceding simulation presumed the normal annual contribution of deductible employer stock to the ESOP. A second projection was prepared using the assumption that the same bank decided to sell $500,000 stock to its ESOP in year one. The ESOP in turn financed the purchase with a loan from a third-party lending institution at a rate of 7½% interest payable over 10 years. It was also assumed the hypothetical bank invested the proceeds of its stock sale in municipal bonds earning 6% while all other aspects of the bank remained the same. Of course, in this situation, the annual contribution to ESOP would be in the form of cash (to enable the ESOP to pay its loan).

The projection, assuming a leveraged ESOP transaction, was prepared using the same techniques which were used in the previous simulation. The following tabulation compares the three alternatives (1) no ESOP; (2) conventional ESOP; (3) leverage ESOP; and their effects on the operations of the bank:

	No. ESOP	Conventional ESOP	Leveraged ESOP
Dividends paid to stock owned by ESOP	$ n/a	$ 106,862	$ 200,402
Total cash flow to ESOP including contributions and dividends net of tax effect	n/a	(319,674)	527,010
Value of stock issued to ESOP	n/a	853,072	599,928
Shares of stock issued to ESOP	n/a	6,056	6,051
Book value per share outstanding year ten	$ 200.73	$ 198.99	$ 201.60
Bank net income through year ten	8,048,400	7,621,866	8,016,812
Bank dividends ten years	2,012,100	1,905,418	2,004,205
Bank total assets year ten	117,897,385	117,897,385	118,840,921
Bank capital year ten	10,036,300	10,569,520	10,612,535
Controlling stockholder's percentage	75%	66.9%	66.9%

The decision to leverage the ESOP resulted in the bank accumulating $843,536 of municipal bonds, earnings were enhanced by $394,946 while the cash flow required amounted to $846,684 when the negative cash flow realized in the conventional ESOP was considered.

Interest of $246,211 paid by the ESOP on its loan was not deductible because of the non-profit status. A conventional ESOP coupled with a $500,000 loan consummated by the bank would have enabled the employer bank to maximize tax deductibility.

CONCLUSION→ Leveraged ESOP transactions are not justifiable unless there is a compelling reason to do so, as in the above simulation (an immediate need for the sale of $500,000 capital stock in year one).

Another important concept to remember is the ESOP trustees are holding 6,056 shares of common stock, each worth $198.99 (assuming conventional ESOP). If the plan had been vesting 10% of the stock each year to employees since its inception and 50% of the employees continued employment over the ten years, the ESOP would have a contingent responsibility to fund purchases of $326,244 stock for employees who could retire or sever employment in year ten. While dividends to the ESOP amount to $106,862 over the ten years, the remaining $219,382 vesting contingency could present further cash flow obligations.

This kind of analysis may lead a prospective ESOP employer to anticipate that the ESOP would be adopted for a specified period of time instead of on a permanent basis. At any rate, ESOPs can provide increased flexibilities to bank management along with tax savings while at the same time provide pitfalls which must be estimated. The above simulation technique can help assess the desirability of adopting an ESOP within a bank.

HYPOTHETICAL E.S.O.P. BANK SCHEDULE

Year	Total Assets	Before ESOP Net Income	Salaries	15% ESOP Contributions	After ESOP Net Income	25% Dividends
1	50,000,000	505,000	356,850	53,528	478,236	119,559
2	55,000,000	555,500	392,535	58,880	526,060	131,515
3	60,500,000	611,050	431,789	64,768	578,666	144,667
4	66,550,000	672,155	474,967	71,245	636,533	159,133
5	73,205,000	739,371	522,464	78,370	700,186	175,047
6	80,525,500	813,308	574,710	86,207	770,205	192,551
7	88,578,050	894,638	632,182	94,827	847,225	211,806
8	97,435,855	984,102	695,400	104,310	931,947	232,937
9	107,179,441	1,082,512	764,940	114,741	1,025,142	256,286
10	117,897,385	1,190,764	841,305	126,196	1,127,666	281,917
TOTALS		8,048,400	5,687,142	853,072	7,621,866	1,905,418
				50% - 426,536		

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Capital end of year	Book value share	Income share x 11	Shares outstanding during the year	Market value per share	ESOP shares contributed
4,412,205	88.24	105.21	50,000	92.48	578
4,865,630	96.20	114.41	50,578	100.75	584
5,364,397	104.85	124.41	51,162	109.74	590
5,913,042	114.26	135.30	51,752	119.52	596
6,516,551	124.49	147.13	52,348	103.15	602
7,180,412	135.61	160.00	52,950	141.71	608
7,910,658	147.70	174.01	53,558	154.28	615
8,713,978	160.85	189.23	54,173	167.95	621
9,597,575	175.16	205.80	54,794	182.82	628
10,569,520	190.71	223.82	55,422	198.99	634
					6,056
		Shares outstanding End of Year 10	56,056		

An Analytical Report

Prepared for the

Profit Sharing Council of America

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FOREWORD

Members of the Profit Sharing Council of America have expressed an interest in the subject of Employee Stock Ownership Plans (ESOPs). Generally, an ESOP is a defined contribution plan which can also be used as a technique of corporate finance. Many questions have been raised about the differences (conceptually, legally and practically) between ESOPs and profit sharing plans. To help answer these questions, the Council commissioned Hewitt Associates to conduct the objective study reported here.

Three recent pieces of legislation have created much of the interest in ESOPs.

- The Employee Retirement Income Security Act of 1974 provides the generic definition of an ESOP as a qualified stock bonus plan or a combination of qualified stock bonus and money-purchase pension plans designed to invest primarily in employer securities including equity securities and, within certain limitations, debt securities.
- The Tax Reduction Act of 1975 incorporates a slightly more restrictive form of ESOP whereby the company can receive an additional 1% Investment Tax Credit on eligible capital expenditures by contributing a corresponding amount to an ESOP strictly to invest in employer stock.
- The Trade Act of 1974 provides for preferential treatment in the granting of government guarantees of loans in trade-impacted areas to companies that also establish ESOPs.

The Regional Rail Reorganization Act of 1973 first presented the ESOP concept in legislative form, but the final form of this Act contained no mandatory provisions regarding ESOPs.

Except where otherwise indicated, the use of the term ESOP throughout this report refers to a plan which is qualified under Section 401(a) of the Internal Revenue Code and *which utilizes debt financing to invest in employer securities*. Such a usage is not intended to imply that an ESOP trust must incur debt; rather, the inclusion of debt financing as implicit to the ESOP concept is based on the premise that *it is the ability of the ESOP to be utilized as a technique of corporate finance that not only differentiates these plans from more traditional forms of defined contribution plans but is the cause of the recent interest and controversy surrounding ESOPs. ESOPs implemented under the provisions of the Tax Reduction Act are considered separately and referred to as Tax Reduction Act ESOPs.* Although a Tax Reduction Act ESOP may also be utilized as a technique of corporate finance, the impetus for implementing such ESOPs is the additional 1% tax credit available to companies (which implement a Tax Reduction Act ESOP) and not the debt financing ability of the plan.

This report addresses the differences between ESOPs and profit sharing plans by:

- providing the background information necessary to an understanding of the ESOP concept (Section I).
- reviewing the legislative history and legal definitions of ESOPs (Section II).

- comparing the characteristics of ESOPs, stock bonus plans, and profit sharing plans (Section III),
- examining an ESOP (as compared to a profit sharing plan) as an employee benefit plan (Section IV),
- analyzing an ESOP as a technique of corporate finance (Section V),
- discussing conversion of profit sharing plans to ESOPs, federal income tax considerations, exclusive benefit of participants, valuation of company stock, and SEC aspects (Section VI),
- reviewing the information supplied in a private survey of ten companies currently employing ESOPs (Section VII),
- discussing the impact of Kelso's two-factor economic theory in order to gain an understanding of the impetus behind favorable ESOP legislation (Section VIII), and
- examining the proposed Accelerated Capital Formation Act of 1975 currently introduced in the House of Representatives. (Section IX).

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The ESOP Concept

The concept of ESOP was introduced by Louis O. Kelso and Patricia Hetter in a book entitled *Two-Factor Theory: The Economics of Reality.** Such plans, as conceived by Kelso and Hetter, would form the basis for a new capitalism that would have a far reaching and beneficial effect on the country's economy. It is their two-factor economic theory that has influenced legislators (most notably Senator Russell B. Long) to pass bills that encourage the implementation of ESOPs. A detailed summary of Kelso and Hetter's economic theory is included in a later section of this report.

The "Kelso Plan" was the first definition of an ESOP. The mechanics for establishing such a plan are as follows:

1. A company establishes a deferred compensation plan and trust in compliance with Section 401 of the Internal Revenue Code. Such a plan would probably take the form of a qualified stock bonus plan but would differ in principle, as will become clear.
2. The company sells a new issue of common stock to the trust; the trust pays an amount equal to the present market value of the stock from a loan (from the bank trustee or insurance company, for example). The company guarantees to make annual (tax deductible) contributions to the trust sufficient to amortize the loan in a reasonable period of time (four to seven years). Presumably, the stock could be used as collateral, but companies having publicly traded stock, would be subject to the Securities Credit Transactions' Regulations of the Board of Governors of the Federal Reserve System. Thus, it is the company's guarantee (creditability) that is crucial to the transaction.
3. The company makes annual (tax deductible) contributions to the trust, which are used to amortize the debt. Shares are allocated to individual participant accounts on a cost basis as contributions are made. Vesting of allocated shares would be according to plan provisions.
4. Once the stock is paid for, dividends of participants' shares would be passed through the trust to them, thus providing a "second income".
5. There would probably be additional stock issued when the first is paid for; but in any event, company contributions would continue to be made thereafter.
6. The participants' holdings in the trust accumulate tax free until retirement or other termination with the company. For tax reasons, a lump-sum distribution would probably be made, in which case the participant would be taxed (as ordinary income, subject to ten-year averaging) on the difference between his cost (zero, unless the ESOP is contributory) and the fair market value (trust's cost) at time of purchase. When the participant sells his stock, appreciation before distribution is taxed as long-term capital gain; appreciation after distribution is long-term or short-term capital gain depending on how long held.

---

*Louis O Kelso and Patricia Hetter. *Two Factor Theory: The Economics of Reality.* New York. Vintage Books, 1967.

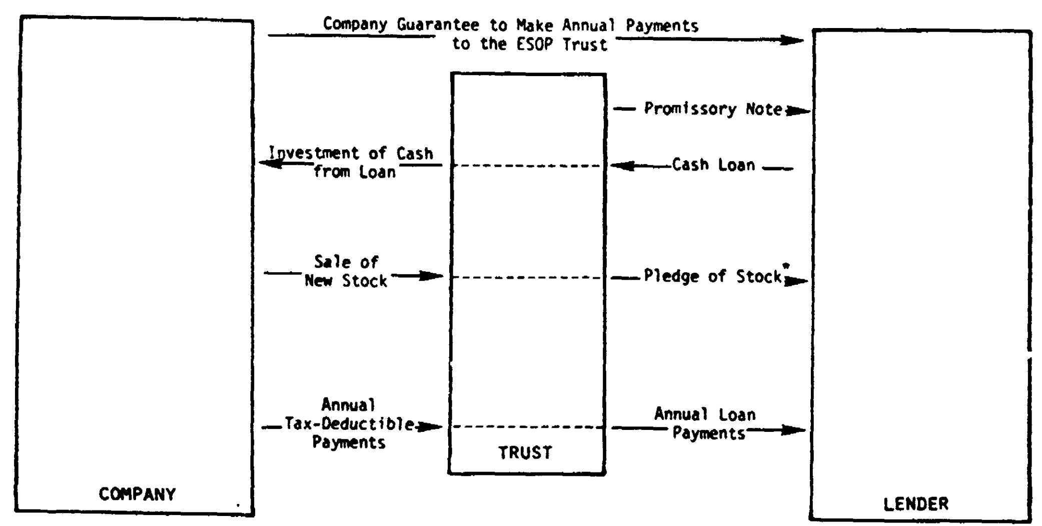
Such a plan, say Kelso and Hetter, would form the basis for a second economy (by creating new and useful capital, and by increasing the purchasing power of consumers) that would be several times as productive as the present one. The presumed advantages are:

- To employer
  - The financial leverage of repaying a loan (interest and *principal*) with pretax dollars;
  - The increase in employee incentive, including management, by giving them a "piece of the action;"
  - Any additional uses, such as financing of acquisitions or estate planning for privately held companies, that may be applicable to a particular company.
- To employee
  - The main advantage to the employee, as compared to a traditional defined contribution plan, is the ability of the trust to use the company's credit. That is, employees are able to acquire equity ownership out of future corporate earnings, rather than out of past corporate earnings.

The following diagram pictorializes the ESOP concept.

Diagram 1

EMPLOYEE STOCK OWNERSHIP PLAN



When Loan is Amortized, Cycle Begins Again

* See point 2, on page 5

ESOPS DEFINED

Thus far, this report has concentrated on explaining the ESOP concept as it was conceived by Kelso and Hetter. Such a context forms a necessary base from which to view the legal evolution of ESOPs, a process which, in fact, is only beginning That is, it is one thing for an economist to define a technique of corporate finance (that also allows employees to become company shareholders) as a plan and trust qualified under Section 401(a) of the Internal Revenue Code, but it is quite a different matter for such an idea to be legally defined.

True, the ESOP idea has been utilized by companies for several years, but since there were really no legal definitions or regulations pertaining *specifically* to ESOPs, such plans were, (in effect) worked out between companies and the IRS district office involved.

Recently, however, four separate pieces of congressional legislation have included definitions of ESOPs. The four Acts involved are:

- The Regional Rail Reorganization Act of 1973
- The Employee Retirement Income Security Act of 1974
- The Trade Act of 1974
- The Tax Reduction Act of 1975

This section of the report examines the ESOP definitions these Acts provide.

Regional Rail Reorganization Act of 1973

A legal definition of ESOPS first appeared in the Regional Rail Reorganization Act of 1973, enacted January 2, 1974:

> Employee stock ownership plan means a technique of corporate finance that uses a stock bonus trust or a company stock money purchase pension trust which qualifies under Section 401(a) of the Internal Revenue Code of 1954 (26 U.S.C. 401(a)) in connection with the financing of corporate improvements, transfers in the ownership of corporate assets and other capital requirements of a corporation and which is designed to build beneficial equity ownership of shares in the employer corporation into its employees substantially in proportion to their relative incomes, without requiring any cash outlay, any reduction in pay or other employee benefits, or the surrender of any other rights on the part of such employees. (RRRA Section 102(5))

The bill was enacted to establish the new Consolidated Rail Corporation, which will eventually run the reorganized Northeast railroads. The original Senate version of the bill would have (to the extent practical) required the new Corporation to meet its capitalization requirements through the use of an ESOP. While the language in the final bill was softened to "giving the Corporation authority to purchase its common stock through an ESOP," the Senate definition of ESOP was adopted.

The elements of the definition that distinguish an ESOP from a traditional qualified defined contribution plan are:

- An ESOP is a technique of corporate finance;
- Allocations *must be* substantially in prooortion to participants' relative incomes; and

- The plan *must not* require employee contributions.

These differences will be repeated in future ESOP definitions.

Employee Retirement Income Security Act of 1974 (ERISA)

ERISA was the next piece of congressional legislation impacting on ESOPs. For the first time ESOPs were given a definition that was to be added to the Internal Revenue Code:

> Employee Stock Ownership Plan — The term "employee stock ownership plan" means a defined contribution plan —
>
> A. which is a stock bonus plan which is qualified. or a stock bonus and a money purchase plan both of which are qualified under Section 401(a). and which are designed to invest primarily in qualifying employer securities; and
>
> B. which is otherwise defined in regulations prescribed by the Secretary or his delegate. (IRC Section 4975(e)(7))

Qualifying employer securities are defined to be:

> Qualifying Employer Security — The term "qualifying employer security" means an employer security which is —
>
> A. stock or otherwise an equity security. or
>
> B. a bond. debenture. note. or certificate or other evidence of indebtedness which is described in paragraphs (1). (2). and (3) of Section 503(e). (IRC Section 4975(e)(8))

The bonds. debentures. notes. etc.. referred to are defined as marketable obligations (essentially. traded on a major exchange or over-the-counter). The plan's holdings of such debt securities. however. cannot exceed 25% of the plan's total assets; nor can such holdings exceed 25% of the aggregate amount of any employer debt issue. Finally. the plan can hold these securities only so long as at least 50% of any single debt issue remains in the ownership of parties independent of the employer (ERISA Section 407(e)).

While the question of corporate financing is not answered specifically in the ERISA definition of ESOP. other sections of the Act make it clear that such a technique of corporate finance is permitted by an ESOP. That is. the prohibited transaction of lending of money or other extension of credit between the plan and a party in interest (employer. employees. directors. 10 percent shareholders. etc..) set forth in Section 406(a)(1)(B) is clearly exempted in the case of an ESOP:

> The prohibitions provided in Section 406 shall not apply to any of the following transactions . . .
>
> (3) A loan to an employee stock ownership plan . . . if —
>
> A. such a loan is primarily for the benefit of participants and beneficiaries of the plan. and
>
> B. such loan is at an interest rate which is not in excess of a reasonable rate.

> If the plan gives collateral to a party in interest for such loan, such collateral may consist only of qualifying employer securities . . . (ERISA Section 408(b)(3))

This exemption is particularly significant because:

- It allows an ESOP to borrow money, repayment of which is guaranteed by the company. It is the ESOP's ability to utilize the company's credit that is critical to the ESOP concept.
- It also allows an ESOP to buy stock on an installment basis from a shareholder (although this is only applicable to smaller, privately-held companies).

However, it is also important to note that any special privileges allowed an ESOP do not change the fact that the plan must be primarily for the benefit of participants. In referring to the transactions listed above (loans guaranteed by company and agreements to buy stock on installment from a shareholder), the Committee Report to Section 408 says:

> Although these transactions normally are for the benefit of plan participants and beneficiaries, the conferees recognize that there may be potential problems. For example, the interest rate should not be too high and the purchase price of the stock from the party-in-interest should not be too high, so that plan assets might be drained off. Also, the terms of the note between the party-in-interest and the plan should not allow the party-in-interest to call the note at his convenience, which might put undue financial strain on the plan. Because of such potential problems, the conferees intend that all aspects of these transactions will be subject to special scrutiny by the Department of Labor and the Internal Revenue Service to ensure that they are primarily for the benefit of plan participants and beneficiaries. (Committee Report to Section 408)

Trade Act of 1974

The Trade Act of 1974 was the next major piece of legislation that included ESOP provisions. The Act provides federal guarantees for loans made to companies hurt by foreign competition . Additionally, companies agreeing to pay 25% of a loan to a qualified trust under an ESOP will be given preference in consideration. The definition of ESOP used in the Act is as follows:

> "Employee stock ownership plan" means a technique of corporate finance that utilizes stock bonus plans or stock bonus plans coupled with money purchase plans qualified under Section 401 of the Internal Revenue Code of 1954 which is designed to invest primarily in qualifying employer securities and which meets such other requirements as the Secretary of the Treasury may prescribe by regulation. (Trade Act of 1974 Section 157(5)(A)).

Again ESOPs are recognized as a *technique of corporate finance*. Qualified employer securities means common stock issued by a corporation or by a parent or subsidiary of that corporation which has the same voting power and dividend rights as that of other common stock issued by the corporation. Other ESOP requirements set down in the Act for qualification for special consideration include:

- Allocations must be substantially in proportion to participants' relative incomes;
- Employees must be allowed to vote stock that is allocated to their accounts; and

- The plan cannot require any employee contributions, any reduction in pay or other employee benefits, or the surrender of any other rights on the part of the employee.

Again, such qualifications distinguish an ESOP from the more traditional forms of qualified defined contribution plans. The fact that Kelso and Hetter's theories on two-factor economics in general and on ESOPs in particular were influential in the passing of the Act are apparent.

The following excerpts are taken from the Report of the Committee on Finance concerning the Act:

> The key to corporate ownership is access to corporate credit. Credit is generally available to well-managed corporations for investing under conditions where the investment is expected to pay for itself. The effect of this policy, however, has been to deny access to more fair and more effective participation in corporate ownership among middle-income and low-income American workers.
>
> Over 95% of investment finance is based on either the reinvestment of current profits or borrowings repaid with future profits; only a tiny fraction is based on the sale of new equities for cash to the small segment of the public who can afford such a cash transaction . . .
>
> Qualitative studies of the U.S. capital ownership base show that almost 100% of privately owned U.S. capital assets are concentrated in less than 10% of U.S. households. Although 20 million Americans own as least one share of corporate stock, the top one percent of U.S. wealth-holders own 50% of all U.S. corporate stock. Hence, few working Americans have any effective means of participating as stockholder-constituents of our free enterprise system . . .
>
> Employee stock ownership plans make it possible for workers in the private sector of our economy to share in the ownership of corporate capital without redistributing the property or profits from existing assets belonging to existing stockholders . . .
>
> The Committee considers the employee stock ownership plans an innovative technique of finance which could have important benefits for labor, management and the economy of the United States. (Report No. 93-1298 of the Committee on Finance)

It is apparent that proponents of ESOPs view these plans as having important implications for the United States.

Tax Reduction Act of 1975

The most recent congressional legislation involving ESOPs was the Tax Reduction Act of 1975. This Act, more than any of the others, has stimulated interest in ESOPs. Under the Act, the normal investment credit available to corporations was extended from 7% to 10%; however, under Section 301(d) of the Act, companies may claim an additional tax credit in an amount equal to 1% of the corporation's qualified investment if such an amount is transferred, either in employer stock or in cash (provided it is used to buy employer stock) to an ESOP. Assets contributed up to 1% of the corporation's qualified investment are used as tax benefits and not as deductions; contributions in excess of required amounts may be deductible. Thus, an 11% credit is available (to companies having ESOPs) with respect to property acquired and placed in service after January 21, 1975 and before

January 1. 1977. An employer contribution must be transferred to an ESOP at one time. In effect. the bill allows companies making qualified investments to pay an amount equal to 1% of that investment to their employees instead of to the government if the company contributes the money to an ESOP. The Tax Reduction Act defines ESOP as a plan which·

A. is a stock bonus plan. a stock bonus and a money purchase pension plan. or a profit sharing plan.

B. is designed to invest primarily in employer securities. and

C. meets such other requirements (similar to requirements applicable to employee stock ownership plans as defined in Section 4975(e)(7) of the Internal Revenue Code of 1954 as the Secretary of the Treasury or his delegate may prescribe. (Tax Reduction Act Section 301(d)(2))

The Act. however. goes on to stipulate the following additional requirements for ESOPs qualifying for the tax credit:

- The ESOP may not require employee contributions or reductions of other employee benefits;
- Qualifying employer securities must be common or convertible preferred stock (or may be such securities of an affiliate);
- Employer contributions are to be allocated to participants in proportion to pay on a non-integrated basis. Annual pay in excess of $100.000 is to be disregarded:
- Employees must have right to vote the stock allocated to them;
- Amounts allocated to participants must be fully vested;
- Distributions to a participant (except in case of death. disability or separation from service) may not occur until the end of the 84th month beginning with the month in which the stock is allocated to the participants' account.

The Act also provides that plans not qualified under Section 401(a) of the IRC may qualify for a tax credit if such a plan meets the additional requirement listed above and if it complies with the allocation restrictions of Section 401 of the Code. the participation provisions of Section 410 of the Code and the limitation on benefits and contributions of Section 415 of the Code. Thus. it is unlikely that a plan meeting the criteria to qualify for the Tax Reduction Act would not also be a tax-qualified plan under Section 401(a) of the Code. In fact. it is apparent that. generally. *an ESOP must meet more requirements to qualify for the Tax Reduction Act than a traditional defined contribution plan must meet to qualify under Section 401(a) of the IRC.* The significance of the Tax Reduction Act regarding ESOPs is the impetus that it gives large corporations to evaluate the ESOP concept.That is. 1% of the qualifying investments of large corporations can be a very significant dollar amount. Despite Kelso and Hetter's assertion that the ESOP concept was especially applicable to large. successful corporations. the fact remained that ESOPs had been primarily implemented by small privately owned corporations. The Committee Report points out their intention to popularize the ESOP concept: "The Committee believes that through the employee stock ownership plan. many corporate employers will be introduced to a new technique of corporate finance that will enable the company to build its ownership for their employees. and in this way benefit society as a whole." (Report No. 94-36 of the Committee on Finance)

It is important to note that the Tax Reduction Act defined ESOPs to include profit sharing plans. The Committee Report accompanying the Act indicates that the additional tax credit allowed by the Act could be obtained by companies combining the ESOP with an existing plan. For instance, if the employer has an existing savings or thrift plan, it may combine a Tax Reduction Act ESOP with this plan in order to take advantage of the additional 1% tax credit available under the Act. The ESOP portion of the plan, however, must be in compliance with the terms of the Act (no matching payments required for participation, allocations substantially in proportion to participants' pay, etc.) In essence, the savings plan would only provide the vehicle for obtaining the 1% tax credit; contributions to the ESOP portion of the plan would not be used to offset employer contributions to the savings plan.

Thus, the inclusion of profit sharing plans in the definition of ESOP in the Act seems to be to allow such plans to take advantage of the tax credit (providing any such contribution is in compliance with the Act) and not to alter the historical differences between ESOPs and profit sharing plans. The attractiveness of implementing a Tax Reduction Act ESOP is, to a large extent, dependent on the value (per participant) of an employer contribution of 1% of the corporation's 1975-1976 qualifying capital investments. That is, while the 1% investment credit in the Tax Reduction Act can involve significant dollar amounts in large corporations, these dollar amounts are not necessarily very significant as a percentage of pay. Such a plan would be most attractive to capital intensive companies.

COMPARISON OF PROFIT SHARING PLAN, STOCK BONUS PLAN AND ESOP CHARACTERISTICS

ESOPs c... be generically described as defined contribution, individual account plans similar to stock bonus plans and profit sharing plans. Such a description relates ESOPs to two familiar employee benefit plans and, thus, creates a base from which these plans may be viewed. Once this base is established, it becomes necessary to differentiate between these three types of defined contribution plans.

ESOPs and Stock Bonus Plans

The fact that ERISA specifically defines an ESOP as a stock bonus plan which is qualified, or a stock bonus and a money purchase plan both of which are qualified under Section 401(a) of the IRC, and which are designed to invest primarily in qualifying employer securities seems to indicate that an ESOP is different from a traditional stock bonus plan. The obvious distinction in the definition is that an ESOP must be *primarily* invested in qualifying employer securities. The nature of a stock bonus plan requires the trust to be sufficiently invested in employer stock to allow the plan the "liquidity" necessary to make the *required stock distributions* to terminating participants. Historically, some stock bonus plans invested parts of their funds in government bonds, key-man life insurance, etc.

The extent to which the word *primarily* mandates an ESOP trust to invest in employer securities can only be determined by future regulations. However, due to the scrutiny these plans will receive, companies should probably practice a strict interpretation in the interim.

A more fundamental difference between an ESOP and a stock bonus plan is the ability of the plan to be utilized as a technique of corporate finance. This difference is implicit in ERISA, which specifically allows an ESOP:

- to borrow money, repayment of which is guaranteed by the company, and
- to buy stock on an installment basis from a shareholder. (ERISA Section 406(a)(1)(B) and Section 408(b)(3))

In effect, an ESOP (generally) is a stock bonus plan which is also designed to allow the trust to utilize company credit as a means of debt financing.

ESOPs and Profit Sharing Plans

ESOPs differ from profit sharing plans in the same ways that they differ from stock bonus plans. Additionally, they differ from profit sharing plans in that, as a form of stock bonus plan, they:

- need not base employer contributions on company profits, and
- must make distributions in employer stock (Reg. § 1.401(b)(1)(iii))

It is the ESOP's facility to guarantee company contributions, regardless of profits, that allows the ESOP to be utilized as a technique of corporate finance.

Different Kinds of ESOPs

The fact that the four acts that have dealt with ESOPs have all offered different definitions of such plans has added to the confusion surrounding this already complex concept. While it is true that the provisions in one act may offer insights into the future regulations for another act, there are two acts – ERISA and the Tax Reduction Act – which are of special interest to companies. The following pages display a profile of plan characteristics for four types of plans:

- Traditional qualified profit sharing plans;
- Traditional qualified stock bonus plans;
- Leveraged ESOPs (essentially as defined by ERISA, and recognized as plans utilizing debt financing); and
- Tax Reduction Act ESOPS (plans designed to take advantage of the additional 1% tax credit and not necessarily used as a means of corporate finance).

PLAN CHARACTERISTICS PROFILE

Characteristics	Profit Sharing Plan	Stock Bonus Plan
Form of Plan:	Profit sharing plan qualified under Section 401(a) of IRC.	Stock bonus plan qualified under Section 401(a) of the IRC.
Participation:	As a qualified plan, a profit sharing plan must meet the non-discriminatory provisions of Section 410 of the IRC. Such participation may not discriminate in favor of officers, shareholders or highly compensated employees. Generally, a plan may not set more stringent minimum age and service conditions than the later of: i) the date on which the employee attains age 25, or ii) the date on which he completes 1 year of service. However, a plan which provides for immediate vesting may substitute "3 years of service" for "1 year of service" in condition (ii) above.	Same as for a profit sharing plan
Investment in Employer Securities:	Historically, many profit sharing plans have invested all or most of their funds in employer stock. Under ERISA, it appears that profit sharing plans may continue to invest large portions of their funds in employer stock. (ERISA Section 404(a)(2)) The percentage of the trust that will be invested in employer stock should probably be specified in the plan document.	Section 1.401(b)(iii) of the Income Tax Regulations provides that a stock bonus plan is a plan established and maintained by an employer to provide benefits similar to those of a profit sharing plan, except that the contributions by employer are not necessarily dependent upon profits and the benefits are distributable in stock of the employer company. The nature of a stock bonus plan obligates the trustee to invest in the stock of the employer.

PLAN CHARACTERISTICS PROFILE

Leveraged ESOP	Tax Reduction Act Qualified ESOP
A stock bonus plan which is qualified, or a stock bonus and a money purchase plan both of which are qualified under Section 401(a) of the IRC, and which are designed to invest primarily in qualifying employer securities. (IRS Section 4975(e)(7)(A))	A stock bonus plan, a stock bonus and a money purchase pension plan, or a profit sharing plan, which is designed to invest primarily in employer securities. (Tax Reduction Act Section 301(d)(2)(A))
Same as for a profit sharing plan.	The ESOP must comply with the participation rules of Section 410 of the Code. (Tax Reduction Act Section 301(d)(7)(C)) The ESOP cannot be a plan integrated with Social Security.
By definition an ESOP must invest primarily in qualifying employer securities. (IRC Section 4975(e)(7)(A))	The ESOP must invest primarily in employer securities. (Tax Reduction Act Section 301 (d)(2)(B))

PLAN CHARACTERISTICS PROFILE

Characteristics	Profit Sharing Plan	Stock Bonus Plan
Qualifying Employer Securities:	The IRS has historically held that in order for an investment to be consistent with the exclusive-benefit-of-employees requirement of Section 401(a) of the IRC, it must meet the following four requisites: 1) the cost must not exceed fair market value at time of purchase; 2) a fair return commensurate with the prevailing rate must be provided; 3) sufficient liquidity must be maintained to permit distributions in accordance with the terms of the plan; and 4) the safeguards and diversity that a prudent investor would adhere to must be present. (Publication 778, Part 2(k)(1)) Generally, investments in employer securities should meet these requisites.	The requirement for a fair return commensurate with the prevailing rate (requisite #2 of profit sharing plans) is not applicable to an obligatory investment made in the stock of the employer by the trustee of a stock bonus trust. (Rev. Rul. 69-65) The nature of a stock bonus plan satisfies the liquidity and diversity requisites. Thus, the valuation of employer stock is of great importance in dealing with stock bonus plans.
Employer Contributions:	Section 404(a)(3)(A) of the IRC allows for tax deductible contributions up to 15% of the participants' eligible compensation, with a carryover provision allowing up to 25% of such contribution in one year. Such contributions must, however, be made from current or accumulated profits. (Reg. § 1.401-(b)(1)(iii)) The maximum annual addition to any one participant's account cannot exceed the lesser of: • $25,000, as adjusted annually for the cost of living, or • 25% of the participant's compensation. (ERISA Sec. 2004 (a)(2))	Same as for profit sharing plans except contributions to stock bonus plan need not be contingent on profits. (Reg. § 1.401-(b)(1)(iii))

PLAN CHARACTERISTICS PROFILE

Leveraged ESOP

A qualifying employer security is:

A. stock or other equity security,
   or
B. a bond, debenture, note, or other evidence of indebtedness . . . (IRC Section 4975(e)(8))

The bonds, debentures, notes, etc., referred to are defined as marketable obligations (essentially traded on major exchange or over-the-counter). The plan's holdings of such debt securities, however, cannot exceed 25% of the plan's total assets; nor can such holdings exceed 25% of the aggregate amount of any employer debt issue. Finally, the plan can hold these securities only so long as at least 50% of any single debt issue remains in the ownership of parties independent of the employer. (IRC Section 503(e)(1)(2)(3))

Same as for stock bonus plans. However, if the ESOP takes the form of a combination stock bonus plan and money purchase plan, it appears that annual tax deductible company contributions of 25% of participants' eligible compensation could be made to the trust, without using contribution carryovers.

Tax Reduction Act ESOP

Qualifying employer securities are common or convertible preferred stock of the employer or an affiliate. (Tax Reduction Act Section 301(d)(9)(A))

Under Section 301(d) of the Act, companies may claim an additional tax credit in an amount equal to 1% of the corporation's qualified investment (with respect to property acquired and placed in service after January 21, 1975 and before January 1, 1977) if such an amount is transferred to an ESOP. Such a contribution must be transferred to an ESOP at one time, and not over 10 years. Contributions to a qualified plan in excess of the 1% tax credit would be tax deductible, subject to the limitation of Section 404(a) of the Code.

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PLAN CHARACTERISTICS PROFILE

Characteristics	Profit Sharing Plan	Stock Bonus Plan
Employee Contributions:	The IRS has ruled that, generally, mandatory employee contributions of 6% or less of eligible annual compensation are not discriminatory. (Rev. Rul. 72-58) The IRS has also placed a maximum limitation on an annual voluntary contribution by a participant of 10% of his eligible compensation. (Rev. Rul. 59-185) SEC registration may be required for plans investing primarily in employer securities and providing for employee contributions.	The IRS rules applying to stock bonus plans are the same as those applying to profit sharing plans. However, employee contributions may raise some SEC considerations. Mandatory employee contributions may constitute a "sale" for Securities Act purposes. Historically, the SEC has treated voluntary employee contributions to a stock bonus plan under a "no sale" philosophy, but the statutory basis for not requiring registration is unclear. Plans allowing voluntary contributions often stipulate that such contributions are not to be invested in employer stock.
Allocations:	Section 1.401-1(b)(1)(ii) of the Income Tax Regulations states that a profit sharing plan must provide a definite predetermined formula for allocating the contributions made to the plan among the participants. Allocation formulas may be based on compensation or on compensation and service. Plans may be integrated with Social Security.	Section 1.401-1(b)(1)(iii) of the Income Tax Regulations states that, for purposes of allocating the stock of the employer, a stock bonus plan is subject to the same requirements as a profit sharing plan.
Voting of Stock:	Voting rights of allocated company stock may or may not be passed on to participants, according to the provisions of the plan.	Same as for a profit sharing plan.

PLAN CHARACTERISTICS PROFILE

Leveraged ESOP	Tax Reduction Act ESOP
Since ERISA defines an ESOP as a stock bonus plan or a combination stock bonus and money purchase pension plan, it appears that an ESOP faces the same SEC considerations concerning employee contributions that a stock bonus plan does. However, in the case of an ESOP (which, by definition must invest primarily in employer securities), these considerations are even greater. Since three of the Acts that have dealt with ESOPs define these plans as not requiring employee contributions (and since ESOPs will likely come under close scrutiny by the SEC), it appears that these plans should not require employee contributions, and perhaps should be non-contributory.	The ESOP may not require employee contributions or reductions of other employee benefits.
ERISA defines an ESOP as a stock bonus plan or a combination stock bonus and money purchase pension plan. However, three of the Acts concerning ESOPs have stated that allocations must be substantially in proportion to participants' relative incomes and should not be integrated with Social Security. Whether Treasury Regulations will similarly restrict allocations is speculative (but should be a consideration of companies implementing such plans). It also appears that in cases where the trust has incurred a debt, the ESOP should allocate contributions based on original cost of the stock to the trust.	Employer contributions are to be allocated to participants in proportion to pay. Annual pay in excess of $100,000 is to be disregarded. (Tax Reduction Act Section 301(d)(3)) The ESOP cannot be an integrated plan.
As a defined contribution plan, it appears that an ESOP has the option of whether or not to extend voting rights of allocated stock to participants. However, plans qualifying under either the Trade Act or the Tax Reduction Act must provide that participants be allowed to vote stock allocated to their accounts.	Employees must have right to vote stock allocated to them. Voting rights must be no less favorable than the voting rights of other common stock issued by the employer (Tax Reduction Act Section 301(d)(9)(A))

PLAN CHARACTERISTICS PROFILE

Characteristics	Profit Sharing Plan	Stock Bonus Plan
Dividends:	Section 401(a) of the Code requires that a qualified plan be for the exclusive benefit of employees or their beneficiaries. The IRS has historically held that trust investments must provide a fair return commensurate with the prevailing rate. (Publication 778, Part 2(K)(1)) The IRS may view stock of the employer with dividend rights less favorable than the dividend rights of other stock issued by the employer as not providing a fair return commensurate with the prevailing rate.	The requirement for a fair return commensurate with the prevailing rate is not applicable to an obligatory investment made in the stock of the employer by the trustee of a stock bonus trust. (Rev. Rul. 69-65) This ruling may allow district IRS offices to rule favorably on stock bonus plans that contribute employer stock with dividend rights less favorable than the dividend rights of other stock issued by the employer.
Vesting:	A profit sharing plan must at least meet one of the three vesting schedules set forth in Section 411 of the IRC: • 5- to 15-year graded standard, • 10-year/100-percent standard, • "Rule of 45" standard. In many cases, defined contribution plans must meet more restrictive vesting requirements.	Same as for a profit sharing plan.
Distributions:	A profit sharing plan must provide a definite predetermined formula for distributing funds accumulated under the plan. (Reg. § 1.401(b)(1)(ii)) A plan that is largely invested in employer stock will often include a provision that distributions should be made in employer stock when, and to the extent, possible. Such a provision aids in the task of complying with the liquidity rule in a profit sharing plan.	Similarly, a stock bonus plan must provide a definite predetermined formula for distributing funds accumulated under the plan. *Distributions must be in company stock.* (Reg. § 1.401(b)(1)(ii)(iii)) Distributions may be made in either a lump-sum or in installments; however, a lump sum distribution may be advantageous to participants because the unrealized appreciation is entitled to capital gains treatment when the participant sells the stock.

PLAN CHARACTERISTICS PROFILE

Leveraged ESOP	Tax Reduction Act ESOP
Apparently the same as for a stock bonus plan. To add another dimension to this device, Kelso and Hetter have advocated dividend "pass-through" as the source of a non-inflationary second income for employees. Several IRS district offices have approved a provision in ESOPs allowing dividends on company stock in the participant's company stock account to be passed-through in cash. The philosophy is that the dividend is part of the beneficial ownership of the stock and should be allowed to be passed-through to the participants.	Dividend rights must be no less favorable than the dividend rights of other common stock issued by the employer. (Tax Reduction Act Section 301(d)(9)(A))
Same as for a profit sharing plan.	Amounts allocated to participants must be fully vested. (Tax Reduction Act Section 301(d)(4))
Apparently the same as for a stock bonus plan. However, if the plan is a combination stock bonus and money purchase plan, future IRS regulations may allow other forms of distributions for the money purchase part of the plan. In the case of a closely-held company, it may be desirable to provide an option for a terminated employee to sell his stock either to the company or to the trustee. Under such an option, the company and/or the trustee would be given a right of first refusal to repurchase the stock when the employee decides to sell. Such an option would provide both a source of stock for future participants in the plan and a market for shares distributed to terminated employees. Accurate valuation of the stock is important for such a transaction.	Distributions of stock to a participant (except in case of death, disability or separation from service) may not occur until the end of the 84th month beginning with the month in which the stock is allocated to the participant's account. (Tax Reduction Act Section 301(d)(4))

ESOP AS AN EMPLOYEE BENEFIT PLAN

As a plan qualified under section 401(a) of the IRC, *ESOPs are first and foremost an employee benefit plan.* As such, they *must be for the exclusive benefit of participants* or their beneficiaries. Any analysis of the advantages and disadvantages of ESOPs must first deal with their value as an employee benefit plan.

The preceding section of this report discussed in detail the characteristics of profit sharing plans, stock bonus plans and ESOPs. Generally, an ESOP is a stock bonus plan designed to allow the trust to borrow money to invest in employer securities. Therefore, it appears that an ESOP differs from a profit sharing plan in that:

- An ESOP must invest primarily in employer securities;
- An ESOP must make distribution in employer stock;*
- An ESOP need not relate employer contributions to company profits;
- An ESOP trust's obligatory investment in employer securities is not subject to a fair return commensurate with the prevailing rate requirement.

One of the consequences of these differences, as pointed out in the preceding section, is that an ESOP may be used as a technique of corporate finance.

Advantage of ESOP to Employee

The *principle advantage* of an ESOP (as compared to a profit sharing plan) *to the employee* is the leverage the trust receives by being able to utilize company credit. This advantage assumes that an investment in company capital is a good investment. In effect, the trust is incurring the same risk the company usually does when it borrows money (that is, that the borrowed money will earn a greater rate of return than the interest cost of the loan).

The following example illustrates the leverage concept. Company A sets up an ESOP; the ESOP obtains a 5-year loan (guaranteed by Company A) of $10,000 to purchase Company A stock. The interest rate of the loan is 8%. If Company A stock earns a 10% rate of return, the ESOP receives the leverage of earning a 10% return on money it borrowed at 8%.

Table 1 on page 26 displays a 5-year history of the ESOP using the above assumptions. The table also shows what the value of a profit sharing plan would be for the same five years if Company A had set up a profit sharing plan and made the same contributions that were made to the ESOP. Notice that the leverage of debt financing would allow the value of the ESOP trust to accrue to $16,105 after five years (vs. $15,326 with a profit sharing plan).

Disadvantage of ESOP to Employee

Of course, the example illustrated in Table 1 assumes that the investment in employer stock earns a higher rate of return than the interest cost of the loan to the trust. This assumption leads to the *principal disadvantage* of an ESOP (again, as compared to a profit sharing plan) *to the employee:* because the ESOP is required to invest primarily in

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*See discussion of distributions for a leveraged ESOP on page 23.

employer securities, the employee is required to "put all of his eggs in one basket." A profit sharing plan may offer a diversified portfolio. However, even in cases where a profit sharing plan is invested primarily in employer stock, participants face less risk.

This can be illustrated by using the same example as before, except assuming that the value of Company A stock remains constant over the five year period (Table 2). Notice that, under these circumstances, the value of the ESOP trust is the same ($10,000) after five years, whereas if the same company contributions had been made to profit sharing plan investing in Company A stock, the value of the trust would be $12,400.

It is apparent that, if both an ESOP and profit sharing plan receive equal employer contributions, an ESOP (by using debt financing) has increased leverage to provide increased return if stock appreciation is larger than loan interest and decreased return if it is not, even if the profit sharing plan is primarily invested in company stock.

(Tables 1 and 2 follow.)

Table 1
Company A Stock Increases 10% Per Annum

Company A ESOP	FIRST YEAR		SECOND YEAR		THIRD YEAR		FOURTH YEAR		FIFTH YEAR	
Value of stock held by trust, beginning of FY	$10,000		$11,000		$12,100		$13,310		$14,641	
Appreciation of stock (10%)	1,000		1,100		1,210		1,331		1,464	
Value of stock held by trust, end of FY		$11,000		$12,100		$13,310		$14,641		$16,105
Principal of loan divided by 5	2,000		2,000		2,000		2,000		2,000	
Interest expense of loan (8%)	800		640		480		320		160	
Company contributions (necessary to amortize loan)	2,800		2,640		2,480		2,320		2,160	
Unamortized debt of trust, end of FY		8,000		6,000		4,000		2,000		0
Value of trust, end of FY		$ 3,000		$ 6,100		$ 9,310		$12,641		$16,105
Company A Profit Sharing Plan (Assumes Company A contributions are same as to ESOP)										
Value of stock held by trust, beginning of FY	$ ——		$ 2,800		$ 5,720		$ 8,772		$11,969	
Appreciation of stock (10%)	——		280		572		877		1,197	
Company contribution (same as ESOP)	2,800		2,640		2,480		2,320		2,160	
Value of trust, end of FY		$ 2,800		$ 5,720		$ 8,772		$11,969		$15,326

Table 2
Company A Stock Remains Constant (0% Return)

Company A ESOP	FIRST YEAR		SECOND YEAR		THIRD YEAR		FOURTH YEAR		FIFTH YEAR	
Value of stock held by trust, beginning of FY	$10,000		$10,000		$10,000		$10,000		$10,000	
Appreciation of stock (0%)	0		0		0		0		0	
Value of stock held by trust, end of FY		$10,000		$10,000		$10,000		$10,000		$10,000
Principal of loan divided by 5	2,000		2,000		2,000		2,000		2,000	
Interest expense of loan (8%)	800		640		480		320		160	
Company contribution (necessary to amortize loan)	2,800		2,640		2,480		2,320		2,160	
Unamortized debt of trust, end of FY		8,000		6,000		4,000		2,000		0
Value of trust, end of FY		$ 2,000		$ 4,000		$ 6,000		$ 8,000		$10,000
Company A Profit Sharing Plan (Assumes same Company A contributions as to ESOP)										
Value of stock held by trust, beginning of FY	$ --		$ 2,800		$ 5,440		$ 7,920		$10,240	
Appreciation of stock (0%)	--		0		0		0		0	
Company contribution (same as ESOP)	2,800		2,640		2,480		2,320		2,160	
Value of trust, end of FY		$ 2,800		$ 5,440		$ 7,920		$10,240		$12,400

Advantages of ESOP to Employer

One of the principal reasons for the sudden interest in ESOPs is the number of purported advantages of such plans to the employer. ESOPs are advertised as being able to solve corporate financial worries by:

- Permitting the corporation to raise additional capital and repay principal and interest with pre-tax dollars;
- Creating a market for stock of closely-held companies;
- Acting as an estate planning device for owners and employees;
- Realizing a tax reduction and corresponding increase in cash flow developed from a contribution of employer stock;
- Providing for the acquisition of another company using pre-tax funds;
- Providing for the implementation of a divestiture of a group or division.

All of the above transactions involve the debt financing aspect of an ESOP. The advantages and disadvantages of an ESOP as a means of corporate finance will be discussed in the next section of this report. For now, it can be said that any of the above transactions may benefit a particular company in a particular situation, but (that while the IRS has ruled that the fact that a plan is for the exclusive benefit of participants does not preclude it from benefiting other parties) an *ESOP still must be a plan for the exclusive benefit of participants.*

An advantage of an ESOP to the employer that does not involve debt financing is that it increases employee incentive by giving them a "piece of the action." This point of view is similar to the one shared by several successful profit sharing plans which have invested large portions of their trust funds in company stock. In the case of an ESOP, the link between company stock performance and the value of the trust to participants is even more volatile as was seen in the two illustrations on trust performance.

Disadvantages of ESOP to Employer

This direct link between company performance and trust fund performance may be viewed as a disadvantage if company stock performs poorly. Value of company stock can be independent of company performance. If the company encourages stock ownership, it may incur a substantial risk of employee dissatisfaction in the event of a market decline (which will be accentuated due to the leverage of the ESOP).

Also, since an ESOP must make distributions in stock, and since the employee will owe taxes, the employer may have an obligation to see that the employee has sufficient "cash" to pay taxes through other methods of compensation so that stock doesn't have to be sold to pay taxes.

ESOP as an Employee Benefit Plan: Overview

The above discussion of the advantages and disadvantages of ESOPs (as compared to profit sharing plans) as employee benefit plans can be summarized as a discussion of *degree of risk.* While both profit sharing plans and ESOPs are capital accumulation plans, the fact that an ESOP invests primarily in employer securities and may subject trust funds to capital financing risks causes the benefit of an ESOP to be one of (financed) company stock ownership. The value of this benefit to both employee and employer depends on the performance of company stock and timing of capital financing

ESOPS AS A TECHNIQUE OF CORPORATE FINANCE

This section presents an assessment of the financial impact on a company of debt financing through an ESOP. In reviewing this section, it is important to *remember that corporate financing is only one aspect of an ESOP. Such plans also provide deferred compensation for employees.* Thus, a company analyzing the applicability of an ESOP as a means of corporate finance should keep in mind the additional worth of an ESOP as a means of compensating employees

To isolate the effects of an ESOP on a company, several simplifying assumptions are made. In general terms, the company's ability to use resources effectively and to deploy assets profitably is held constant to highlight the impact of implementation of an ESOP as distinct from the effects of changes in the profitability of the company due to external factors.

Two questions are addressed below:

- How does an ESOP alone affect a company's ability to earn and to whose benefit or detriment?
- How does the financial impact of an ESOP differ from that of a profit sharing plan?

The objective of this analysis is to identify the direction of the financial effect of an ESOP, not to provide precise measures of the magnitude of such effects The impact in absolute terms on any company will depend on the proportion of outstanding shares transferred to employees under an ESOP.

Analytical Method

To identify the effects of an ESOP as a financing device, four examples are presented below:

- *Base Case* — ABC Company, a company with $100,000 in assets and $100,000 in shareholders' equity raises no new capital from external sources, thereby choosing to grow only by means of retention of earnings.
- *Debt Financing* — ABC Company raises an additional $50,000 in capital by means of a direct loan from a bank or other lender.
- *Equity Financing* — ABC Company raises an additional $50,000 through an offering of new shares of common stock.
- *ESOP Financing* — ABC Company raises new capital of $50,000 by means of debt financing through an ESOP, for which the company makes both a direct guarantee of the loan to the ESOP's trust and a pledge to make sufficient contributions to the trust to amortize its debt obligation.

Tables 1-4 present the Balance Sheets, Income Statements, and Statements of Changes in Financial Position for ABC Company under each of the four cases identified above. Several simplifying assumptions underly the numbers that appear in these tables:

- Gross income is strictly a function of assets. In particular, ABC Company is assumed to earn 20% on its assets.
- The effective tax rate of the company is 50%.

- All flows and payments occur at year-end (to simplify the computation of earnings and interest).
- All earnings are retained (the company pays no dividends).
- Loans, either to the company or to the ESOP, bear an interest rate of 8% per annum and a maturity of five years. Loans are repaid in equal annual installments of principal plus accrued interest at the date of repayment.
- Initially, 10,000 shares of common stock are outstanding. The ESOP buys 5,000 new shares.
- The company applies cash flows either to current assets or to the reduction of long-term debt. There are no other uses of funds.
- The market price of the stock remains constant at $10 per share. This unrealistic assumption simplifies the computation of earnings per share under the treasury-stock method (in the ESOP case only) and isolates the effects of ESOP debt financing from the effects of market price changes.

Under these assumptions, the company's earnings are determined by its total assets at the end of the prior year. For example, in Table 1 (Base Case), the company's gross income for Year 1 is $20,000, or 20% of the assets shown under Beginning Balance Sheet. Net income for Year 1 is then $10,000, after deducting taxes, all of which income serves to increase equity to a total of $110,000 at the end of Year 1. Likewise, assets are increased to $110,000. Gross income in Year 2, therefore, is 20% of $110,000, or $22,000.

The example in Table 2 (Debt Financing), is slightly more complicated. Gross income in Year 1 is 20% of $150,000, or $30,000. Due to the incurrence of additional debt, interest expense of $4,000 (8% of $50,000) must be deducted from gross income to determine pre-tax income. The resultant net income after taxes of $13,000 again increases equity to a total at the end of Year 1 of $113,000. Liabilities decrease at the end of Year 1 to $40,000 since the company makes a $10,000 principal payment in addition to its interest payment. The change in assets for Year 1 is accounted for by the Changes in Financial Position as the difference between net income and debt payments. Thus, in the case of debt financing, assets increase by only $3,000 in Year 1.

Table 3 (Equity Financing) flows in the same manner as Table 1 (Base Case) since both of these examples present ABC Company as a company financed only with equity. Table 3, however, reflects additional equity of $50,000. Gross income in Year 1 is $30,000 (20% of $150,000), and net income is $15,000, all of which increases equity ($165,000 at the end of Year 1).

In the case of ESOP financing, as Table 4 (ESOP Financing) indicates, the company's entire payment of principal and interest (in the form of a contribution to the trust) is deductible for tax purposes. The deductibility of the principal portion of the loan thus reduces pre-tax income by an additional $10,000 and taxes by $5,000, or 50% of the additional $10,000. Likewise, net income in the case of ESOP financing is $5,000 less than in the case of debt financing in Year 1.

Table 4, moreover, reflects the accounting treatment of leveraged ESOPs in accordance with Accounting Principles Board Opinion No. 25 ("Accounting for Stock Issued to Employees"). The establishment of the ESOP increases both assets and equity by $50,000. Simultaneously, however, the company incurs a fixed obligation to make

contributions sufficient to amortize the ESOP trust's debt (shown under Liabilities as "Obligation to ESOT"). The offsetting entry to this obligation is the initial value assigned to Unearned Compensation, which reduces equity by an amount equal to the trust's outstanding debt. Earnings per share may be computed in subsequent years in either of two ways:

- *"Fully outstanding" method* — Net income is divided by the total number of shares outstanding, including those held by the trust.
- *Treasury stock method* — Earnings per share is computed in the same manner as above except that the number of shares outstanding is reduced by the number of shares that could be purchased *(hypothetically)* with the remaining unearned compensation (i.e., the remaining balance in Unearned Compensation divided by the then-current value per share of stock).

Tables 1-4 present the financial performance of ABC Company over a ten-year period under each set of assumptions regarding new financing. As mentioned earlier, debt obligations are assumed to be repaid in five years, as is shown in Tables 2 and 4.

These tables, therefore, provide a basis for understanding the effects of ESOP financing both before and after the expiration of the ESOP's loan. A graphical representation these results and a summary of financial effects appear after the following tables.

TABLE 1: BASE CASE

	Beginning Balance Sheet	End of Year 1	2	3	4	5	6	7	8	9	10
BALANCE SHEET											
Assets	$100,000	$110,000	$121,000	$133,100	$146,410	$161,051	$177,156	$194,872	$214,359	$235,795	$259,374
Liabilities	—	—	—	—	—	—	—	—	—	—	—
Equity	100,000	110,000	121,000	133,100	146,410	161,051	177,156	194,872	214,359	235,795	259,374
INCOME STATEMENT											
Gross Income		$ 20,000	$ 22,000	$ 24,200	$ 26,620	$ 29,282	$ 32,210	$ 35,431	$ 38,974	$ 42,872	$ 47,159
Other Expenses		—	—	—	—	—	—	—	—	—	—
Pre-tax Income		20,000	22,000	24,200	26,620	29,282	32,210	35,431	38,974	42,872	47,159
Taxes		(10,000)	(11,000)	(12,100)	(13,310)	(14,641)	(16,105)	(17,715)	(19,487)	(21,436)	(23,580)
Net Income		$ 10,000	$ 11,000	$ 12,100	$ 13,310	$ 14,641	$ 16,105	$ 17,716	$ 19,487	$ 21,436	$ 23,579
No. of Shares Outstanding		10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000
Earnings per Share		$1.00	$1.10	$1.21	$1.33	$1.46	$1.61	$1.77	$1.95	$2.14	$2.36
CHANGES IN FINANCIAL POSITION											
Sources— Net Income		$ 10,000	$ 11,000	$ 12,100	$ 13,310	$ 14,641	$ 16,105	$ 17,716	$ 19,487	$ 21,436	$ 23,579
Applications— Reduction of Debt		—	—	—	—	—	—	—	—	—	—
Increase (Decrease) in Working Capital		$ 10,000	$ 11,000	$ 12,100	$ 13,310	$ 14,641	$ 16,105	$ 17,716	$ 19,487	$ 21,436	$ 23,579

TABLE 2: DEBT FINANCING

	Beginning Balance Sheet	End of Year 1	2	3	4	5	6	7	8	9	10
BALANCE SHEET											
Assets	$150,000	$153,000	$156,700	$161,170	$166,487	$172,736	$190,009	$209,010	$229,911	$252,902	$278,192
Liabilities	50,000	40,000	30,000	20,000	10,000	—	—	—	—	—	—
Equity	100,000	113,000	126,700	141,170	156,487	172,736	190,009	209,010	229,911	252,902	278,192
	$150,000	$153,000	$156,700	$161,170	$166,487	$172,736	$190,009	$209,010	$229,911	$252,902	$278,192
INCOME STATEMENT											
Gross Income		$ 30,000	$ 30,600	$ 31,340	$ 32,234	$ 33,297	$ 34,547	$ 38,002	$ 41,802	$ 45,982	$ 50,580
Other Expenses (interest)		(4,000)	(3,200)	(2,400)	(1,600)	(800)	—	—	—	—	—
Pre-tax Income		26,000	27,400	28,940	30,634	32,497	34,547	38,002	41,802	45,982	50,580
Taxes		(13,000)	(13,700)	(14,470)	(15,317)	(16,248)	(17,274)	(19,001)	(20,901)	(22,991)	(25,290)
Net Income		$ 13,000	$ 13,700	$ 14,470	$ 15,317	16,249	$ 17,273	$ 19,001	$ 20,901	$ 22,991	$ 25,290
No. of Shares Outstanding		10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000
Earnings per Share		$1 30	$1.37	$1.45	$1 53	$1.62	$1.73	$1.90	$2.09	$2.30	$2.53
CHANGES IN FINANCIAL POSITION											
Sources— Net Income		$ 13,000	$ 13,700	$ 14,470	$ 15,317	$ 16,249	$ 17,273	$ 19,001	$ 20,901	$ 22,991	$ 25,290
Applications— Reduction of Debt		(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	—	—	—	—	—
Increase (Decrease) in Working Capital		$ 3,000	$ 3,700	$ 4,470	$ 5,317	$ 6,249	$ 17,273	$ 19,001	$ 20,901	$ 22,991	$ 25,290

TABLE 3: EQUITY FINANCING

	Beginning Balance Sheet	End of Year 1	2	3	4	5	6	7	8	9	10
BALANCE SHEET											
Assets	$150,000	$165,000	$181,500	$199,650	$219,615	$241,576	$265,734	$292,308	$321,538	$353,692	$389,061
Liabilities	—	—	—	—	—	—	—	—	—	—	—
Equity	150,000	165,000	181,500	199,650	219,615	241,576	265,734	292,308	321,538	353,692	389,061
INCOME STATEMENT											
Gross Income		$ 30,000	$ 33,000	$ 36,300	$ 39,930	$ 43,923	$ 48,315	$ 53,147	$ 58,462	$ 64,308	$ 70,738
Other Expenses		—	—	—	—	—	—	—	—	—	—
Pre-tax Income		30,000	33,000	36,300	39,930	43,923	48,315	53,147	58,462	64,308	70,738
Taxes		(15,000)	(16,500)	(18,150)	(19,965)	(21,962)	(24,157)	(26,573)	(29,232)	(32,154)	(35,369)
Net Income		$ 15,000	$ 16,500	$ 18,150	$ 19,965	$ 21,961	$ 24,158	$ 26,574	$29,230	$ 32,154	$ 35,369
No. of Shares Outstanding		15,000	15,000	15,000	15,000	15,000	15,000	15,000	15,000	15,000	15,000
Earnings per Share		$1.00	$1.10	$1.21	$1.33	$1.46	$1.61	$1.77	$1.95	$2.14	$2.36
CHANGES IN FINANCIAL POSITION											
Sources— Net Income		$ 15,000	$ 16,500	$ 18,150	$ 19,965	$ 21,961	$ 24,158	$ 26,574	$ 29,230	$ 32,154	$ 35,369
Applications— Reduction of Debt		—	—	—	—	—	—	—	—	—	—
Increase (Decrease) in Working Capital		$ 15,000	$ 16,500	$ 18,150	$ 19,965	$ 21,961	$ 24,158	$ 26,574	$ 29,230	$ 32,154	$ 35,369

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TABLE 4: ESOP FINANCING

	Beginning Balance Sheet	End of Year 1	2	3	4	5	6	7	8	9	10
BALANCE SHEET											
Assets	$150,000	$158,000	$167,200	$177,720	$189,692	$203,261	$223,587	$245,946	$270,540	$297,594	$327,354
Liabilities											
—Obligation to ESOT	50,000	40,000	30,000	20,000	10,000	—	—	—	—	—	—
Equity											
—Total Equity	150,000	158,000	167,200	177,720	189,692	203,261	223,587	245,946	270,540	297,594	327,354
—Unearned Compensation	(50,000)	(40,000)	(30,000)	(20,000)	(10,000)	—	—	—	—	—	—
—Net Equity	$100,000	$118,000	$137,200	$157,720	$179,692	$203,261	$223,587	$245,946	$270,540	$297,594	$327,354
Total Liabilities & Equity	$150,000	$158,000	$167,200	$177,720	$189,692	$203,261	$223,587	$245,946	$270,540	$297,594	$327,354
INCOME STATEMENT											
Operating Income		$ 30,000	$ 31,600	$ 33,440	$ 35,544	$ 37,936	$ 40,652	$ 44,718	$ 49,189	$ 54,108	$ 59,520
Other Expenses (contribution)		(14,000)	(13,200)	(12,400)	(11,600)	(10,800)	—	—	—	—	—
Pre-tax Income		16,000	18,400	21,040	23,944	27,136	40,652	44,718	49,189	54,108	59,520
Taxes		(8,000)	(9,200)	(10,520)	(11,972)	(13,569)	(20,326)	(22,359)	(24,595)	(27,054)	(29,760)
Net Income		$ 8,000	$ 9,200	$ 10,520	$ 11,972	$ 13,569	$ 20,326	$ 22,359	$ 24,594	$ 27,054	$ 29,760
OUTSTANDING SHARES											
"Fully Outstanding" Method		15,000	15,000	15,000	15,000	15,000	15,000	15,000	15,000	15,000	15,000
Treasury Stock Method		11,000	12,000	13,000	14,000	15,000	15,000	15,000	15,000	15,000	15,000
EARNINGS PER SHARE											
"Fully Outstanding" Method		$ .53	$ .61	$ .70	$ .80	$ .90	$1.36	$1.49	$1.64	$1.80	$1.98
Treasury Stock Method		.73	.77	.81	.86	.90	1.36	1.49	1.64	1.80	1.98
CHANGES IN FINANCIAL POSITION											
Sources— Net Income		$ 8,000	$ 9,200	$ 10,520	$ 11,972	$ 13,569	$ 20,326	$ 22,359	$ 24,594	$ 27,054	$ 29,760
Applications— Reduction of Debt		—	—	—	—	—	—	—	—	—	—
Increase (Decrease) in Working Capital		$ 8,000	$ 9,200	$ 10,520	$ 11,972	$ 13,569	$ 20,326	$ 22,359	$ 24,594	$ 27,054	$ 29,760

Financial Results

Figures 1-3, which follow, depict the financial results of the Base Case and the three alternative financing methods described above. These Figures provide some insight into the effects of ESOP financing:

- During the life of the ESOP's loan, net income (Figure 1) is less than under either of the other two forms of new financing and less even than in the Base Case. Thus, an ESOP could be said to divert earnings from prior shareholders during the life of its loan.
- After the expiration of the ESOP's loan, the company's net income exceeds that in the Base Case and in the case of Debt Financing The excess of earnings in the case of ESOP Financing over earnings in the case of Debt Financing is attributable to the more rapid accumulation of assets in the ESOP case (see figure 2) which results from the sheltering of taxes provided by the ESOP. Equity is correspondingly preserved. This preservation of assets and equity is strictly a function of the tax savings available to the company under its ESOP.
- In total, the ESOP has the effect of changing the structure of the company's income stream, as Figure 1 depicts
- This change, however, is not entirely to the benefit of prior shareholders, as Figure 3 indicates: earnings per share in the case of ESOP Financing is less than that of the other cases, including the Base Case This difference in earnings per share highlights the importance of the use to which new capital is put. The company must use its ESOP dollars to pursue unusually profitable opportunities if it is to maintain its earnings per share at prior levels

The last of the above observations suggests that an ESOP can be an expensive source of new capital for a company. ESOP financing can be expensive for two reasons:

- This form of financing provides rapid accumulation of equity capital, usually the most expensive in terms of the level of earnings required to maintain the company's ability to attract capital
- Although the implementation of an ESOP helps generate new equity capital, it also creates a fixed obligation on the part of the company to repay the indebtedness of the trust.

Again, it must be remembered that an ESOP also provides deferred compensation for employees. It is imperative that a company weigh all other aspects of an ESOP, as well as its financing needs and alternative sources of funds, when it analyzes the applicability of an ESOP.

Figure 1: Net Income by Type of Financing

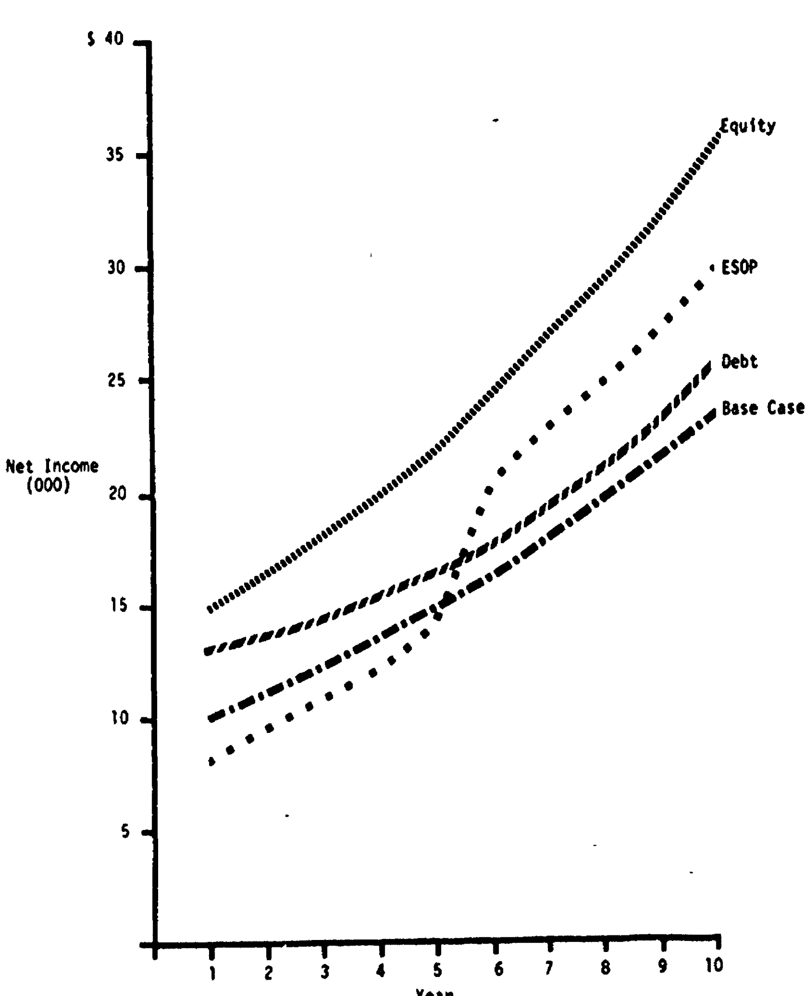


Figure 2: Total Assets by Type of Financing

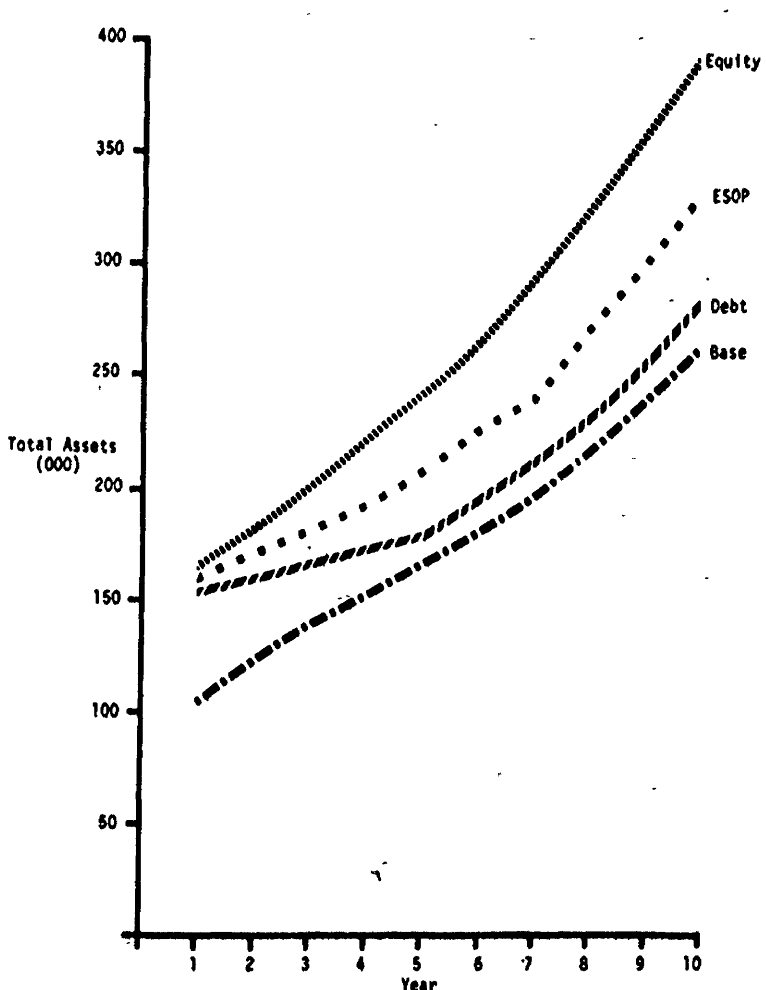
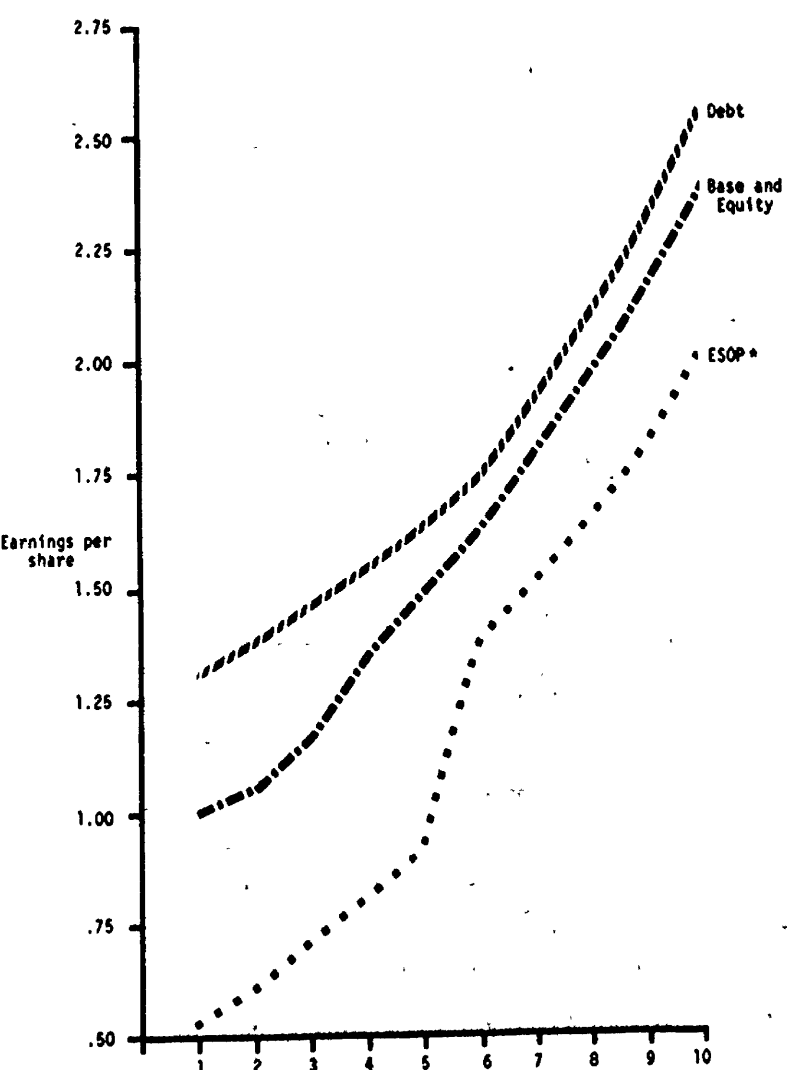


Figure 3: Earnings per share by Type of Financing



*Under the "fully outstanding" method.

ESOPs Vs. Profit Sharing Plans

The absence of an opportunity to raise new capital through a profit sharing plan complicates the comparison of profit sharing plans and ESOPs Nonetheless, some observations can be made about the differences between the financial effects of a profit sharing plan on a company and those of an ESOP. As a basis for comparison, consider three cases:

- An ESOP used as a financing device (Company A)
- A profit sharing plan designed to invest solely in new shares of company common stock (Company B).
- A profit sharing plan designed to invest solely in external securities (Company C).

Furthermore, assume that Companies A, B, and C all anticipate earnings of $100,000, of which Company A is obligated to pay $10,000 to the ESOP and Companies B and C expect to pay $10,000 to their profit sharing plans, to which these companies have promised 10% of earnings.

If each of the three companies realizes its expected level of earnings ($100,000), then the contribution by each company to its plan equals 10% of earnings. Some differences in relative burden arise, however, if actual earnings fall short of expected earnings. If earnings reach only $50,000, for example, then companies B and C must contribute only $5,000 to their profit sharing plans, whereas Company A must contribute $10,000 nonetheless Therefore, as earnings decline, an ESOP with a financing obligation imposes a heavier and heavier burden on the company. This difference is depicted in Figure 4, which gives contribution as a percentage of earnings in the case of an ESOP and in the case of a profit sharing plan for which contributions are determined as 10% of earnings. The financial effects on Companies B and C differ only in that Company C's contribution goes to investment in external securities, for which the company experiences a direct outflow of cash. Company B, on the other hand, directs its contribution to investment in company stock, thereby retaining the associated cash for use within the company.

In summary, the above comparisons provide the following insights into the differences between ESOPs and Profit Sharing plans:

- An ESOP can provide a new capital device to the company. This feature of ESOPs alone may provide impetus for their growth, in view of current competition for new funds in the capital markets *
- Profit sharing plans, in most cases, impose a variable burden on the earnings of a company (a burden that can be reduced when earnings decline), whereas ESOPs impose a fixed obligation on a company regardless of the level of earnings.
- Profit sharing plans designed to invest in external securities can create a drain on a company's working capital, whereas ESOPs and profit sharing plans designed to invest in employer securities can both work to preserve working capital.

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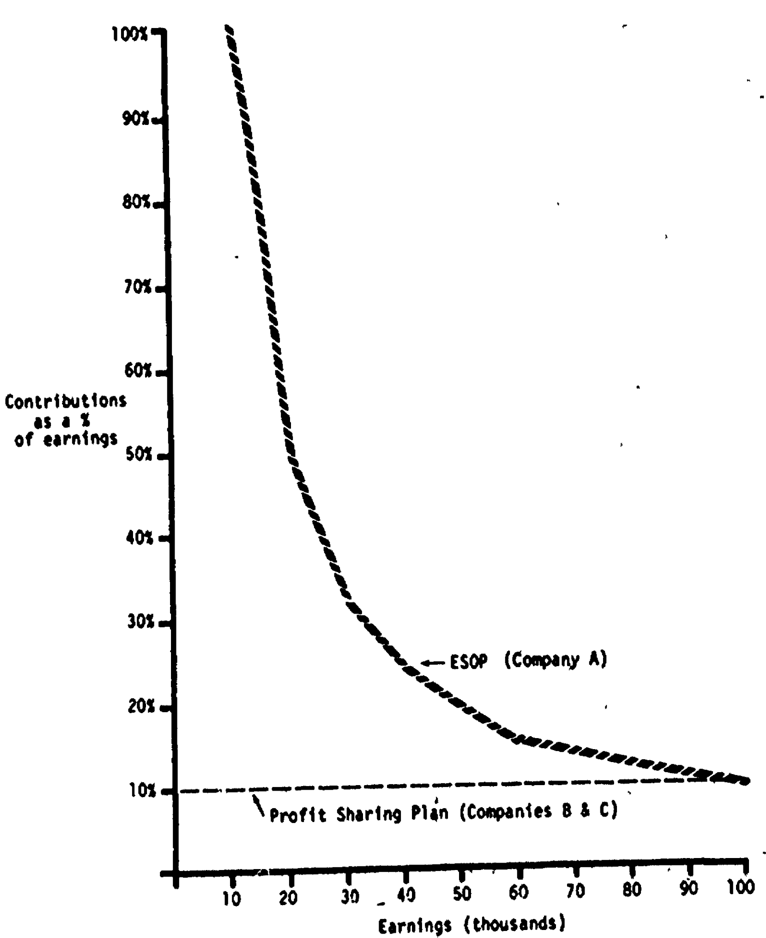
*See for example "The Capital Crisis" *Business Week*, September 22, 1975

Figure 4: Contributions as a Percent of Earnings

(ESOP vs. Profit Sharing Plan)



ADDITIONAL ESOP CONSIDERATIONS

Conversion of Profit Sharing Plans to ESOPs

Because profit sharing plans and ESOPs are both qualified, defined contribution plans, it appears that it is possible to convert an existing profit sharing plan to an ESOP without disqualifying the plan. IRS District Offices may differ as to whether the assets of the converted profit sharing plan may be reinvested in employer stock. If reinvestment of profit sharing trust funds is not permitted, the converted plan would be required to maintain separate investment accounts for preconversion assets as well as the accounts required for the normal operation of the ESOP.

Federal Income Tax Considerations

The federal income tax considerations for an ESOP are the same as those for a profit sharing plan except that in the case of an ESOP, distributions must be entirely in employer stock. Thus, the federal income tax considerations to the employee are:

- Funds accumulate tax free until distributed.
- If distributed in lump sum (where stock is distributed) unrealized appreciation of stock is not taxable when distributed. The remainder is taxed as ordinary income, subject to rules governing lump sum distributions.
- When employee sells stock, apprciation before distribution is long-term capital gain; appreciation after distribution is long-term or short-term capital gain depending on how long held.
- If distributed over a period of time, the income each year is treated as ordinary income, and stock is taxed at market value at time of distribution.

Employer contributions up to 15% of participants' annual pay are tax deductible (25% with a carryover or if ESOP is a combination plan).

Exclusive Benefit of Participants

As a plan qualified under Section 401(a) of the IRC, *an ESOP must be for the exclusive benefit of participants and their beneficiaries*. The four Acts that have dealt with ESOPs, and especially ERISA, indicate that a plan may benefit other parties and still be for the exclusive benefit of participants.

All transactions involving ESOPs, however, may not be viewed by the IRS as satisfying exclusive benefit requirements. Rev. Rul. 71-311 states:

> . . . The borrowing of funds by a trust and investing them in the securities of, or entering into transactions with, the employer or an entity closely related to the employer do not disqualify a trust as one for the exclusive benefit of employees unless the borrowing is undertaken for the purpose of benefiting the employer as, for example, borrowing in order to furnish capital or property for use in the employer's business at a time when the employer's financial condition is such that it is unable to borrow money from usual financial sources.

One often cited use of an ESOP is that such a plan can be utilized to provide a market for the stock of a controlling shareholder of a closely-held company. The benefit of such a

transaction to plan participants will probably be closely scrutinized by the IRS Accurate valuation of the stock is imperative. Whether the company has a history of encouraging employee ownership of company stock may also be considered.

Additionally, if the selling shareholder has been instrumental to the success of the company, the impact on the company of the absence of that person may also be taken into consideration

The IRS's sensitivity to the potential abuses involving the debt financing capability of an ESOP will subject plans to special scrutiny. Companies should exercise prudence in all transactions involving ESOPs.

Valuation of Company Stock

Accurate valuation of company stock acquired by an ESOP trust is important in assuring that an ESOP is for the exclusive benefit of employees In the case of a closely-held company, it appears that the methods used in valuing closely-held stock should be the same as those used in valuing such stock for estate tax purposes Such a valuation includes consideration of the following factors:

- The nature of the business and the history of the enterprise from its inception;
- The economic outlook in general and the condition and outlook of the specific industry in particular;
- The book value of the stock and the financial condition of the business,
- The earning capacity of the company;
- The dividend-paying capacity;
- Whether or not the enterprise has goodwill or other intangible value;
- Sales of the stock and the size of the block of stock to be valued,
- The market price of stocks of corporations engaged in the same or a similar line of business having their stock actively traded in a free and open market, either on an exchange or over-the-counter (Rev Rul 59-60).

Due to the importance of accurate valuation of company stock, it appears that the valuation of closely-held stock should be carried out by a qualified, independent third party

In the case of a publicly-held company, the established market for the stock can be used to make the stock valuation. However, if company stock contributed to the trust is restricted, or if such stock possesses dividend rights or voting rights less favorable than the dividend rights or voting rights of company stock traded in the open market, accurate valuation may again require the services of a qualified, independent third party.

Accurate valuation of company stock purchased by the ESOP trust is imperative at time of purchase. Additionally, the Reporting and Disclosure provisions of ERISA seem to indicate that a yearly appraisal may be necessary to establish the stock value for purposes of determining valuation and reporting to participants. In any event, it appears that yearly stock appraisals will probably be necessary to facilitate repurchase of stock distributed to terminating employees of closely-held companies.

SEC Aspects

ESOPs are subject to scrutiny by the SEC The question of whether or not stock held by a trust (qualified under Section 401 of the IRC) must be registered is unclear. Generally, it appears that if participants do not pay anything or otherwise give value, there is "no-sale" for SEC purposes. The conservative ESOP approach, then, would be to not allow or require employee contributions. Also, because registration exceptions to the various securities acts seem to apply to a plan managed by a bank (or invested through an insurance company), it appears that an ESOP should be managed by a bank.

Although the original issuance of stock to the participants will probably be treated as "no sale," the resale of these securities (upon distribution) by the recipient may be a different matter. Such resale may be subject to SEC Rule 144, which sets restrictions (including a two-year holding period), regarding the sale of securities which are acquired through a private (nonpublic) transaction. In several cases involving very large companies, the staff of the SEC has issued no-action letters indicating that the restricted security concept of SEC Rule 144 does apply. Plans involving smaller companies may be allowed a private placement exemption since such companies are often closely-held.

In any case, because of the increased interest in ESOPs, it is certain that the SEC will be reconsidering and clarifying the security laws that apply to ESOPs. Due to the potential SEC considerations, a company planning implementation of an ESOP should consult with a securities lawyer to determine which SEC laws are applicable to its situation.

SURVEY OF COMPANIES EMPLOYING ESOPS

Any discussion of ESOP characteristics or legal history is incomplete without a study of the experience of companies which have already implemented such plans. This section of the report examines the plans of ten companies currently employing ESOPs

Survey Methodology

Hewitt Associates telephoned prospective companies to determine which companies actually had ESOPs and would be interested in participating in the study. The criteria used to determine which companies would be included in the survey was whether the company telephoned considered their plan to be an ESOP

Participating Companies

The survey was addressed to eleven companies. Of these, ten companies participated by supplying information about their ESOP. The following table displays a distribution according to size, based on annual sales and number of employees, of participating companies Since proponents of ESOPs have emphasized the applicability of these plans to many business situations, one objective in choosing survey participants was to include a cross section of business and industry both in terms of size of company and in terms of type of business The participating companies range in size from $3 million to $1.6 billion in annual sales, and participants include industrial, professional, and over-the-counter organizations Both private and publicly-held companies were included

Distribution of Participating Companies

Annual Sales Range

Sales Range	No. of Participants	Employee Range	No. of Participants
Less than $10 million	2	100 to 200	4
$10-100 million	5	200 to 1,000	3
$100-500 million	2	1,000 to 10,000	2
Over $500 million	1	Over 10,000	1
TOTAL	10	TOTAL	10

About the Survey

The ESOP information gathered in the survey can be divided into three categories·

- General information of ESOP,
- ESOP specifications, and
- ESOP experience.

A general summary, followed by a table displaying survey responses, of each of these three categories is included over the next several pages. Because of the concern for confidentiality expressed by the participants, data is presented in a coded fashion.

Summary — General Information of ESOPs

ESOPs are a relatively new form of employee benefit plan. The oldest plan in the survey has been in effect since January, 1972. All of the plans are qualified under Section 401(a) of the IRC.

The ESOPs generally take the form of a stock bonus plan; two of the companies have an ESOP that is a combination stock bonus and money purchase pension plan. Half of the companies also provide employees a defined benefit pension plan.

On the average, 69% of company employees participate in the ESOP. The only plan requiring employee contributions for participation has the lowest percent (27%) of employee participation.

General Information of ESOP

Co. Code	Effective Date of ESOP	Type of ESOP	IRC Qualified	Percent of Employees in Plan	Other Plans
A	7/73	Stock bonus plan	Yes	63%	Defined benefit pension plan
B	1/75	Stock bonus plan (converted profit sharing plan, assets of which remain diversified)	Yes	95%	
C	10/72	Combination stock bonus and money purchase pension plan	Yes	92%	
D	1/75	Profit sharing plan	Yes	27%	Defined benefit pension plan
E	1/72	Combination stock bonus and money purchase pension plan	Yes	100%	
F	1/74	Stock bonus plan	Yes	67%	Profit sharing plan
G	1/74	New ESOP (essentially a stock bonus plan) established in tandem with old profit sharing plan	Yes	45%	Defined benefit pension plan
H	5/74	Stock bonus plan	Yes	61%	
I	10/72	Stock bonus plan	Yes	60%	Profit sharing plan
J	2/75	Stock bonus plan	Yes	78%	Defined benefit pension plan; thrift plan

Summary – ESOP Specifications

The plan specifications of the ESOPs in the survey showed some strong prevalences:

- Employee contributions are usually not allowed, and when they are, such contributions are not invested in employer stock;
- Eighty percent of the plans allocate contributions in proportion to participants' pay;
- Eighty percent of the ESOP trusts own company stock that has voting rights, but only 20% of the plans allow employees to vote stock held by the trust;
- While most (6) of the ESOP trusts own company stock that pays dividends, none of the plans provide for such dividends to be "passed through" the trust to employees as a form of second income;
- Distributions (at least to the ESOP part of a plan) are made in company stock.

The ESOPs in the survey seemed to provide for company contributions according to the needs of the plan

ESOP Specifications I

Co. Code	Administrator	Company Contributions	Employee Contributions	Allocations
A	Committee	Amount enabling ESOP to discharge obligations plus discretionary addition determined by Board	Voluntary, but not invested in company stock	In proportion to participant s base pay
B	Committee of employees and trustees who are employees	*Target* of 15% of eligible compensation	Allowed but not invested in company stock	In proportion to participant s total pay
C	Committee of 3	Formula 25% of eligible compensation	None	In proportion to participant s total pay
D	Bank	Minimum of 25% of employee contributions additional contributions (up to 275% of employee contribution) based on corporate profits	Required for participation, 5% of W 2 earnings	In proportion to participant s total pay
E	Trustees	Formula 25% of eligible compensation	None	In proportion to participant s total pay
F	Committee of three officers of company	Amount enabling ESOP to discharge obligations plus discretionary addition determined by company	None	Formula based on pay and years of service of participant
G	Committee appointed by Board of Directors	Discretion of Board of Directors	Voluntary to old profit sharing plan (which is separate from ESOP part)	Formula based on pay and years of service of participant
H	Bank and Company in conjunction	Discretion of employer	None	In proportion to participant s pay (years of service is being considered for future change)
I	Independent consulting firm	Discretion of employer	None	In proportion to participant s total pay
J	Benefits Section of personnel	Discretion of employer	None	In proportion to participant s total pay

ESOP Specifications II
Stock Held by Trust Characteristics

Co. Code	Vesting	Voting Rights	Dividends Paid	Distributions
A	10% per year of participation	Yes, employees vote vested shares	Yes, but not "passed through" trust	Company stock
B	100% after 5 years	Yes but employees do not vote	Yes but not "passed through" trust	Company stock for ESOP part, cash for profit sharing part
C	10% per year after first 2 fiscal years	Yes, but employees do not vote	Possible, but not "passed through" trust	Company stock
D	10% per year of participation	Yes, employees vote allocated shares	Yes, but not "passed through" trust	Employer fund — stock Employee fund — cash
E	(Not available)	No	No	Company stock
F	10% per year of participation	Yes but employees do not vote	No	Company stock
G	50% after 5 years, 10% for each year after 5 years	No	Yes, but not "passed through" trust	Company stock for ESOP part; cash for profit sharing part
H	10% per year of participation	Yes but employees do not vote	No	Restrictive agreement, first buy back option to company
I	10% per year of participation	Yes but employees do not vote	Yes, but not "passed through" trust	Company stock
J	10% after 3 years 15% for each additional year	Yes but employees do not vote	(Not available)	Company stock

Summary — ESOP Experience

One of the most interesting questions concerning ESOP experience is whether companies are actually using their plan as a corporate finance technique. Five of the 10 companies in the survey reported that they have used their ESOP as a technique of corporate finance. The sources utilized by the trusts to obtain employer securities included:

- tender offer to shareholders,
- new issue of company stock,
- buy-sell agreement with major shareholder, and
- terminees and other selling stockholders.

The reasons for companies implementing ESOPs also varied, with most companies listing two or three reasons for implementation. While 2 of the companies surveyed felt that their plan was too new to make an evaluation of its success, 7 of the remaining 8 companies rated their plan as either *very good* or *excellent* in accomplishing the goals that had been set for the ESOP. The one company that rated its ESOP as *good* was the only company that did not list increasing employee incentive as a reason for implementing the plan.

The degree to which ESOPs are invested in employer securities was also explored in the survey. The percentage of the ESOP trust funds currently invested in employer securities ranged from 20% to 100%, with 5 of the companies reporting that virtually all of the trust was invested in employer securities

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ESOP Experience I

Co. Code	Used As Corporate Finance Technique	Reasons for ESOP Implementation	Evaluation of ESOP
A	Yes tender offer to shareholders	• Increase employee incentive • Supplement to pension plan	Very good
B	No	• Increase employee incentive • Provide alternative means of corporate finance • Provide retirement benefit	Very good
C	Yes new issue of company stock	• Increase employee incentive • Provide alternative means of corporate finance • Provide estate planning mechanism • Provide retirement benefit	Very good
D	No	• Increase employee incentive • Supplement to pension plan	Excellent
E	Yes buy-sell agreement with major shareholder	• To provide an estate planning mechanism for a major shareholder	Good
F	Yes new issue of company stock	• Increase employee incentive • Provide retirement benefit	Very Good
G	Yes, debt financed shares obtained from terminees and other selling stockholders	• Increase employee incentive • Provide alternative means of corporate finance • Supplement to pension plan	Excellent
H	No	• Increase employee incentive • Provide alternative means of corporate finance • Provide retirement benefit	Too early to make evaluation
I	No	• Increase employee incentive • To create a market at a fair price for gradual transfer of ownership from original principals	Excellent
J	No	• Increase employee incentive • Supplement to pension plan	Too early to make evaluation

ESOP Experience II

Co. Code	Communication of ESOP	General Employee Reaction	Employer Securities Held by Trust
A	Booklet bulletin board notice company newspaper slide film presentation and employee meeting	Good has generated much interest in Company s stock	98%
B	Booklet company news paper and employee meeting	New plan, allocation has not yet taken place	40%
C	Booklet bulletin board notice company newspaper slide film presentation employee meeting personalized letter VTR presentation	Favorable	100%
D	Booklet	Very favorable	50%
E	Bulletin board notice and personalized letter	No noticeable employee reaction	35%
F	Booklet and employee meeting	Favorable	100%
G	Booklet bulletin board notice employee meeting and personalized letter	Very favorable	100% (ESOP part)
H	Booklet bulletin board notice employee meeting and personalized letter	Employees attitudes have not changed to any great extent	(Not Available)
I	Personalized letter and outline description of plan provisions	No noticeable employee reaction	100%
J	Personalized letter	Too new to know	20%

UNDERSTANDING THE IMPETUS FOR FAVORABLE ESOP LEGISLATION

It is difficult to understand the ESOP phenomenon without viewing it in the context in which it was introduced. That is, an understanding of the mechanics of employee stock ownership plans and of the legal implications of such plans will not by itself explain why ESOPs have received special recognition in four pieces of Congressional legislation in slightly more than a two-year period. It is necessary to understand the economic theory behind the concept that has enamored legislators. The questions of *why ESOPs* can only be answered when these plans are seen as they were originally envisioned by Louis O. Kelso and Patricia Hetter — that is as a means to an end, with the end being *general affluence*.

In their book *Two-Factor Theory: The Economics of Reality*, Kelso and Hetter assert that general affluence (defined as the standard of living enjoyed by the top ten percent of the income pyramid, to the extent that such a standard can be achieved for all within the physical limits of available resources, manpower and know-how) is a natural and desirable goal of an industrialized society and that such a goal is attainable only through universal capitalism.

Kelso and Hetter's theory of universal capitalism begins with the proposition that *there are two factors of production in an industrial economy:*

- labor (intellectual and technical as well as manual), and
- capital (productive land, structures and machines).

Capital, they maintain, produces wealth in precisely the same sense (physically, economically, politically and ethically) as labor. Further, technology — defined as the process by which man harnesses nature through his capital instruments and makes it work for him — is the feature distinguishing an industrial economy from a pre-industrial one and acts only upon the capital factor of production. Thus, they assert, capital and not labor is the source of affluence in an industrial society; or, stated another way, *affluence is the product of capital.*

Given the premise that affluence is the product of capital, it follows that general affluence can only be obtained through universal capitalism. At this point, Kelso and Hetter argue that capitalism, as it presently exists in the United States, is responsible for creating a narrow and stationary ownership base and is, therefore, incapable of achieving a goal of general affluence. They cite statistics which show that corporations — owners of the most productive assets and producers of most of the goods and services — finance 96% of their new capital formation through internal sources (retained earnings, depreciation, depletion and amortization allowances, and investment credits allowed against corporate income taxes). Internal funding, they assert, acts to concentrate rather than broaden the ownership of corporations.

Such concentration of corporate ownership, say Kelso and Hetter, reflects corporate management's failure to understand the principle underlying Say's Law, which states that in a market economy the aggregate market value of the wealth produced is equal to the aggregate purchasing power created by the process of production. Thus a business strategy of maximizing production while disregarding maximization of the purchasing power of workers is incomplete. Such maximization of purchasing power, if two-factor

economic theory is valid, can only be accomplished through universal capitalism By ignoring the importance of Say's Law, Kelso and Hetter argue, business in effect necessarily defaults the responsibility of increasing purchasing power to government Government then engages in neediest (socialist) redistribution of wealth through creating non-useful jobs, welfare, Social Security, etc. all of which act to increase purchasing power but fail to increase the production of useful goods and services and are thus inflationary Such measures, say Kelso and Hetter, may avert indigence but will never accomplish affluence

Current economic policy, however, can be changed, assert Kelso and Hetter. Their first step toward universal capitalism is the "recognition by management that it has both the opportunity and duty to use its own prerogatives and the production-marshalling efficacy of the corporation to connect individual consumers with the productive power of the corporation, either through employment, to the degree that the state of technology requires participation by labor, or through the ownership of the non-human factor of production represented by the capital of the corporation itself "* Once this recognition is accomplished, legislative reforms would be made that would facilitate the implementation of universal capitalism Such legislative reforms include:

- gradual step-by-step elimination of the corporate income tax,
- gradual tax guidance compelling mature corporations to pay out all net earnings, after depreciation and operating reserves only, to its stockholders,
- providing corporations with a new (external) and unlimited source for financing growth

Enter ESOPs The preceding explanation of two-factor economic theory is intended to provide only a skeletal framework in which to view employee stock ownership plans. The soundness of Kelso and Hetter's theories are not further explored except to note that "Kelso converts" include academicians, businessmen, and politicians who are in positions that influence United States economic policy. That is

- if the United States is capable of producing general affluence,
- if general affluence is a good and desirable goal,
- if production is a function of two factors (labor and capital),
- if affluence is the product of capital,
- if internal financing of new capital prevents diffusion of meaningful capital ownership,
- if production and consumption in a market economy form a natural equation,
- if new capital can be financed easily and logically from credit by means that create new capital owners simultaneously with new capital assets,
- then it is apparent that ESOPs must be viewed as more than just another employee benefit plan

Add to the theory of universal capitalism the assertion that such a policy would have the side effect of controlling inflation (dramatic increase of *useful* goods and services with simultaneous increase in purchasing power of workers is not inflationary says Kelso) and one begins to understand the reasons behind the surge in favorable ESOP legislation.

**Two-Factor Theory The Economics of Reality* p 75

PROPOSED LEGISLATION: THE ACCELERATED CAPITAL FORMATION ACT OF 1975

One of the themes of this report has been that ESOPs are in the process of being formulated into law. Four pieces of legislation have already dealt with ESOPs; these acts have served to encourage companies to implement such plans. Currently, Representative William Frenzel (D-MN) has filed a bill – The Accelerated Capital Formation Act of 1975 (H.R. 462) – designed to provide more tax incentives and to otherwise encourage the formation of ESOPs.

The provisions of the bill that would be especially advantageous to ESOPs are:

1. Remove the present statutory limitation of 25% of covered compensation as the maximum amount an employer can contribute to a qualified employee stock ownership plan when such payments are used to enable the plan to repay stock acquisition debts incurred in connection with meeting the employer's capital requirements
2. Provide a tax deduction to corporations for the amount of dividends they distribute either directly as taxable second incomes on stock held in an employee's account or which are used to repay stock acquisition indebtedness of the employees' trust.
3. Provide for advance IRS opinions on valuations of stock or other assets acquired by an ESOP where the parties to a financing transaction, which utilized an ESOP, would be subject to serious risk of penalties if the IRS, on a subsequent audit, disagreed with the valuation or other key features of the financing plan.
4. Exempt payments to an ESOP made for financing purposes from treatment as a conventional employee benefit for purposes of any wage, salary, deferred compensation, or other employee benefit controls or guidelines that might be established under executive order, regulations, or future economic stabilization laws at the federal or state level.

The bill is currently in the House Ways and Means Committee but probably will not be given consideration until, at best, late in 1975.

While it is unlikely that the Accelerated Capital Formation Act of 1975 will be passed, and it is almost certain that a similar act would be amended before it could be passed, the Act serves as another indication that many legislators are interested in encouraging ESOP development. A copy of H.R. 462 is included in an appendix to the report.

SUMMARY AND CONCLUSIONS

Employee stock ownership plans (ESOPs) are currently being widely discussed Business publications contain articles and advertisements which extoll ESOPs as plans which increase employee incentive by giving them a piece of the action," while simultaneously offering the company a means of financing new capital with pre-tax dollars Some of these advertisements and articles are obviously shaded by the interests of their authors However, favorable ESOP articles have recently appeared in such publications as the *Wall Street Journal, Barron's*, and *Newsweek*.

Much of the interest in these plans has been generated by legislation (ERISA, The Tax Reduction Act, and The Trade Act) designed to encourage ESOP implementation The ESOP concept has appealed to diverse political leaders. ESOPs, as presented by Kelso, would work toward solving many problems facing the United States, including:

- motivating a work force which, sociologists say, no longer adheres to the work ethic practiced by past generations:
- creating an alternative source for new capital at a time when national projections of the need for such new capital are at an all time high; and
- helping to control inflation by creating both new and useful capital while simultaneously increasing the purchasing power of consumers

Additionally, the idea of ESOP — essentially, every man a capitalist — has a strong populist appeal. A recent poll by Hart Research Associates showed that 66% of the public would favor working for a company that is employee owned and controlled

All of the above factors will continue to influence legislators to encourage ESOP development. However, the nature of an ESOP, both as an employee benefit plan and as a technique of corporate finance, is generally more complex than many advocates of these plans have portrayed. Sections IV and V of this report discussed some of the considerations concerning ESOPs. Briefly,

- An ESOP may subject participants' accounts to a greater potential for loss relative to employer contributions (than traditional capital accumulation plans) during a declining market by subjecting trust funds to the risk of debt financing; and
- An ESOP has the effect of changing the structure of the company's income stream in a way that may prove disadvantageous to prior shareholders (the financial impact of an ESOP should be viewed relative to the companies' commitment to providing deferred compensation for employees, a profit sharing plan, too, changes the structure of the companies' income stream)

This does not mean that implementing an ESOP would be unwise for all companies. Such a position would be just as erroneous as that taken by the advertisements that proclaim the "magic" that an ESOP can work in any company. The fact that the ten ESOP companies in the survey sponsored by the Council have had a generally favorable response to their plans indicates that ESOPs can prove to be beneficial for a particular situation. It is *imperative*, however, that any company considering implementing an ESOP make a careful evaluation of its *needs* and its *alternatives* both for motivating employees and for supplying funds for its financing needs.

APPENDIX

CONGRESSIONAL RECORD—HOUSE

WASHINGTON, TUESDAY, JANUARY, 14, 1975

Vol. 121 *No. 1*

INTRODUCTION OF THE ACCELERATED CAPITAL FORMATION ACT OF 1975

The SPEAKER PRO tempore. Under a previous order of the House, the gentleman from Minnesota (Mr. Frenzel) is recognized for 30 minutes

Mr FRENZEL. Mr Speaker, I rise today to introduce the Accelerated Capital Formation Act of 1975. This is a refined version of H R 8590 which I introduced in the 93d Congress

During the last session a great deal of progress in advancing the financing method known as ESOP or the employee stock ownership plan was made A provision for study of the ESOP plan in restructuring the Penn Central and other Northeast and Midwest railroads was included as a vital section of the Railroad Reorganization Act In the Pension Reform Act, signed into law last Labor Day, the ESOP was given special recognition as a form of employee benefit that could also be used to attract outside financing to meet the capital requirements of an expanding enterprise In the Trade Reform Act companies utilizing ESOP will be given special preferences in the $1 billion program of federally guaranteed loans to companies expanding or locating in areas adversely affected by foreign competition There were at least three other major pieces of legislation being considered in the 93d Congress which, though they did not reach the floor, contained ESOP provisions, these were railroad improvement loans, energy development and the Pan Am Assistance Act.

Though a great deal of progress has been made in recent years many people have questioned just what an ESOP does Essentially, under existing law, the ESOP makes accessible to all corporate employees the techniques of corporate finance Without any actual cash outlay from corporate employees — as in conventional employee stock purchase programs — and without any deduction in take-home pay or fringe benefits an ESOP builds blocks of corporate shares into employee ownership while providing moneys necessary for capital requirements It has been used to finance corporate expansion, acquire new assets, accomplish divestitures or spinoffs and finance mergers, et cetera

A standard ESOP incorporates a deferred compensation trust — technically a qualified stock bonus trust alone or coupled with a money purchase pension trust — into the financing process itself In one common technique the employees trust borrows funds to invest in the employer corporation. This then allows the affected employees, subject only to the trusts paying off the loan, to become beneficial owners of the companies' stock.

The employer corporation obligates itself to make annual payments into the trust in amounts sufficient to amortize the debt out of tax deductible dollars

The tax deduction makes it possible for the corporation to build greater capital ownership into the employees than it could otherwise, and the costs of financing its growth is about the same as if it conveniently borrowed and repaid — as to principal — in after-tax dollars After the employers stock has been paid for in this manner the trust can, if desired, be diversified by tax-free exchanges of stock for other securities, or by a public offering out of trust

This ESOP method, simply stated, allows greater benefits to the corporation than common expansion and financing techniques and permits the employee to gain a larger share of the organization he serves than conventional profit-sharing methods

The first known use of ESOP financing pioneered by Louis Kelso, involved an employee buy-out of a chain of California newspapers that was threatened with takeover by a major chain in 1956 But only in the last few years has the business world at large become aware of this innovation. A number of investment banking firms are pioneering this approach and several major firms have begun to recommend ESOP's to their clients Over 100 corporations have, largely in the last year, adopted ESOP's including two of our larger electronic manufacturers Many smaller firms and several major unions have adopted ESOP's

In order to facilitate the use of the ESOP technique, and thus effectively link daily employee performance with the growth and operation of a business, the bill modifies the Internal Revenue Code as follows:

First, the bill removes the present statutory limitation of 25 percent of covered compensation as the maximum amount an employer can contribute to a qualified employee stock-ownership plan when such payments are used to enable the plan to repay stock acquisition debt incurred in connection with meeting the employer's capital requirements

This places the sole limitation on financing contributions on the enterprise's capacity to service the debt out of cash flow This reform reduces the cost of capital growth and transfers in the ownership of corporate assets, while accelerating the rate at which employees as individuals and as a group can accumulate stock of their employer and other income-yielding assets as a new and noninflationary form of employee benefit. Although treated as a tax deduction, this change would have the same impact as an investment tax credit in terms of encouraging capital spending, however, the investment tax credit increases the concentration of corporate ownership while ESOP contributions correct this economic factor.

This also rechannels corporate profits that would otherwise have gone into the corporate income tax base into productivity increases of the private sector, thus generating lower prices for consumers, expanded private payrolls, and a broadening base of taxable personal incomes and personal estates among productive workers.

Second, the bill provides a tax deduction to corporations for the amount of dividends they distribute either directly as taxable second incomes on stock held in an employee's account or which are used to repay stock acquisition indebtedness of the employees' trust This provision also converts taxable corporate income into either taxable dividend incomes for employees to supplement their paychecks or their retirement and social security incomes or a more rapid rate of accumulation by employees of individual capital estates for their retirement security

Third, the bill provides that a qualified employee stock ownership plan and trust shall have the tax characteristics of a charitable organization for purposes of estate, gift, and income taxes This would encourage affluent taxpayers to make gifts to qualified trusts in order to reconnect the ownership of capital with a broader base of private individuals, namely productive employees some of whom have contributed to the building of the donor's wealth Allocations to participants of the trust would become an immediate source of taxable second incomes — to the extent dividends

are passed through the trusts — and a retirement estate for the employee-beneficiaries and their heirs On the other hand, Government would lose no tax revenues since such contributions made to charitable organizations are already exempt from taxation, and profits from donated income-producing property are frequently accumulated tax-free within such organizations

Fourth, the bill establishes a cutoff on further contributions in behalf of any employee when the value of the assets that employee has acquired during his working lifetime through one or more ESOP's exceeds $500,000 Such a safeguard on excessive accumulations acquired through tax deductions would be especially important in highly capital-intensive industries and would help foster more widespread and equitable sharing of ownership among Americans generally

Fifth, the bill adds to the options of ESOP participants when distributions are made when they retire, die, or are otherwise separated from service Although profit sharing plans are permitted to make distributions in many forms, the Internal Revenue Service has ruled that distribution from an ESOP must be made exclusively in company stock

Although enabling employees to accumulate sizable holdings of employer stock has obvious motivational value, when an employee leaves the company and can no longer directly influence the yield on the company stock accumulated in his ESOP account, it is desirable to provide the departing employee and the remaining employees, through their ESOP, to arrange an exchange for his accumulated assets with other income-yielding assets or cash of an equivalent value This bill would provide ESOP's the same flexibility in making distributions that is now enjoyed by profit sharing plans

Sixth, the bill permits a repurchase option for plans of enterprises that are wholly owned by their employees, so that stock of departing employees can remain exclusively held within the employee group

Seventh, the bill exempts lump sum distributions of income-yielding estates derived from an ESOP from any form of taxation, provided the assets are held to produce a taxable second income for the taxpayer or his beneficiaries However, if the assets are converted into spendable income and not reinvested within 60 days, the uninvested proceeds will be taxed as ordinary income, instead of partially at the lower capital gains rate permitted under present law

Eighth, the bill enables affected parties to seek advance IRS opinions on valuations on stock or other assets acquired by an ESOP where the parties to a financing transaction which utilizes an ESOP would be subject to serious risks or penalties if the IRS, upon subsequent audit, disagreed with the valuations or other key features of the financing plan This is similar to the "no action" procedures already instituted by the FTC and SEC

Ninth, the bill exempts payments to an ESOP made for financing purposes from treatment as a conventional employee benefit for purposes of any wage, salary, deferred compensation, or other employee benefit controls or guidelines that might be established under executive order, regulations, or future economic stabilization laws at the Federal or State levels Instead, it would be treated as any other form of capital spending that would have a counterinflationary effect In effect, it offers labor a trade-off for wage increases where wage ceilings are established

I hope that the members of this body will carefully consider the legislation I am hopeful that further progress can be made in this session

A copy of the bill follows

H R —

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1 TITLE — This Act may be cited as the "Accelerated Capital Formation Act of 1975"

SEC 2 PURPOSE — The purpose of this Act is to provide incentives for accelerated financing of the formation of U S corporate capital and to encourage voluntary means for broadly diffusing equity ownership among employees of U S enterprises both (a) with respect to existing capital by means consistent with the protection of private property and (b) with respect to newly formed capital by means which extend the logic of conventional business finance to corporate employees

SEC 3 AMENDMENT OF INTERNAL REVENUE CODE — The Internal Revenue Code of 1954 is amended by adding the following new Section 416 at the end of Subpart B of Part I of Subchapter D of Chapter 1

SEC 416 — EMPLOYEE STOCK OWNERSHIP PLAN FINANCING

(a) DEFINITIONS (1) "Employee stock ownership plans" means a technique of corporate finance described in Section 4975(e)(7) that utilizes stock bonus plans, or stock bonus plans coupled with money purchase pension plans, which satisfy the requirements of Section 401(a) and are designed —

(A) to invest primarily in qualifying employer securities,

(B) to meet general financing requirements of a corporation, including capital growth and transfers in the ownership of corporate stock,

(C) to build into employees beneficial ownership of qualifying employer securities,

(D) to receive loans or other extensions of credit to acquire qualifying employer securities, with such loans and credit secured primarily by a commitment by the employer to make future payments to the plan in amounts sufficient to enable such loans and interest thereon to be repaid, and

(E) to limit the liability of the plan for repayment of any such loan to payments received from the employer and to qualifying employer securities, and dividends thereon, acquired with the proceeds of such loan to the extent such loan is not yet repaid

(2) For purposes of this section, the term "employer securities" means securities issued by the employer corporation, or by an affiliate of such employer.

(3) For purposes of this section, the term "qualifying employer securities" means common stock, or securities convertible into common stock, issued by the employer corporation, or by an affiliate of such employer

(b) Special Deductions. (1) In addition to the deductions provided under section 404 (a), there shall be allowed as a deduction to an employer the amount of any dividend paid by such employer during the taxable year with respect to employer securities, provided —

(A) such employer securities were held on the record date for such dividend by an employee stock ownership plan, and

(B) the dividend received by such plan is distributed not later than 60 days after the close of the plan year in which it is received, to the employees participating in the plan, in accordance with the plan provisions, or

(C) the dividend received by such plan is applied, not later than 60 days after the close of the taxable year, to the payment of acquisition indebtedness (including interest) incurred by the plan for the purchase of qualifying employer securities

(2) Notwithstanding the limitations of section 404(a), there shall be allowed as a deduction to an employer, the amount of any contributions paid on account of a taxable year (as described in section 404(a)(6) to an employee stock ownership plan, provided such contributions are applied to the payment of acquisition indebtedness (including interest) incurred by the plan for the purchase of qualifying employer securities

(3) For purposes of sections 170(b)(1), 642(c), 2055 (a), and 2522, a contribution, bequest, or similar transfer of employer securities or other property to an employee stock ownership plan shall be deemed a charit-

able contribution to an organization described in section 170(b)(1)(A)(vi), provided—

(A) such contribution, bequest, or transfer is allocated pursuant to the terms of such plan, to the employees participating under the plan in a manner consistent with section 401(a)(4),

(B) no part of such contribution, bequest or transfer is allocated under the plan for the benefit of the taxpayer (or decedent) or any person related to the taxpayer (or decedent) under the provisions of Section 267(b) or any other person who owns more than 25% in value of any class of outstanding employer securities under the provisions of Section 318(a), and

(C) such contribution, bequest or transfer is made only with the express approval of such employee stock ownerhsip plan

(c) *Treatment of Participants* (1) Qualifying employer securities acquired by an employee stock ownership plan through acquisition indebtedness incurred by the plan in connection with the financing of capital requirements of the employer corporation or its affiliates must be allocated to the accounts of the participating employees to the extent that contributions and dividends received by the plan are applied to the payment of such acquisition indebtedness (including interest) in accordance with the terms of the plan and in a manner consistent with Section 401(a)(4)

(2) Upon retirement death or other separation from service an employee participating under an employee stock ownership plan (or his beneficiary in the event of death) will be entitled to a distribution of his nonforfeitable interest under the plan in employer securities or other investments allocated to his account in accordance with the provisions of such plan If the plan so provides the employee (or beneficiary) may elect to receive all or a portion of the distribution from the plan in —

(A) employer securities other than qualifying employer securities,

(B) cash

(C) a diversified portfolio of securities,

(D) a non-transferable annuity contract or

(E) any combination of the above

(3) An employee stock ownership plan may provide for the required repurchase of qualifying employer securities from an individual receiving a distribution thereof if all other of such outstanding employer securities whether or not acquired through the plan are subject to repurchase from non-employee shareholders under similar circumstances

(4) Upon receipt of a lump sum distribution as described in Section 402(e)(4)(A) from an employee stock ownership plan, an individual may exclude from gross income that part of the distribution which consists of employer securities or other assets if income producing, held or reinvested within 60 days in income producing assets of equivalent value, for the purpose of providing the individual with dividends or other forms of realized income from such assets Upon subsequent sale or disposition of any employer securities or other assets distributed by an employee stock ownership plan to the extent that proceeds realized from such sale or disposition are not reinvested with in 60 days in income producing assets, the total amount of such proceeds (or the fair market value of any such securities or assets that are transferred without adequate consideration) shall be treated as ordinary income to the individual

(5) An employee receiving a distribution under paragraph (b)(1)(B) of this Section shall be subject to taxation under Section 402(a)(1) and the provisions of Section 116 shall not apply to such distribution

(6) A contribution by an employer which is deductible under paragraph (b)(2) of this Section, or a contribution described in paragraph (b)(3) of this Section shall not be included in the meaning of annual addition under Section 415(c)(2)

(7) No contribution to an employee stock ownership plan may be allocated for the benefit of any participant if the value of the total accumulation of employer securities and other investments under the plan for the benefit of that participant equals or exceeds $500 000, less the amount of any such accumulation for that participant under any other employee stock ownership plans

(d) *Special Provisions* (1) The acquisition or holding of qualifying employer securities and the incurring of acquisition indebtedness by an employee stock ownership plan shall be deemed to satisfy the requirements of Section 404(a)(1) of the Employee Retirement Income Security Act of 1974 provided that—

(A) the requirements of Section 408(b)(3) and 408 (e) of such Act are satisfied, and

(B) the same standards of prudence and fiduciary responsibility that corporate management must exercise with respect to its shareholders are satisfied

(2) Upon application by an employee stock ownership plan the Secretary of the Treasury or his delegate shall issue an advance opinion as to whether a proposed transaction involving that employee stock ownership plan will satisfy all the requirements described in paragraph (1) of this subsection and any such opinion shall be binding upon the Secretary

SEC 4 — *Effect of Economic Stabilization* — Payments by an employer to an employee stock ownership plan as defined in Section 416(a)(1) of the Internal Revenue Code of 1954, for the purpose of enabling such plan to pay acquisition indebtedness incurred for the purchase of qualifying employer securities or other contributions to such plan shall not be treated as compensation, fringe benefits or deferred compensation payments for the purposes of any laws, executive orders or regulations designed to control, establish guidelines or otherwise stabilize employee compensation or benefits, but shall be treated as the equivalent of debt service payments made in the normal course of financing the capital requirements of that employer

Worker-Owned Plants

(By Gus Tyler)

New York.—In the Pacific Northwest, there are 16 plywood plants that consistently show higher productivity than their competitors. All of these superfirms are owned by their employes.

These companies are not fly-by-night operations. The first of them—Olympia Plywood—came into being in 1921 when 125 carpenters, mechanics and lumberman chipped in $1,000 apiece. In return for the small investment, each worker got a job, an equal share in company profits, and an equal voice in running the plant.

Other workers followed a similar pattern to become the owner-employes of companies whose businesses range from $3 million to $20 million in gross revenues with work forces of between 80 and 450 people.

The method of compensation is startling, almost unbelievable. Everybody in the plant is paid the same wage. Describing the unusual pay system in World of Work Report (May 1977) Paul Bernstein of the University of California at Irvine notes:

"Highly skilled workers sometime resent not receiving more pay than men who do the simplest jobs in the firm. Because their roots are in a cooperative, egalitarian philosophy, the mills pay all members an equal wage—floorsweeper, skilled panelfinisher, and accountant alike."

BALANCING ACT

A problem arises on those occasions when some workers spend more time than others on the job for one reason or another. This little difficulty is handled in a novel and sophisticated way.

If a worker falls short on hours, he will have a chance to make up for it by weekend or overtime work; if another worker has put in unusually long hours, he must work less the next week.

The plant is run by a manager who is hired by the Board of Directors that, in turn, is elected by the worker-owners.

By conventional wisdom, these plants should show low productivity for at least two reasons. First, if workers are their own boss, who will be there to crack the whip; second, if everybody gets paid the same, where is the incentive to work hard.

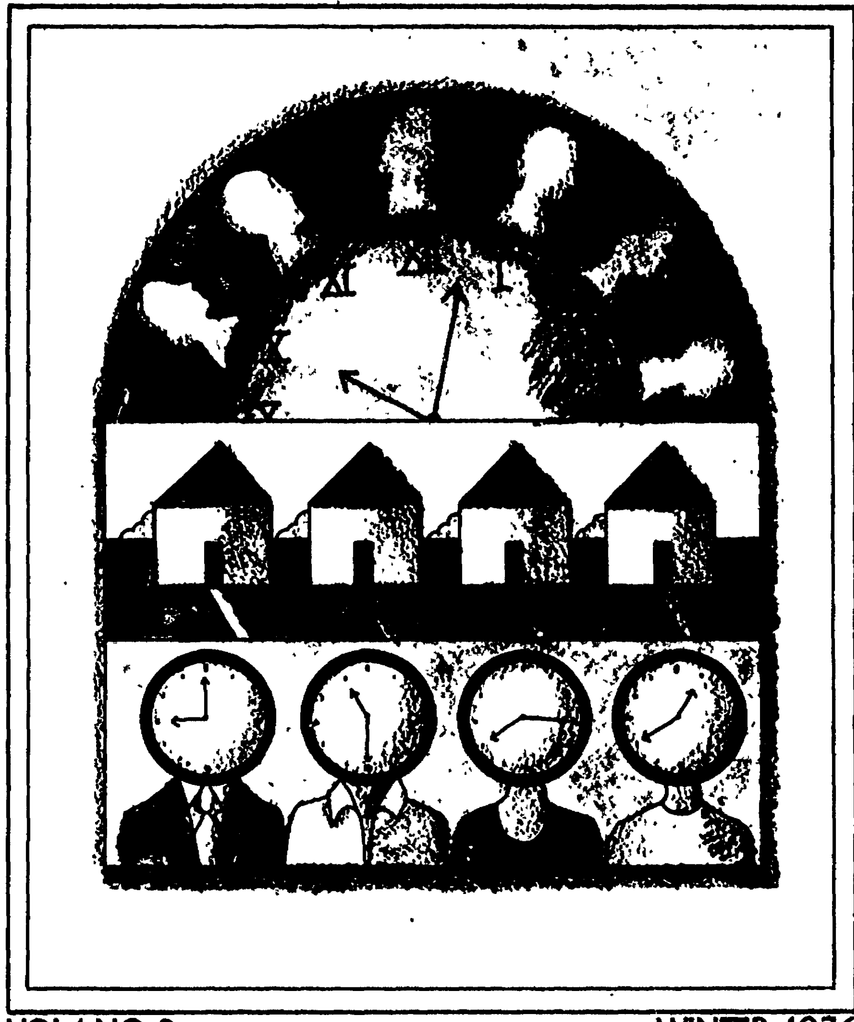
PRODUCTIVITY SURGES

Yet, lo and behold, these plants regularly outperform their rivals. In 1950, these cooperatives turned out 115 to 120 square feet of plywood per man-hour as against the 80 to 85 square feet for their competitors. In 1960, the former turned out 170 square feet as against their rivals' 130.

Because productivity is high, wages are high. Indeed, the Internal Revenue Service thought the wages were too high and was a trick of these companies to cut down corporate profits to avoid paying corporate taxes. But the IRS charge failed because the companies were able to prove that their high productivity justified these high wages.

Why have these plants been successful? Apparently, because these workers feel that this is their very own thing. The company's success is their own personal success. They take pride in the company; they also make a good profit from it. Shares bought at $1,000 now sell at $20,000 to $40,000.

EMPLOYEE RELATIONS LAW JOURNAL



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Employee Stock Ownership Plans After ERISA

RONALD L. LUDWIG*

ESOPs—Employee Stock Ownership Plans—are designed to give the participating employee a stake in the financial success of the employer's business while, at the same time, providing an innovative approach to solving various corporate financing problems. Structuring such a stock bonus plan is the subject of this article which points out and cautions against the pitfalls of misusing the ESOP technique.

Introduction

The use of Employee Stock Ownership Plans, often referred to as "Kelso Plans," has become increasingly popular in the past few years, as both a technique of corporate finance and an attractive employee benefit program. Employee Stock Ownership Plan ("ESOP") financing utilizes an employees' trust, qualified under Section 401(a) of the Internal Revenue Code, as a vehicle for financing corporate growth and transfers in ownership of corporate stock, while building ownership into the participating employees of the employer corporation.

Stock bonus trusts (a basic element of ESOP financing) were first granted tax-exempt status under the Revenue Act of 1921, but were not widely used until recent years. In 1956, San Francisco lawyer-economist Louis O. Kelso first designed a qualified employees' trust as a financing vehicle, thereby pioneering the ESOP concept as a new technique of corporate finance. Largely through Mr. Kelso's continued work over the past twenty years, ESOP financing has become a recognized vehicle for providing employee stock ownership. Congress has recently encouraged the use of the ESOP technique under the Regional Rail Reorganization Act of 1973, the Employee Retirement Income Security Act of 1974 ("ERISA"), the Trade Act of 1974, and the Tax Reduction Act of 1975.

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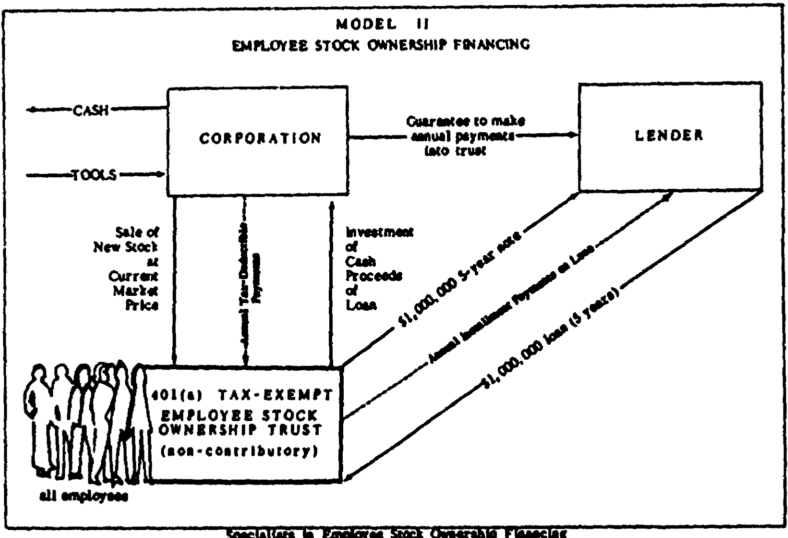
An ESOP Financing Model

The basic use of the ESOP technique is for financing new corporate capital formation, through debt repayable with pretax corporate dollars. This transaction is commonly structured as follows:



• The corporation establishes an ESOP, designed to qualify as an employee stock ownership plan under Sections 401(a) and 4975 (e)(7) of the Internal Revenue Code. The ESOP includes as participants a nondiscriminatory group of employees, whose relative interests under the ESOP are generally in proportion to their relative compensation during the period of the financing.

• The corporation arranges for a loan (from a bank or other lender) to the ESOP. The ESOP Committee (normally appointed by management) directs the ESOP Trustee to invest the loan proceeds in newly issued common stock of the corporation, at its current fair market value. The corporation now has additional funds necessary for financing its expansion and operations.

• The ESOP gives its note to the lender, which note may or may not be secured by a pledge of the stock. If the loan is so secured, the pledge is designed for release of proportionate amounts of stock each year, as repayments on the loan are made to the lender.

• The corporation issues its guarantee of the loan to the lender, assuring that it will make annual payments to the ESOP in amounts sufficient to enable the ESOP to amortize debt principal and interest due to the lender. Within the limits specified under Code Section 404(a), such payments are tax deductible by the corporation as contributions to a qualified employee deferred compensation trust. Thus, the lender has the general credit of the corporation to support repayment of its loan, plus the added security resulting from the fact that the loan is repayable with pretax corporate dollars. If necessary, the corporation may pledge its own assets as additional security for the ESOP loan.

• Each year, as a payment is made by the corporation to the ESOP and repayments on the debt are made to the lender, there is allocated proportionately among the accounts of the participating employees a number of shares of stock proportionate to each participant's allocated share of the payment. This permits the employees to acquire stock ownership interests in increments over a period of years at a price fixed at the time the block of stock is first purchased. Special allocation formulas have been designed to counteract the relatively high proportion of early debt amortization payments used to pay interest and the relatively high proportion of later amortization payments used to pay principal.

• As the financing is completed and the loan repaid to the lender, the beneficial ownership of the stock accrues to the participating employees. Most ESOPs are designed to permit the withdrawal of stock in kind, subject to vesting provisions, at retirement, death, or other termination of employment. Favorable tax treatment is allowed for lump sum distributions of employer stock under Code Section 402(a)(2) and (e).

• The ESOP may be designed to permit dividend income on shares of stock that have been paid for by the financing process (and are then allocated to employees' accounts) to be distributed currently to the employees, thus giving them a second source of income through their capital ownership. During the financing process, dividends may be applied to accelerate the repayment of the ESOP loan.

• Voting rights on shares of employer stock held by the ESOP may be exercised by the ESOP Committee, or may be passed

through to the employees as shares are allocated to their accounts (or as allocated shares become vested).

• After the ESOP has repaid its debt to the lender, additional debt financing may be arranged to finance new capital growth of the employer. Alternatively, the ESOP may be used to create an "in-house" market for stock of the corporation, by acquiring shares from existing shareholders (including former ESOP participants).

• Diversification of investments under the ESOP can be achieved, if desired, after a particular block of stock has been paid for, by exchanging a portion of the employer stock, at fair market value, for other investments of equal value. Since the ESOP Trust is a tax-exempt entity under Code Section 501(a), such diversification is without tax impact.

• If the ESOP is to serve as an "in-house" market for stock of the corporation, it is desirable to maintain sufficient liquidity to provide funds for the repurchase of stock from former ESOP participants.

• Through the technique of ESOP financing, nonrecourse corporate credit has been extended for the benefit of employees, enabling the corporation to finance its capital requirements with pretax dollars. ESOP financing builds beneficial ownership of common stock into employees, on a tax-sheltered basis, without any personal investment risk and without requiring any reduction in their take-home pay.

Requirements of IRC and ERISA

As a qualified employees' plan, the ESOP is designed to satisfy all applicable requirements of Section 401(a) of the Code, including the new requirements imposed by ERISA. The ESOP must be a plan for the benefit of employees in general and may not discriminate in favor of officers, shareholders, or highly compensated employees. In addition, ESOP financing transactions must satisfy requirements for the special exemptions from the prohibited transaction rules of ERISA.

Code Section 4975(e)(7) and ERISA Section 407(d)(6) define "employee stock ownership plan" as a stock bonus plan, or a combination stock bonus and money purchase pension plan, qualified

under Code Section 401(a), designed to invest primarily in employer stock, and meeting such other requirements as the Secretary of Treasury may prescribe by regulation. Guidance for regulations defining ESOP comes from the legislative history under the four laws which Congress has enacted relating to ESOP financing. Congress has recognized and defined ESOP as a technique of corporate finance which is designed—

(1) To meet general financing requirements of the corporation, including capital growth and transfers in the ownership of corporate stock;
(2) To build into employees beneficial ownership of stock of their employer (or its affiliated corporations), substantially in proportion to their relative incomes, without requiring any cash outlay, any reduction in pay or other employee benefits, or the surrender of any other rights on the part of such employees; and
(3) To receive loans or other forms of credit to acquire employer stock, with such loans and credit secured primarily by a binding commitment by the employer to make future payments to the ESOP in amounts sufficient to enable such loans to be repaid.

As a qualified stock bonus plan, the ESOP may be designed with a discretionary contribution feature and with reallocation of forfeitures to remaining participants. However, any debt service requirements under ESOP financing will create a definite liability for employer contributions. That portion (if any) of an ESOP which constitutes a money purchase pension plan must include a definite contribution formula (subject to the funding standards of Code Section 412) and must provide that forfeitures be applied to reduce employer contributions.

Differences From Other Qualified Plans

Section 1.401-1(a)(2)(iii) and (b)(1)(iii) of the existing Income Tax Regulations state that a stock bonus plan is established to provide benefits similar to a profit-sharing plan, except that such benefits are distributable in stock of the employer and that contributions are not necessarily dependent upon profits. The following

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will set out some greater differences, which have become clear under ERISA:

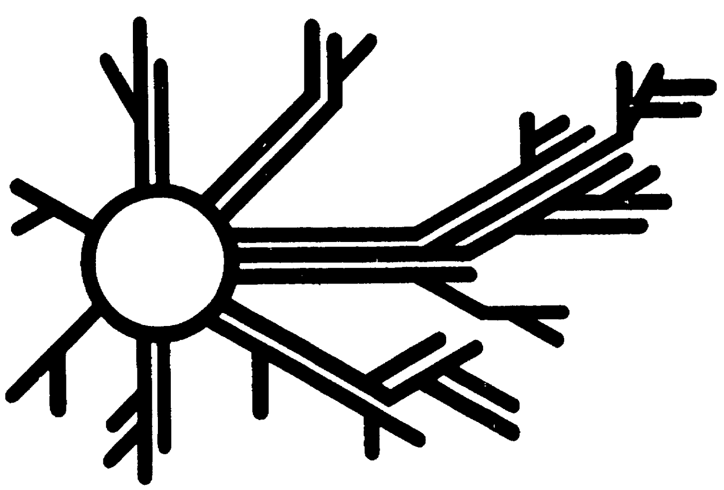
(1) *Primary purpose.* Rev. Rul. 69-65 states that the purpose of a stock bonus plan is "to give the employee-participants an interest in the ownership and growth of the employer's business. . . ." This distinction in purpose from pension plans and profit-sharing plans is important in interpreting the fiduciary responsibility provisions of ERISA. ERISA Section 404(a)(1) requires fiduciaries to serve for the "exclusive purpose of providing benefits to participants" and to serve as a "prudent man acting in a like capacity . . . in the conduct of an enterprise of a *like character* and *with like aims.*" The purpose of ESOP financing is the use of corporate credit to acquire ownership of employer stock for participants, while financing capital requirements of the employer corporation. Both the "exclusive purpose" and "prudent man" requirements applicable to an ESOP (and the "exclusive benefit" rule of Code Section 401(a)) must be interpreted in light of this purpose. ESOP is required to acquire and hold employer stock, as the benefits to be provided to participating employees. ESOP is not primarily a "retirement plan" or a "plan for deferred profit sharing." See Rev. Rul. 69-494 for the applicability of the "exclusive benefit" rule to an investment in employer stock. ERISA Sections 404(a)(2) and 407(b)(1) permit an ESOP to be invested wholly in employer stock.

(2) *Financing vehicle.* ESOP is the only qualified employees' plan permitted to receive loans or other extensions of credit from a party-in-interest for the acquisition of employer stock. The prohibited transaction exemptions in Code Section 4975(d)(3) and ERISA Section 408(b)(3) are available only to an ESOP and are not applicable to conventional stock bonus plans or profit sharing plans. Other qualified plans may not be used to finance corporate capital requirements and may not be used as vehicles for debt financing transactions involving parties-in-interest.

(3) *Second income for employees.* An ESOP may be designed to currently distribute dividends on employer stock to participants. Such distributions result in increased spendable income for employees, without a corresponding increase in labor costs (through pay increases) for the employer corporation.

(4) *Employee motivation.* Stock ownership may be a powerful tool for motivating employees. Through stock ownership provided on an accelerated basis under ESOP financing, employees are placed in a position where their work efforts can directly affect the

value of their deferred compensation benefits. Profit-sharing plans which invest in diversified investments result in benefits to employees which cannot directly reflect the profitability of the employer. ESOP provides employees with a "piece of the action," without requiring any personal investment or reduction in take-home pay. ESOP financing allows nonrecourse credit of the corporation to be made available for the purpose of building stock ownership into its employees.



(5) *Expense of deferred compensation.* Conventional qualified plans are items of pure expense to the employer corporation. The incentive to the employer is often to minimize its contributions to conventional plans, and thereby its costs. Through use of ESOP financing, an employer may wish to maximize coverage of its employees and its employer contributions, thereby increasing its ability to finance capital requirements with pretax dollars and increase corporate cash flow. ESOP financing uses the same corporate pretax dollars to finance capital requirements as are used to finance deferred compensation benefits.

(6) *Contribution limits.* Through use of a combination stock bonus plan and money purchase pension plan in ESOP financing, employer contributions may be tax-deductible to the extent of 25 percent of covered payroll, under Code Section 404(a)(7). If

credit carryovers are available under Code Section 404(a)(3)(A), a 25 percent deduction limit (30 percent for years beginning prior to January 1, 1976) may be achieved without the definite contribution formula required with a money purchase plan. However, for years beginning after December 31, 1975, the allocation limits of Section 415(c) and (e), applicable to both contributions and reallocated forfeitures under an ESOP, may reduce the allowable contributions below the maximum allowable for deduction purposes. Credit carryovers accrued under a qualified profit-sharing plan are available for use under an ESOP.

Applications of the ESOP Financing Technique

Capital Formation

The basic ESOP model provides for financing new capital formation and corporate growth, with pretax dollars being used to repay loan proceeds supplied by outside lenders. The ESOP technique enhances the ability of the employer corporation to meet debt service requirements, as repayment of both principal and interest are made from pretax corporate dollars. Conventional loans require repayment of principal with after-tax dollars. ESOP financing makes use of corporate credit for the purpose of building ownership of common stock of the employer corporation into participating employees.

Transfers of Ownership

ESOP financing provides a vehicle for the acquisition of employer stock from existing shareholders, again using pretax corporate dollars. The selling shareholder is able to dispose of all or a portion of his shares, without the potential of dividend treatment which may apply to corporate redemptions under Code Section 302. Sales of employer stock to an ESOP by a shareholder are sales of capital assets which can be taxed as long-term capital gains. A corporate redemption not only involves the potential of dividend treatment, but also requires the use of after-tax corporate earnings. Funds for a financed purchase of employer stock from existing shareholders may be obtained from outside lenders, or the ESOP may acquire the stock under an installment sale agreement with the shareholder.

Refinancing Existing Debt

If acceptable to a lender, an ESOP may be used to refinance existing corporate debt so that it is repayable with pretax dollars. In this situation, the employer corporation would issue new shares of its common stock to the ESOP equal in value to the amount of the debt principal assumed by the ESOP. The balance sheet of the corporation may be strengthened by the conversion of debt to equity. From the lender's viewpoint, the debt is more secure, being repayable with pretax dollars.

Alternative to Going Public

ESOP financing is an attractive alternative to selling stock to the public. Shares of employer stock may be acquired by the ESOP either from the corporation (to finance new capital) or from existing shareholders, or both. The costs of a public underwriting and registration with the Securities and Exchange Commission, and the expenses of operating as a publicly owned company, may be avoided through use of the ESOP. In addition, the value of employer stock in an "in-house" market need not be subject to the fluctuations of a public market. Employee-owners are generally more loyal shareholders than outsiders.

Financing of Acquisitions and Divestitures

The ESOP technique may be used to finance the acquisition of other companies. The pretax earnings of the acquired company (and the increased employee compensation base) are available to repay debt incurred for financing the acquisition.

ESOP financing provides a technique for divesting a division (or subsidiary) to a new corporation, owned by employees in whole, or in part, through an ESOP. The pretax earnings of the new corporation are available to "bootstrap" the purchase, which may be financed through loans from outside lenders or from the divesting company.

"Going Private"

ESOP financing provides a method for publicly owned corporations to "go private," using pretax corporate dollars to finance the

transaction. Rather than using corporate after-tax dollars for stock redemptions, ESOP finances the transfer of ownership to employees with pretax dollars. Several publicly owned corporations have used ESOP as the vehicle for a tender offer to public shareholders, thereby replacing outsiders with employee-owners.

Direct Stock Contributions

An ESOP may be used to receive direct contributions of employer stock from the employer corporation. This results in tax deductions to the corporation equal to the fair market value of the contributed shares, without any cash outlay. The tax savings increases corporate cash flow for use in financing the business.

Uses in Estate Planning

For the closely held corporation which does not wish to (or cannot) go public, ESOP financing is useful in solving estate liquidity problems. The ESOP provides a ready market for the stock of a deceased major shareholder. Acquisitions of employer stock from the estate may be financed, through ESOP, using pretax corporate dollars, without the redemption restrictions under Code Sections 302 and 303. In addition, with an ESOP in operation, an acceptable valuation of employer stock for estate tax purposes may be established.

Special Investment Tax Credit

The Tax Reduction Act of 1975 provides for an additional one percent investment tax credit (above the 10 percent credit permitted during 1975 and 1976) to corporations which will contribute that one percent to an ESOP for the benefit of its employees. The contribution must be in employer stock, or in cash to be invested in employer stock, and is allocated to participants' accounts in proportion to their relative compensation, up to $100,000. The investment credit contributions to an ESOP must be nonforfeitable as to all participants, and participants must be given the right to direct the voting as to the shares of employer stock allocated to their accounts. This special investment tax credit provides 100 percent government financing of employee stock ownership.

ESOP Financing Problem Areas

Acquisition of Employer Stock

Section 408(e) of ERISA and Code Section 4975(d)(13) permit an ESOP to acquire employer stock from a party-in-interest (including the employer), so long as no more than "fair market value" is paid. If the purchase price exceeds fair market value, the acquisition would constitute a prohibited transaction subject to penalty taxes and corrective action under Code Section 4975, as well as potential liability on fiduciaries for losses.

In closely held corporations, the question of valuation may create problems in the absence of arm's-length transactions. It can be expected that the Internal Revenue Service and the Department of Labor will closely scrutinize ESOP acquisitions of employer stock, especially with respect to "fair market value." A valuation by a qualified appraiser of corporate stock is strongly advisable.

Debt Financing

The concept of a qualified employees' trust borrowing funds for investment in employer stock is recognized in Rev. Rul. 71-311, loan which predates ERISA. Section 408(b)(3) of ERISA and Code Section 4975(d)(3) allow a prohibited transaction exemption for an ESOP loan (or other extensions of credit, including loan guarantees and installment purchases) which is "primarily" for the benefit of participants. The loan must bear a reasonable rate of interest, and any collateral given to a party-in-interest by the ESOP must be limited to employer stock. If these conditions are not satisfied, the entire loan amount may be subject to prohibited transaction penalty taxes, corrective action, and potential fiduciary liability.

Elements of the "primary benefit" test are apparent in the legislative history of the four laws recognizing the ESOP financing concept. Generally, a loan will be primarily for the benefit of participants if the proceeds are used to acquire stock of the employer (or its affiliates) on equitable terms for the benefit of employees, in connection with the financing of corporate capital requirements. Further, the primary security for the loan should be corporate credit; there should be a binding commitment by the employer to pay sufficient contributions (or dividends on employer stock) to enable the ESOP to repay debt principal and interest. Finally,

liability of the ESOP for repayment of the loan should be limited to the payments received from the employer corporation and to any employer stock remaining subject to pledge (that is, the loan should be nonrecourse as to other ESOP assets).

In addition to these requirements, it is necessary to design ESOP financing transactions so that employer contributions required to service debt principal and interest will not result in allocations to any participant exceeding the limitations under Code Section 415 (which include contributions *and* forfeitures). Further, it is necessary to allow for sufficient liquidity if the ESOP is to create an "in-house" market for employer stock distributed to terminated participants.

Securities Laws

ESOP financing requires careful study of the possible effects of federal and state securities laws. Generally, in closely held corporations, these laws do not create major impediments to the implementation of an ESOP, as long as employee contributions are not used to acquire employer stock.

Allocations of Employer Stock

Special attention must be given to allocations to participants' accounts under an ESOP. Allocations are generally made in shares (and fractional shares) of employer stock to one account for each participant, and in dollars and cents to another account for each participant representing his interest in ESOP assets other than employer stock. In addition, employer stock acquired by the ESOP through debt financing transactions is allocated to participants' accounts only as repayments of debt principal and interest are made to the lender, or as payments are made under installment purchase agreements.

Conversion of Existing Plans

Under proper circumstances, existing pension plans and profit-sharing plans may be converted (by amendment) into ESOPs. If the requirement of prudence (under ERISA Section 404(a)(1)(B)) can be satisfied, existing assets of such plans may be used to acquire employer stock for the benefit of participants, either from existing shareholders or directly from the employer corporation.

Conversion of a profit sharing plan into an ESOP will generally not require 100 percent vesting of participants' accounts, and credit carryovers under Code Section 404(a)(3)(4) are available for use under the ESOP. Conversion of a money purchase pension plan into an ESOP will not require 100 percent vesting if the ESOP includes a comparable money purchase plan. Conversion of a defined benefit pension plan into an ESOP will be a termination for purposes of Title IV of ERISA (relating to plan termination insurance) and may also require 100 percent vesting of participants' accounts.

Conclusion

ESOP financing provides an innovative approach to solving various corporate financing problems. In addition, it provides an opportunity for employees to accumulate significant capital ownership and a stake in the financial success of the business of their employer. Congress appears to be encouraging the use of ESOP financing, and several pending bills would greatly enhance the incentives for corporations to build ownership into employees while financing their capital requirements. ESOP financing, when properly designed and utilized, results in favorable benefits for the employer corporation, its shareholders, and its employee-owners. Care should be taken to avoid the pitfalls of misusing the ESOP technique. The Internal Revenue Service, the Department of Labor, and Congress will all be closely investigating the applications of ESOP financing, in order to prevent abuses and to protect the interests of employee-participants.

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Beyond ESOP: Steps Toward Tax Justice

By NORMAN G. KURLAND

A two-part article reprinted from the April and July 1977 issues of

Beyond ESOP: Steps Toward Tax Justice†

By NORMAN G. KURLAND*

> **"Our tax system is a national disgrace."**
>
> **--President Jimmy Carter, during his 1976 Presidential Campaign**
>
> **"The Congress in a series of laws . . . has made clear its interest in encouraging employee stock ownership plans as a bold and innovative method of strengthening the free enterprise system which will solve the dual problems of securing capital funds for necessary capital growth and of bringing about stock ownership by all corporate employees."**
>
> **--Section 2701, U.S. Tax Reform Act of 1976**
>
> **"To begin to diffuse the ownership of capital and to provide an opportunity for citizens of moderate income to become owners of capital rather than relying solely on their labor as a source of income and security, the Committee recommends the adoption of a national policy to foster the goal of broadened ownership. . . . Whatever the means used, a basic objective should be to distribute newly created capital broadly among the population. Such a policy would redress a major**

† This is Part 1 of a two part article. Part 2 is scheduled for publication in the July 1977 issue.

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imbalance in our society and has the potential for strengthening future business growth."

—1976 Annual Report of the Joint Economic Committee of the U.S. Congress

The Carter administration has announced its intention to submit to Congress a package of comprehensive reforms to the U.S. tax system. No one knows exactly what that package will contain and whether it will represent some fundamentally new directions in U.S. tax policy. But if there is to be a new world economic order, as President Carter has promised, no stone should remain unturned in the debate that will shape the tax philosophy of the President. It is in that spirit that this article is written.

The monumental task of reforming the U.S. tax system requires willingness to go back to the beginning, to reexamine fundamental principles and ideals from which this unique nation was born, and to question any assumptions in current economic and tax philosophy that may be inconsistent with those fundamentals. The forthcoming debate will certainly center around issues of *justice*, *equality* and *loopholes*, terms bound to produce confusion and divisions among Americans if their thinking remains shackled along present ideological lines. This article will suggest a philosophical framework that offers new definitions for these vague expressions and an alternate perspective for understanding basic issues of tax reform. It attempts to shed more light on the philosophy behind the creeping movement on Capitol hill to foster a new national goal of broadened capital ownership. And it attempts to explain the broader context surrounding employee stock ownership plans (ESOPs) and how it fits into a more comprehensive national ownership strategy, within which a totally new approach to taxation is a prerequisite. Finally, this article offers new guideline suggestions to unite opposing forces on some of the most controversial issues facing tax reformers. At the very least, the writer hopes to provoke thinking people, persons who recognize their responsibility for making today the decisions that will determine the way of life twenty or thirty years from now, to think again.

MARX AND ENGELS OR KELSO AND ADLER?

Since the goal of equality has a certain universal moral ring to it, as we boldly approach the tax system as an instrument for achieving greater equality for Americans, we should be reminded of de Tocqueville's final warning to us after observing American democracy in action:

The nations of our time cannot prevent the conditions

> of men from becoming equal; but it depends upon themselves whether the principle of equality is to lead them to servitude or freedom, to knowledge or barbarism, to prosperity or wretchedness.

Let us start with a simple thesis. Political democracy cannot preserve the institutions of a free society unless everyone can participate on an equal basis. An economically free and classless society—another way of describing economic democracy—is therefore both a goal and a means for supporting political democracy. Where opportunities to accumulate wealth are grossly unequal, great inequalities in the distribution of wealth are readily seen as flagrant contradictions to the goal of a free, just and economically classless society. Therefore, attacking the problem of inequality of wealth is a legitimate concern of a democratic government. How to build an economically free and just social order, however, forces us to think about what we mean by economic justice.

A thorough search through the literature of Western civilization for a pathway to a just economic order, will eventually lead the serious scholar to two seminal philosophical works, each diametrically opposed to the other, not in their quest for an economically free and classless society, but rather in the moral and political principles and the institutional framework each considered necessary for achieving economic democracy.

That the first one, written in 1848, has had a profound and growing influence on tax philosophy and tax reforms around the world, is hardly debatable. In the second chapter of The Communist Manifesto, Karl Marx and Friedrich Engels presented a list of ten measures "which appear economically insufficient and untenable, but which in the course of the [communist] movement, outstrip themselves, necessitates further inroads upon the old social order, and are unavoidable as a means of revolutionizing the mode of production." Marx and Engels described these ten measures as "despotic inroads on the rights of property" which the propertyless masses will use to "wrest, by degrees, all capital from the bourgeoisie [and] to centralize all instruments of production in the hands of the State." Besides calling for abolition of property in land, the extension of factories and instruments of production owned by the State, and the centralization of the means of communication and transport in the hands of the State, among other things, the second and third items on the list were:

2. A heavy progressive or graduated income tax.
3. Abolition of all rights of inheritance.

If Marx and Engels have correctly predicted that the ulti-

mate conclusion of their pathway to economic justice is a society where everyone is equally propertyless, equally liable to labor for a single employer, the State, and equally dependent for their subsistence on wealth redistributed by the State ("the dictatorship of the proletariat"), do the roots of America offer a better road to a free and classless economic order?

Directly challenging Marx and Engels, Louis O. Kelso and the eminent American philosopher Mortimer J. Adler reasoned in The Capitalist Manifesto (1958) that, while concentrated capital ownership was manifestly unjust and destructive of a free and democratic order, a higher order of economic justice should be built upon the proposition that *everyone, as a fundamental human right, must become an owner of capital.* Property as an institution was not the fundamental flaw of nineteenth century capitalism, as Marx and Engels asserted. And the redistribution of income is not necessarily just and orderly. Rather, countered Kelso and Adler, an industrial society could achieve a more just and orderly distribution of wealth by preserving the institution of private property and redistributing future ownership opportunities. Thus, as new and more advanced technology is added, more and more and gradually all persons would gain direct property stakes in productive resources. Following the wisdom of America's founding fathers and some of history's greatest political philosophers since Aristotle, Kelso and Adler made a logical and socially compelling case (to which no article as brief as this can do justice) that the institution of property is a prerequisite for preserving a free society and the foundation upon which all other human rights must be grounded.

Since, in the words of Daniel Webster, "power naturally and inevitably follows the ownership of property", a society where all power is supposed to rest in its citizens, must necessarily develop means to keep property broadly diffused.

The world-wide moral appeal of this fundamental right is recognized by Article 17 of the UN's Universal Declaration of Human Rights, which reads: "Everyone has the right to own property, alone as well as in association with others."

Moreover, argued Kelso and Adler, welfare and charity, while justified as humane, short-term expedients for coping with severe cases of economic deprivation, offer no lasting, politically realistic solutions to economically unjust situations. As expedients, however, they can be carried on simultaneously with a comprehensive long-range program for restructuring the future ownership patterns of a society.

The Kelso-Adler version of a just society rests upon three basic principles of justice:

An Input or Principle of Participation. Since everyone has the right to life, everyone must be provided, as a fundamental human right, the right to produce a self-sufficient income. In other words, one can legitimately participate as a producer of marketable goods and services, either as a worker or as an owner of capital instruments, or both. In terms of a high technology society, Kelso and Adler would redefine the term equality of economic opportunity to require government to lift all barriers and take affirmative action to promote more equal access to the future ownership opportunities. Where new capital formation is added through expanded bank credit, for example, this means that everyone should be provided equal access to society's credit system.

An Outtake or Principle of Distribution. Reward should be based, not on one's clout or on charity, but on the value of one's input to production, whether through one's human efforts or through one's ownership of productive capital, or both. If a person wants to consume more, it follows that he must produce more; otherwise he must become dependent on the wealth produced by someone else's labor or someone else's property. However, just as the denial of one's entitlement to the fruits of his hands or mind is a denial of his property rights in his own body, taking away anyone's property income is a direct erosion of his property rights in the means of production.

Under the private property principle of wealth distribution, how would wages and profits be determined? Following Aristotle, Kelso and Adler would allow the free and competitive marketplace to determine what is a just wage, a just price, and a just profit. Neither coercion on the buyer or on the seller of any goods or services would be allowed. In the freely competitive marketplace, the laws of supply and demand, not special privilege or superior clout, control economic values. In this democracy of the marketplace, consumer sovereignty reigns and everyone's vote counts.

ine Feedback or Principle of Limitation (Anti-Monopoly). Where a few own too much of the means of production and most of society owns too little property or none at all, justice is automatically denied. No one is born with property in the means of production. In a free society everyone is born with property in their own bodies. The ownership of capital is wholly determined by society's institutions, which in turn are products of society's laws. Hence, no monopoly can exist with-

out the approval or tolerance of government. Since most technological gains are produced by improved tools (i.e., machines, techniques, structures, organizations), an economy is inherently unjust if government permits a monopoly over the ownership of its instruments of production. Such a monopoly is a systematic denial of equal economic opportunity because it denies others the right to produce enough to support themselves by owning the tools that produce wealth. Since tools continue to produce more with less and less human efforts, concentrated capital ownership, if left uncorrected, leads inevitably to redistribution and the eventual breakdown of the other two principles of economic justice. By allowing a few to produce radically more than they and their families can consume, others are forced into conditions of dependency. One man's surplus is another man's poverty.

If Kelso and Adler's version of economic justice is more sound than that of Marx and Engels, then we can well understand why tax reform during the last sixty years has failed so miserably. What becomes almost self-evident is that tax reformers in general have put the cart before the horse. By discouraging new capital formation through discriminatory taxes on property and property incomes and emphasizing redistributive goals of taxation instead of encouraging broadened ownership opportunities, tax reformers have elevated the tax system and government stimulated demand to a position higher than the nation's wealth production system, upon which all tax revenues and everyone's ultimate standard of living depends.

SOUND TAX POLICY FOLLOWS SOUND NATIONAL ECONOMIC POLICY

A sound tax policy cannot be constructed upon confused or unsound political or economic principles. The Kelso-Adler concept of economic justice offers a solid foundation upon which business, labor, and government can forge a new consensus and new common strategy to enable our Nation to cope more realistically with today's industrial world, with our capital and other shortages, and with the challenges we can expect from accelerating technological change.

Sound tax policy is based upon a reassertion that once made America the last best hope of mankind. It would recognize that government does not produce wealth and that every subsidy must originate with those individuals whose productive toil and productive capital actually produce society's marketable goods and services, including those diverted through taxation. It would also recognize that wealth is produced most efficiently within competing privately owned enter-

prises vying to satisfy private consumer demand, with every buyer voting with his own dollars to reflect his choices among available goods and services.

Government, through its taxing and spending powers, has the power to redistribute wealth, in addition to carrying on its originally conceived and more normal functions of enforcing contracts, protecting property, suppressing violence and otherwise maintaining a just and peaceful society. And to the extent it can create legal tools like the business corporations to meet the needs of society, it can regulate them. On the other hand, when business corporations, voluntary associations, or any other specialized social inventions become socially dysfunctional and create, rather than solve, problems for society, government is the instrument through which we overcome the problem, directly or through a restructuring of our institutions and laws. It is not in the nature of government to leave social vacuums unfilled.

As a result of defects in our economic institutions, wealth patterns in America have become grossly distorted. The gap between the very rich and the very poor continues to widen. Class divisions between propertied and non-propertied Americans produce a neverending political battle. This is in the 1976 Annual Report of the Joint Economic Committee, which found that the richest 1% of Americans own over 50% of all individually owned corporate equity and receive about 46% of all corporate dividends, and that concentrated ownership patterns will only worsen in the years ahead because of traditional methods used by U.S. corporations for financing their new capital formation.

Today, as a result of the maldistribution of ownership and income, we have reached a point where government itself is suffering from an acute case of functional overload. Public redistribution and efforts to control the economy have placed responsibilities on government that are contrary to its very nature. The mere shifting of centralized governmental activities to state and local levels totally ignores this problem. Reorganization of the federal bureaucracy is similarly futile.

The State--civilization's most important social invention--can no longer effectively carry on the highly specialized and limited functions for which it was originally designed. The State, in the view of many, is mankind's only legitimate monopoly, our social contrivance for monopolizing coercion and violence. As such, however, it is a highly dangerous and unnatural tool when it tries to assume powers best left to private individuals and their associations, especially where mar-

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ket disciplines are present to govern economic decision-making.

Next to the State itself, the modern corporation is our most important social tool. It is an excellent vehicle for absorbing technology, harnessing together talent and capital, and marketing on a global basis. Since industrial capital produces an increasing share of society's wealth, a sound and just governmental policy would remove roadblocks to broader participation in corporate equity ownership all households, so that the need for governmental intervention and income redistribution would gradually and systematically be reduced to tolerable levels. The corporation is, after all, a mere creature of the law and to the extent it does not serve the ends of justice, our system of justice is necessarily deficient.

Encouraging growth of the corporation while broadening the base of its future stockholder constituency means that the necessary costs of government can then be shared by a constantly growing base of citizens with private incomes distributed directly in the form of paychecks and dividend checks from our corporate sector as a whole.

From a political standpoint, a corporate stockholder constituency consisting of a more representative base of American households would also automatically make management of our largest and most powerful corporations less vulnerable to self proclaimed consumer advocates. As it becomes more directly people connected, the corporation will become more popular as an instrument of society. Corporate profit would soon lose its social and political attackers as companies provided second incomes to the broadest possible consumer base. Making its future growth opportunities accessible to every citizen would enable the corporation, in my opinion, to make a quantum advance in its own evolutionary development as a major component of a domestic society. (In terms of its presently narrow constituency base and its efficiency as a direct distributor of mass buying power, the mass production corporation is still remarkably primitive, about comparable in historical terms to the democratic form of government over a thousand years ago.)

WHAT IS AN ESOP AND HOW DOES IT HELP ADVANCE THE KELSO-ADLER PRINCIPLES OF ECONOMIC JUSTICE?

Congress has acted five times since late December 1973 to promote the ESOP. What has surfaced thus far is only the tip of the proverbial iceberg. Below that surface lies the revolu-

tionary private property philosophy and comprehensive ownership strategy first articulated by Kelso and Adler. Too scholarly in its tone to inspire a new political movement and too revolutionary in its ideas to gain the support of economists and academics wedded to orthodox ideologies and the economic status quo, this bible of an advanced socio-economic order seldom is associated with the history of ESOP, although both were inspired by the same person, San Francisco lawyer and investment banker Louis O. Kelso.

When this writer first became associated with Kelso in 1965, to most politicians, businessmen, and labor leaders, ESOP sounded like the author of ancient parables and Kelso was a famous winning race horse. By 1972 several dozen ESOPs were established. Since Congress legitimated the ESOP an estimated 200 or more classical ESOPs and perhaps 1,000 or more plans that masquerade as ESOPs have been launched. The mass media and professional journals have begun to take serious notice of the ESOP and since 1974 articles on the ESOP have appeared in Time, Newsweek, Fortune, Business Week, The Wall Street Journal, The American Bar Association Journal, Harvard Business Review, The Tax Executive, Barron's, and even The Village Voice. Many criticisms have surfaced regarding the ESOP, some valid and constructive, some simply nitpicking and totally negative, some based upon fear and ignorance. Few recognized that the ESOP, even in its primitive form, is only a small part, a single instrumentality, of a much bigger picture. The most comprehensive compilation of the pros and cons of ESOP were covered in two days of congressional hearings in late December 1975 before the Joint Economic Committee. Without attempting to address these problems here, let us examine the nature and purpose of this controversial tool.

Here is how the Senate Finance Committee, chaired by the ESOP's most ardent champion on Capitol hill, Senator Russell B. Long, describes the ESOP:

> Employee stock ownership plans make it possible for workers in the private sector of our economy to share in the ownership of corporate capital without redistributing the property or profits from existing assets belonging to existing owners. Since its first application as a financing tool in 1957, [ESOPs] have been implemented by a growing number of successful U.S. corporations. Through the vehicle of a specially designed tax-exempt trust, this method of finance offers corporations certain tax incentives and cost-reductions not available under conventional methods of finance. The [ESOP] also allows workers to accumulate significant holdings of capital in a tax-free manner during their working careers,

> **while being taxed only on second incomes received in the form of dividend checks or on their assets when removed from their trust accounts. (Sen. Report 93-1298, Trade Reform Act of 1974, Nov. 26, 1974, pp. 158-9.)**

From this description it seems clear that the classical ESOP is not a mere stock bonus plan, although its legal basis can be traced to the same provisions of the tax laws which deal with stock bonus plans, profit sharing plans, pension plans, thrift plans and other IRS-qualified employee benefit plans. Like the stock bonus plans and the relatively few profit sharing plans that invest heavily in company stock, it is not basically a retirement vehicle, but is designed to link all employees of a company to the full status of stockholders, up to 100% of the company's equity ownership.

The ESOP is an ownership creating tool, **plus**. Unlike profit-sharing and conventional stock bonus plans, the ESOP, if properly designed, adheres rigidly to protecting the private property rights of other shareholders, as mandated by Kelso-Adler principles of economic justice. It does not share **their** profits with non-owners. It does not dilute **their** ownership rights by simply issuing new stock without a corresponding increase in productive capacity or in disposable cash available to the corporation for corporate investment purposes. It merely makes capital growth and growth profits accessible to new owners. Unlike thrift plans, stock purchase plans and stock option plans, the ESOP is a credit device and requires no cash outlay whatsoever from those to whom new equity opportunities are to be extended. It instead makes the magic of non-recourse corporate financing work for new owners, based on credit designed to be amortized with *expanded* future corporate profits. It should not be adopted by a management unwilling to be accountable to its employees in their newly acquired status as stockholders. And the ESOP should not be adopted for financing growth, unless the expansion capital will pay for itself. Then, as long as a baseline after tax cash flow per share held by present shareholders is maintained in the future, all projected increases in after tax cash flow can legitimately be applied for building ownership of newly issued equity into employees, without violating the property rights of existing shareholders.

Here's how the classical ESOP works for financing corporate growth: Suppose a $1 million company with 10 owners and 100 workers needs to double its plant capacity and, having paid out dividends in the past, finds itself with little or no retained earnings. With solid contracts on hand to justify the expansion program, the company turns to a syndicate of

lenders who are willing to lend the necessary million dollars for the second plant, repayable with future after tax dollars. Management hears about the ESOP and sets one up to cover all 200 employees (including the new 100 employees to be hired when the second plant becomes operational). The ESOP borrows the $1 million, the company gets its cash by selling $1 million in new shares to the ESOP at the current market value, the company guarantees the ESOP's credit by agreeing to pay out of projected future profits enough cash to the ESOP to service the ESOP's debt. If the stock is not pledged as collateral, it is held in an unallocated account. As installments of the ESOP's debt are paid, blocks of stock, once paid for, are divided up according to payroll and placed in each of 200 individual trust accounts. At the end of the financing period on this single transaction, therefore, the average employee will have gained $5,000 in new equity and the right to future dividend checks to supplement his payroll and retirement checks. The original 10 owners will not have lost any of their original equity or dividend rights from their $1 million investment. Even better, the company, through the unique privileges Congress has extended to ESOP financing, is permitted to service the debt for its expansion capital with pre-tax, rather than post-tax corporate dollars, a tax advantage that increases the company's cash flow by roughly 50¢ on every dollar borrowed by the ESOP. This is so because Congress has specially recognized the ESOP, both as a socially improved technique of corporate finance and as a new form of employee benefit. Up to 15% of covered payroll, the cash for servicing the ESOP's stock acquisition debt is treated as a tax-deductible contribution. Although dividends may currently be used to accelerate repayment of the ESOP's debt, under present tax laws stock dividends are discouraged. In the future, Congress may allow corporations to take tax deductions for dividends paid out, perhaps initially only for ESOP acquired stock. (See proposals below.) Then ESOP financing would be designed to be repayable primarily with projected pretax dividend payouts rather than employee benefit dollars, which under today's accounting procedures create an illusion of reducing corporate net earnings.

The Investment Tax Credit ESOP

In contrast to the classical ESOP, the investment tax ESOP can be justifiably labeled as a giveaway, not from present shareholders but from the federal treasury. Nevertheless, unlike other tax subisdies, this bonus to companies adopting an ESOP contain the seeds of the quiet and creative revolution

launched by Kelso and Adler. It points to a new direction for business, labor and government and to a gradual overhaul of the tax system itself, along lines suggested in this paper.

Admittedly, qualification for the 1% ESOP tax credit bonus does not *necessarily* affect the manner in which a company finances its new equipment and other capital needs. Legally, the company, as have most of the major corporations that have adopted investment tax credit ESOPs, may simply adopt a traditional stock bonus plan and channel no more stock than that paid for by the government with the extra tax credit dollars. However, more farsighted management will establish a classical ESOP to receive and distribute tax-credit stock to their employees. By combining the full 11% investment credit with ESOP financing of its new machinery, the company combines the tax and other advantages of both types of ESOP. It gains a whole new form of employee benefit as a bargaining chip when employees seek inflationary increases in wages and fringe benefits.

Tax Philosophy Behind the Classical ESOP

As noted earlier, the classical ESOP involves no give-away from present owners. And, unlike the normal 10% investment tax credit, tax deductible payments to a classical ESOP are wholly distinguishable from tax subsidies and should no more be considered a taxpayer gift than that which permits corporations to deduct wages and salaries from gross earnings. While many tax deductions are hardly distinct from direct government expenditures, and thus can be labeled subsidies, this is not the case for deduction of debt service contributions to an ESOP. Rather, from a standpoint of the philosophy of economic justice upon which the ESOP is based, the double tax penalty on corporate profits is a direct violation of the private property rights of a corporate equity owner. The corporation income tax is therefore inherently an unjust tax under any social system which is based upon the institution of private property. If all corporate net earnings were deductible to the corporation to the extent they were paid out directly to the equity owners as dividends and taxable as personal incomes, the double tax problem would vanish. (See proposal below.) It is in this light that the nature of the ESOP can be properly understood.

Behind the ESOP is a philosophy of taxation and a carefully conceived strategy to remove gradually the tax system's present bias against property and property accumulations, on the one hand, and, at some point, to reduce the government's use

of the tax system as an income redistribution mechanism, on the other. The 48% corporate income tax involves pure redistribution. Instead of treating all incomes the same, whether they are derived from capital or labor, the tax on corporate profits dilutes by half the property incomes (and thus the property rights) of present shareholders. Then when that income becomes available to owners in the form of dividends or capital gains, the government takes a second bite out of the remainder. Where the corporation tax is a direct frontal attack on the institution of private property, the ESOP offers a powerful means for counterattacking in a manner that will simultaneously serve other desirable social goals: it can help overcome shortages in private sector capital formation; it fosters more equity financing; it can help foster more private sector jobs in the fabricating and operations of newly added plant and equipment; it can help expand the federal revenue base from expanded private payrolls and dividend rolls; and it can help create a broader base of stockholder constituents to help corporations surmount unreasonable and unwarranted political attacks. In contrast to true tax subsidies, the ESOP is a solution, not an excuse for perpetuating or ignoring structural flaws in our major economic institutions. OOO

Part 2 of Beyond ESOP: Steps Toward Tax Justice is scheduled to appear in the July 1977 issue of The TAX EXECUTIVE.

Beyond ESOP: Steps Toward Tax Justice--Part 2†

By NORMAN G. KURLAND*

Beyond ESOP, a strategy for capital formation and broadened citizenship participation in capital seems to be an idea whose time has come.

Under a comprehensive national plan for stimulating and redistributing future growth opportunities directly among Americans who have no capital, three basic ownership diffusing mechanisms would be employed to link capital to individuals: employee stock ownership plans (ESOP), to cover employees of viable enterprises; consumer stock ownership plans (CSOP), to cover all regular customers of regulated public utilities and mass transit systems; and individual stock ownership plans (ISOP), to provide people who do not work for viable corporations in the competitive sector of the economy with the means to gain a diversified holding of newly issued stock reflecting growth of the competitive corporate

† This is the concluding part of this article. Part 1 appeared in the April 1977 issue of The TAX EXECUTIVE.

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REEXAMINATION AB INITIO

The monumental task of reforming the U.S. tax system requires willingness to go back to the beginning, to reexamine fundamental principles and ideals from which this unique nation was born, and to question any assumptions in current economic and tax philosophy that may be inconsistent with those fundamentals. The forthcoming debate will certainly center around issues of *justice*, *equality* and *loopholes*, terms bound to produce confusion and divisions among Americans if their thinking remains shackled along present ideological lines. This two part article suggests a philosophical framework that offers new definitions for these vague expressions and an alternate perspective for understanding basic issues of tax reform. It attempts to shed more light on the philosophy behind the creeping movement on Capitol hill to foster a new national goal of broadened capital ownership. And it attempts to explain the broader context surrounding employee stock ownership plans (ESOPs) and how it fits into a more comprehensive national ownership strategy, within which a totally new approach to taxation is a prerequisite. Finally, this article offers new guideline suggestions to unite opposing forces on some of the most controversial issues facing tax reformers. At the very least, the writer hopes to provoke thinking people, persons who recognize their responsibility for making today the decisions that will determine the way of life twenty or thirty years from now, to think again. - - N.G.K.

sector. Each of these tools is structured to reduce drastically the cost of new capital formation and to overcome present tax and credit barriers to a more equitable sharing of future ownership opportunities.

Employe Stock Ownership Plans (ESOP)

As noted previously, present laws already provide for the establishment of ESOPs, although even existing ESOP law could be improved considerably to make the ESOP more attractive to corporate management, labor unions, existing stockholders, and to the employes themselves. Acceleration of private sector investment rates, virtually everyone would agree, is the best means for overcoming economic scarcity and for absorbing into productive jobs close to ten million

people whose talents are now being wasted in unemployment lines and in non-productive and wasteful jobs on public and private payrolls. Hence, the highest priority in channeling new capital financing in both the competitive and non-competitive public utility sectors of the private economy should be placed on the use of ESOPs. It offers new efficiencies and cost savings for capital creation and it offers a meaningful tradeoff for inflationary increases in wage and fringe benefit levels. A share in the capital growth pie and in corporate profits offers a far more significant economic benefit than has ever been demanded through collective bargaining for working Americans. Slicing up among workers the $3 to $5 trillion capital pie that the economy expects to be adding in the decade ahead could average as much as $50,000 each for 100 million workers, assuming (without expecting) that all new capital will be financed through ownership diffusing mechanisms.

In the competitive sector, at least one third to one half of a company's annual capital expansion budget should be reserved for financing through an ESOP covering all its employes. Another portion might be reserved for the ESOPs covering employes of outside suppliers and construction firms that help fabricate that company's new plant and equipment. And the remaining portion of its expansion capital should be financed through the sale of new equity to ISOPs.

Individual Stock Ownership Plans (ISOP)

Within the non-regulated, competitive sector of the economy, all future growth (not replacement capital) of SEC-qualified firms, which is not financed through ESOPs, should be financed through ISOPs, established for individuals at their local banks as a supplement to each American's participation in the Social Security system. For example, a company like IBM would sell new equity shares for one-half of this year's IBM expansion needs. Based upon their present overall wealth accumulations and projected new ownership opportunities each year from all sources, plus some other relevant factors, each adult American would be allocated a quota of credit to buy a diversified block of the IBM and other newly issued qualified equity shares. The ISOP would be IRS-qualified and would permit tax-free accumulations. Low interest bank loans to the ISOP would provide the funds to buy newly issued equity directly from the SEC-qualified corporations. The loans would be non-recourse to the ISOP participant and would be structured to be repaid wholly with projected tax-deductible dividends paid out by each of the corporations selling their

new equity on the new ISOP market. Stockmarket speculators and other secondary market sources would not be allowed to sell to ISOPs. Once shares of stock are paid for, the owners would receive the dividends as second incomes.

Consumer Stock Ownership Plans (CSOP)

Corporations in the non-competitive, regulated segment of the U.S. economy (e.g., telephone companies, electric and gas production and distribution utilities, mass transit, cablevision systems) would gain opportunities to fund their expansion through new equity issuances sold to CSOPs and ESOPs, with low-interest credit provided from commercial lenders and repayable with future pre-tax profits. A new mass transit system, for example, might have 25% of its total construction costs funded by an issuance of equity shares through an ESOP covering all those involved in constructing the system, another 25% through an ESOP covering its operating and maintenance employees, and the remaining 50% financed through a CSOP designed to build equity shares into each of its future regular customers. Like the ESOP and ISOP, the CSOP would be a tax-free equity accumulator and an account would be set up for each regular transit rider, tied into his monthly billing account. Rates would be set so that, after taking into account any real estate profits earned by the mass transit system, mass transit riders would cover the full capital costs and operational costs of the system, without government subsidies. But for his patronage, the regular rider would get back a piece of the action, represented by shares released to his CSOP account as the CSOP's debt is repaid with pre-tax dollars paid in the form of tax-deductible dividends on CSOP-held shares. Released shares would be allocated among users according to their relative patronage of the system. Future dividends on CSOP stock would be used to offset each user's monthly bill.

Low-Interest Expanded Bank Credit for Expanding Ownership

Under a national planned ownership strategy, the Federal Reserve system, using its present powers to expand bank credit through the discounting of eligible paper, would reduce bank interest rates to 2% to 3% for banks making loans to IRS-qualified ESOPs, ISOPs, and CSOPs to enable mature, well-managed corporations to sell newly issued equity to their workers and other Americans. All loans would be non-recourse to the individual and would be repayable with projected pre-tax profits. The low-interest rates and the use of pre-tax dollars for servicing capital formation debt would, of course,

lower the cost of capital expansion within the private sector, at least when compared to the use of after-tax dollars and today's high interest rates. Only when all wasted and non-productive human talent gained work opportunities in the growing private sector and all other resources became fully employed, would the Federal Reserve clamp down on the supply of low interest credit. Any further expansion would not increase production and would therefore be inflationary. A sound national ownership program would aim at a target of zero rate of inflation and a maximum rate of production.

The Capital Diffusion Insurance Corporation (CDIC)

A Capital Diffusion Insurance Corporation would be established to operate with functions similar to those of the FHA home mortgage insurance agency and the Pension Guarantee Insurance Corporation. Part of the interest payment on loans to ESOPs, CSOPs, and ISOPs, perhaps 0.5% or so, would be used to pay an annual premium to protect the lending institutions against the full losses in the event of loan default, to cover the eventuality that the companies issuing the stock against which the loans were made, would no longer be capable of generating profits. Naturally, the safer the companies whose debt-repayment ability is insured by the CDIC, the lower the premium charges necessary to spread the risk of loan default over the overall economy. Differential risk categories, with adjustable premium rates, could be set up for grouping participating corporations, based upon their maturity, earnings history, the quality of their management, the nature and special risks of their industry, somewhat along the lines of Moody's and Standard & Poor bond ratings.

Similar to the pension insurance now being offered by the PGIC, the CDIC could also offer portfolio insurance for an additional premium for employee accounts within ESOPs, which normally lack the kind of diversification that would be found in ISOPs. It would insure workers against the downside risk, so that, upon retirement, a worker would be guaranteed a high percentage of the initial values for all company stock purchased in his behalf through his ESOP account. Then, even if the company failed, he would not lose all his retirement assets before he had a chance to diversify. Premiums could be kept relatively low if CDIC portfolio insurance for ESOPs was limited to companies that had been in operation on a profitable basis for at least three years. The premium costs to cover the high risk, start up companies would be astronomical, compared to those for mature companies with a solid track record of earnings.

WHERE DO WE GO FOR TAX JUSTICE?

On the Purpose of Taxation. If tax reformers become persuaded that redistributive taxation is morally wrong and contrary to the basic values and objectives of a free and democratic society, that redistribution keeps the rich rich and the average taxpayer a job serf, that redistribution leads to unnecessary shortages and bureaucratic wastes, that it perpetuates mass propertylessness, then it may be possible to make a new beginning in rebuilding today's overly complex, inherently unjust tax system. Until someone offers a more definitive overview of what constitutes tax justice, let us take advantage of the guiding principles and general strategy conceived by Kelso and Adler, at least to analyze some of the central issues all tax reformers must face. Any new beginning must start with the simple question, "Why do we have a tax system?" If we reject Marx and accept Kelso, the answer is also simple: to yield the revenue to pay the costs of a limited government, without damaging the incentives to the maximum production of wealth and the broadest distribution of capital ownership. From this point, a whole new set of conclusions follow:

The bias in the present tax laws against property accumulations and property incomes should be removed. The bias in favor of redistribution, as a practical matter, must be more gradually phased out, as redistribution of income is supplanted with an effective program of redistributing future ownership opportunities. The tax system and federal laws generally should be re-structured to encourage the creation, accumulation and the maintenance of property, its widespread distribution among all households, and the maximum generation of new wealth and improved technology within the free enterprise system. Government should announce a target goal for the economy of a minimum floor of capital self-sufficiency for every household to achieve within the next thirty years. A national ownership plan, including new tax laws, would be launched to reach that goal, similar to the manner in which government assisted Americans in the building of our agricultural base through the Homestead act of 1862. Although the 160 acre ceiling made sense in distributing shares of our necessarily finite land frontier, the amounts that could be accumulated under this industrial homestead program is limited only by our talent, our know-how, our technological potential, and our ability to mobilize all our resources in building a new and more productive industrial frontier during the next several decades. Hence, in today's world, a target floor is more appropriate than a ceiling as the focus of government

initiatives under a national ownership program. Where most government initiatives in the last century have tended to centralize economic power, these initiatives would aim at widely diffusing economic power, while keeping it in the hands of individual citizens.

An effective tax system would offer incentives for the enterprise system itself, as the principal source of wealth production, to become a more direct and efficient distributor of mass purchasing power for all consumers in the economy.

As the need for income redistribution and governmental intervention within the private sector lessens to an irreducible minimum, the functions and costs of government should drop progressively, eventually to the tolerable levels projected by the founding fathers. Instead of constricting private initiatives and production, as under today's tax laws, government, under a soundly conceived national ownership strategy, would become a major stimulant to production.

Since government, by its nature and highly specialized social functions, is a monopoly, it is not inherently an efficient producer of wealth, as the followers of Marx are beginning to discover. And, with a few rather unfortunate exceptions government in the United States does not engage directly in the production of real wealth. Although some redistribution advocates seem to assume that all wealth is produced by government, taxpayers know otherwise. Since the wealth necessary to cover the costs of government are products of private labor and private capital, taxes should be viewed as charges to consumers for essential services not available through the private sector. Unlike other services, however, the buyer is compelled to buy and the government will remain the sole seller, at least until these same services can be satisfactorily provided through the competitive enterprise system. This seemingly minor change in emphasis could open up some new ideas and new opportunities for creative businessmen.

Direct or Indirect Taxation. Any tax blunts incentives, but a direct income tax on individuals is the least damaging and, at the same time, places before the electorate the cost of government. Sales taxes, consumption taxes, value added taxes, most excise taxes, and other indirect taxes, not only mask the spending patterns of public servants and elected officials from close taxpayer scrutiny and direct accountability. Indirect taxes also add to the costs of goods, thus shifting taxes to the consumer, reducing the competitiveness of U.S. enterprises and also our growth. Taxes on property discourage new construction, improvements, and maintenance. But taxes on corporations are the most counterproductive of all forms of

indirect taxes. The corporation income tax damages the corporation, an invention of man that is indispensable to the maximum production of wealth. To the extent return on investment is reduced, growth is stifled and the investment will go elsewhere. But a more serious practical effect of present corporation income tax laws is the incentive they now offer to the financing of industrial growth without the issuance of new equity instruments. The non-deductibility of dividends encourage the use of retained earnings or conventional borrowings for financial growth. Thus, the corporation tax minimizes opportunities for all households to share in the growth opportunities of the economy.

Rates of Taxation. A growing number of tax scholars have argued that the case for progressive or graduated rates of taxation is uneasy at best. If redistribution of income (in contrast to a redistribution of future ownership opportunities) is a form of direct discrimination against property, a progressive income tax is inherently an unjust tax, assuming one accepts the Kelso-Adler, rather than the Marx-Engels, version of economic justice.

But what about the poor? No more effective aid can be provided the poor than allowing them to share in the new job and ownership opportunities within a healthy and growing private economy. The problem of those still too poor to share in the cost of government can be handled through tax exemptions or tax credits, and perhaps even the kind of negative income tax advocated by Nobel prize winner Milton Friedman.

Yet responsible citizenship is best served when everyone pays some direct tax. In an economy productive enough to provide a high standard of living for all households, which should be the long-range goal of economic decision makers, the cost of government would be minimal. Since government benefits should be equally accessible to each member of society, absolute justice would demand an equal per capita charge on all individuals, without regard to their income levels. But this, of course, is impractical at this stage of our economic history.

A more realistic and just tax today would be a flat or proportionate rate imposed on all direct earned and unearned incomes of all taxpayers. It would be administratively more efficient than a progressive or graduated tax. And it would help make government vastly more accountable to the electorate. If tied into a vigorous national growth and expanded ownership strategy, one could easily imagine future candidates for public office actually competing for votes on the

basis of who could offer the best government services at the lowest flat rate. Each year's single direct tax rate could be adjusted up or down to provide sufficient revenues to avoid budget deficits.

Under a progressive or graduated tax, on the other hand, political irresponsibility and waste is more easily tolerated. Many voters believe that the heaviest costs are borne by a tiny fraction of high-income individuals or by fat cat corporations, or they fail to appreciate the dangers of printing press money where there are sizeable budget deficits. A flat tax would help raise the levels of economic sophistication of the taxpayers. Another shortcoming of a progressive or graduated tax is that tax evasion and the search for tax loopholes increase as tax rates increase. And when inflation forces workers into higher tax brackets, pressures for additional pay increases add more fuel to the inflationary fires.

Resources tend to be misallocated under a progressive or graduated tax. Economic decisions become increasingly made, not on their economic merit, but on tax considerations. Thus, high tax brackets stifle growth and incentives to innovate and increase production, making all of society the poorer and less competitive.

Earned or Unearned Income. Under the Kelso-Adler theory of economic justice, the earnings from one's property in the means of production are morally indistinguishable from the earnings produced by one's skill or brainpower. Since they are both rewards directly related to production, they should be taxed alike. And discrimination against property discourages investment and reduces society's overall productive capacity.

Karl Marx considered profits as income stolen from labor. Our tax laws that discriminate against property incomes reflect the same bias. But if capital is recognized as a producer of wealth, then capital incomes are legitimately earned by those who share property rights in that capital, the same as those paid for their skills and ingenuity. The most serious problem with laws that discriminate against property incomes is that they hurt the poor more than they do the rich. Access to the full, undiluted stream of earnings from capital is a prerequisite for the financing on credit of broadened ownership opportunities and for more widespread distribution of second incomes among today's non-owning citizens, including civil servants, many professionals, teachers, the military and the unemployable.

The only form of income that can properly be classified as

unearned is that which is truly gratuitous and wholly unrelated to the production of marketable goods and services. Such unearned income, which should be directly taxed at the same rate as earned incomes, would include: welfare checks, unemployment checks, social security checks, gifts and bequests, unclaimed valuable findings, gambling gains, .and other gains not immediately converted into tax-free individual capital accumulations, as described below.

Individual Capital Accumulations. As discussed previously, building capital self-sufficiency into every American household cannot take place overnight. But once we establish a specific minimal level or floor as a ten or twenty year goal to strive toward, it allows everyone to focus on the importance of property and the need to remove all institutional barriers to the broader distribution of ownership opportunities as expeditiously as possible. The floor of capital accumulations per household should represent the industrial equivalent of the 160 acres of frontier land that the federal government made available to its propertyless citizens under the Homestead act of 1862. Thus, the tax laws should be reconstructed to encourage the tax-free accumulation of an industrial homestead for all Americans over their working careers, consisting of a growing number of equity shares in the economy's expanding industrial frontier. Each individual would set up a tax-qualified ISOP at his local bank to serve as his tax-free accumulator of capital. Shares acquired through ESOPs and CSOPs could be rolled over into one's ISOP account tax-free, as well as income-producing property acquired through tax-free gifts and bequests. Each individual's total acquisitions would continue to accumulate in a tax-free manner until the federally established capital sufficiency floor was reached. Thereafter, future accumulations would be subject to a reasonable wealth tax, designed to discourage grossly excessive, monopolistic accumulations of capital in the future. Fairness in the distribution of future ownership opportunities would mainly be controlled through the traditional IRS tax-qualification controls over discriminatory allocations and through the Federal Reserve Board's control over bank credit allocated to foster growth of the economy through ESOPs, CSOPs and ISOPs.

Under H.R. 462, the proposed Accelerated Capital Formation Act introduced by Ways and Means Committee member Bill Frenzel, this tax-free floor was set at $500,000. Whatever the target amount, it should be set at a level that both fosters initiative and a desire for income independence for its owner, and it could be adjusted to rise with a person's age and capacity to work. To encourage the continued accumulation and

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retention of income-producing investments, and to discourage squandering, all tax-qualified accumulation trusts would be required to pay out all property incomes on a regular basis as second incomes to the owners, subject to direct personal income taxes.

The rationale behind permitting tax-free accumulations below excessively large wealth concentrations follows the principle that new capital formation and widespread capital accumulations should be encouraged, both for promoting economic democracy and for raising the standard of living for all citizens. Taxes on property slows down the capital creation and accumulation process. On the other hand, a direct tax on the incomes from already accumulated capital assets is simpler to understand, less harmful to investment and the care of property, and easier for tax authorities to administer.

Offsetting Revenue Losses from Reduced Corporate Tax Revenues and Reduced Personal Income Taxes Channeled Into Homestead Accumulations. Presently the federal corporate income tax accounts only for roughly 14% of total federal revenues. It would shrink in relative size only gradually under even the most optimistic rate of implementing a national ownership strategy . The question is whether the benefits to be derived, from the standpoint of American business, labor, the voting public, and even the Treasury itself, is a worthy trade off for this shrinkage of corporate tax revenues. To weigh the trade off, one must focus on the big picture. The overall dynamics that should be expected in the proposed comprehensive national ownership strategy are two-fold: (1) to increase private production, private taxable job incomes, and private taxable property incomes; and (2) to reduce federal budgets for unemployment, welfare. Hence, the overall tax burden, as now wasted manpower and other resources are absorbed within a faster growing private sector, should gradually be reduced. To argue that the trade off is not worth it, considering today's high unemployment rates and continuing high rates of inflation, would seem preposterous.

Government Debt and Government Deficits. Since tax policy affects the size of the government's debt and government deficits in general, a few comments on the wisdom of debt and deficit spending policies are in order.

Under the influence of Keynesian economic concepts, the objective of many tax decisions in the past forty years is to cure inflation and unemployment. Keynes assumed the continuance of historic patterns of extreme maldistribution of capital ownership, and sought merely to fine tune that mal-

structured economy through the bureaucratic manipulation of government tax, spending, interest, and money-creation machinery. Structural reforms to our corporate ownership patterns were not part of Keynes' approach to the problems of unemployment and inflation.

In the Kelso-Adler strategy, however, the structural void left by Keynes is met head-on. Kelso and Adler would attack inflation and unemployment at the roots. The main thrust of their approach is to super stimulate expanded rates of private sector capital investment, financed so as to broaden the base of equity owners in society.

The credit financing of corporate expansion must meet rigid standards of feasibility and must be repaid as a self-liquidating investment. New dollars flow directly into new productive capacity. In sharp contrast, government debt seldom, if ever, finances any production increases. Rather, it goes into non-productive spending, war, and even into wastes of human talent and natural resources. Government debt is therefore inherently inflationary. Even worse, when government spending is not matched with current tax revenues, the inflationary impact worsens. Funds must either be borrowed (thus diverting those same funds from productive investment in the private sector) or simply issued as printing press money.

From a standpoint of economic justice, government deficits make no sense at all. They cause inflation and are therefore a pernicious form of hidden tax on the public, most painful to the poorest members of society. A just tax system would work toward the elimination of future inflationary budget deficits and to curb further increases in the already bloated government debt. Better yet, a concerted effort should be made to begin to repay this debt.

Today the Federal debt already exceeds one half trillion dollars or 35.5% of the GNP. Annual interest charges on this debt -- one of the highest expenses in the entire budget -- amounted to $34.6 billion in 1976 and are rising. President Carter envisions a $68 billion deficit for the current fiscal year (widened from President Ford's $57.2 billion) and projects at least a $57.7 billion budget deficit for fiscal 1978.

Inheritance Policy. Under a national ownership strategy, inheritance policy should be restructured to discourage excessive concentrations of wealth and, in order to promote individual initiative and capital self-sufficiency, to encourage the broadest possible distribution of income-producing assets. Gift and estate taxes therefore should not be imposed on the donor

or his estate, but rather on the size of the recipient's total accumulations after receiving the gift or bequest. If the value of the recipient's homestead accumulations remain below the floor mentioned above, no tax would be imposed on the newly acquired assets. Above that floor, a reasonable wealth tax would be paid.

Wealth Tax. Above the targeted homestead accumulation floor, a wealth tax would be imposed on each new owner to discourage future excess concentrations of wealth and economic power. It would replace the existing estate and gift tax systems. The wealth tax could be avoided by distributing excess accumulations to others, including family members, friends, and employees, as long as their accumulations remain below the floor.

Integration of Personal and Corporate Income Taxes. The double tax penalty now imposed on corporate profits is becoming widely accepted as an unjust form of tax discrimination that should be eliminated. Some reformers are proposing to mitigate this problem through a highly complicated and arbitrary compromise that not only avoids the problem but worsens it. Instead of eliminating the double tax directly at the corporate level, they would permit a partial deduction for dividend payouts to the corporation and a redistribution oriented partial tax credit for shareholders. Hence, it neither restores private property in corporate equity nor does it promote expanded distribution of equity issuances. It merely makes the top 1% who own the majority of directly-owned outstanding corporate shares even richer.

The Kelso-Adler theory of tax justice would attack this problem directly with elegant simplicity. It would recognize that property and profits are inseparable and therefore all corporate net earnings, whether distributed or retained by the corporation, are earned by its owners and therefore should be taxable at the personal level, on the same basis as any other direct income. Under this alternative, the corporation would be treated for tax purposes like a partnership, with its business expenses attributed at the enterprise level and all capital incomes attributed individually according to each owner's proprietary stake in the business. To encourage more equity financing of corporate growth, higher dividend payouts must be encouraged and alternative low-cost sources for financing must be made available to expanding and viable new enterprises.

Dividend Deductions at the Corporate Level. Corporations should be allowed a dollar-for-dollar tax deduction for any dividends they distribute either (1) directly to their share-

holders (including beneficial owners, such as employees under tax-qualified ESOPs, profit sharing plans, pension plans, etc.) to the extent such earnings become currently taxable at the individual level or (2) to repay stock acquisition indebtedness on any new equity issuances through tax-qualified financing mechanisms that further the goals of a national planned ownership program.

Capital Gains Taxation. How to tax capital gains is a continuing source of much of the complexity and confusion that now plague our tax laws. How would a property oriented theory of tax justice handle this problem?

First, it would restructure the tax laws to encourage investment and discourage speculation. It would add disincentives to gambling in high-risk securities and the commodities market, at least for non-wealthy individuals. Tax laws would be designed to facilitate the acquisition, accumulation and retention by today's capital-deficient Americans of long term investments, held mainly for their potential of yielding high, steady, and relatively secure second incomes to supplement their paychecks and retirement checks in the future.

To the extent capital gains income results from short term purchases and sales of commodities and securities, as under present law, it should be treated like any other kind of direct personal income.

Capital gains from long term holdings deserve different treatment, however, under a national strategy to broaden the base of capital ownership. As recommended above, to the extent that investments are accumulated within a tax-qualified vehicle, the gains should be permitted to increase tax-free, until the individual affected reaches a targeted floor of capital self-sufficiency. Above that level, gains would be subject to a reasonable wealth tax.

If all of the proposals recommended in this article were adopted, the capital gains problem would gradually disappear. Much of the appreciation in the values of corporate common stock can be traced to the retention by management of earnings for meeting their capital requirements. As dividend payouts increase and new sources of equity financing become readily available, the value of individual shares would tend to stabilize over time and be based on current and projected dividend yields per share. Hence, long term capital gains would be less a source of future government revenues.

To some extent, long term capital gains result, not from the increased productive value of the underlying assets, but

from a gradual debasement of the American currency. Only inflation inducing government economic policies can be blamed for these increases in profits and capital values. Hence, except where prices increase from natural shortages. government should assume total responsibility for inflationary increases in the value of investments. Therefore capital gains taxation should always be inflation indexed to see if any gains in value actually exist.

State and Local Tax Systems. Today, a heavy portion of local revenues come from the taxation of property, thus discouraging investment and improvement of industry and residential property in their areas. Sales taxes also increase price levels, encourage tax evasion by local merchants, discourage trade, and generally can cause one area to become less attractive than another. Since high production, high incomes, and a higher quality of life rests on the quality of the structures, industrial equipment and facilities, and technology available to the residents of an area, it should be obvious that taxes on local property are counter productive and should be gradually supplanted with a universal system of state and local taxation based upon the direct incomes of its residents from whatever sources. Thus, federal tax policy should create additional incentives for state and local taxing authorities to gradually shift to direct flat rate income taxes at the individual level, for the same reasons outlined above. To simplify tax collections, the state and local rates could be set at a percentage of the federal tax imposed on residents of the area. Another advantage of this approach is that all areas of the country would become tax-neutral for investment purposes, thus increasing the nation's overall efficiency in the allocation of our manpower and other resources.

Tax Simplification. Although the wealth tax discussed above is new and may be initially resisted by those fearing disclosure of their property holdings (for understandable reasons given the redistributive, anti-property bias of current tax philosophy), a wealth tax would be much simpler to administer than the present estate tax and gift tax, and much less confiscatory. Through assets accumulated within ESOPs, CSOPs and ISOPs. within one generation, the nation would gain a useful profile of total property accumulations and its wealth distribution patterns. It would also be a way of meeting the recommendation of the Joint Economic Committee in its 1976 Annual Report calling for:

> **[A] quadrennial report on the ownership of wealth in this country which would assist in evaluating how successfully the base of wealth was being broadened over time. (p. 100)**

In the final analysis, an annual wealth tax return is no more onerous or an invasion of privacy than an annual income tax return. And since under a national ownership strategy at least 95% of American households would be classified as capital deficient and therefore beneficiaries of a planned ownership program, one could reasonably anticipate little taxpayer resistance to a wealth tax, if it was carefully designed and communicated to the American people. Even the wealthiest families would gain by a reduction of the confiscatory bias of the present tax system and the promotion of private property industrial homesteads based, not on a redistribution of present wealth, but a redistribution of future growth opportunities.

Although corporate income tax returns would still be important for disclosure purposes and for corporations unwilling to pay out their earnings fully to their stockholders, most of the tax revenues would flow from the expanded personal tax base. The personal income tax return and the tax system itself would, as result, be enormously simplified and easier to understand.

A CHALLENGE AND A TOOL

The main purpose of this article is not to offer definitive answers but to suggest some new questions that tax professionals might pose in evaluating tax reform proposals in the future. It is not intended to leave the reader feeling comfortable, because the history of tax reform leaves little room for optimism about the future of the privately owned corporation and the free enterprise system in general. But, it might aid the socially minded business statesman to gain some deeper philosophical insights into the history and trends of tax reform over the last century. Whether Karl Marx' tax strategy will succeed in finally destroying the privately owned corporation and converting it into one owned and controlled by a dictatorship of the proletariat, remains an open question.

Some in the business world seem unconcerned as to who signs their salary check. They seem to have thrown in the towel to Marx. Others seem prepared to take a new stand against further erosion of our private property system. It is the latter to whom this discussion is primarily addressed.

The author rejects the piecemeal and narrowly partisan approach to tax reform. This is a call for a new tax philosophy that will transcend the interests of special power blocs and interest groups. The tax system affects each of us, and will certainly affect the kind of society we will bequeath to future generations of Americans. Armed with a set of principles

that are totally consistent with the revolutionary philosophy that fathered our nation, each of us can better judge tax reform proposals as they are presented to the American people.

When proposals are delivered to Congress, we need to judge whether those proposals will move us toward tax justice or toward further tax injustice, whether they support property or are further despotic inroads on the rights to property, whether Karl Marx has won another victory or whether we have turned in a genuinely new direction.

Senator Russell Long, when he urged his Senate colleagues to consider converting the failing northeast rail system into a 100% employee owned private corporation, said:

> [T]here are but three political-economic roads from which we can choose. . . .
>
> We could take the first course and further exacerbate the already intensely concentrated ownership of productive capital in the American economy.
>
> Or we could join the rest of the world by taking the second path, that of nationalization.
>
> Or we can take the third road, establishing policies to diffuse capital ownership broadly, so that many individuals, particularly productive workers, can participate as owners of industrial capital.
>
> [T]he choice is ours. There is no way to avoid this decision. Non-action is a political decision in favor of continued, and indeed increased, concentrated ownership of productive capital.

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"The Expanded Employee Stock Ownership Act of 1978—A Summary and Analysis"

(By John E. Curtis, Jr., Counsel, Senate Finance Committee and Ronald L. Ludwig, Attorney at Law, San Francisco, and Counsel to Employee Stock Ownership Council of America)

I. TRASOP LEGISLATION

A. Commentary

On June 23, 1978, Senator Russell B. Long, Chairman of the Senate Committee on Finance, introduced the "Expanded Employee Stock Ownership Act of 1978" (S. 3241). This bill marks the latest major congressional effort towards broadening the access of employees to stock and capital ownership in their employers. In the Regional Rail Reorganization Act of 1973,[1] Congress provided that the Consolidated Rail Corporation (CONRAIL) could use an employee stock ownership plan (ESOP) as part of its financing program, thereby enabling CONRAIL employees to share in ownership of the new railroad system. In the Employee Retirement Income Security Act of 1974,[2] Congress for the first time formally recognized ESOP as an employee benefit plan and established criteria for its adoption and operations. In the Trade Act of 1974,[3] as part of the relief package being established for companies which are members of foreign trade impacted industries, Congress provided that some preference would be given for assistance to such companies which use an ESOP in conjunction with federal loan guarantees. In the Tax Reduction Act of 1975,[4] Congress established the "TRASOP," an ESOP funded through an additional investment tax credit allowed for corporate employees. The Tax Reform Act of 1976[5] expanded the provisions for TRASOPs and provided guidance to the federal agencies for developing final ESOP regulations.

The purposes of the Expanded Employee Stock Ownership Act of 1978 are to further the steps already taken by prior ESOP legislation and to make the ESOP a better instrument for providing stock ownership to employees. The bill accomplishes these goals primarily by expanding the use of the TRASOP, the special form of ESOP presently tied to the additional investment tax credit available under the Tax Reduction Act of 1975, as amended by the Tax Reform Act of 1976. For purposes of this article, the term "TRASOP" will be used to refer to a "tax credit ESOP," while the term "ESOP" will apply to any ESOP (including a TRASOP). The purpose of this analysis is to explain each provision contained in the bill and to analyze the background problem or underlying reason for its inclusion.

Changes for TRASOP

The major changes made by S. 3241 are in the TRASOP area. As part of the overall increase in the investment tax credit from 7 percent to 10 percent, the Tax Reduction Act of 1975 provided for an additional 1 percent investment tax credit. This credit could be claimed by an employer that adopted a TRASOP (satisfying the requirements established by that Act) and contributed to the TRASOP an amount of employer stock (or cash to buy stock) equal in value to the amount of the additional tax credit claimed. The Tax Reform Act of 1976 expanded this concept, providing that an employer could claim an additional ½ percent investment tax credit for TRASOP contributions (thereby increasing its total available investment tax credit to 11½ percent provided that participating employees made matching contributions to the TRASOP equal to the additional ½ percent investment tax credit). Such employee contributions were a mandatory prerequisite for the claiming of the additional ½ percent investment tax credit by the employer. It is important to note that the additional investment tax credit for TRASOP contributions would largely be available only to capital-intensive corporations, and would have little applicability to labor-intensive corporations. In addition, the Tax Reform Act of 1976 extended the additional investment tax credit for TRASOP contributions only through 1980. This was because the TRASOP was tied to the investment tax credit increase from 7 percent to 10 percent which is due to expire on December 31, 1980.

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[1] Pub. L. 93-236.
[2] Pub. L. 93-406.
[3] Pub. L. 93-618.
[4] Pub. L. 94-12.
[5] Pub. L. 94-455.

S. 3241 makes significant changes in TRASOPs. In the first place, it increases the investment tax credit which an employer can claim for its TRASOP contribution from one percent to two percent. In addition, it removes the provisions for matching employee contributions to the TRASOP; rather, any employee contributions are to be purely voluntary and subject to a decision by the employer at the time that the TRASOP is adopted or amended. More significantly, the TRASOP provisions are to be permanently incorporated within the Internal Revenue Code in new §§44C and 416. This means that TRASOPs would not expire with the tax cuts under the Tax Reduction Act of 1975. Finally, in an effort to broaden this type of ESOP, the bill provides an alternative tax credit based on payroll for labor-intensive companies which adopt a TRASOP and contribute stock to it. This provides a tax credit equal to 1 percent of the compensation of all participating employees under the TRASOP, provided that the employer contributes to the TRASOP an amount of stock (or cash used to purchase stock) equal in value to the tax credit claimed.

In introducing S. 3241, Senator Long noted that this country faces a serious shortage of capital formation. The Chase Manhattan Bank has predicted that over the next decade our economy will require 1.5 trillion dollars of new capital formation. S. 3241 attempts to partially resolve that capital shortage by requiring that the employers who adopt and fund a TRASOP will be doing so in a manner that will generate additional capital formation. The bill requires that at least one-half of the tax credit claimed for TRASOP contributions (whether based on the additional investment tax credit or the payroll credit) would have to be represented by the transfer of newly-issued securities to the TRASOP.

A major problem which exists in the TRASOP area is the requirement[6] that each employee who participated in the TRASOP at any time during the year must share in the allocation of stock representing the employer's annual TRASOP contribution, even if he was no longer employed at the end of the year. This creates a great recordkeeping problem in that a record had to be maintained as to the location of each terminated participant so that he can receive an allocation (and in most cases a distribution) of stock for the year in which he ceased to be employed by the employer and ceased to be a TRASOP participant. The bill provides that an employer need allocate stock from its current TRASOP contribution only to participants who are employed on the last day of the TRASOP plan year. This is an optional provision and does not preclude an employer, if it so chooses, from making allocations of employer securities to the TRASOP account of a participant who terminated employment during the year.

The Tax Reduction Act of 1975, in establishing the TRASOP, required that each participant must be entitled to direct voting rights on all stock allocated to him under the TRASOP.[7] Generally, TRASOPs have ben established only by large capital-intensive corporations, most of which are publicly-traded. For these companies, the expense and burden of providing participants with the proxy solicitation materials regarding the voting of such shares is relatively minor. However, the requirement for the pass-through of voting rights has acted as a deterrent for closely-held corporations which desired to adopt a TRASOP. With the creation of the labor-intensive tax credit for TRASOP contributions, this problem would be magnified. Many of the companies which would take advantage of these provisions are closely-held and would be deterred from establishing a TRASOP (and thereby broadening its ownership base) because of a requirement that TRASOP stock be voted by participants. Therefore, the bill requires the pass-through of voting rights to participants only when the employer is a publicly-traded company (generally, a company which is reporting to the Securities and Exchange Commission under the Securities Exchange Act of 1934). This approach was first suggested in the staff report of the Joint Economic Committee on ESOPs which was issued in 1976.

In establishing the requirements which a TRASOP must satisfy in order to obtain the additional investment tax credit, the Tax Reduction Act of 1975 provided that a TRASOP, whether or not "qualified" under § 401(a) of the Internal Revenue Code, would have to meet the minimum participation standards for qualified plans under Code § 410.[8] Under § 410(b)(2)(A), employees covered by a collective bargaining agreement could be excluded provided that retirement benefits were the subject of good-faith bargaining between the employer and the

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[6] Section 301(d)(3, Tax Reduction Act of 1975.
[7] Section 301(d)(5).
[8] Section 301(d)(7)(c).

bargaining representatives. Since many TRASOPs were adopted during the term of existing collective bargaining agreements, some employers which adopted TRASOPs elected not to include union members as participants. In order to alleviate this apparent unfairness, the bill provides that all employees who are covered by a collective bargaining agreement will become participants in the TRASOP (subject to minimum age and service requirements) unless their bargaining representatives waive their right to participate in the TRASOP. The Committee Report on the bill is expected to expand upon this and point out that bargaining on the TRASOP issue will in no way reopen an existing collective bargaining agreement for bargaining on other issues.

Cash distribution option

In 1976, the IRS promulgated proposed regulations regarding ESOPs. These regulations contained significant problems which, if allowed to go unchanged, would have seriously curtailed the adoption of ESOPs by employers and the broadening of stock ownership among employees. In the Conference Report on the Tax Reform Act of 1976, Congress specifically instructed the IRS and the Department of Labor regarding the ways in which the proposed regulations were unsatisfactory. The agencies published final ESOP regulations in 1977 which generally alleviated the problems under the proposed regulations. However, in one critical area, the final ESOP regulations did not totally remove obstacles that acted as a deterrent to the adoption of ESOPs. These were the regulations regarding the granting of "put options" to employees who receive a distribution of ESOP stock acquired under ERISA's "ESOP loan exemption." The Department of Labor and the IRS felt, and justifiably so, that any participant who receives a distribution of stock of a closely-held corporation from an ESOP should have a market for the stock. This is an extremely critical point when an employee might well find himself holding employer stock for which there is no market at the time he is subject to income tax liability on his ESOP distribution. The agencies felt that the best solution for such a problem is to require that a closely-held employer grant a "put option" to the participant to resell his stock to the employer. In establishing this right, the final regulations contained very specific requirements regarding the duration of the put option, the terms for resale of the stock by the participant and other related matters. Many employers were concerned that the effect of these onerous put option regulations would be to make the leveraged ESOP unworkable for closely-held corporations. Accordingly, the bill provides that if the terms of the ESOP give each employee the option (prior to the distribution of benefits) of receiving cash in lieu of employer stock as his ESOP benefit, there would be no requirement that an employee who elected to receive stock be granted a put option. In this way, each employee is given the option to receive cash in lieu of stock and, therefore, is not faced with the problem of lack of marketability. This change would allow an ESOP to avoid the requirements for put options under the regulations and would simplify the administration of the ESOP, while at the same time offering employees the ability to "cash out" their ESOP shares. The bill provides such an employee election would not constitute the offering of a security under federal or state securities laws.

Charitable deduction

S. 3241 provides that an individual (or an estate or trust) will be eligible to claim a charitable deduction (for income, estate and gift tax purposes) for any "donation" to an ESOP. This would include an outright "gift" to an ESOP and a "bargain sale" to an ESOP. However, to assure that such deduction will not be providing a tax benefit for a transaction designed to benefit the donor (directly or indirectly), the bill establishes criteria which must be met in order for the deduction to be available. The donation to the ESOP must be allocated among participants in a nondiscriminatory manner, pursuant to Code § 401(a)(4). In addition, no part of the donation may be allocated to the donor or persons related to the donor under Code § 267(b). Finally, no portion of the donation may be allocated to any other persons owning (directly or indirectly) more than 25 percent of any class of employer securities. This provision would create an alternative to traditional contributions to charity (or private foundatoins) for major shareholders and would be an incentive to provide stock ownership for employees.

Dividend deduction

S. 3241 would allow a tax deduction for dividends paid on employer stock held by an ESOP, provided that such dividends were "passed-through" to participants within sixty days after the close of the year in which paid. This provision would be limited to dividends on voting common stock). The purpose of this provision is to encourage ESOPs to provide participants with an immediate tangible benefit of stock ownership. Section 803(h) of the Tax Reform Act of 1976 has made it clear that an ESOP could currently pay out such dividends to participants in cash. This provision of the bill would serve as an incentive to pay out dividends by providing a tax deduction to the employer.

Other tax changes

The bill also contains certain changes which affect employee benefit plans other than ESOPs and TRASOPs. Under the Tax Reform Act of 1976, a lump-sum distribution from a qualified plan is no longer eligible for the estate tax exclusion under Code §2039(c). It is unclear whether the denial of the estate tax exclusion is applicable to any total distribution or whether it applies only to a distribution for which the special ten-year averaging provisions for income tax treatment is elected under §402(e).

In order to clarify this matter, the bill provides that the estate tax exclusion would be denied only when lump-sum distribution income tax treatment is elected under Code § 402(e). In addition, the estate tax exclusion would be extended to a TRASOP not qualified under § 401(a) to the extent applicable to qualified plans.

In order to defer taxation on a lump-sum distribution through a "rollover" to an individual retirement account (IRA), any property (such as employer stock) received in the distribution must be "rolled over" in the same form as it is received.[9] This requirement has created a problem with respect to distributions of employer stock from an ESOP. It is often difficult to find an IRA trustee willing to receive a rollover of employer stock, particularly if the stock is not publicly traded. In addition, an ESOP distributee frequently elects to resell stock received in a lump sum distribution back to the employer (or the ESOP) immediately, often pursuant to the put option granted at the time of distribution. However, under existing law if the participant were to resell his shares of employer stock he is not permitted to roll over the cash proceeds from the sale to an IRA and thereby defer tax on the distribution. Therefore, the bill provides that an employee may resell employer stock to the employer or to the ESOP (or other plan) and still defer taxation on the distribution by rolling over the cash proceeds of the sale to an IRA. In addition, the bill provides that an employee who elects to receive cash in lieu of employer stock from an ESOP will also be able to transfer the cash distribution as a rollover contribution to an IRA.

S. 3241 also provides that participation in a TRASOP (whether or not "qualified") would not preclude deductible IRA contributions by the participant under Code §§ 219 and 220. If the participant did not participate in any other plan qualified under § 401(a), he would still be entitled to contribute to an IRA. This provision would remedy the problem of participation in a TRASOP (possibly representing a small percentage of pay) denying the opportunity for retirement savings by an individual through an IRA.

Under existing Code § 402(e), a participant who receives a distribution from a qualified plan which constitutes a "lump-sum distribution" may elect to take advantage of the ten-year forward averaging provision available for such a distribution. However, if the distribution to the participant includes employer securities which have appreciated in value during the time that they were held by the plan, the participant is taxed only on the plan's cost basis for such securities. The appreciation will be taxed as long-term capital gain upon subsequent disposition. In the event of an immediate resale of the securities, total tax liability will be a combination of ten-year averaging and capital gain treatment. In many cases, this results in greater tax liability than if the entire value of the distribution were subject to ten-year averaging. In order to alleviate this increased tax burden and to provide greater simplicity in calculating the tax liability on a lump sum distribution including employer securities, the bill would allow an election to the recipient to treat the entire distribution (including appreciation in value of employer securities) as ordinary income for purposes of § 402(e) and the ten-year

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[9] Code § 402(a)(5).

averaging provisions. This is similar to the election added in Code § 402(e) (4) (L) in 1976 to allow ten-year averaging with respect to pre-1974 participation.

Under the Tax Reform Act of 1976, an employer which makes a TRASOP contribution and which later recaptures a portion of this investment tax credit, may, if the TRASOP has allocated contributions to separate segregated accounts, recapture a portion of the stock from the TRASOP.[10] It is also worth noting that the employer would have the option of leaving the stock in the TRASOP and simply taking a deduction for that portion of the contribution which is reflected by the recapture. However, assuming that the employer wished to actually recapture any stock from the TRASOP, a problem is presented for participants. This is because the participant must receive his entire distribution within a single year in order to be eligible for the beneficial tax treatment on lump-sum distributions.[11] Any amount held in the segregated account would probably not be distributed to him at that time, resulting in the loss of lump-sum distribution treatment for a significant number of employees. Therefore, the bill provides that if such a situation exists and the TRASOP is holding stock for its participants in segregated accounts subject to recapture, an employee who receives a distribution of the remaining portion of his benefit under the TRASOP will still be eligible to elect lump-sum distribution treatment on that portion. Any amount later distributed to him from a segregated account will simply be treated as ordinary income. However, the beneficial tax treatment which attaches to a lump-sum distribution will be eligible for the initial distribution.

Under present law,[12] any reduction in taxes which occurs as the result of a credit claimed under Code § 38 may result in increased liability for the minimum tax on tax preferences. Since the TRASOP tax credit is claimed as a result of the investment tax credit provided by § 46 of the Code, its actual basis for claim is § 38. Therefore, if an employer received no net benefit from the reduction of taxes by reason of the TRASOP contribution offsetting its tax savings, it might find itself paying an increased minimum tax. For this reason, the bill adds back the credit for a TRASOP contribution (the additional investment tax credit or the tax credit based on payroll) to the regular tax computation for purposes of determining liability for the minimum tax under § 56.

With the exception of the minimum tax relief provided by the bill, all sections of the bill will generally be effective for taxable years beginning after December 31, 1977. Because the problems created by the minimum tax on tax preferences would have dated back to the effective date of the Tax Reduction Act of 1975, the effective date of that section is for all plan years beginning after December 31, 1974.

Increase in ESOP contribution limits

On July 14, 1978, Senator Mike Gravel introduced S. 3291 to propose an additional incentive for ESOPs. Under S. 3291, the deduction limits under Code § 404(a) and the allocation limits under Section 415(c) for ESOP contributions would be increased from 25 percent of covered payroll to 50 percent of covered payroll. These increased limits would be subject to the restrictions on allocations to officers, shareholders and highly-compensated employees included in existing Code § 415(c) (6).

Conclusion

S. 3241 and S. 3291 demonstrate the interest of the Senate Finance Committee in providing increased incentives for the adoption of ESOPs to allow for greater "ownership-sharing" opportunities for employees. On July 19–20th, the Finance Committee held ESOP hearings to consider these bills and other matters relating to ESOPs. It may be expected that action on these bills will occur sometime this year and that ESOPs will continue to be encouraged by Congress.

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[10] Section 301(d) (8) (B) (iii).
[11] Code § 402(e) (4) (A).
[12] Code § 56.

APPENDIX B

Communications Received by the Committee Expressing an Interest in these Hearings

Statement of Senator Mark O. Hatfield

Mr. Chairman, thank you for this opportunity to provide a written statement in support of S. 3241, a bill which would strengthen the incentives for creating Employee Stock Ownership Plans (ESOP's). ESOP's can play an important role in reducing the growing economic and social problems facing the country today and this legislation would certainly further that objective.

Since 1973 I have been supportive of the usage of ESOP's to provide immediate financing for industry, while providing an opportunity for employees to participate directly in the profitability of their employer.

I was the sponsor of an amendment to revitalize ConRail through the usage of ESOP. This was a situation in which increasing federal subsidies were not sufficient to prevent continued deterioration and future labor-management conflicts. The railroad crisis was one more example in which a bankruptcy of leadership and vision led to a vacuum in the corporate sector. This vacuum led to increasing government power and controls and more costly bureaucracies. My amendment signeled an end to this trend and provided an opportunity to revitalize the Northeast Rail Corporation by allowing employees an opportunity for direct participation in the profitability of ConRail.

Since that time, the Senate has taken additional steps to encourage the use of ESOP's. These steps have demonstrated continued Congressional commitment to the concept of expanded employee stock ownership. These bills include the Employee Retirement Income Security Act of 1974, the Trade Act of 1974, the Tax Reduction Act of 1975 and the Tax Reduction Act of 1976.

I have been supportive of the efforts to encourage the utilization of ESOP's and I am in support of this bill before the Committee today. ESOP is not a new concept, but it is possible that certain barriers in the U.S. tax laws have hampered its adoption by business. The bill before the Committee today is one more effort to remove barriers to its usage. However, there comes a point where an idea or concept must sell itself on the marketplace of ideas. That is the fundamental nature of the free enterprise system. I believe Congress has reached a point where additional Congressional action to amend U.S. tax laws could be considered a subsidy to companies who chose to use ESOP as a form of financing. Therefore, future changes in the law must be scrutinized to assure that free market forces can operate fully and freely in determining if ESOP is an idea whose time has come.

The bill before this Committee is indicative of Congressional commitment to ESOP and the growing interest of companies in using this format to expand ownership and acquire financing. By increasing the available tax credit to 2 percent, provided an equivalent ESOP contribution is made, and discontinuing the one-half percent contribution for employers who already have adopted an ESOP, Congress will be encouraging the expansion of stock ownership which will result in a more stable economy.

Even though we express the doctrines of free enterprise with great zeal, capital stock ownership remains as concentrated in the hands of a few as ever before. In many ways this country is very poor. The great majority of citizens in this country have a net worth of less than $10,000, with no hope of being able to participate in and enjoy the presumed benefits of U.S. prosperity. The owning of stock, a traditional means for the citizens of this country to contribute to and receive benefits from the prosperity of the U.S. economic growth, is becoming concentrated in the hands of a few. There has been an 18% decline in ownership of stock by individuals in the past eight years. The role of stock in

financing development has diminished, as its contribution to financing has dwindled to less than one percent.

Another indication of the economic stagnation within the American economy is the control of capital stock and assets. Although the United States has experienced a tripling of its wealth since 1925 and this amount will more than likely double by the end of this century, control of capital stock has not changed significantly in the past fifty years. One-half of all the wealth in this country is still controlled by 5 percent of the population. At the other end of the spectrum, 12% of the population have a net worth of less than $1,000. This pattern will not change unless something can be done to expand stock ownership.

Many persons entering the job market today or exiting it after many years are not receiving any lasting benefits for their efforts. Individuals must work to meet daily living needs with little hope of accumulating wealth and enjoying the economic prosperity of this nation. These persons would not need the charity of the U.S. government and they would be able to have adequate income without the assistance of the federal government if stock ownership was expanded. In turn, the nature of the U.S. economy could be substantially strengthened if ownership were to be expanded.

There are two basic objectives which ESOP addresses. First of all, ESOP provides the company with an additional and cheaper means of financing development. This serves to build a vested and growing property stake for the company, while raising dividend income for stockholders. In addition, technological improvement, once feared, contribute to the retirement income of persons working for a company with ESOP. Secondly, ESOP provides an effective means for employees to become owners of stock and expand ownership of stock in this country. This serves to provide employees with part ownership of the company leading to greater motivation to contribute to the profitability of the company. Under ESOP, their efforts lead to a direct reward through increasing the value and ownership of capital stock. Clearly, both of these advantages contribute to the economic well-being of the country and its citizens.

Therefore, I encourage favorable consideration by this Committee of this legislation. ESOP's contribute greatly to diversifying capital stock ownership, enable citizens to participate directly in the profitability of their employers and provide a quick financial impetus for companies needing capital infusion. Finally, ESOP's promote economic prosperity for employers and employees, leading to a more stable economy.

Remarks of Congressman Doug Walgren

Mr. Walgren. A loophole in the Tax Reduction Act of 1975 which permitted companies to exclude from stock ownership plans those employees who are covered by a collective bargaining agreement, so long as there was good faith bargaining on pensions, has given management the right to close its stock ownership plans to everyone not in management positions.

Certainly any stock ownership plan offered at the expense of the United States Treasury should include all employees of a company. Each employee should have the right to decide if he wishes to participate in any plan funded by the Government. It is unthinkable that it was the intent of Congress to give special access to management of public funds.

I urge you to included in the Senate tax package a provision to terminate this inequity.

Statement of Carl A. Nordberg, Jr.

The Expanded Employee Stock Ownership Act of 1978 would provide greater incentives to make ESOP's more attractive to business and thereby expand the number of employees benefitting under ESOP's. However, an inequity of the bill, as under existing law, is that it continues to direct these incentives generally to employees of companies which are consistently profitable. Because many businesses, large and small, old and new, experience cyclical periods of profit and loss, we urge the Committee to make the credit for ESOP contributions refundable. This would eliminate the discrimination in the existing ESOP concept and make these benefits available to substantially all employees rather than to only a selected segment of our national workforce.

Many companies eligible for the proposed increased credit for ESOP contributions will be unwilling to adopt an ESOP because of uncertainty as to when, if ever, the credit will be allowable. New businesses frequently do not incur any tax liability for the first few years of operation because start-up costs exceed income. Established businesses with a long history of success may currently be experiencing or recovering from a period of significant operating losses. For both types of businesses, a credit which is allowable only to the extent of tax liability is not an incentive to adopt ESOP's for their employees. In fact, the risk of not being able to use the ESOP credit would be increased under the bill because only a one year carryover of the credit would be allowed.

While both new and existing businesses may temporarily experience losses, the potential for capital appreciation in their stock may be just as great, if not greater than in the case of profitable companies. The adoption of ESOPs by these companies could thus be an important economic benefit to their employees. Witnesses who recently testified before the Committee have shown that, by vesting employees with an ownership stake in the business and future of their employer, the establishment of an ESOP can promote greater employee motivation and productivity which improves the employer's performance. This not only preserves jobs but generates tax revenues.

Because current law encourages the adoption and funding of ESOP's primarily by profitable companies, a substantial segment of the U.S. work force does not share in the benefits of the ESOP concept. The result is that the federal government is encouraging employee stock ownership only for employees of profitable companies, thereby discriminating against employees of many other companies. These latter employees should not be effectively excluded from the ESOP program which was designed to broaden worker ownership of U.S. business. In recent years, there have been several proposals recognizing the discrimination between businesses which exist under a system whereby tax incentives to encourage investment or other objectives are allowable only to the extent of tax liability. This inequity should be remedied under the ESOP program where the goal is to increase stock ownership by employees generally.

The benefits of ESOPs equitably should be made available to the broadest possible spectrum of the U.S. work force. An amendment to S. 3241 to make the credit for ESOP contributions refundable (at the election of the employer) if the credit cannot be used in the tax return for the year the credit is earned, would help achieve that objective. Of course, any employer electing a refund under this provision would forfeit any credit allowable for ESOP contributions. Also, to help limit the cost of a refundable feature to new companies or companies with cyclical profit and loss periods, the election to receive a refund could be limited to five consecutive taxable years. We urge the Committee to adopt such an amendment in connection with its consideration of the Expanded Employee Stock Ownership Act of 1978.

STATEMENT OF JOHN J. ROSS, GENERAL MANAGER, TAXES, GULF OIL CORP.

Gulf Oil Corporation supports the enactment of the Expanded Employee Stock Ownership Act of 1978 as a means of encouraging the adoption of new Employee Stock Ownership Plans (ESOPs) and the maintenance and funding of existing ESOPs by employers. Gulf established an ESOP, beginning with its 1976 taxable year, pursuant to the provisions of the Tax Reduction Act of 1975. At the present time, approximately 25,000 Gulf employees, substantially all of its U.S. employees, are participating in the ESOP.

We believe that the major provisions of S. 3241 are very meritorious. Increasing the credit for ESOP contributions to two percent of the qualified investment will promote greater funding of ESOPs resulting in more meaningful benefits to employees. This approach is much more desirable than the complex and administratively burdensome provisions of current law allowing an additional ½ percent credit for employer contributions matching employee contributions. The alternative one percent of pay provision should encourage the adoption of ESOPs by labor intensive businesses.

The inclusion of provisions for ESOPs in the Internal Revenue Code will increase the public perception of ESOPs as a more permanent program. Temporary provisions—particularly where they involve employee benefits—represent an un-

desirable approach to tax legislation, and the current temporary rules have probably discouraged many employers from establishing ESOPs.

While S. 3241 includes many worthwhile provisions to encourage the expansion of ESOPs and to resolve some technical problems of current law, we believe there are certain aspects of the bill which continue to present major impediments to the establishment and funding of ESOPs. Our comments on these and other provisions are set forth below.

1. *Proposed Requirement that 50 Percent of the Value of Employer Securities be Newly Issued.*—While this requirement might increase capital formation somewhat, the increase would be very marginal in the case of large companies. The practice of most large companies is to fund employee benefit plans involving employer stock through purchases on the open market (or treasury shares so acquired). Where funding is accomplished through open market purchases, the economy may benefit to the extent that the market for the employer's stock is broadened. On the other hand, the proposed "50 percent newly issued stock" requirement could deter employers from adopting or contributing to ESOPs. This is because, depending on the size of the company and its current financial status, the issuance of new shares could significantly dilute earnings and lower the price of its shares.

The "50 percent newly issued stock" requirement does not seem necessary to accomplish the primary objective of encouraging broader stock ownership by employees. This requirement should be deleted from the bill because its potential detrimental impact on the ESOP program would appear to outweigh any potential capital formation benefit.

2. *Coverage of Union-Represented Employees.*—One provision of the bill would require ESOP coverage of union-represented employees unless the union specifically declines such coverage. This requirement is consistent with the overall objective of the bill to broaden employee stock ownership. However, an exception limited to those ESOPs which meet the 70 percent coverage test of existing law without relying on the "good faith bargaining" exclusion is also consistent with that objective. A plan which complies with the 70 percent test (IRC § 410(b)(1)(A)) has long been considered to provide for such substantial coverage that it has not been necessary to consider the actual composition of the covered or non-covered groups. If an ESOP can meet this test under current law without excluding union-represented employees from the computation, the ESOP in effect provides the benefits of employee stock ownership to substantially all of its U.S. work force. Consequently, a limited exception to this provision of the bill for already broad-based ESOPs is warranted.

If the Committee decides to adopt this provision of the bill in its current form, however, we urge that it be subject to an effective date no earlier than the first plan year after the current collective bargaining agreement expires. Otherwise, employers and unions may have to go to the bargaining table—before the next scheduled round of bargaining—to discuss ESOP coverage, with potentially disruptive effects on normal labor-management relations.

3. *One Year Carryover Period.*—Under the bill, the credit for ESOP contributions would be a carryover only to the taxable year following the year it was earned. The one year carryover period may discourage employers (including new employers incurring start-up losses) from adopting ESOPs. Moreover, it may prevent employers maintaining ESOPs from deriving the anticipated benefits from establishing and funding their ESOPs.

The general policy of the tax laws is to allow liberal carryovers and carrybacks of tax credits (ordinarily seven years forward and three years back). There is no apparent reason why this policy should not apply to the credit for ESOP contributions. An amendment to the bill to include carryover and carryback rules comparable to the existing provisions will eliminate a potentially significant disincentive to adopt ESOPs presented by a one year carryover, and will help ensure that employers currently maintaining ESOPs actually benefit from their ESOP contributions as intended.

4. *Reimbursement for Ongoing Administration Expenses.*—The bill carries forward the provisions of existing law allowing the employer to be reimbursed by the ESOP for ongoing expenses of administration in an amount related to dividend income of the ESOP. (Ordinarily the applicable limitation is 10 percent of the first $100,000 in dividend income and 5 percent of the excess dividend income.) However, in the early years of an ESOP, when the assets of the trust are small, the amount of dividend income may be insufficient to allow

reimbursement of all significant administration expenses (e.g., trust services, computer costs, etc.). An amendment to the bill which would allow such "excess" expenses to be carried forward and recovered over the 10 year period following the year such expenses were incurred would be a reasonable solution.

As stated previously, we believe that the Expanded Employee Stock Ownership Act of 1978 is generally meritorious and will promote the expansion of the ESOP program. We appreciate this opportunity to provide our views on the ways in which S. 3241 could be improved, and we urge their adoption in connection with the Committee's consideration of the bill.

UNITED STEELWORKERS OF AMERICA,
August 1, 1978.

Hon. RUSSELL B. LONG,
Russell Office Building,
Washington, D.C.

DEAR SENATOR LONG: I regret not having time to prepare a statement for the Senate Finance Committee hearing on Employee Stock Ownership Plan (ESOP), in Washington on July 18th.

I feel Mr. Boulis' testimony covered our situation here at South Bend Lathe quite well. However, I feel it is important to convey my feelings and the feelings of the members of Local 1722 and the employees of South Bend Lathe.

ESOP has not only saved five hundred jobs at South Bend, but it has given us a chance to control our economic future. We feel that ESOP can be good for all American workers. Therefore, we lend our support of Bill S-3241.

Remember, Senator "A worker who has job security is a worker that's happy, and a happier worker is a more productive worker."

Respectfully,

GERALD F. VOGEL,
Vice President, Local 1722, USWA,
South Bend Lathe, Inc.

NORTHERN ILLINOIS GAS,
Aurora, Ill., July 19, 1978.

Hon. RUSSELL B. LONG,
U.S. Senate,
Russell Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: Effective as of January 1, 1975, Northern Illinois Gas Company established an employe stock ownership plan meeting the requirements of both section 301(d) of The Tax Reduction Act of 1975 and section 401(a) of the Internal Revenue Code of 1954. Our plan was subsequently amended to allow participants to make matched voluntary contributions in accordance with the provisions of The Tax Reform Act of 1976. Against that evidence of the Company's support of the stock ownership plan concept, I have reviewed, with great interest, bill S. 3241 introduced on your behalf by Senator Byrd on June 23, 1978. With the important exceptions that I note below, I personally strongly favor the enactment of S. 3241 into law.

I am concerned that the open-ended right of declination provided to a collective bargaining representative in section 416(a)(15) could effectively cause an employer to necessarily postpone, for an indefinite period, adoption of a "416 plan" for the benefit of the remainder of its employes.

Further, S. 3241 fails to specifically provide that a "416 plan" is *not* a subject of mandatory collective bargaining. Stock ownership arrangements have traditionally been considered within the prerogative of management and not a subject for collective bargaining under the National Labor Relations Act. Therefore, it is quite probable that stock ownership plans are not subject to mandatory bargaining under current National Labor Relations Board law. In any event, I respectfully suggest that to make "416 plans" a mandatory bargaining subject would, for the following reasons, be inappropriate, unnecessary and would not advance the goals that your legislation seeks to achieve.

Proposed section 416 appears to contemplate that an employer will maintain a "416 plan" for all its eligible employees. I believe that this is evidenced by that fact that S. 3241 contains no provision for the allocation of the proposed section 44(C) tax credit between multiple "416 plans" maintained by a single

employer. If I am correct, and if collective bargaining is required with respect to such plans, a small minority of organized employes could affect the provisions of such a plan as applied to all of an employer's employes. Such a result would be highly unsatisfactory, not only to an employer, but also to its other employes. Also, two bargaining groups could take diametrically opposed positions with respect to a particular "416 plan" provision. The attendant managerial dilemma would be impossible to resolve.

Proposed section 416(a)(6)(A) requires that an amount equal to one-half of the additional tax credit claimed by an employer be contributed in newly-issued shares of employer stock. If an employer were required to bargain, again perhaps with a minority of the covered employes, as to the magnitude of its contribution under a "416 plan", it would, at the same time, be compelled to bargain with respect to the number of its authorized and issued shares. Certainly, the latter has always been, and should remain, a management prerogative

I sincerely feel that the stringent requirements for the qualification of a "416 plan", combined with the fact that an employer will be subject to civil penalties under proposed section 416 (a)(11) for failure to meet those requirements, renders a mandatory bargaining requirement unnecessary with respect to "416 plans".

My final concern stems from the fact that S. 3241 does not directly authorize the amendment of an existing plan to a form that will comply with the requirements of proposed section 416.

If, after analysis of S. 3241, other employers share my concerns, it is quite possible that "416 plan" adoption will not proceed at the pace proponents of the stock ownership plan concept would desire. I believe that this possibility could be eliminated by certain minor revisions to proposed section 416(a)(15). I have caused to be prepared, and am attaching for your consideration, a revision of that section. I believe, that the revision overcomes the problems that I perceive in a fashion that is fully consistent with the intent of your proposed legislation. I would be happy to discuss the contents of the attachment with you or with appropriate members of your staff.

Sincerely yours,

C. J. GAUTHIER.

Enclosure.

(15) Notwithstanding any provision of this title to the contrary, employes who are included in a unit of employes covered by a collective bargaining agreement between any employe representative and one or more employers and who satisfy the minimum age and service requirements, if any, established by the plan (*including any existing plan amended to meet the requirements of this section*), shall not be excluded from eligibility under the plan, unless the employe representative, *within 10 days of written notification by the employer to the employe representative of the establishment of a plan,* declines coverage for employes in the unit *by written notice to the employer. It shall not be an unfair labor practice within the meaning of section 8(a)(5) of the National Labor Relations Act, or any other provision of that Act, for an employer to refuse to bargain collectively with an employe representative with respect to (i) the establishment by the employer of a plan meeting the requirements of this section; or (ii) the terms and conditions of a plan or trust agreement forming a part thereof should the employer notify an employe representative of the establishment of a plan.* Where the employe representative declines coverage, section 410(b)(2)(A) shall apply.

STATEMENT OF FRANK ALTMAN

The major issue of economic policy facing the United States today asks a fundamental question: what measures can be used to strengthen capitalism? The system needs a dose of good old-fashioned economic growth. Debate on this issue has recently focused on fiscal policy, and more specifically, on tax measures to engender capital formation.

It is commonly agreed that cost inflation adversely affects capital formation by weakening profits, and concern over this problem has resulted in two concrete proposals: The Steiger Amendment and a Tax Based Incomes Policy (TIP). The Steiger Amendment, which recognizes the problem of lagging return on investment, would accommodate the burden of cost inflation by lowering the capital

gains tax. And TIP would act directly against excessive wage settlements to provide "breathing space" for prices, and an opportunity for economic expansion.

By comparison with either of these measures, an Employee Stock Ownership Plan (ESOP) provides a *direct* incentive for capital formation. Employer contributions to the Plan which result in employee ownership of company stock, form the basis for a tax benefit to the company and, because the tax advantage to (all) shareholders is generally in proportion to the *market* value of ESOP stock, the plan contains a built-in attraction for capital resources to the faster-growing segments of the economy. As a fiscal measure it is therefore more specifically growth-related than is a measure which provides a capital gains tax reduction, uniformly, for any firms.

Thus, the advocacy of ESOP as fiscal policy is coincident with the use of taxing power to stimulate growth; but the ESOP approach is qualitatively different from the usual Keynesian measures which find their orientation in static analysis: what Schumpeter once referred to as "bloodless economics". For Keynes, an expansive fiscal policy would act to pull firms' output up along a "U-shaped cost curve" which costs would allow—but with a lag. As Keynes said in his Treatise On Money, this would allow the wealth of nations to be enriched, "not during Income Inflations but during Profit Inflations—at times, that is to say, when prices are running away from costs." So Keynes was a strong advocate of firms' profitability, while postulating a rather fixed, or static relationship between costs and prices.

Interestingly, this thinking is incorporated into the proposal for a Tax-Based Income Policy. TIP assumes the Keynesian cost-price fixity, and would use taxing power to penalize firms and employees where wage settlements were "above-norm". This would enforce a lag between rising costs and prices, and give profits a chance to grow—a la Keynes—so that noninflationary expansion could ensue.

On the other hand, the fiscal policy implied by ESOPs concentrates on the innovative capability for firms to provide the profits needed for expansion. By giving a tax incentive to faster-growing firms whose stock values are rising, the ESOP works to shift capital flows into the more productive areas of the economy, with all the advantages which attend increased investment returns: higher levels of employment and output and, as a by-product of increased production, lesser inflation.

Unlike TIP, which concentrates on bringing wages into line with productivity, the ESOP turns this relationship around so that productivity advances accommodate wages. The difference between these two plans points up the divergent policy implications between the Keynesians and those who advocate a virile capitalism: the Keynesian approach, largely because it is static, ends up relying on government measures to effect the appropriate economics, but reliance on innovation implies the primacy of the entrepreneur.

At this point, it is instructive to note Joseph Schumpeter's prescription for inflation. Speaking 30 years earlier, that great economist stated succinctly that "the best remedy for inflation is an increase in production" ("There Is Still Time To Stop Inflation", *Nation's Business*, June, 1948). Schumpeter also advocated a policy of credit restriction, primarily in opposition to consumption and in favor of investment. The overall point was to get an increase in the output of goods and services which was greater than the increase in incomes.

Moreover, to this prescription, Schumpeter added a corollary with regard to fiscal policy. While it is true, he pointed out, that reducing the taxpayers' burden leaves larger disposable incomes—and therefore a potential source of further inflation—that outcome would follow only from greater expenditure on consumer goods. On the other hand, if incomes could be canalized into industrial investment "they would exert an anti-inflationary effect because they would finance, in a non-inflationary manner, those industrial requirements that are at present financed by the inflationary method of borrowing from banks." And so, Schumpeter suggested reducing taxes on "the saved part of corporate and individual income" as a consideration for capital formation, and as an important part of an overall policy for winding down inflation. (*Nation's Business*, June, 1948).

This is exactly what ESOP legislation accomplishes—by definition. The employer stock contributions which form the basis for tax deductions are in the nature of capital ownership (not wage or salary compensation). And, because the ESOP taxbreak is in favor of the more dynamic firms, the net effect would be to stimulate production: Schumpeter's "best remedy for inflation". It is time that the ESOP ceased being considered a populist nostrum and looked at as the legitimate fiscal tool which it is in fact.

ALLIED PLYWOOD CORPORATION,
Alexandria, Va., July 17, 1978.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee, Russell Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: I am writing this letter in view of the ESOP hearings which are scheduled for July 19 and 20. If you really want to encourage ESOPs, why not give a major stockholder or any stockholder for that matter the same consideration he would get by merging his company with another corporation? Tax-free stock exchanges under the present tax structure offer the major stockholder of a small corporation the only equitable way of disengaging himself. Large corporations become larger and small corporations fade away. As you can see by the enclosed articles, we have an ESOP and it is working out fine for everyone except our own stockholders, especially me. Even though I may sell my stock to our ESOP trust and have the proceeds treated as capital gains, the total effective tax rate is about 50%. That includes the preferential tax treatment of the untaxed half, the effect on my earned income and state taxes. Why should any stockholder in an ESOP corporation pay taxes at all if the proceeds are immediately reinvested in another corporation?

Now for a moment, think about our employees. Without an ESOP few of them would acquire stock in our free enterprise system. Thousands of ESOPs surely are never formed because of taxes which must be paid when stock is sold to an ESOP trust. Why should not employees be able to have a "piece of the action" just as easily as another corporation can via a merger? Their opportunity to do this is impaired by the reluctance on the part of present stockholders to form an ESOP in the first place. Now here is another matter to consider since new equity capital is so much in the news. Under a tax-free exchange system for ESOPs every dollar contributed to an ESOP trust would represent new capital investment. Every dollar used by the trust to buy authorized but unissued stock would represent new equity capital. Also, every dollar used by the trust to buy outstanding stock would result in new capital formation if this dollar were reinvested immediately. Such a system would be a vast improvement over a corporate merger. To encourage corporate mergers is only to encourage larger corporations which results in no added tax revenues and no added new capital. Most small corporations are composed of stockholders who are "locked in". To sell their stock is to lose a great deal of their investment in taxes. I would suggest the following legislation which I believe would result in thousands of new ESOPs with attending new capital, social benefits and very little loss in tax revenues:

> Stockholders in corporations with an ESOP should be allowed to sell their stock to the ESOP trust and use the proceeds within sixty days to buy stock of their own choosing. This transaction would be done in a tax-free manner and need not be reported on tax returns. The cost basis of this new stock would, of course, be adjusted to reflect the original cost to the stockholder; or, as an alternative.
>
> An ESOP trust should be allowed to buy stock in any corporation and by mutual agreement exchange this stock on a tax-free basis for stock held by stockholders in the corporation which sponsored the ESOP. The stockholder would, of course, have to use his original cost to determine his cost basis.

If the above suggestions were made into law, it would simply give the individual the same benefits that corporations now share with each other. I cannot close this letter without mentioning that ESOPs should be encouraged because they represent new capital in the hands of ordinary workers. There is a repressive maldistribution of capital ownership in our country at present, and I believe it is the duty of our legislators to try hard to give citizens at least the same rules of stock exchanges that corporations now enjoy. I believe that to start this trend with ESOPs would not only be conservative but would have some very beneficial side effects to our economy.

Yours very truly,

EDWARD H. SANDERS, *President.*

Enclosures.

[From The Washington Star, Nov. 28, 1977]

ALLIED PLYWOOD CORP. EMPLOYEES TO GET FIRM

(By Ron Snider)

Edward H. Sanders, founder and owner of Allied Plywood Corp. of Alexandria, is giving way his highly successful company.

Over the next 10 years, using a complex federal law known as ESOP (Employee Stock Ownership Plan), Sanders' 19 employees will obtain all the stock of Allied, which has sales of more than $5 million a year, without its costing them a cent.

"Instead of selling the company or merging," Sanders said, "I'm using ESOP so the employees will own the company and run it."

Sanders said that each year Allied will place in a trust fund 25 percent of each employee's compensation and the trust will use the money to buy stock in the company.

Because Sanders and his wife own most of Allied's stock, the trust will be buying shares from them, in effect using the company's earnings before taxes.

And Sanders' gains on the sale of his stock will be considered long-term capital gain, rather than the ordinary income it would be considered if he should sell the stock directly to the company.

"It avoids lots of unnecessary taxes," Sanders said, pointing out that the employees won't be taxed on the shares they receive as long as they remain in the trust.

Allied, which sells plywood to building contractors, was founded by Sanders in 1951 and has been operating in the Washington area since 1956.

Sanders said the ESOP law gives him a means of selling out his interest while giving his employees lots of protection. He said the stock would be sold at the company's book value, currently around $725,000.

"I'm sure I could get more if I sold it to another company," he said.

Persons close to the company said Sanders' move to turn Allied over to its employees is typical of the way he has been running the company for years.

They said that while the salary base at Allied is low, employees are on a monthly profit-sharing plan and receive year-end bonuses based on total company profits.

Sanders confirmed that under the profit-sharing and bonus plans some of his warehousemen and drivers will earn more than $25,000 this year.

He said that in addition to the tax advantages of the ESOP program, it will bring about more interest in management among employees because they know they eventually will have to run the business.

"I'm going to die some day," Sanders said, "and this is better than waiting for some disaster to hit."

He said the 10-year timetable for turning the company over to employees will depend on continued profitability of the business, which operates in the highly cyclical construction industry.

"We have gone 20 years without losing money," Sanders said. "And we've had lots of ups and downs in that period. But we have been able to cut back when we've had to."

Also, Sanders said that the Washington area has been more stable than some others and this has helped the company.

"And I have a hunch this will be a good area for many more years," he added.

[From The Washington Post, Nov. 27, 1977]

EMPLOYEES TAKING OVER ALLIED PLYWOOD THROUGH ESOP

(By Jerry Knight)

Along about the third week of every month, Ed Sanders chalks a note on the blackboard at Allied Plywood, Inc., in Alexandria, letting the employees know the company has reached its first goal for the month—it has wholesaled enough plywood to cover expenses.

Every day after that, more numbers go up on the board, indicating through a point system how much money the company is making.

The blackboard is watched closely by Allied's 19 employees because the company's profitability is directly related to their paychecks.

Once the company covers its costs, 30 per cent of the gross profits for the month goes to the full-time employes; the 15th of every month they get a check for their share of the previous month's earnings.

Last year, the monthly incentives—and yearly bonuses when final profits are figured—added up to $12,000 per employee, enough that with what Sanders acknowlegdes are modest base wages, some of the warehousemen and truck drivers made $28,000.

"That is already one of the most exciting employee reward structures anywhere," said Norman Kurland, a Washington lawyer and corporate finance specialist, who recently set up another incentive for Allied Plywood.

The truck drivers, warehousemen, salesmen and secretaries, all the full-time employees, are becoming capitalists under an Employee Stock Ownership Plan (ESOP) formulated by Kurland.

As of the end of Allied's fiscal year, Sept. 30, each full-time employee owns stock in the company amounting to 25 per cent of his or her earnings during the year, and will get a profit-sharing stock bonus amounting to at least 10 per cent of the wages each year.

Over the next 10 years, ownership of the plywood distribution firm will be acquired by an ESOP trust fund for the employees. When Sanders and his wife, the founders and principal stockholders, are ready to retire, the long-time workers will own the company and Mr. and Mrs. Sanders will have realized their capital gains.

Kurland, who touts ESOP as vigorously as others sell soap or salvation, claims the concept is not only a major innovation in employee benefits, but also a fundamental improvement in the private enterprise system. ESOP, he argues, turns "wage slaves" into coupon-clipping capitalists.

Employee stock plans also provide a new method of capital formation, allowing companies to repay debt with pretax dollars and, in the case of Allied Plywood, provide a method for a business owner to sell out without selling his employees down the river.

Sanders, who founded Allied and built it into a major independent plywood distributor, was motivated to consider an ESOP after an earlier attempt to take some of his capital out of the company.

He sold a few shares of the greatly appreciated stock in the very closely held corporation back to the company, only to discover that such a sale does not qualify as a capital gain. If a corporation's founder or his immediate family own more than half the outstanding shares in the company, the income from sale of stock back to the corporation is considered a dividend, the Internal Revenue Service told Sanders when it claimed a whopping chunk of his money.

The only way to realize the appreciation on his investment in the business appeared to be to sell the stock outside, in effect forcing him to merge with or be acquired by a competitor. That, Sanders said, would leave the employees who helped him build the company at the mercy of a new owner.

A conventional sale to the staff seemed impossible because of the difficulty of the workers in obtaining financing to buy the business.

Sanders said he first learned of ESOP when he read a letter to the editor in The Washington Post from Kurland defending ESOP; a phone call to Kurland got the ball rolling.

Kurland is the nation's leading proponent of employee ownership of business, a concept first promulgated by San Francisco financier-philosopher Louis Kelso. He helped put together the prototype for such plans when 500 workers at the South Bend (Ind.) Lathe Co. bought the company to keep it from closing; that was three years ago and the company today is operating profitably.

Major users of ESOPs in the Washington area include E Systems, Inc., a Texas-based defense contractor with offices in Northern Virginia and Lowe's, the lumber yard chain.

Basically, Employee Stock Ownership Plans work this way:

An ESOP trust fund is set up, financed with contributions from the company, like profit sharing or any other employee benefit. Contributions to the ESOP are tax deductible for the company and are limited by the IRS to 25 per cent of the eligible employees' salaries, or $25,000 a person, whichever is smaller.

Rather than investing the employee benefit monies in securities as most corporate pension funds do, the ESOP trust uses its funds to buy stock in the com-

pany. The ESOP trust can purchase stock from public owners via a tender offer—a complex and rarely used method, from principal owners like Mr. and Mrs. Sanders, or from the corporation's authorized but unissued shares—which is also being done at Allied Plywood.

The ESOP trust fund can acquire all or part of the funding corporation's shares. It can buy the shares gradually—over a 10-year period at Allied Plywood—or can borrow money to acquire a block of shares all at once. That is called a "leveraged ESOP."

As with other forms of profit sharing, ESOPs generally have vesting restrictions. Most of them also limit the employees' options in disposing of the shares acquired through the plan, giving the ESOP trust a right of first refusal on any sale and requiring the trust to buy any shares offered if there are no other buyers.

Most of the legislation creating ESOPS has been shepherded through Congress by Sen. Russell Long (D.-La.), a convert to Kurland's philosophy of employee ownership. The tax legislation covering ESOPs gives corporations which set them up an added 1.5 per cent investment tax credit for doing so.

That provision has led to establishment of a special class of employee stock ownership plans known as TRASOPs—after the Tax Reduction Act that gave the extra investment tax credit. As of Oct. 31, there were 345 TRASOPs, the Internal Revenue Service says.

Virtually all TRASOPs are intended to get their corporation the investment tax credit and provide additional corporate financing, rather than give employees a significant stake in the business, Kurland points out.

ESOPs also have come to be identified with bail-outs of troubled companies; more than one conglomerate has disposed of a marginally profitable and unmarketable division by selling it to its employees. That's not the primary purpose, Kurland stresses. Although some ESOP advocates, including Kelso who invented the idea, oppose ESOP purchase of troubled companies, Kurland does not object. "If you have a good tool, it ought to be used for solving problems," he says.

He opposes using ESOP techniques to allow the management of a company to buy it, usually with government-subsidized loans. The recent purchase of American Safety Razor Co. in Staunton, Va., by a dozen of its top officers with federally financed low interest loans is a case in point. A true ESOP would have allowed all the American Safety Razor employees to benefit from owning their employer.

From this capitalist-reformer point of view, Kurland argues that the role of profits in a capitalist system would be better understood if more people got them. He contends employee-owned companies ought to pay regular dividends, so profits would be as important as wages to the employee-owners.

Linking profits and productivity through employee ownership minimizes labor problems by putting labor and management on the same side, he contends. "I don't know of any strikes in companies that have ESOPs," he says, though many employee-owned firms have unions and ESOPs can be a bargainable issue.

Kurland stresses repeatedly that employee ownership and employee management are not the same thing. It takes a strong, independent board of directors and professional management to run an employee-owned company, he said, criticizing Scandinavian and German efforts to put union members on board of directors as a conflict of interest.

In a small employee-owned company like Allied Plywood, developing a new management team to take over when the original owners leave is the toughest problem, Kurland acknowledged.

CADICK, BURNS, DUCK & PETERSON,
Indianapolis, July 18, 1978.

Senator RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Dirksen Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: On July 19 and 20 the Senate Finance Committee of which you are Chairman is conducting hearings to determine the value of the benefits of ESOPs and what legislation is needed to promote the broadening of stock ownership and to prevent abuses arising therefrom. The problem encountered by a client of this office in attempting to establish an ESOP demonstrates the need for a minor change in the law which will significantly increase

the number of employees who will have the opportunity to participate in ESOPs.

Our client is a midwestern manufacturing concern with several hundred employees. The company has been successful and has enjoyed a substantial and steady increase in net profits through the years. Recently, the family which owns the controlling interest decided to retire from active management and to establish a program under which the employees would become the owners of the company. However, this desire to convey ownership to the employees has been frustrated by the interaction of regulations issued under the Employee Retirement Income Security Act of 1974 ("ERISA") and the Securities Act of 1933.

Specifically, the company proposes to convert its existing defined benefit pension plan into an individual account ESOP and to use the funds formerly in the pension plan to acquire company securities. The problem with this program arises as follows: the Pension Benefit Guaranty Corporation ("PBGC") established by ERISA takes the position that the conversion of a defined benefit pension plan into an individual account ESOP is technically a plan termination and therefore the participants in the pension plan must be offered the option of either receiving annuities or having their interests in the pension plan converted into individual accounts in the ESOP. The Securities and Exchange Commission treats this election as a "sale" under the 1933 Securities Act and therefore requires the preparation and dissemination of prospectuses, which involves the expenditure of many tens of thousands of dollars. The cost of complying with the SEC prospectus requirements is prohibitive for small to middle size concerns and effectively prevents the establishment of ESOPs by the conversion of defined benefit pension plans.

The PBGC and SEC place no obstacles in the path of converting profit sharing plans into ESOPs, and this is a common practice. Since the value of funds held by pension plans far exceeds those held by profit sharing plans, the growth of ESOPs would be greatly enhanced if it were possible to convert pension plans to ESOPs at a reasonable cost.

We recognize that in the case of an absolute termination, the only way the PBGC can insure that a participant will receive his guaranteed benefit is to require that he be offered an annuity at the time of termination. However, in the case of converting a pension plan to an ESOP, the plan is ongoing and the administrator, both with regard to the conversion and after the conversion, has the duty under ERISA Section 404(a) to act for the exclusive benefit of participants and their beneficiaries and with the care, skill, prudence, and diligence of an expert. If the conversion should be undertaken for any reason than the exclusive benefit of participants and their beneficiaries or if the resulting ESOP should be administered in any way than for the exclusive benefit of participants and their beneficiaries, the administrator and his bonding company will be liable. Similarly, the administrator and his bonding company will be liable if the administrator does not exercise the requisite due care in the administration of the ESOP, and this includes the investment of its assets.

In short, ERISA Section 404(a) permits the conversion of a pension plan to an ESOP only if the company's securities are of fiduciary quality and permits the continued interest in such securities only so long as they remain of such quality. There is thus no need to require that upon the conversion of a pension plan to an ESOP participants be offered the opportunity to receive annuities. Their ongoing rights continue to be protected fully under ERISA.

The foregoing problem caused by the interrelationship of regulations issued by the PBGC and the SEC has been explored fully with these agencies. Enclosed as Exhibits A and B are letters from this firm to Mr. Henry Rose, General Counsel, Pension Benefit Guaranty Corporation, dated February 21, 1978 and March 3, 1978, respectively. The PBGC took no action upon our request that they deviate from their annuity rule with regard to ESOPs. Enclosed as Exhibits C and D are our request to the SEC for a "no-action letter" and the SEC's response stating that the conversion of the pension plan to an ESOP will require compliance with its prospectus requirements.

While the point of law involved here is a narrow one, its application is extremely broad. We respectfully request your consideration of legislation remedying this problem, thus making the benefits of stock ownership available to hundreds of thousands of additional employees.

Very truly yours,

CHARLES W. CULP.

Enclosures.

EXHIBIT A

CADICK, BURNS, DUCK & PETERSON,
Indianapolis, February 21, 1978.

MR. HENRY ROSE,
General Counsel,
Pension Benefit Guaranty Corporation,
Washington, D.C.

DEAR MR. ROSE: Patrick Callahan and I represent a client who wishes to convert a pension plan into an unleveraged ESOP. This letter will amplify the thoughts conveyed to you by my partner, Martin Zohn, in a telephone conversation with you in December, 1977 and a letter to you from Pat Callahan dated February 10, 1978.

We believe that the requirement in proposed regulations 29 CFR, Part 2615 that participants in a terminating defined benefit pension plan be offered the option of receiving an annuity at the time of termination (41 Fed. Reg. 48,504 (1976)) should *not* be applied to the conversion of a defined benefit pension plan into an individual account ESOP. To do so is not necessary to protect the interests of the participants and would have the practical effect of preventing such conversions and frustrating Congress's express intent to encourage the proliferation of employee stock ownership plans.

FACTS

Our client proposes to convert an existing defined benefit pension plan into an individual account ESOP. This will be accomplished through a plan amendment, and assets of the pension plan will be sold and qualifying employer securities will be purchased with the proceeds. In the future, employer contributions will be used to purchase qualifying employer securities. Participants in the pension plan will be participants in the ESOP. Except to the extent required by the Pension Benefit Guaranty Corporation, no option will be given to participants to receive annuities at the time of the conversion.

The existing pension plan is trusteed with assets invested in listed securities. The plan is contributory, but only the portion of the fund attributable to employer contributions will be involved in the conversion to the ESOP.

Assume that on the date of the conversion the value of the plan assets less liabilities equals or exceeds the value of the plan benefits in priority categories 1 through 4 and the cost of early retirement benefits in priority categories 1 through 4, in other words, assume that the assets are sufficient to discharge when due all obligations of the plan with regard to guaranteed benefits. Assume also that the ESOP will not be leveraged.

LAW

The Securities and Exchange Commission takes the position that an election by plan participants to receive their vested interests in the assets of a defined benefit pension plan or to transfer these assets to an individual account ESOP constitutes a "sale" within the meaning of Section 2(3) of the Securities Act of 1933, 15 U.S.C. Sec. 77a–77aa. See *Guaranty Corp.* [1976–1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80, 709, a copy of which is attached. A requirement by the PBGC that participants in a pension plan being converted to an ESOP have the option to receive their interests in the form of annuities at the time of conversion thus has the effect of subjecting the transaction to the disclosure provisions of the 1933 Securities Act. Specifically, a prospectus must be prepared involving accounting, legal, and printing costs running to many tens of thousands of dollars, thus making the conversion of a defined benefit plan into an ESOP impracticable except in very rare cases.

For purposes of the PBGC and the Internal Revenue Service, the amendment of a defined benefit pension plan into an individual account plan is deemed to be a technical termination of the defined benefit plan. ERISA Sec. 4041(f) and 4021(b)(1) (29 U.S.C. 1341(f) and 1321(b)(1)); Treas. Reg. Sec. 54.4975-11 (a)(6) (1977).

ERISA requires that the administrator of a plan terminating with guaranteed benefits obtain a notice of sufficiency from the PBGC, but the Act does not establish whether a plan is sufficient nor specify the manner in which its affairs are to be wound up. ERISA Sec. 4041a) (29 U.S.C. 1341(a)); 29 CFR, Part 2615

(41 Fed. Reg. 48,504 (1976). The PBGC is thus free to fashion reasonable rules regarding the disposition of assets of a terminated plan.

The fiduciary duties of the administrator of a defined benefit pension plan being converted into an individual account ESOP apply to the conversion and remain the same after the conversion with the single exception that the administrator is under no duty after the conversion to diversify investments. ERISA Sec. 404(a)(1) and (2) (29 U.S.C. 1104(a)(1) and (2)); Treas. Reg. Sec. 54.4975-11(a)(6) (1977). Specifically, with regard to the conversion and the period following the conversion, the administrator must act solely in the interest of participants and their beneficiaries, for the exclusive purpose of providing benefits to participants and their beneficiaries, and with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with matters would use in the conduct of an enterprise of a like character and with like aims, in other words, with the care et cetera of an expert.

Congress in a number of Acts has made clear its interest in encouraging the establishment of employee stock ownership plans. Tax Reform Act of 1976, Pub. L. No. 94-455, Sec. 803(h); 26 U.S.C. 4975 note.

DISCUSSION

The Pension Benefit Guaranty Corporation has the discretion under ERISA Sec. 4041 to fashion reasonable rules for winding up the affairs of pension plans terminating with guaranteed benefits. The procedure need not be the same for all terminations and should not be the same if there are substantial differences in the form of the termination. The procedure should not be the same for defined benefit plans being converted into individual account plans as for defined benefit plans being terminated absolutely.

In the case of an absolute termination, the only way the PBGC can insure that a participant will receive his guaranteed benefit is to require that he be offered an annuity at the time of termination. However, in the case of conversion, the plan is ongoing and the administrator, both with regard to the conversion and after the conversion, has the duty under ERISA Sec. 404(a) to act for the exclusive benefit of participants and their beneficiaries and with the care, skill, prudence, and diligence of an expert. If the conversion should be undertaken for any reason than the exclusive benefit of participants and their beneficiaries or if the resulting ESOP should be administered in any way than for the exclusive benefit of participants and their beneficiaries, the administrator and his bonding company will be liable. Similarly, the administrator and his bonding company will be liable if the administrator does not exercise the requisite due care in the administration of the ESOP, including the investment of its assets.

There is thus no need to require that upon the conversion of a pension plan to an ESOP participants be offered the opportunity to receive annuities. Their ongoing rights continue to be fully protected under ERISA.

On the other hand, if the requirement that a participant in a terminating pension plan be offered the option of receiving his interest as an annuity is applied across the board to all terminatnig pension plans including conversions of defined benefit plans to individual account plans, this will have the practical effect of preventing the formation of ESOPs by this method. The offering of the annuity option forces the Securities and Exchange Commission to require compliance with its prospectus requirements, with resulting costs of twenty to fifty thousand dollars or more in accounting, legal, and printing expenses. This obviously will inhibit such conversions and reduce the spread of stock ownership plans, all in direct conflict with the express intent of Congress.

Congress's desire to foster the growth of stock ownership arrangements is set out clearly and emphatically in section 803(h) of the Tax Reform Act of 1976 (26 U.S.C. 4975 note):

> The Congress, in a series of laws (the Regional Rail Reorganization Act of 1973, the Employee Retirement Income Security Act of 1974, the Trade Act of 1974, and the Tax Reduction Act of 1975) and this Act has made clear its interest in encouraging employee stock ownership plans as a bold and innovative method of strengthening the free private enterprise system which will solve the dual problems of securing capital funds for necessary capital growth and of bringing about stock ownership by all corporate employees. The Congress is deeply concerned that the objectives

sought by this series of laws will be made unattainable by regulations and rulings which treat employee stock ownership plans as conventional retirement plans, which reduce the freedom of the employee trusts and employers to take the necessary steps to implement the plans, and which otherwise block the establishment and success of these plans.

In summary, we respectfully request that the requirement in proposed regulations 29 CFR, Part 2615 (41 Fed. Reg. 48,504 (1976)) that participants in terminating defined benefit plans be offered the option of receiving their benefits at the time of termination in the form of annuities not be applied to the conversion of defined benefit plans into individual account ESOPs.

CONFERENCE

We believe this issue is of the utmost consequence not only to our client but to many other companies similarly situated. In order that this matter may be resolved in the very near future, we request an opportunity to meet with you in your office in Washington on a day of your choosing prior to March 17, 1978.

We are sending a copy of this letter to Senator Russell Long because of his interest in the development and proliferation of stock ownership plans.

Very truly yours,

CHARLES W. CULP.

Enclosure.

[¶ 80,709] Guaranty Corporation

Securities and Exchange Commission, Division of Corporation Finance, July 22, 1976. (Available August 22,1976). Correspondence in full text.

Securities Act—Sale—Employee Stock Plan—Election by Participants.—The election by each plan participant to receive his vested interests in the assets of a defined benefit pension plan or to transfer these assets to a money purchase pension plan to be invested in securities of the company, may be deemed to involve a "sale" within the meaning of Section 2(3) of the Securities Act. The money purchase plan was adopted as an amendment to the defined benefit pension plan which is being terminated.

See ¶ 1101, "Securities Act—Definitions" division, Volume 1.

SEC STAFF REPLY

This is in response to your letter of June 23, 1976 concerning the establishment and operation of an Employee Stock Ownership Plan ("ESOP") by the Guaranty Corporation (the "Company") without compliance with the registration requirements of the Securities Act of 1933 (the "1933 Act").

The facts may be summarized as follows: The Company's securities are publicly traded and the Company is a reporting company under the Securities Exchange Act of 1934 (the "1934 Act"). The ESOP has been adopted by the Company and its participating subsidiaries for the benefit of its employees. The ESOP consists of a stock bonus plan and a money purchase pension plan and is intended to be qualified under Sections 401 and 4975 of the Internal Revenue Code. There are no contributions from employees. The money purchase pension plan under the ESOP was adopted as an amendment to the defined benefit pension plan formerly maintained by the Company. The amendment will have the effect of terminating the defined benefit pension plan due to the provisions of the Employee Retirement Income Security Act of 1974 ("ERISA").

Prior to the transference of the assets of the defined benefit plan, the Pension Benefit Guaranty Corporation ("P.B.G.C.") must issue a "Notice of Sufficiency" as to the amount of assets therein. As a condition precedent to the issuance of this notice and such transfer, the P.B.G.C. has requested that each employee having an interest under the pension plan file a written election form whereby the employee elects whether to receive a distribution of the plan assets or has them transferred to the money purchase pension plan under the ESOP.

The assets of the money purchase pension plan will be invested in the common stock of the Company by an independent trustee, the Bank of New Orleans and Trust Company (the "Trustee"). At the time employment is terminated, participants will receive their vested interest primarily in such common stock. Participants in the plan must agree to grant to the ESOP and the Company a right of first refusal on the stock. Further, the Company or the ESOP may grant to participants an option to sell their shares back to the Company or ESOP at its current fair market value.

This Division is unable to concur in your opinion that the election made by each participant whether to receive his vested interests in the assets of the defined benefit pension plan or to transfer these assets to the ESOP to be invested in securities of the Company would not be deemed to involve a "sale" within the meaning of Section 2(3) of the 1933 Act.

Accordingly we are unable to conclude that we would not recommend enforcement action to the Commission if the securities of the Company are offered or sold in the manner proposed without compliance with the registration requirements of the 1933 Act.

LETTERS OF INQUIRY

On behalf of Guaranty Corporation, its participating subsidiaries and the Guaranty Group Employee Stock Ownership Plan ("ESOP"), we request that the staff of the Division of Corporation Finance ("Division") advise us whether it would recommend to the Securities and Exchange Commission that it take action if the Trustee under the ESOP, The Bank of New Orleans and Trust Company, acting pursuant to written election forms from participants as required by the Pension Benefit Guaranty Corporation ("PBGC"), acquires stock in Guaranty Corporation using funds formerly held in a terminated defined benefit pension plan.

GUARANTY CORPORATION

Guaranty Corporation is a Louisiana corporation, as are its two subsidiaries which are participating in the ESOP, Guaranty Broadcasting Corporation and Guaranty Income Life Insurance Co. The shares of stock in Guaranty Corporation are publicly traded in over-the-counter market and Guaranty Corporation is a reporting company under the Securities Exchange Act of 1934.

THE EMPLOYEE STOCK OWNERSHIP PLAN

The ESOP has been adopted by Guaranty Corporation and its participating subsidiaries for the exclusive benefit of their employees. It consists of a stock bonus plan and a money purchase pension plan, and is intended to be qualified under Sections 401(a) and 4975(e)(7) of the Internal Revenue Code.

The money purchase pension plan under the ESOP is adopted as an amendment to the defined benefit pension plan formerly maintained by Guaranty Corporation and its subsidiaries. Under the Employee Retirement Income Security Act of 1974 ("ERISA"), such an amendment has the effect of "terminating" the defined benefit pension plan. In such a situation, the assets under the defined benefit pension plan can be distributed to the participants or transferred to the successor plan (the money purchase pension plan). However, the PBGC must first issue a "Notice of Sufficiency" as to the amount of the assets in the defined benefit pension plan. In this situation it is desired that these assets be transferred to the money purchase pension plan under the ESOP. As a condition precedent to the issuance of the "Notice of Sufficiency" and such a transfer, the PBGC has requested that each employee having an interest under the pension plan file a written election form, whereby the employee elects whether to receive a distribution of the plan assets or have them transferred to the money purchase pension plan under the ESOP.

As part of the ESOP, the money purchase pension plan is designed to invest primarily in stock of Guaranty Corporation. Although the employees will have no investment discretion as to any future employer contributions into the ESOP, the administrative procedure used by the PBGC will have the effect of giving employees an indirect investment decision over the assets transferred from the defined benefit pension plan, in that an employee would be electing to have his assets transferred to the money purchase pension plan under the ESOP, which invests primarily in employer stock.

When a participant terminates employment with Guaranty Corporation or its participating subsidiaries, his vested interest in the ESOP will be distributed to him (or to his designated beneficiary, if the participant is deceased) primarily in common stock of Guaranty Corporation. At the time of the transfer, the ESOP and Guaranty Corporation require the participant to agree to their "right of first refusal" on the stock, and may grant the participant an option to sell his shares back to the ESOP or to Guaranty Corporation at its current fair market value. Transfer of all stock in Guaranty Corporation distributed by the ESOP will be

restricted to transfers permitted under applicable Federal and state securities laws.

In a letter dated September 3, 1975, the Division of Market Regulation of the Securities and Exchange Commission granted an exemption under Rule 10b-6 for the acquisition of Guaranty Corporation stock by Guaranty Corporation and the ESOP.

SECURITIES ACT

It would appear that, consistent with the position which the Division has taken in similar matters that:

1. The acquisition of company stock by the ESOP, the ESOP distribution of company stock to participants and the subsequent repurchase of these shares by the ESOP falls within the policy considerations which have determined that no action be recommended in prior similar situations, without requiring registration of the ESOP or the shares under the Securities Act of 1933; and

2. The PBGC requirement, purely as an administrative matter, that each participant in the former defined benefit pension plan elect whether his assets be distributed to him or be transferred to the money purchase pension plan under the ESOP is not the type of sale which would require registration pursuant to the Securities Act of 1933.

[¶ 80,710] Berger Nechamkin & Associates, Inc.

Securities and Exchange Commission, Division of Corporation Finance, July 9, 1976. (Available August 8, 1976). Correspondence in full text.

Exchange Act—Annual Reports—Advertising of Another Company.—The inclusion of advertising in an annual report is not regulated by the SEC. The annual report to shareholders may be in any form deemed suitable by management.

See ¶ 23,601, "Exchange Act—Registration; Reports" division, Volume 2.

SEC STAFF REPLY

This is in response to your letter of June 21, 1976 which asks our views as to whether an annual report of a public corporation may include advertising of another company.

In general, the federal securities laws require that publicly held companies, those whose securities are registered on a national securities exchange or which have total assets exceeding $1 million, and a class of equity securities held of record by five hundred or more persons, and registered investment companies must furnish an annual report to their shareholders in connection with any annual meeting of their shareholders at which directors are to be elected. Further, the annual report is required to contain certain specified information, including financial statements, a brief description of the corporation's business, and information as to its lines of business and classes of similar products and services.

However, the Commission's rules provide that, subject to the specified requirements, the annual report to shareholders may be in any form deemed suitable by management. In addition, although copies of the report are required to be mailed to the Commission, the report is not deemed to be filed with the Commission.

Accordingly, the inclusion of advertising in an annual report is not regulated by this Commission. Of course, any such advertising, as well as any disclosure in an annual report is subject to the general prohibition in the federal securities laws against fraud and misrepresentation of material facts in connection with the purchase or sale of any security or the solicitation of proxies. In addition, we express no view as to any other possible federal or state regulation affecting such advertising.

LETTER OF INQUIRY

We are an advertising agency that occasionally produces annual reports for public corporations.

We would like to know if an annual report of a public corporation may be permitted to show advertising of another company. As an example, and a completely fictitious one, of course, suppose that XYZ Motors Corporation has on the back cover of its corporate annual report a statement, perhaps accompanied by an appropriate design or logo, from the ABC Oil Corporation that says that XYZ motors function best when ABC oil and ABC oil products are used.

Can this be done within the law?

[¶ 80,711] Morgan Guaranty Trust Company of New York

Securities and Exchange Commission, Division of Corporation Finance, July 28, 1976. (Available August 30, 1976). Correspondence in full text.

Securities Act—Dividend Reinvestment—Registration Not Required.—A proposed plan for holders of receipts representing shares of a foreign corporation to reinvest the distributions on the receipts of cash dividends received from the underlying shares, may be effected without compliance with the registration requirements of the Securities Act, in the opinion of the SEC staff. Under the plan, a holder of the receipts may authorize a trust company to utilize his distributions together with voluntary cash * * *

EXHIBIT B

CADICK, BURNS, DUCK & PETERSON,
Indianapolis, March 3, 1978.

MR. HENRY ROSE,
General Counsel,
Pension Benefit Guaranty Corporation,
Washington, D.C.

DEAR MR. ROSE: On February 21, 1978, I wrote you on behalf of a client who wishes to convert a defined benefit pension plan into an individual account ESOP. On Friday, February 24, I received a telephone call from an attorney on your staff who was kind enough to send me copies of some materials he felt were relevant, which materials I received March 2. These materials consist of reports of two lawsuits against trustees arising out of their causing assets of profit sharing plans to be converted into qualifying employer securities. The balance of the material deals with reports and debates on the Tax Reform Act of 1976 pertaining to TRASOPs.

As you will recall, the question presented in our February 21 letter is whether participants in a defined benefit pension plan must be offered, at the time of the plan's conversion into an individual account ESOP, the option of receiving their interests in the form of deferred annuities rather than continuing to participate in the plan after its conversion into an ESOP. The question is more than academic since the option, if it is given, will require the preparation and use of a prospectus and compliance with the provisions of the 1933 Securities Act. The cost of this compliance has the practical effect of preventing the creation of the ESOP.

With regard to the materials received March 2, I would like to make the following points:

1. A conversion of a defined benefit pension plan or an individual account profit sharing plan into an individual account ESOP can only be done if the conversion is solely in the interest of the participants and beneficiaries and is otherwise in accordance with the fiduciary requirements of ERISA Section 404(a)(1), other than the diversification requirements. Likewise the continued operation of the ESOP is subject to these fiduciary requirements so that if the conversion is in the best interest of the participants but, at some future date, continued investment in qualifying employer securities ceases to be in their best interest, the trustee is under an obligation to cease such investment. The cases of *Usery* v. *Whatley* and *Eaves* v. *Penn* forwarded to me illustrate these points and emphasize that the fiduciary provisions of the Act can be enforced under Section 502(a)(3) by either the Secretary or by any participant, beneficiary, or fiduciary.

2. Since our client's defined benefit pension plan will be terminated in any event, the choice to the employees is whether they will continue to participate in a retirement plan in the future in the form of an ESOP or whether they will not participate in any plan in the future. The decision not to participate in any plan will cause them to lose their share of future employer contributions. Stated most simply, the choice is between something and nothing.

3. The likelihood of a decline in the value of assets held by an ESOP is obviously the same whether the ESOP is created by the conversion of a profit sharing plan or by the conversion of a defined benefit pension plan. No one argues that in the case of a conversion of a profit sharing plan, the employees should be offered annuities equal to the present value of their accounts.

4. The simple fact of the matter is that a pension plan instituted in good faith can be terminated at any time. All that the participants are entitled to under

ERISA in the event of termination is their accrued benefit which cannot be less than the guaranteed portion of their benefit earned to the date of termination. ERISA does not guarantee them the benefit which they would have earned if the plan had remained in effect until their normal retirement age. The conversion of a pension plan into an ESOP does a great deal more for the participants than a mere termination. Through the conversion, the employees will continue to participate in a retirement program and will continue to receive credit towards retirement benefits until they reach normal retirement age.

5. Since the fiduciary duty under ERISA Section 404(a)(1) to exercise due care in the investment of retirement plan assets is the same for ESOPs as for other qualified pension and retirement plans, except for diversification, there is no reason to assume and it is improper to assume that assets in an ESOP will not produce the same appreciation and return as investments in other qualified plans.

6. The legislative history in the materials received March 2 pertains to a proposed addition to the definition of "employee stock ownership plan" in IRC Sec. 4975(e)(7). This additional language would have required an ESOP to give participants the option not to participate. It was not enacted and, to the extent relevant, supports the propositions that Congress does not desire participants to have this option.

We look forward to meeting with you later this month to discuss this matter.

Very truly yours,

CHARLES W. CULP.

EXHIBIT C

CADICK, BURNS, DUCK & PETERSON,
Indianapolis, April 20, 1978.

1933 Act/2(3)
1933 Act/4(2)
1933 Act/3(a)(2)
1934 Act/12(g)(2)(H)
1934 Act/13(e)
1934 Act/14
Investment Company Act/3(c)(11)
Investment Advisors Act/202(a)(11)
Rule 144

SECURITIES AND EXCHANGE COMMISSION,
Division of Corporation Finance,
Washington, D.C.

GENTLEMEN: On behalf of Imaginetics, Inc., an Indiana Corporation ("Imaginetics"), Imaginetics' proposed Employee Stock Ownership Plan (the "Plan"), and Thomas & Skinner, Inc., an Indiana Corporation ("Thomas & Skinner"), we are requesting advice from you to the effect that the Division of Corporation Finance will not recommend that the Commission take any action if shares of the common stock of Imaginetics are acquired, held, and distributed by the Plan to beneficiaries of the Plan as hereinafter described.

DESCRIPTION OF IMAGINETICS

Imaginetics was incorporated September 7, 1977 for the purpose of acquiring the operating assets of Thomas & Skinner. Thomas & Skinner is engaged in the manufacture and sale of permanent magnets and transformer laminations. James C. Skinner and Oramel H. Skinner, Jr., brothers, with their families, own collectively 128,840 shares of the common stock of Thomas & Skinner, representing approximately 88.5 percent of the outstanding shares of that company. Neither James C. Skinner nor Oramel H. Skinner, Jr. is an officer or shareholder of Imaginetics.

Imaginetics' authorized capital stock currently consists of 1,000 shares of common stock without par value. Of these shares, 100 are currently issued and outstanding. These shares are owned by three officers of Imaginetics who are presently officers, directors, and shareholders of Thomas & Skinner. These three will resign as officers and directors of Thomas & Skinner in conjunction with Imaginetics' acquisition of Thomas & Skinner's operating assets.

Imaginetics will obtain the funds with which to purchase the operating assets of Thomas & Skinner through the authorization of additional shares of common stock and their sale to the Plan and to a few individual investors who may also

the shareholders of Thomas & Skinner. The price for the stock will be determined in an arm's length transaction by independent outside appraisers. Additionally, preferred stock will be authorized and issued to Thomas & Skinner and short term debt will be incurred. Approximately $4,000,000 will be raised from these sources.

CONVERSION OF THOMAS & SKINNER PENSION PLANS

Effective December 15, 1940, Thomas & Skinner established qualified defined benefit pension plans for its employees. Following earlier amendments and restatements, the resultant two plans, covering all Thomas & Skinner employees, were amended effective January 1, 1976 to comply with the requirements of the Employee Retirement Income Security Act of 1974 (ERISA).

Effective January 1, 1979, Thomas & Skinner proposes to convert each of these defined benefit pension plans into individual account profit sharing plans qualified under Section 401(a) of the Internal Revenue Code. Under ERISA this conversion has the effect of "terminating" the pension plans. Before the assets of the pension plans can be transferred to the profit sharing plans, the Pension Benefit Guaranty Corporation (PBGC) must first issue a "Notice of Sufficiency" as to the amount of the assets in the pension plans. As a condition precedent to the issuance of the "Notice of Sufficiency" and such transfer, the PBGC will request that each employee having an interest under the pension plans file a written election form in which the employee elects whether to receive his total interest in the plan assets or have it transferred to the profit sharing plans and trusts.

No portion of the assets of the Thomas & Skinner profit sharing plans will be invested in employer securities.

CONVERSION OF THHOMAS & SKINNER'S PROFIT SHARING PLANS AND ASSUMPTION OF THESE PLANS BY IMAGINETICS

In conjunction with the Imaginetics purchase of Thomas & Skinner's operating assets, the employees of Thomas & Skinner will become employees of Imaginetics, and Imaginetics will assume all rights and duties under Thomas & Skinner's two new profit sharing plans. During 1979 these profit sharing plans will be merged and converted into an ESOP (the Plan) effective retroactively to January 1, 1979. Since this conversion and merger involves only individual account plans, it will not be treated as a "termination" by the PBGC, and no election will be granted participants to receive a distribution of plan benefits in lieu of continuing in the Plan.

DESCRIPTION OF THE PLAN

General

A copy of a draft of the Plan, in substantially final form, is attached as Exhibit 1. The assets of the Plan will be held by Merchant's National Bank and Trust Company of Indianapolis, Indiana, as trustee, pursuant to an Employee Stock Ownership Trust Agreement, a copy of a draft of which, in substantially final form, is attached as Exhibit 2.

The assets in the Plan received from the prior two profit sharing plans will be sold and reinvested in Imaginetics common stock. Substantially all future contributions will be invested in such securities.

The purpose of the Plan is to enable the employees of Imaginetics to have the opportunity to share in the Company's growth. The plan is to be administered by a committee (the "Committee") appointed by the Board of Directors of Imaginetics to serve at the pleasure of the Board and without compensation.

Imaginetics will request a determination letter from the Internal Revenue Service that the Plan is qualified under Section 401(a) of the Internal Revenue Code, as amended.

Eligibility

All active participants in the Thomas & Skinner profit sharing plans assumed by Imaginetics will automatically become participants in the Plan. All other common law employees of Imaginetics, other than those covered by collective bargaining agreements not providing for inclusion, will be eligible to participate on and after January 1, 1979, after completing six months of continuous employment. As of January 1, 1978, approximately 174 employees are active participants in the two Thomas & Skinner pension plans, and it is anticipated that approximately this number will participate in the Plan.

Contributions

No participant is required or permitted to make contributions to the Plan. Company contributions are made in amounts determined by the Board of Directors of Imaginetics, not to exceed limits set by ERISA and the Federal Internal Revenue Code.

Employer contributions may be made in Imaginetics common stock, cash, or other property, or any combination thereof, as determined by Imaginetics' Board of Directors. Shares of common stock contributed by Imaginetics will be valued at their fair market value as of the date of contribution. Any cash received by the trustee will, to the extent practicable, be invested in common stock of Imaginetics. All shares purchased will be at fair market value determined as of the preceding December 31 or, in the case of a transaction with a disqualified person (as defined in Section 4975(e) of the Internal Revenue Code), as of the date of the transaction. Pending such investment in employer securities, the trustee may invest in other forms of investment available to corporate fiduciaries.

Voting Rights

All shares of Imaginetics common stock held by the trustees are to be voted in accordance with Committee instructions.

Generally speaking, interests in the Plan vest at the rate of 5 percent per year for the fifth through tenth year of service and at the rate of 10 percent a year for the eleventh through fifteenth year of service. However, if a participant dies or retires under the provisions of the Plan, all amounts in his account become fully vested.

Plan benefits are to be paid solely in common stock of Imaginetics, except financial shares which may be paid in cash. Distributions will be made to the participant or his designated beneficiary if a participant is dead.

Put Option and Right of First Refusal

Participants receiving distributions of Imaginetics common stock from the trustee are to be granted options to put such shares to Imaginetics, and Imaginetics will be obligated to purchase unless the Plan agrees to assume Imaginetics' rights and obligations at the time the put is exercised. The put will remain in effect for a period of 15 months after the shares of stock are distiributed and is to be at the fair market value of such shares as of the preceding anniversary date unless a disqualified person is involved, in which event, fair market value will be determined as of the date of the transaction.

Further, Imaginetics is to have a right of first refusal to purchase shares of its common stock distributed to participants at the greater share of the price set in a good faith written offer by a third party prospective buyer in an arm's length transaction or the fair market value determined as of the immediately preceding valuation date or, in the case of a disqualified person, as of the transaction date.

ISSUES PRESENTED

The Staff is requested to issue a letter stating that no action will be recommended to the Commission as to:

1. Contribution of Imaginetics common stock to the Plan and the Plan's purchase of Imaginetics common stock from Imaginetics and other shareholders without registration under the Securities Act of 1933 (the "1933 Act");

2. Existence of participation interests in the Plan held by each employee without registration of these interests (the "Participation Interests") under the 1933 Act;

3. Existence and operation of the Plan without registration under Section 12(g) of the Securities Exchange Act of 1934 (the "1934 Act");

4. Distribution of Imaginetics common stock from the Plan to participants without registration under the 1933 Act;

5. Issuance of a "put" to participants and maintenance of the right of first refusal by Imaginetics as to distributed Imaginetics common stock without registration under the 1933 Act;

6. Reacquisition of distributed Imaginetics common stock without registration under the 1933 Act and without compliance with the rules relating to acquisition of Imaginetics securities under sections 13, 14, and other applicable sections of the 1934 Act;

7. Existence and operation of the Plan without registration under the Investment Company Act of 1940 (the "Investment Company Act");

8. Operation of the Plan Administrator without registration under or compliance with the Investment Advisor's Act of 1940 (the "Investment Advisor's Act"); and

9. Without characterizing distributed Imaginetics common stock as "restricted securities", the sale or transfer by employees of such stock under the holding period provision of Rule 144.

DISCUSSION

1. Issuance of Imaginetics common stock to the Plan.

The Staff is asked to concur that the PBGC requirement that participants in the Thomas & Skinner defined benefit pension plans elect whether their assets be distributed to them or be transferred to the new profit sharing plans and the subsequent assumption of all rights and duties under the profit sharing plans by Imaginetics and the conversion of such plans into an ESOP (the Plan) does not constitute a sale under Section 2(3) of the 1933 Act and therefore does not require registration under such Act. In this regard, see *Guaranty Corp.* (avail. August 22, 1976), holding that under the facts of that case, a sale within the definition of Section 2(3) did occur.

If the Staff should not concur in the foregoing, Imaginetics will establish the Plan independently of any prior plan of its own or Thomas & Skinner, and no assets of any prior plan will be transfered to the Plan. In such event, we believe transfers of shares of common stock by Imaginetics to the Plan may be effected without complying with the registration requirements of the Act. Neither the trustee of the trust funding the Plan nor Plan participants have any investment discretion: the trustee must accept the transfer and participants are not asked to determine the nature of the investment or amounts credited to their accounts. Hence, such transfers do not constitute "sales" within the meaning of Section 2(3) of the 1933 Act. Moreover, even if such transfers could be deemed sales, we believe that they can be made without registration in reliance on the exemption provided by Section 4(2) of the Act.

In the case of sales of shares of Imaginetics common stock to the Plan by shareholders who did not receive such shares from the Plan, which could occur in the future, in view of the power of the Committee to direct Plan purchases and the fact that there will be only Imaginetics contributions, such sales should be viewed as indirect purchases by an issuer followed by transactions not constituting sales or, if sales, exempt transactions under Section 4(2) of the Act.

For convenience we note that this position is in conformity with the Staff's responses in no action letters issued to *Lionel D. Edie & Company, Inc.* (avail. December 27, 1976); *Texas Eastern Corporation Employee Stock Ownership Plan* (avail. November 29, 1976); *Howmedica, Inc.* (avail. November 26, 1976); *MEKontrol, Inc.* (avail. November 8, 1976); *Pass & Seymour, Inc.* (avail. October 1, 1976); *Advance Machine Co.* (avail. September 27, 1976); *Independent Lumber Co.* (avail. September 16, 1976); *Nielsen Engineering & Research, Inc.* (avail. September 6, 1976); *Southern Saw Services, Inc.* (avail. July 2, 1976); *Swift, Henke & Co., Inc.* (avail. June 10, 1976); *Finnigan Corp.* (avail. May 3, 1976); *Fisk Electric Co.* (avail. December 24, 1975); *DeCouper Industries, Inc.* (avail. December 22, 1975); *Lewis Business Forms, Inc.* (avail. August 11, 1975); *Wegman's Food Markets, Inc.* (avail. April 25, 1975); *LTV Corporation* (avail. April 14, 1974); *Computer Sharing Services, Inc.* (avail. March 4, 1974); and *Republic Gear Industries* (avail. March 31, 1972).

2. *Participation Interests.*

We request the Staff's concurence that Participation Interests in the Plan may be issued without registration under the 1933 Act by virtue of the exemption provided by section 3(a)(2) thereof. We note in that connection that no employee contributions may be invested in employer securities, that the Plan is not a "Keogh Plan" or "H.R. 10 Plan", and that the trust funding the Plan has a "bank" as its trustee. Further we note that the Plan is a qualified profit sharing plan under section 401(a) of the Internal Revenue Code of 1954.

We also ask concurrence that the allocation of assets (including Imaginetics common stock) to participants' accounts and the vesting of interests in the Plan will not constitute a "sale" or an "offer to sell" the underlying securities within the meaning of Section 2(3) of the 1933 Act. These positions are in conformity

with the Staff's responses in no action letters issued to: *Lionel D. Edie & Company, Inc.* (avail. December 27, 1976); *Exxon Corp.* (avail. October 14, 1976); *Pass & Seymour, Inc.* (avail. October 1, 1976); *Advance Machine Co.* (avail. September 27, 1976); *Communications Satellite Corp.* (avail. September 23, 1976); *Independent Lumber Co.* (avail. September 16, 1976); *Nielson Engineering & Research, Inc.* (avail. September 6, 1976); *Amtrol, Inc.* (avail. June 7, 1976); *Kelly Company, Inc.* (avail. April 19, 1976); *Ra-Dis-Co, Inc.* (avail. June 30, 1975); and *Radio Distributing Co., Inc.* (avail. June 21, 1974).

In addition, we ask the Staff's concurrence that, notwithstanding the provisions of section 3(a)(2), registration of Participation Interests is not required under the 1933 Act by reason of the fact that no "security" is involved and that if a security were deemed to be involved, no "sale" of or "offer to sell" that security is involved. These positions are in conformity with the Staff's no action letters issued to: *Northwest Energy Co.* (avail. November 8, 1976); *Hallmark Cards, Inc.* (avail. May 1, 1975); *Cannondale Corp.* (avail. March 3, 1975); *Kirkwood Industries, Inc.* (avail. January 11, 1975); *Computer Sharing Services, Inc.* (avail. March 4, 1974); *Whitfield, Musgrave, Selvy, Kelly and Eddy* (avail. June 22, 1973); *People's Pension Plans* (avail. September 28, 1972); *Spencer Foods, Inc.* (avail. July 28, 1971); and *Indiana Insurance Co.* (avail. May 5, 1971).

3. *Existence and Operation of the Plan.*

We request the Staff's concurrence that the Plan and trust funding the Plan may exist and operate without registration under Section 12(g) of the 1934 Act in accordance with the exemption from registration granted under section 12(g)(2)(H), and that such registration will not be required in the event that its asset level and number of participants exceed those otherwise triggering registration under Section 12. This position is in conformity with the Staff's no action letters issued to: *E. G. Snyder Co., Inc.* (avail. February 12, 1976); *Tampa Electric Co.* (avail. July 7, 1975); *Trust Company of Georgia* (avail. May 22, 1975); *Wegman's Food Markets, Inc.* (avail. April 25, 1975); and *Monsanto Co.* (avail. September 27, 1974).

4. *Distribution of Imaginetics Stock to Participants.*

We request the Staff's concurrence that the distribution of Imaginetics common stock from the Plan to the participants will not constitute a "sale" under Section 2(3) and may be made without registration under the 1933 Act. For convenience we note that this position is in conformity with the Staff's response in no action letters issued to: *Lionel D. Edie & Company, Inc.* (avail. December 27, 1976); *Texas Eastern Corporation Employee Stock Ownership Plan* (avail. November 29, 1976); *MEKontrol, Inc.* (avail. November 8, 1976); *Advance Machine Co.* (avail. September 27, 1976); *Southern Saw Services, Inc.* (avail. July 2, 1976); *Tia Maria, Inc.* (avail. June 25, 1976); *Finnigan Corp.* (avail. May 3, 1976); *Kelly Company, Inc.* (avail. April 19, 1976); *Fisk Electric Co.* (avail. December 24, 1975); and *Monsanto Co.* (avail. September 27, 1974).

5. *Issuance of a "Put" and Right of First Refusal.*

We request the Staff's concurrence that a "put" may be issued to a participant or a right of first refusal retained by Imaginetics as to the distributed Imaginetics common stock without registration under the 1933 Act. This position is in accord with the Staff's no action letters issued to: *Underground Construction Co.* (avail. October 18, 1976); *Groth Equipment* Corp. (avail. September 16, 1976); *Southern Saw Services, Inc.* (avail. July 2, 1976); *Kelly Company, Inc.* (avail. April 19, 1976); *N. C. Ribble Co.* (avail. March 10, 1976); *Kirkpatrick, Pettis, Smith, Polian, Inc.* (avail. March 1, 1976); and *Fisk Electric Co.* (avail. December 24, 1975).

6. *Reacquisition of Distributed Imaginetics Common Stock.*

The Staff is asked to concur that Imaginetics may reacquire distributed Imaginetics common stock without registration under the 1933 Act and, even if the Plan were registered under the 1934 Act, without compliance with the rules relating to acquisitions of company securities under Sections 13(e), 14, and other applicable sections of the 1934 Act. This position is in conformity with the Staff's response in a no action letter issued to *Amtrol, Inc.* (avail. June 7, 1976).

7. *The Investment Company Act.*

The Staff is asked to concur that the Plan and trust funding it may exist and operate without registration under the Investment Company Act pursuant to the exemption granted in Section 3(c)(11) thereof. This position conforms with the Staff's responses in no action letters issued to: *Long Island Lighting Co.* (avail. November 5, 1976); *Consolidated Edison Co. of New York* (avail. October 31, 1976); *Monsanto Company* (avail. October 21, 1976 and September 27, 1974); *Columbia Gas System, Inc.* (avail. October 13, 1976); *Tia Maria, Inc.* (avail. October 13, 1976); *National Industries, Inc.* (avail. May 6, 1976); *Finnigan Corp.* (avail. May 6, 1976); *E. G. Snyder Co., Inc.* (avail. February 28, 1976); *N. C. Ribble Co.* (avail. February 13, 1976); *Fisk Electric Co.* (avail. January 7, 1976); and *WaWa, Inc.* (avail. aJnuary 2, 1976).

8. *The Investment Adviser's Act.*

The Staff is asked to conquer that the Committee as plan administrator will not be required to register under or comply with the Investment Advisor's Act. This position is in substantial accord with the interpretation of Section 202(a)(11) contained in Reg. § 275.202-1 (added in Release No. IA-503, March 12, 1976).

9. *Sale or Transfer of Distributed Imaginetics Common Stock by Participants.*

In a number of recent no action letters, the Staff has taken the position that the employer securities distributed to employees by an employee benefit program are "restricted securities" within the meaning of Rule 144. See e.g., *G. C. International, Inc.* (avail. October 19, 1975); *Hunter Corporation* (avail. September 27, 1975); and *Crown City Plating Co.* (avail. August 25, 1975.) Without necessarily agreeing with the Staff's position in this regard, we would appreciate advice from you relating to the holding period provisions of Rule 144 as applied to the Plan.

A. *Tacking of Holding Period.*

As previously indicated, a participant's interest in his account in the Plan vests in accordance with a formula over 15 years and becomes fully vested at the time of death, disability, or retirement, if certain service requirements are met. To the extent that interests vest, they are not forefeitable for any reason. It appears to us that upon receipt of shares of common stock from the Plan, a participant should be able to tack the holding period of the Plan for purposes of Rule 144(d) to the extent of any vested interest in his account (and thus shares). This would mean, for example, that shares, which are non-forfeitable, which were distributed to a participant more than two years after becoming non-forfeitable, should be deemed held by the participant for at least two years at the time of distribution to him. Further, it appears to us that in such a case, a participant ought to be able to disregard the identity of specific shares received by him. Hence, if he received 150 shares as a Plan benefit, of which 50 had been held by the Plan on a vested basis for at least two years, he should be able immediately to sell any 50 of such 150 shares under Rule 144 (if the other conditions of the Rule were satisfied). We would appreciate advice from you as to whether you concur in our conclusions.

B. *Put Option.*

Rule 144(d)(3) provides in substance that the required holding period excludes periods during which the holder has a put or other option to dispose of equity securities of the same class. While it is true that the Plan provides for a "put" to each participant in respect of common stock distributed to him, the period of the put does not commence until such distribution. Hence, it appears to us that any "tacked" holding period of the Plan should run without regard to the put so that shares distributed and having a "tacked" two-year holding period would be immediately eligible for sale under Rule 144 (assuming the other conditions of the Rule could be satisfied). We would appreciate advice from you as to whether you concur in this opinion.

CONCLUSION

On the basis of the foregoing, we would appreciate your advice that the Staff will not recommend to the Commission that any action be taken if the Plan and trust funding the Plan are operated in the manner previously described without compliance with the various registration requirements.

Very truly yours,

CHARLES W. CULP,
Special Counsel for Imaginetics, Inc. and Counsel for Thomas & Skinner, Inc.

EXHIBIT D

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C. June 22, 1978.

Re Imaginetics, Inc.

CHARLES W. CULP, Esq.,
Cadick, Burns, Dush & Peterson,
Union Federal Building,
Indianapolis, Ind.

DEAR MR. CULP: This is in response to your letter of April 20, 1978 and subsequent telephone conversations with a member of the staff, in which you raised certain questions regarding the application of various provisions of the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act") to the Employee Stock Ownership Plan of Imaginetics, Inc. (the "Company"). Your questions with respect to Section 3(c)(11) of the Investment Company Act and Section 202(a)(11) of the Investment Advisors Act have been referred to the Division of Investment Management for their consideration and separate response.

We understand the material facts, as more fully set forth in your letter, to be as follows. The Company was incorporated in 1977 for the purpose of acquiring the operating assets of Thomas & Skinner, Inc. ("Thomas & Skinner"), an Indiana corporation engaged in the manufacture and sale of permanent magnets and transformer laminations. James C. Skinner and Oramel H. Skinner, Jr., with their families, own collectively 128,840 shares of the common stock of Thomas & Skinner, representing approximately 88.5% of the total stock presently outstanding. Neither James C. Skinner nor Oramel H. Skinner, Jr. is an officer or shareholder of the Company.

The Company's authorized capital stock consists of 1,000 shares of no par common stock, of which 100 shares are currently issued and outstanding. These shares are held by three officers of the Company who are presently officers, directors and shareholders of Thomas & Skinner.

On December 15, 1940, Thomas & Skinner established qualified defined benefit pension plans for its employees which were amended on January 1, 1976 to comply with the requirements of the Employee Retirement Income Security Act of 1974 ("ERISA"). Effective January 1, 1979, Thomas & Skinner proposes to covert the defined benefit pension plans into individual account profit sharing plans qualified under Section 401(a) of the Internal Revenue Code. The conversion will have the effect of terminating the defined benefit plans under the applicable provisions of ERISA.

Prior to the transferance of the assets of the defined benefit plan, the Pension Benefit Guaranty Corporation ("PBGC") must issue a "Notice of Sufficiency" as to the amount of assets therein. As a condition precedent to the issuance of this notice and such transfer, the PBGC will request that each employee having an interest under the pension plans file a written election form whereby the employee elects whether to receive his total interest in the plan assets or have them transferred to the profit sharing plan or trusts. No portion of the assets of the Thomas & Skinner profit sharing plans will be invested in employer securities.

In conjunction with the purchase of Thomas & Skinner, the Company will assume all rights and duties under Thomas & Skinner's new profit sharing plans. The profit sharing plans will be merged and converted into an Employer Stock Ownership Plan (the "Plan") effective retroactively to January 1, 1979. Since this conversion and merger involves only individual account plans, it will not be treated as a "termination" by the PBGC, and no election will be granted participants to receive a distribution of profit sharing plan benefits in lieu of continuing in the Plan.

The Plan, intended to qualify under Section 401(a) of the Code, calls for the Company to make contributions in either stock or cash to the Plan Trustee (the "Trustee"),' an independent bank not in any way affiliated with the Company. Cash contributions received by the Trustee for the accounts of the employees will be invested primarily in Company stock, with purchases to be made directly from the Company and/or shareholders at a price not to exceed the fair market value. Assets in the Plan received from the prior two profit sharing plans will be sold and reinvested in the Company's common stock. The Trustee will establish and maintain a separate account for each participant who: (a) was a participant in the prior profit sharing plan, and (b) elected, in writing, to transfer his interest from a predecessor defined benefit plan to a profit sharing plan (the

"merger account"). Employees will neither be required nor permitted to contribute to the Plan.

The Plan will be administered by a committee composed of three persons appointed by the Board of Directors to serve without compensation at the pleasure of the Board (the "Committee"). The Committee will have the authority to determine and direct the voting or exercising of any right or power involving Company stock held in the trust fund.

Each participant's account becomes fully vested after fifteen years of completed service or upon their retirement, death or disability. Amounts in a participant's merger account, if any, shall be one hundred percent vested at all times. Distribution of plan benefits will be in the form of a lump sum payment of common stock with fractional share interests to be paid in cash. However, the Committee may, in its sole discretion and after consulting with the participant or beneficiary, if it so desires, distribute Plan benefits in substantially equal annual, semi-annual or quarterly installments over a period not to exceed ten years. Withdrawals of Plan benefits prior to termination of a participant's employment are not allowed.

The Company's common stock distributed as Plan benefits will bear restrictive legends permitting public resales only in accordance with the Securities Act and the rules and regulations promulgated thereunder. Participants will be granted options at the time of distribution to require the Company or the Pan to purchase the distributed stock for fair market value, as determined under the Plan. In addition, the Company will retain the right of first refusal prior to any sale by a participant.

You request that the Division concur in your opinion that the PBGC requirement that participants in the Thomas & Skinner defined benefit pension plans elect whether their assets be distributed to them or be transferred to the new profit sharing plan does not constitute a "sale" under Section 2(3) of the Securities Act. Based on the facts presented, we are unable to concur in your opinion that the election made by each participant whether to receive his vested interests in the assets of the defined benefit pension plans or transfer these assets to the profit sharing plans for a subsequent conversion of the assets to the Plan, to be invested in securities of the Company would not be deemed to involve a "sale" within the meaning of Section 2(3) of the Securities Act. Accordingly, we are unable to conclude that we would not recommend enforcement action to the Commission if the Plan is implemented as described without compliance with the registration provisions of the Securities Act.

Alternatively, you have raised questions relating to the applicability of the registration requirements of the Securities Act and the Exchange Act to: (a) shares of stock purchased by the Trustee from the Company or its shareholders, (b) interests in the Plan created by the allocation of shares so acquired to accounts of the participants, and (c) distribution of such shares to such participants made in accordance with the terms of the Plan, if the Plan is established independently of any prior plan of the Company or Thomas & Skinner, and no assets of any prior plan will be transferred to the Company's Plan. Based on these facts, without agreeing that no sale is involved as defined in Section 2(3) of the Securities Act, this Division will not recommend any enforcement action to the Commission if interests in the Plan are granted, Company shares issued and distributed pursuant to the Plan and sales of shares to the Plan by Company shareholders are made without compliance with the registration requirements of the Securities Act in reliance upon your opinion as counsel that such transactions are exempt therefrom, provided the Plan acquires such shares solely with an intention to hold and distribute them to participants pursuant to the terms of the Plan. Further, his Division will raise no objection if Plan participants sell stock received pursuant to the Plan back to the Plan or the Company without compliance with the registration requirements of the Securities Act, in reliance upon your opinion as counsel that such transactions are exempt therefrom. In addition, we will raise no objection if interests in the Plan are not registered under the Exchange Act, in reliance upon your opinion as counsel that registration is not required.

It should be noted that in our view, Plan participants will be deemed to have acquired "restricted securities" within the meaning of Rule 144 under the Securities Act. Public resale of such securities must be made either pursuant to an effective registration statement or in accordance with the terms of Rule 144, including the two year holding period. It is the view of this Division that the two-year holding period required by Rule 144(d)(1) would not begin to run

until the participant's interest in the shares becomes fully vested and may not be forfeited. Once vesting occurs, the fact that the vested shares are held by the Trustee will not prevent the commencement of the holding period. The period granted to participants to "put" the shares back to the Plan will toll the two-year holding period if it has not run prior to the distribution of the shares.

Because this position is based upon respresentations made to this Division in your letter, it should be noted that any different facts or conditions might require a different conclusion. Further, this letter only expresses the Division's position on enforcement action and does not purport to express any legal conclusions on the questions presented. Moreover, this position is taken without any determination whether the terms of the Plan comply with the provisions of other applicable laws, such as ERISA.

Sincerely,

RICHARD K. WULFF,
Attorney Adviser.

J. C. PENNEY,
August 15, 1978.

Re S. 3241—Expanded Employee Stock Ownership Act of 1978
Hon. RUSSELL B. LONG,
Chairman, Committee on Finance, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: The J. C. Penney Company is pleased to submit its written comments in support of S. 3241, the "Expanded Employee Stock Ownership Act of 1978."

The Company is a major employer in the retailing industry, with more than 180,000 employees in over 2,000 stores throughout the United States. For many years, the Company has maintained employee benefit plans, such as a qualified savings and profit sharing plan, that are invested, in whole or in part, in Company stock, thus providing its employees with the opportunity to share in Company ownership.

Under current law, the annual amount contributed to a Tax Reduction Act ESOP by an employer is limited to 1% of the employer property eligible for the investment tax credit for the year. The investment tax credit is geared to manufacturing and similar capital intensive industries with a heavy investment in equipment and machinery. Retailers, on the other hand, have relatively more of their investment dollars devoted to buildings and to other assets which, for the most part, do not qualify for the investment tax credit. Retailers are thus handicapped in establishing ESOPs under current law: a relatively small benefit (tied to the amount of investment tax credit) must be spread among a relatively large number of eligible employees. Under current rules, it is impossible for labor-intensive employers to provide their employees with a meaningful ESOP benefit.

As part of a labor-intensive industry, the Company particularly welcomes S. 3241's recognition of payroll as a measure of the tax credit available to fund such plans. By permitting an employer a credit for contributions to an ESOP equal to a percentage of the aggregate participant compensation paid by the employer, S. 3241 would enable labor-intensive industries to consider favorably the benefits of an ESOP for their employees.

In addition, employers would derive a benefit from such plans as well. S. 3241 would assist in the desirable goal of capital formation by permitting employers to increase their equity capital base on an annual basis over the life of the plan. Thus, the bill would provide a welcome option for companies that have, in the current economic climate, found it difficult to raise additional equity capital.

Finally, the increased employee benefits derived from an ESOP established under S. 3241 could be achieved on a non-inflationary basis. The deferred distribution feature contained in the bill would not create immediate additional disposable income for employees and, because the employer could provide these ESOP benefits at little or no additional cost, there would be no increase in labor cost to trigger an employer price increase.

For all the foregoing reasons, the Company believes that the Committee should favorably report S. 3241.

Respectfully submitted,

DONALD V. SEIBERT.

Statement of the American Gas Association

On behalf of the American Gas Association and its 300 member natural gas transmission and distribution companies, the following written statement is submitted for the record in support of the Expanded Employee Stock Ownership Act of 1978 (S. 3241).

A.G.A. is the national trade association for that portion of the gas industry which delivers natural gas from producers to final end-users. Approximately 43 million homes, businesses, and industrial facilities in all 50 states are served with natural gas. The distribution company members of the Association serve 93% of these customers.

A recent study conducted in April, 1977 sponsored by the A.G.A. Gas Industry Finance Committee indicated that 49 A.G.A. member companies out of 119 surveyed had established an Employee Stock Ownership Plan (ESOP) under the Tax Reduction Act of 1975. Of those 49 plans, 35 provided for participation in the plan by all employees, and 15 of the 49 indicated plans to provide for matching contributions by employees beginning in 1977 (the additional one-half percent investment tax credit). Regarding stock issued under the ESOP, 23 companies used outstanding stock issues and 27 used stock authorized, but not previously issued.

Since the April, 1977 survey, many more plans have been implemented and more are under consideration within the gas industry. There is also greater use of unissued stock. The equity which has accrued on an annual basis to gas industry employees through these plans has grown significantly. The revisions in current law offered under S. 3241 are expected to expand that ownership further.

For this reason, the gas industry endorses S. 3241 as an appropriate measure to expand the use of ESOPs and extend their benefits to additional corporate employees. This is an important consideration at a time when the gas industry faces massive capital formation requirements within the next decades to finance necessary supplemental gas supply projects, such as LNG, coal gasification and the Alaska pipeline. The increased credit based on investment will expand employee ownership while providing an important source of capital for meeting these capital requirements that the gas industry faces.

A.G.A. wishes to offer the following specific comments on S. 3241 for the Committee's consideration:

A.G.A. strongly supports the 2 percent employee contribution provisions which should remove the source of substantial administrative problems for ESOPs.

A.G.A. strongly favors abolition of the ½ percent employee contribution provisions which should remove the source of substantial administrative problems for ESOPs.

A.G.A. urges the Committee to ensure that the new rules under S. 3241 conform to existing requirements under Section 401 of the Internal Revenue Code. A.G.A. also recommends that the legislation and the legislative history be sufficently specific so that the Treasury/IRS cannot limit the expression of Congressional intent regarding ESOPs by implementing regulations.

PERMANENT INCREASE IN THE CREDIT BASED ON INVESTMENT

The increase in the credit based on investment to 2 percent will provide a strong incentive making ESOPs more attractive to American corporations. S. 3241 also takes a major step to broaden employee ownership of stock in labor-intensive corporations by providing an alternative investment tax credit based on company payroll. This provides additional flexibility and broadens the appeal of ESOPs to labor-intensive as well as capital-intensive industries.

A.G.A. also emphasizes that the increase in the credit to 2 percent must be made permanent. For the additional investment credit for ESOPs to achieve maximum effect, it must be made a permanent part of the tax laws to provide a stable environment for American industry and the financial community to plan and carry out capital expenditure programs that may be partially financed by ESOPs. One of the inhibiting factors in estbalishing ESOPs in the past has been the limited life for these plans under current law.

ABOLITION OF ONE-HALF PERCENT EMPLOYEE CONTRIBUTION PROVISIONS

A.G.A. also urges this Committee to abolish the one-half percent employee contribution provisions for ESOPs enacted in the Tax Reform Act of 1976. This would remove a source of substantial administrative problems and would effectively ensure that maximum advantage can be taken of the ESOP. The Com-

mittee should also consider permitting the company to refund prior employee contributions made under these provisions. This would remove many of the past problems associated with the one-half percent employee contribution provisions and contribute towards simpler administration of the ESOP.

CONFORMING REQUIREMENTS UNDER SECTION 401

Finally, the Committee should take steps to ensure that the new rules enacted under S. 3241 conform to existing requirements under Section 401 of the IRC governing qualified pension, profit sharing, and stock bonus plans. The tax consequences of a non-qualified plan vary from those of a qualified plan. Considerable problems have occurred in the past regarding when a plan had to be in effect in order to qualify under Section 401. Ensuring conformity with Section 401 would effectively assure minimal disruption of ESOPs currently in effect.

Also, the history of Treasury/IRS regulations to implement the ESOP provisions of the Tax Reduction Act of 1975 and the Tax Reform Act of 1976 reflects a serious limitation of Congressional intent involving broad ownership of company stock by employees through ESOPs. In an effort to avoid this problem, as this Committee considers S. 3241, A.G.A. respectfully urges that the legislation be sufficiently specific to ensure that the Treasury/IRS cannot limit the expression of Congressional intent regarding ESOPs by its implementing regulations. In the alternative, the legislative history of this bill should express the Committee's dissatisfaction with prior regulations governing ESOPs and urge the Treasury/IRS to develop and interpret regulations governing ESOPs in a non-restrictive manner.

CONCLUSION

The gas industry strongly supports the ESOP concept and current efforts before this Committee to expand and broaden the appeal of the ESOP. We thank this Committee for the opportunity to submit this written statement for the record, and would be pleased to provide any additional information this Committee may require.

STATEMENT OF RICHARD M. RASHMAN, TRUST COUNSEL, UNION BANK, LOS ANGELES, CALIF.

Mr. Chairman and members of the committee: I am Trust Counsel for Union Bank, a California Bank which has been one of the leading trustees of ESOPs for a number of years. In fact, Union Bank may still be the only major commercial bank which is active in the ESOT field. We maintain a strong interest in ESOTs and have seen a great many successful plans established. Therefore, we support and commend your efforts to promote ESOTs and to expand employer stock ownership. We believe that your new proposals would go far toward encouraging a number of substantial companies to adopt these plans.

Beyond supporting current legislation to encourage new ESOTs, we would like to comment on ways to deal with current problems with existing ESOPs. Our greatest concern is not just interference from agencies regulating ESOPs, or a need for higher benefits, but rather the general uncertainty which pervades this field. As long as companies and fiduciaries are unsure of the law governing these plans and of the risks incumbent with adopting them, it is difficult to expand their use regardless of the benefits.

We would like to cite some specific areas as examples of where further guidance would be helpful. This could be in the form of additional statute, committee report or regulation. As a background, let me say a few words first about Union Bank's own ESOT policies and our view of the law in this area. First, we are unsure of the type of prudency test to be applied to ESOTs under ERISA, but we assume that some form of prudency test is mandated. Thus, we have a special committee of top trust division officers from the legal, investment, employee benefit and general trust management areas which review our ESOTs on a continuing basis to evaluate the prudency of investing in company stock. Aside from fulfilling our own fiduciary responsibility, we believe that this kind of extensive, continuing and independent review provides an important level of protection to the company and other fiduciaries. Second, we are concerned about the type of financial information that can be relied on in making these financial judgments. To be sure we can adequately meet our responsibility, we have decided to only trustee ESOTs for companies that provide certified financial statements. Third, we believe that the most

critical decision is that of company stock price. In addition to requiring an independent valuation of company stock, we subject the valuation to a review by a second independent valuation firm at our own expense. Fourth, we have closely followed the emerging discussion of federal securities laws as they relate to ESOTs and pay particular attention to issues raised by registration, proposed SEC Rule 13(e)(2) and Rule 144.

In light of this discussion, we would suggest that a first important area requiring more guidance is company stock investment. Most would agree that the prudency test as applied to ESOPs is unclear. Beyond this, there are serious questions of what a fiduciary should do if it believes that company stock investment is imprudent. Stock sales or failure to invest in stock may contradict the terms of the plan and trust and subject the trustee to state law damages. The trustee may have investment discretion but be required by the trust to hold stock. Or, the trustee may be directed to buy and hold stock by a committee. What is a trustee to do? Should he resign, go to court to force a change in the trust or committee directions, inform the Internal Revenue Service, or just inform the company of its conclusions. In the absence of further federal guidance on such questions, we feel that the law in this area will be established by a cross pattern of state and federal court decisions which may only further confuse the problem and drive more companies and fiduciaries away from ESOTs.

Second, the application of federal securities laws is a growing concern for all fiducaries and ESOT companies. Rather than let these many questions be answered piece-meal, if at all, through SEC and judicial deliberations, it would make more sense for the Congress to take a hard look at this problem and make a decision about what restrictions and requirements should be applied to ESOPs and pension plans in general. One answer is that pension plans be exempted from the securities laws with a overlay of additional pension law requirements if necessary to prevent abuses. If the current securities aws were technically and fully applied to ESOPs by the SEC, there seems little question but that ESOPs would become a practical impossibility. Further, we must pay increased attention to the application of state securities laws, assuming they will not be preempted by ERISA. Back in California, the Department of Corporations is currently considering regulations subjecting ESOPs to stock permit requirements which would make it very difficult for California ESOTs to continue.

Third, we believe that more guidance should be given on the question of conversions. Current IRS regulations suggest that conversions of assets of prior plans are allowable, although they must still be subjected to fiduciary considerations. At Union Bank we will not allow conversions unless each employee can elect whether his individual account should be converted. This is because of the fiduciary questions involved and because of our belief that an employee's interest in a diversified plan should not be mandatorily converted to company stock. However, since such elections might mandate a federal securities law registration, it becomes impractical for most companies to undergo new types of conversion under our policy. We believe the Congress should make a determination as to whether conversions are or are not to be allowed. Either they should be prohibited altogether or, alternatively, the umbrella of fiduciary risk should be removed and they should be specifically authorized so that the fiduciaries can proceed.

As a final comment, we would like to point to the problem of dealing with public companies where stock is thinly traded. There is a real question in such cases of whether fiduciaries should use the market price, an independent valuation, or some other device to determine fair market value. Perhaps the best means of establishing value in these cases would be "reverse tender offers" where the trustee invites bids from prospective sellers. The trustee can then proceed to buy up its needed shares beginning with the lowest prices tendered so that this reverse tender offer establishes a true market place. However, in the cases where we have expressed interest in such a procedure the SEC has not allowed it. Thus, we must struggle along and make an imperfect choice between a thinly and perhaps a questionable market versus an independent valuable which might differ from the actual market price.

Mr. Chairman, let me thank you again for this opportunity to testify and to express some of our concerns and proposals. Union Bank expects to continue its active involvement with ESOTs and certainly appreciates your strong interest and assistance in the field.

TRW, INC.,
Cleveland, Ohio, August 15, 1978.

Hon. RUSSELL B. LONG,
U.S. Senate,
Washington, D.C.

DEAR SENATOR LONG: TRW wholeheartedly endorses your bill, S. 3241, "Expanded Employee Stock Ownership Act of 1978", as a means of enabling additional corporations to implement an ESOP for the benefit of employees. We particularly support the provisions which will allow labor intensive corporations, such as TRW, to determine its ESOP contributions based on participants' compensation, as we have been unable to develop a meaningful plan for our employees based on the investment tax credit.

We have one suggestion, which we believe would further enhance the possibility of corporations such as ours adopting ESOPs. We urge you to modify the requirement that one half of the securities which are transferred to an ESOP must be stock not previously issued. We suggest that in place of this requirement, publicly traded corporations be allowed to either transfer unissued stock to an ESOP or to contribute cash which will be used by the ESOP trustee to purchase stock on the open market.

We would be glad to discuss our endorsement and comments on the bill with you or a member of your staff. TRW also intends to inform other members of Congress and other interested employers of our support for your bill.

Sincerely yours,

J. E. DUNLAP,
Vice President, Human Relations.

STATEMENT OF GEORGE A. STRICHMAN, CHAIRMAN, COMMITTEE TO REFORM DOUBLE TAXATION OF INVESTMENT

This statement is submitted on behalf of the COMMITTEE TO REFORM DOUBLE TAXATION OF INVESTMENT, an organization of over 830 corporate members (representing over 31 million shareholders) and 10,000 individual members. In addition, 8,000 other interested persons participate in the Committee's informational services.

We commend Chairman Long for his commitment to the concept of Employee Stock Ownership Plans (ESOPs). We believe the hearings of the Senate Finance Committee on the subject can contribute significantly to the improvement of Federal tax laws as they affect the organization and viable operation of such plans.

I strongly advocate the ESOP concept and urge, as a matter of practical desirability, the increase now of from one to two percent.

The objective of our Committee is to support the phase-out of the present inequitable and economically burdensome double taxation of corporate earnings, and I take this opportunity to point out the significant relationship between employee stock ownership and double tax relief. Chairman Long's bill to stimulate the creation of ESOPs recognizes this relationship. In addition to the features designed to facilitate the acquisition of stock by employees, it proposes to allow ESOP corporations to deduct dividend payments made to employee shareholders, pursuant to Section 416(a)(9) of the Tax Code. This would effectively eliminate the double tax with respect to ESOP-qualified, employee-owned securities. This obviously would make the prospect of stock ownership much more attractive in terms of the company's after-tax earnings.

But to alleviate the double tax inequity for only one type of ownership would result in the creation of a "previleged" corporate class with ongoing competitive advantages over other businesses in their field. The only other for-profit corporations which now escape double taxation are those organized under Subchapter S. The severe limitations of Subchapter S and its potential adverse impacts on shareholders generally have limited its application to very small, individually-owned or family-owned corporations.

ESOP, however, is intended to apply to corporations of any size . . . some of which will have a significant share of the market for their products. To grant a benefit not available to competitors would be contrary to the concept of tax equity.

Other incentives in Chairman Long's bill are more directly related to the establishment of ESOP's. These are: The two percent additional investment credit which the corporation is to contribute to the employee stock ownership fund, the elimination of the employees' matching contribution requirements, the extension of the tax credit to labor-intensive businesses, and improvements in treatment of employee retirement benefits.

The across-the-board elimination of the double tax would undoubtedly encourage broader interest in stock ownership plans. Certainly, it would be more beneficial to our economy as a whole and more equitable if needed relief from double taxation were extended to all corporate ownerships.

Many studies by economists and tax experts—some of them commissioned by our Committee—have demonstrated that the double tax is both inequitable and economically inefficient. Its repeal is justified on those grounds and on the basis that it would constitute a significant step toward ensuring the future economic prospects of all productive elements of our economy. These studies indicate that even a phase-in elimination of the double tax would substantially increase GNP, business and personal savings, business investment, real personal income, and employment. Initial revenue losses would be offset in later years by revenue gains resulting from increased business and investment activities. Virtually every other industrialized nation has recognized these benefits and has incorporated double tax reduction or elimination into its tax system.

Finally, we believe that the ultimate success of employee-owned corporations is contingent upon the same economic management factors as publicly-held or closely-held corporations. These factors are: The overall vitality of the U.S. economy, the maintenance of a strong competitive marketplace, the stimulation of capital formation, and the wise use of such capital to improve productivity and innovation. Of one or more of these factors is missing, we all lose.

The Committee to Reform Double Taxation of Investment urges, therefore, that Congress take steps to alleviate the stifling burden of double taxation on all for-profit corporations. We believe that such action, along with provisions specifically designed to make possible the acquisition of stock by employees, would better stimulate the development of ESOP's and would make their future more secure by creating a better economic climate in which to grow and prosper.

We support the improvement of the Employee Stock Ownership Plans which is contained in the Chairman's bill as a proposal worthwhile of enactment now but would strongly urge its strengthening by full elimination of double taxation of corporate dividends with respect to ESOP and non-ESOP companies.

AMTROL, INC.,
West Warwick, R.I., August 10, 1978.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Washington, D.C.

DEAR MR. STERN: It was interesting to note that hearings were held on Wednesday, July 19, and Thursday, July 20, 1978, relative to Employee Stock Ownership Plans (ESOP). Our ESOP was adopted in 1975, and since our experience has been positive over the last three years, we wish to submit written testimony for the Committee record.

Enclosed you will find a packet of material (5 sets) which contain the following:

1. Memorandum from the individual in our company who coordinates the personal annual meeting with all employees and supervises and directs our entire employee benefit package (M .E. F. Almon).
2. A memorandum which outlines the retirees and distribution of AMTROL stock for the years 1975–76–77.
3. A representative individual account report which is submitted to each employee on an annual basis during their personal interview.
4. A copy of the AMTROL ESOP pamphlet which is distributed to each new employee.
5. An AMTROL Employee Financial Report, a copy of which is mailed to the employee's home annually. This report is prepared especially for our ESOP participants.

6. A report outlining the stock ownership of AMTROL as of August, 1978. You will note that this report indicates that ESOP ownership of AMTROL shares is approximately 20% in just three years. In addition, noted on this report are six (6) shareholders who received their stock under our Employee Stock Ownership Plan and retained it rather than exercise the PUT which was issued to them at the time of distribution.

In closing, we wish to state that all of our Employee Shareholders recognize the benefits of the ESOP, and we are continually trying to improve their understanding through education and communication. Our experience has been excellent, our contributions for the three years since its adoption have been the maximum allowed by law (i.e., 15% of total eligible compensation), and we expect to enjoy the benefits of the strong relationship that develops between a company and its employees under the ESOP concept.

We are pleased to be able to participate in the Senate hearings.

Very truly yours,

A. N. D'AMICO,
Vice Chairman of the Board.

Enclosures

AMTROL INC.,
West Warwick, R.I., August 4, 1978.

To: C. H. Kirk and A. N. D'Amico.

From: E. F. Almon.

Subject: AMTROL employee stock ownership plan.

The presentations to participants of the AMTROL Inc. Employee Stock Ownership Plan have been proceeding as scheduled and the time is appropriate to report to you on the following:

1. The progress of the presentations to individuals and groups.
2. The type of information the presentations attempt to disseminate.
3. The reaction of participants to the presentation.

1. Progress of the presentations to individuals and groups

Following our previous policy, we have made group presentations to every U.S. employee of AMTROL.

The individual one-on-one interviews presenting the Report to the participant are about two-thirds complete. There are now 529 participants in the Plan so the magnitude of the task is apparent. However, the work is nothing compared to the positive reaction on the part of each participant to be able to sit down with an officer of the Company. Much of the positive results of the program would be lost if we made a simple mailing of the Reports because:

1. The printed word is losing much of its impact and is an area in which the average employee often feels inept.
2. A mailing is a unilateral form of communication and does not encourage any dialogue or input from the employee.
3. The employee is made to feel that he belongs when someone takes the time to sit down with him to discuss the Company and his personal position in it.

2. The type of information the presentations attempt to disseminate

A. Group Presentation: This presentation made to every U.S. employee had three main objectives:

1. A showing of the film "60 Minutes" providing everyone with an excellent background of the philosophy of ESOP.
2. A review of the status of the Trust Fund.
3. A review in detail of the 1977 Financial Report.

This is followed by a question and answer period during which we refer to the handbook.

B. Individual Presentation: A very detailed review of the employee's position in the Plan. (See attached example).

3. Reaction of participants to the presentation

I feel that there is a much better understanding of the ESOP this year because:

1. The Plan has now been in effect for three-years.
2. The film "60 Minutes" was worth showing again and especially beneficial to those who were not here at the outset of the Plan.
3. The employees are aware that retired participants have received substantial benefits. (See attached)

There has been a very definite improvement in the morale of the employees. This is evident in conversations in which the word "THEY" is seldom used when referring to management. Most employees now use the word "WE" when discussing AMTROL.

There has been a definite increase in efficiency as shown by the reduction in manufacturing costs to 71.3% from 72.9%.

There has been improvement in attendance as reported by Personnel. The employees want the Company to prosper and realize that they share in the ESOP contributions as a percentage of their gross pay.

The physical appearance of the Plant, while previously good through the efforts of the management, is now just as good and it is maintained this way at less expense because each employee has a sense of ownership.

We have put a lot of time, money and effort into the ESOP at AMTROL, but I'm convinced that it is paying off in improved morale, increased efficiencies and a general feeling that everyone at AMTROL has a "Piece of the Action."

EXHIBIT 2

JULY 1978

AMTROL INC.
West Warwick, R. I.

ESOP DISTRIBUTIONS

RETIREE	NO. OF SHARES	PRICE	STOCK VALUE	FRACTIONAL SHARE	TOTAL	EXER. PUT
RETIRED 1975 — DISTRIBUTION 1976						
John Belham	943	$9.00	$ 8,487.00	$ 8.25	$ 8,495.25	YES
Fred Mikkelsen	231		2,079.00	8.70	2,087.70	YES
David Charter	269		2,421.00	.68	2,421.68	YES
1976 TOTAL	1,443		$12,987.00	$17.63	$13,004.63	
RETIRED 1976 — DISTRIBUTION 1977						
Everett Rathbun	106	$13.50	$ 1,431.00	$ 3.14	$ 1,434.14	NO
Monroe Knight	271		3,658.50	11.94	3,670.44	NO
John Peretti	224		3,024.00	6.32	3,030.32	NO
John Wegzyn	205		2,767.50	12.97	2,780.47	NO
John Fanella	189		2,551.50	9.86	2,561.36	YES
John Martish	294		3,969.00	.58	3,969.58	YES
1977 TOTAL	1,289		$17,401.50	$44.81	$17,446.31	
TWO YEAR TOTAL	2,732		$30,388.50	$62.44	$30.450.94	
RETIRED 1977 — DISTRIBUTION 1978						
Pasco Corelli	345	$14.00	$ 4,830.00	$ 8.77	$ 4,838.77	YES
Arthur Brunetti	228		3,192.00	6.26	3,198.26	YES
John McLennan	411		5,754.00	13.10	5,767.10	NO
Ed Boeglin	555		7,770.00	9.07	7,779.07	NO
1978 TOTAL	1,539		$21,546.00	$37.20	$21,583.20	
THREE YEAR TOTAL	4,271		$51,934.50	$99.64	$52,034.14	

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EXHIBIT 3

AMTROL INC.

EMPLOYEE STOCK OWNERSHIP PLAN

REPORT TO

JOHN DOE

YOUR ACCOUNT BALANCES AT DECEMBER 31, 1976

1. Number of Shares of AMTROL Stock: 94.035
2. Value of AMTROL Stock at $13.50 Per Share.............. $1,269.47
3. Value of Cash Account $1,261.52
4. Total Value $2,530.99

TRANSACTIONS FOR THE YEAR 1977

5. From the $1,261.52 (Line 3) the Trustee
6. Purchased 96.342 Shares of AMTROL Stock
7.* At $13.13 Per Share (Total Cost $1,264.61),
8. Leaving Cash Balance of $3.09-

FOR THE YEAR 1977 YOU RECEIVED:

9. Your Share of Employer Contributions........................... $1,150.57
10. Your Share of Reallocated Forfeitures........................... $116.30
11. Your Share of Trust Income $26.95
12. Total Cash Balance (Lines 8, 9, 10, 11) $1,290.73

TOTAL VALUE OF YOUR ACCOUNTS AT DECEMBER 31, 1977

13. You Now Have in Your Account 190.377 Shares of AMTROL Stock (Line 1 plus Line 6).
14. At $14.00 Per Share, Your Stock Is Worth.. $2,665.28
15. Present Stock Value $2,665.28
16. Your Tax Basis.. $2,110.93
17. Your Accumulated Gain.............................. $554.35
18. Your Cash Balance (Line 12) $1,290.73
19. Total Value of Your Account... $3,956.01

Years of Service in the Plan at End of Year....................... 3

% of Vested Right in Your Account Balances................. 0%

Respectfully Submitted by Your ESOP Administrative Committee

C.H. KIRK	ALBERT N. D'AMICO	EDWARD F. ALMON

* AVERAGE COST PER SHARE

EXHIBIT 4

ESOP

The AMTROL

EMPLOYEE

STOCK

OWNERSHIP

PLAN

Answers to questions
some AMTROL employees
have asked

1. **Who is eligible to participate in the Plan?**
   Every employee of AMTROL who works at least 1,000 hours in a year and is actively on the payroll or on an approved leave of absence on December 31st, is an eligible participant in the ESOP.
2. **Do I sign up to become a participant?**
   No. Every employee who qualifies as described in No. 1 above is automatically a participant.
3. **Do I contribute to the Plan?**
   No. Employees are neither required nor permitted to contribute to the Plan. AMTROL is not selling stock to the employees; it is allowing them to share in the fruits of their labor, in the true capitalistic sense, by giving the employees a share in the ownership of these assets that produce a profit.
4. **How does AMTROL contribute to the Plan?**
   Each year the Directors will review the financial condition of the Company and the contribution to the Plan will be governed by the decision of the Directors.
5. **How does each of us share in that contribution?**
   AMTROL's contribution will be allocated to each eligible employee's account as a percentage of his total yearly earnings for that year.
6. **Does each employee receive the same percentage of his earnings as a stock bonus?**
   Yes. Everyone's percentage is the same. The Internal Revenue Code limits the amount that may be contributed by the Company in any year to a maximum of 15% of eligible annual payroll. There is also an additional limitation of 25% of eligible annual payroll for the allocation of contributions *and* forfeitures.
7. **Where is the Fund deposited?**
   The Industrial National Bank of Rhode Island has been appointed Trustee of the Stock Ownership Plan and must comply with all laws regulating Trustees. The Trustee's function is to receive the contributions made to it by AMTROL and to hold those assets in trust for each participant in the Plan. The Trust assets will be invested primarily in AMTROL stock.

8. Does the stock have voting rights and, if so, who votes it?

Yes. All AMTROL stock has voting rights. Under the terms of the AMTROL Inc. ESOP, the Trustee will vote stock held by it in accordance with directions received from the Administrative Committee. The participant in whose account the stock is being held in trust will not vote.

9. When do I gain full ownership in the stock?

Immediately upon retirement, total disability or death, regardless of the vesting schedule. After completion of 15 years' service in the Plan, you will have acquired a non-forfeitable interest in the stock, according to a progressive vesting schedule which works the same as the pension plan. Vesting of accounts will be graduated over a fifteen year period, with 25% vesting beginning after five years of credited service. Credited service begins on date of hire, or January 1, 1975, whichever is later. See detailed vesting schedule on Page 6.

10. What happens to the stock in the accounts of those employees who leave and are not fully vested?

They receive their vested interest and the portion of their account that is not vested is forfeited and automatically reallocated in proportion to relative compensation to the accounts of remaining participants each year.

11. When do I receive my shares of AMTROL stock?

Only after you retire, become disabled, leave the employ of the Company, or incur a break in service is your vested interest in the ESOP distributed to you by the Trustee.

12. Do I pay a tax each year on my share of the stock bonus?

No. That is one of the favorable tax aspects of the Plan. Your entire tax is postponed until you receive the stock (see question14); thus, the entire amount of the bonus works for you tax free until you leave the Company.

13. Will I owe a tax on the stock distribution when I receive it?

Yes, but according to present tax laws, it will be favorably treated by the Internal Revenue Service. Taxes are a complex subject and cannot be explained in

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a handbook of this type. However, upon leaving the Company and receiving your shares of AMTROL stock, the Administrative Committee will be available to advise you, and will provide you with a printed handout explaining the current tax treatment of ESOP distributions.

14. **What can I do with the stock after I receive it?**

    You may (1) retain it and continue as a shareholder with full rights and risks of ownership, or (2) at the discretion of the Administrative Committee, you may be granted a put option which will enable you to sell your stock for cash to the Trust Fund or to AMTROL at the then fair market value. It is AMTROL's present intention to buy any shares that a former participant in the Plan may offer, thus keeping control and ownership of AMTROL in the hands of the employees.

15. **Could the value of AMTROL stock go down as well as up?**

    Yes. As with any equity investment, the value will fluctuate according to the general welfare of the Company. If we are to be owners as well as employees of AMTROL, we must accept all the responsibilities and risks of ownership, as well as the rights and benefits. Up to this point, AMTROL has been very successful, and its continued success will depend upon how well each one of us does our job; the difference being that now we will share fully in future endeavors as owners, as well as employees.

16. **How will I be kept informed of the progress of my Company and the Trust Fund?**

    In addition to sending you summaries of annual financial performance, we have a personal interview with each employee/owner at least once a year. During that interview, we can discuss any subject regarding AMTROL that you choose, and you will receive a written report of the total Trust Fund, as well as an accounting of your personal share of the Trust.

17. **How long does the Management intend to continue the ESOP?**

    The present intention is to continue the Plan so that AMTROL will eventually be 100% employee-owned.

The Company intends to continue the Plan indefinitely. However, it is possible that future circumstances may require modification or even termination of the Plan. Accordingly, the Company reserves the right to amend or discontinue. At no time can an amendment be made which would deprive a participant of any values which had been built up by contributions already made for his account. If the Plan should be completely discontinued, each participant would immediately become 100% vested and would receive his AMTROL stock certificates, plus cash for any fractional share.

FINALLY:

This booklet is intended to acquaint you with AMTROL's philosophy that this is a "People Company." If you have any questions or wish further information, you may visit with any member of the Administrative Committee or inspect the detailed legal Trust Agreement establishing the AMTROL Employee Stock Ownership Plan.

ADDENDUM

The following information is of a more technical nature and is supplied for your information:

1. **Designated Agent for Service of Legal Process:**
   Tillinghast, Collins & Graham Inc.
   2000 Hospital Trust Tower
   Providence, Rhode Island
2. **Administrative Committee Members:**
   Chester H. Kirk
   Albert N. D'Amico
   Edward F. Almon
   All of 1400 Division Road West Warwick, R.I.
3. **Trustee:**
   Industrial National Bank of R.I.
   100 Westminster Street
   Providence, Rhode Island
   Attn: Duncan Merriman, Vice President

4. **Employer Identification Number:**
05-0246955-002

5. **Qualification for Benefits upon Retirement:** Each participant automatically qualifies for benefits upon retirement. The actual distribution of stock will take place shortly after the Anniversary Date following retirement.

6. **Anniversary Date:** December 31st of each year.

7. **Plan Year** is the Calendar Year.

8. **Detailed Vesting Schedule:** If your participation in the ESOP ceases for any reason other than retirement, death or total disability, the vested share of your accounts will depend on the number of plan years of credited service with the Company (after January 1, 1975) as follows:

Credited Service (After January 1, 1975) **At Date of Termination**	Percent of **Accounts Vested**
Less than Five Years	0%
Five Years	25%
Six Years	30%
Seven Years	35%
Eight Years	40%
Nine Years	45%
Ten Years	50%
Eleven Years	60%
Twelve Years	70%
Thirteen Years	80%
Fourteen Years	90%
Fifteen or More Years	100%

9. **Approved Absence:** A leave of absence from work approved for an Employee by the Company under its uniform leave policy; or a layoff of an Employee from work by the Company which does not constitute a termination of Service; or an absence from work for service in the Armed Forces or other government services, provided that, and only so long as, reemployment rights are protected by law. However, any absence from work for which the Employee is directly or indirectly compensated by the Employer shall not be treated as an Approved Absence.

10. **Beneficiary:** The person or persons entitled to receive any benefits under the Plan in the event of a Participant's death.

11. **Break in Service:** A Plan Year during which a Participant has not completed more than 500 hours of Service.

12. **Covered Compensation:** The total cash compensation paid to a Participant by the Company in each Plan Year (as shown on IRS Form W-2), including salary, wages, commissions, overtime compensation and bonuses, but excluding contributions to this or any other deferred compensation plan, and all other extraordinary compensation.

13. **Credited Service:** Period of Service during which an Employee has completed at least 1000 hours of service in each Plan Year, excluding all service prior to January 1, 1975.

14. **The Plan Benefits** are not insured by the Pension Benefit Guarantee Corporation.

15. We have appointed the firm of:
Borah & Associates
715 Hospital Trust Building
Providence, Rhode Island 02903
to do the actuarial work involved in the administration of the ESOP.

Employee Financial Report
1977

Published Especially for E S O P Employees

EXHIBIT 5

AMTROL INC.

To Our Employee Shareholders:

We are presenting this, our third ESOP Employee Financial Report, with a great deal of pride and satisfaction and hope that you will be as gratified with the results as we are. 1977 was another record year for AMTROL in both consolidated (world-wide) Sales and Profits and many of our achievements are noteworthy and should be mentioned.

Some major items of interest are: Sales of almost $45 Million, a 13% increase; profit retained by the Company of approximately $1.2 Million, a 17% increase; earnings per share of $1.38; a new stock valuation of $14.00 per share - up 56% from the original valuation of $9.00 per share in 1975; and an ESOP contribution of $909,873. One of the significant factors contributing to this excellent performance last year was the turn around at ATROL, our European subsidiary, and its return to profitable operations.

The three of us wish to convey to each and every one of you a sincere note of gratitude. We recognize that this kind of continued performance can only be realized and accomplished by an overall team effort, with everyone participating and contributing.

Our hope is that we will be able to establish new future records and achievements together.

Cordially,

OFFICE OF THE PRESIDENCY

Chester H. Kirk

Kenneth L. Kirk

Albert N. D'Amico

AMTROL INC. AND SUBSIDIARY

Consolidated Statements of Operations For The Years Ended December 31, 1977 and 1976

	1977	% Of Sales	1976	% Of Sales
Gross Sales — We charged our customers	$43,663,194	—	$38,533,565	—
Less:				
Credit allowed for Returned Goods	1,127,501	2.6*	961,016	2.5*
Cash Discounts taken by customers	752,523	1.7*	607,485	1.6*
Freight we paid for Goods Shipped	1,636,150	3.8*	1,286,096	3.3*
Net Sales — Received from customers	40,147,020	100.0	35,678,968	100.0
Costs and Expenses:				
Cost to make our products	28,642,758	71.3	26,017,876	72.9
Cost to sell our products	3,940,495	9.8	3,122,726	8.8
Administrative and Engineering Costs	3,821,785	9.5	3,130,593	8.8
Interest paid to Banks	473,745	1.2	478,233	1.3
We contributed to our ESOP	909,873	2.3	801,450	2.2
	37,788,656	94.1	33,550,678	94.0
Profits Earned	2,358,364	5.9	2,128,290	6.0
We must pay Income Taxes of	1,155,000	2.9	1,097,000	3.1
Net amount retained by the Company	$ 1,203,364	3.0	$ 1,031,290	2.9
Capital Stock Information:				
Number of Shares of Stock	870,415		840,415	
Earnings Per Share	$1.38		$1.23	
Valuation Per Share as of December 31st	$14.00		$13.50	
Items of Interest:				
Total wages paid	$ 8,623,958		$ 8,050,003	
Wages paid to eligible ESOP participants	$ 6,065,817		$ 5,343,003	
ESOP contribution (15% of eligible payroll)	$ 909,873		$ 801,450	

*Percent of Gross Sales

EXHIBIT 6.—AMTROL INC., WEST WARWICK, R.I.

Name	Stock ownership, August 1978	
	Shares	Percent
Chester H. Kirk	277,457	30.32
Lewis N. Madeira	277,457	30.32
ESOT	178,698	19.53
Kenneth L. Kirk	67,324	7.36
Albert N. D'Amico	55,557	6.07
Harold Brewster	16,500	1.80
John Belham	8,460	.93
Helen Belham	7,400	.81
Hanns Winkhaus	8,500	.93
Gertrude Jarbeau	2,475	.27
Howard Brewster	1,000	.11
John Rhodes	1,000	.11
Joachim Weissfeld	1,000	.11
John Diamont	10,000	1.09
Ralph Benn	200	.02
Herb Jacobi	200	.02
Monroe Knight [1]	271	.03
Margaret Peretti [1]	224	.03
Rosalie Wegrzyn [1]	205	.02
Nancy Payne [1]	106	.01
Edward Boeglin [1]	555	.06
John McLellan [1]	411	.05
Total	915,000	100.00

[1] Shareholders received their AMTROL stock as a distribution from our employee stock ownership plan (ESOP) and decided to retain the shares instead of exercising their "put".

Statement of Central Hudson Gas & Electric Corporation

Central Hudson Gas & Electric Corporation is an investor-owned utility supplying electric and gas service in the Hudson River Valley region of New York State to a total of about 245,000 customers.

The purpose of this statement is to bring to the attention of this Committee a conflict between the Investment Credit recapture provisions of the Internal Revenue Code of 1954, as amended ("Code"), and the Congressional intent of encouraging employers to establish Tax Reduction Act Stock Ownership Plans ("TRASOP") as presently expressed in Section 803(h) of the Tax Reform Act of 1976. It is our belief that this conflict tends to defeat the intent of the TRASOP program because it may result in depriving employees of a part of their opportunity to become participants as shareholders in the companies for which they work.

Effective September 12, 1977, Central Hudson established a TRASOP. Central Hudson's TRASOP is designed to be qualified under Section 401(a) of the Code and to confirm to the definition of an "Employee Stock Ownership Plan[1] contained in Section 301(d) of the Tax Reduction Act of 1975, as amended ("Reduction Act").

The Central Hudson TRASOP is intended to give eligible employees an equity interest in Central Hudson, to provide them with the incentives implicit in ownership of stock and to encourage them to remain in its employ.

As this Committee knows, the method of funding a TRASOP is by the use of an additional 1 percent Investment Tax Credit claimed by the employer on its Federal Income Tax return. If there is a "recapture" of an employer's Investment Tax Credit under Section 46(a)(2)(B) of the Code, then in such event Section 301(d)(8)(B) of the Reduction Act permits the employer to elect to—

(1) reduce current or future contributions to the TRASOP equivalent in amount to that portion of the recaptured Investment Tax Credit which is attributable to the employer's contribution to the TRASOP;

(2) take a tax deduction equivalent in amount to such portion of the recaptured Investment Tax Credit;

(3) withdraw from the TRASOP an amount equal to such portion of the recaptured Investment Tax Credit; all subject to meeting certain conditions.

Central Hudson, like all public utilities, is capital intensive because of heavy construction programs necessary to meet its customers' needs. In many cases, such as for Central Hudson, these capital expenditures relate to generating plants

which may take up to ten years before they are put in service. Under the Code, a utility may take an Investment Tax Credit before these plants are put in service, based on the "progressive payments" made toward construction of these plants. However, under the Code the exposure to recapture continues until seven years after the plant is put in service.

In Central Hudson's case, it is participating, as a tenant-in-common owner, with other New York utilities in the current construction of two nuclear generating facilities, one of which is scheduled to be placed in service in 1984 and the other in 1988.

The possibility of the recapture of the Investment Tax Credit relating to these "progress payments" is real; for example, in New York the concept of a statewide generating company is currently before regulatory agencies. If approved this new company will purchase Central Hudson's, and other utilities', interests in two nuclear stations. Furthermore, Central Hudson may well sell all or part of its interests in generating stations toward which progress payments have been made.

If a corporation sells property for which it has claimed the Investment Tax Credit, the Investment Tax Credit may, under the provisions referred to above, be "recaptured". If that corporation has a TRASOP in operation and there is a recapture of the Investment Tax Credit, the corporation has the option which, in effect, require it either to pay for the stock which was purchased by Investment Tax Credit monies which have now been recaptured, or design some method by which it can recover from the employees the stock they have received. In either case the Congressional intent will be thwarted. If the corporation has to pay, it will advance monies which, under the statute, it was not contemplated that it should pay. If it recaptures the stock, the employees are deprived of a portion of their opportunity to become participants as shareholders in the business for which they work.

The problem cannot be unique to Central Hudson. The other New York utilities participating in the generating company also have a similar exposure. And utilities in other states constructing new plants may also be exposed if the project is terminated before completion or if a co-ownership interest is sold to another utility.

Central Hudson feels that this conflict between the "recapture" provisions of the Code and the intent and purpose of the Reduction Act may discourage rather than encourage capital intensive employers from establishing and continuing TRASOP's. We believe that employees participating in Central Hudson's TRASOP would be discouraged if Central Hudson was forced to withdraw stock from its TRASOP due to a recapture. Furthermore, in Central Hudson's case, with approximately one-half of the shares allocated to employees being subject to the recapture provisions, the true Congressional intent, namely employee incentive, is diluted, and in the minds of many employees, more than 50% diluted. With the pall of recapture hanging over a portion of their shares, many employees simply lose interest.

Central Hudson feels that this conflict should be corrected and urges upon this Committee the sponsoring of corrective legislation, principally under Section 47 of the Code, which would, in the case of a recapture of Investment Tax Credit, permit the employer to retain any such credit which has been used to fund a TRASOP. Such legislation would correct what Central Hudson believes to be a serious and fundamental flaw in this otherwise excellent concept of strengthening the free enterprise system.

SILVERSTEIN AND MULLENS,
Washington, D.C., August 10, 1978.

Re ESOP hearings.

Hon. RUSSELL B. LONG,
U.S. Senate,
Washington, D.C.

DEAR SENATOR LONG: On July 19 and 20, the Senate Finance Committee held hearings on ESOPs generally and, in particular, on S. 3223 and S. 3241. The announcement of those hearings indicated that the Committee would be pleased to receive written testimony for the record. We are submitting this statement for inclusion in the record on the ESOP hearings.

We strongly support the concept of employee stock ownership and are particularly supportive of S. 3241 since it would substantially improve the availability of ESOPs and TRASOPs. We especially support the fundamental purpose

of ESOPs in providing increased equity ownership to employees through tax incentives that encourage employers to distribute their stock to employees.

While the Committee is improving the methods for broadening employee stock ownership, an additional means of accomplishing broadened employee stock ownership should be considered. That is the use of direct grants of stock to employees by employers under a special form of restricted stock plan. The proposal we suggest could be called an Incentive Stock Ownership Plan or ISOP. This program would not involve the use of qualified retirement plans such as ESOPs or TRASOPs, but would simply involve a direct transfer to employees of employer stock subject to a restriction on the stock that requires the employee to continue working for the employer for the period of the restriction. The restriction could be phased-out on a gradual basis comparable to the vesting schedules now permitted for qualified retirement plans.

Under present law, companies may utilize restricted stock plans as a means of compensating employees and providing employees with an equity ownership in the company. Under these plans, stock in the employing corporation is granted or sold to an employee subject to a restriction of forfeitability if the employee terminates employment before a prescribed time. In many situations, the forfeitability provision gradually lapses over a period of years so that the employee may substantially vest in the stock transferred in accordance with a vesting schedule roughly similar to what many qualified retirement plans utilize. This is a direct means of granting equity ownership in the company to the employees receiving the grant and therefore does not involve the complexity and administrative cost of a qualified plan.

A hardship exists under present law in the utilization of restricted stock plans because at the time the employee substantially vests in the ownership of the stock, i.e., when the restrictions lapse on the stock, the employee must pay income tax on the fair market value of the stock at that time. Since in many cases the employee will not have sufficient cash assets to pay that tax, the employee is often forced to sell the stock in order to pay the income tax liability. As a consequence, the present income tax laws operate contrary to the interests of increasing equity ownership by forcing employees who have received vested equity interests in their employer through restricted stock plans to sell their stock in order to generate the funds with which to pay the income tax liability.

Our ISOP proposal would amend § 83 of the Internal Revenue Code to permit a deferral of the income tax under a tax qualified ISOP until a subsequent event, such as the termination of the individual's employment or the sale of the stock. It is, in fact, only at the time that the employee actually disposes of the stock that he generates the necessary cash funds with which to pay the income tax liability. This deferral would permit these plans to be a major means of increasing employee stock ownership since the employee would no longer be taxed on income when he does not have the funds to pay the tax.

In order to prevent ISOPs from being tax-favored devices for compensating shareholders, the availability of ISOPs should be limited to employees who own less than 5 percent of the company. This is comparable to the limit that existed for qualified stock options under § 422 of the Internal Revenue Code. Other restrictions and limitations on the use of ISOPs may be appropriate after further consideration.

We would be happy to develop detailed legislative language to assist you and your staff in this matter if that would be helpful. The purpose of this letter is to bring to your attention this additional means of providing increased employee equity participation.

Very truly yours,

LEONARD L. SILVERSTEIN.
STUART M. LEWIS.

EMPLOYEE STOCK OWNERSHIP COUNCIL OF AMERICA,
San Francisco, Calif., August 18, 1978.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR LONG: Enclosed for inclusion in the record of the ESOP Hearing held by the Committee on Finance on July 19–20, 1978, is the summary of the results of the UCLA Graduate School of Management "Survey of Employee Stock Ownership Plans," which was sponsored last year by the Employee Stock Ownership Council of America.

The work was a result of several months of intense effort on the part of the student UCLA Field Study Team and their professors. We believe that the Study is an important step toward an understanding of the experiences of some of the companies which have been pioneers in the ESOP area. The full Study comprises 110 pages and includes much statistical data. For this reason, we believe that only the enclosed Summary need be included in the hearing record.

Very truly yours,

RONALD L. LUDWIG,
General Counsel.

Enclosure.

SUMMARY OF THE RESULTS OF THE "SURVEY OF EMPLOYEE STOCK OWNERSHIP PLANS" CONDUCTED BY THE UCLA GRADUATE SCHOOL OF MANAGEMENT, DECEMBER 1977, AND SPONSORED BY ESOP COUNCIL OF AMERICA

EXECUTIVE SUMMARY

Although employee stock ownership plans (ESOPs) have received a great deal of consideration in professional journals and seminars, only llimted information is available on individual company experience with ESOPs. Recognizing the need for such knowledge, the ESOP Council of America, a tax exempt trade organization, sponsored this study by the UCLA Management field study team.

The study was designed to ascertain whether the ESOP met the intended objectives of the company and the nature and extent of any problems. It was intended to provide an overall evaluation of current ESOP experience and to assist the Council in understanding the characteristics and needs of its membership.

The study included a direct mail survey to 850 companies known to have ESOPs, personal and telephone interviews and a review of current literature. The results are based on the response of 180 companies, most of which were closely held corporations with 2 to 5 principal stockholders. The number of employees in the companies responding ranged from 1 to 44,000, although 82% of the sample had under 200 employees. Primarily manufacturing, wholesale, financial, construction and service industries were represented. The sample also represented 33 states, with 42% of the companies being in California.

Most of the companies (87%) identified their ESOPs as stock bonus plans; the rest (13%) were stock bonus and money purchase plans. Sixteen percent of the plans were leveraged. The average length of time the plans had been in effect was three years.

The benefits and advantages considered most important by respondents were improved employee motivation, tax advantages, cash liquidity and market for closely held stock. It appeared that one of the most important uses of an ESOP was for estate (or life) planning, transfer of ownership, and preservation of the firm.

The problems most frequently cited as important were changing governmental regulations, administrative complexity, on-going costs and negative employee response. Even those companies generally pleased with the plan commented on the complexity, time and cost involved with the administration.

Dilution, considered one of the drawbacks to ESOPs, was not considered an important factor by the majority of respondents. Also, less than 6% of those responding thought loss of confidentiality was an important problem.

The risk inherent in an ESOP due to all an employee's eggs being in one basket was of concern to some, although it appeared that most felt the advantages of the ESOP outweighed the risks involved.

Because most plans had been in existence only a few years, most respondents were unsure of the ESOP's effect on employee motivation. Some of the factors mentioned as relevant to the effect on employee motivation were employee age and position in the company, as well as characteristics of both the firm and the industry. Comments indicated the ESOPs had not created an esprit de corps where none existed previously. The complexity of the plan and the difficulty of making an intangible benefit appear real underscored the need for education and good employer/employee communications.

Overall, most of the companies were highly satisfied with their ESOPs. They believed it was living up to expectations and that it was important to the company. The great majority also said they would install an ESOP again if given the choice.

The study also showed, however, that the ESOP is a highly complex financial planning and employee benefit tool, and is limited in application.

Any company considering an ESOP would do well to define its objectives and needs carefully, and should investigate the alternative ways of accomplishing goals.

Plan design and implementation are also extremely important and should be undertaken with great care. Some companies felt their problems were due more to poor plan design than to improper use of an ESOP. Professional assistance is very important, but company administrators should also insure they understand the plan thoroughly themselves.

One of the important contributions the ESOP Council can make is to provide such assistance to companies with existing ESOPs and to those considering one. Clearly evident in the study was the willingness of those who participated to discuss their ESOP experience as well as a strong interest in the experience of others with ESOPs and the field generally.

SUMMARY OF THE RESULTS OF THE "SURVEY OF EMPLOYEE STOCK OWNERSHIP PLANS"

Purpose

1. The purpose of the survey was to contact companies with ESOPs currently in operation to ascertain whether an ESOP met the intended objectives and what the major advantages and problems have been in practice.
2. To provide a source of data about the characteristics of ESOPs in existence, including specific benefits and problems.
3. To set forth any solutions devised by participants to common ESOP problems.
4. To provide a source of information for companies contemplating the initiation of an ESOP; and
5. To evaluate the effect of present government regulations of ESOPs.

Participants

UCLA Graduate School of Management Field Study Team:

Professors: Dr. John P. Shelton, professor of finance, UCLA Graduate School of Management. Arthur H. Kuriloff, professor of accounting, UCLA Graduate School of Management.

Field study team: Matthew J. Bonaccorso, Sheridan M. Cranmer, David G. Greenhut, Daphne T. Hoffman, and Niel Isbrandtsen.

Methodology

Questionnaires were mailed to 850 companies with ESOPs as well as to various administrators, trustees and other professional associations involved with ESOPs.

Over 180 responses were received. This is roughly a 20% return, and a good response in that it appears to be a fair cross section.

The survey team conducted personal and telephone interviews with company managers in order to obtain a better perspective about their experiences with ESOPs.

The team also spoke to administrators, lawyers, accountants, trustees, and consultants, as well as to government officials.

All the quanititative responses were entered into a computer and the results of the data analyzed and certain correlations established.

The source of the data was kept confidential and is only available to the UCLA Graduate School of Management. When the ESOP Council initiates the follow-up survey to determine whether the length of time the plan is in existence affects the company's satisfaction with the plan, the factors and data gathered in the second study can be compared with the results of the first to determine possible trends.

The study did not measure the degree of employee ownership and more research is certainly indicated. Further, the 22% response may indicate a selection bias. With a wider and wider base of employee stock ownership plans springing into existence, later studies may indicate different findings.

The data and the questionnaire

The results of the questionnaire used will be analyzed by proceeding step by step through the questions.

The questionnaire is divided into sections A through H and is printed in the Appendix of this Summary.

Section A. Company information

The question related to the type of industry in which the company is involved.

Question 1. The team had responses from a broad spectrum of industries: 29% responding characterized their industry as manufacturing, 17% as wholesale, 12% as financial, 10% as construction, and 9% as "service."

The remainder were from numerous categories.

Question 2. In the second question, "Number of Principal Stockholders," the responses were as follows:

Percent of Stockholders	*Percent of Firms*
1	17
2–5	42
6–10	12
11 or more	29

Question 3. With the third question, "Annual Sales", the percentage of firms checking each category were as follows:

8 percent checked the first, 0 to $1,000,000.

28 percent checked the second, $1,000,000 to $5,000,000.

20 percent checked the third, $5,000,000 to $10,000,000.

29 percent checked the fourth, $10,000,000 to $30,000,000, and

15 percent checked the last, over $30,000,000.

Note that the annual sales figures may not provide an accurate picture of the "size" of the companies responding. There is not necessarily a correlation bettween the number of employees and annual sales.

Section B. Employee information

Question 4. The number of full-time employees ranged from 1 to 44,000. Eighty-two percent (82%) of the sample, however, reported fewer than 200, and the median for the sample was 90.

Approximately 27 percent of the firms responding to the question as to whether there was a union, indicated they had one.

Many of these firms indicated that union members were excluded from the ESOP.

One large firm indicated they had to negotiate with 118 separate unions.

Questions 5 and 6. Questions 5 and 6 did not provide figures which were meaningful. The data was generally as follows:

Age mix for the entire sample (that is, the groups average age):

Age group	*Percent*
Under 35 years old	49
35–50	37
Over 50	14

The turnover rate given for the sample as a whole was about 18 percent. The questions did not provide enough information to determine if there was any difference between vested and nonvested participants.

Question 7. Question 7 asked: "Has the plan had any effect on the number of people leaving each year?"

20 percent of those responding indicated yes.

80 percent said no.

From reading the range of comments, it seems that the effect depends upon the individual characteristics of the firm.

Many commented that the plan had not been in effect long enough to assess the impact.

Other comments ranged from very positive to a qualified negative.

One indicated no effect at all on those under age 35.

Others included: Turnover reduced, Older employees stay, Plan not well understood, Too short a time to know, Once people are in the plan, the farsighted employees see the advantages.

The owner of one company indicated that two of his employees had left his firms and used the money they received from their shares to start a competing firm.

Section C. Plan description

Question 8. Question 8 asked the type of plan.

87 percent indicated they had a stock bonus plan.

13 percent indicated they had a stock bonus plan and money purchase pension plan.

Question 9. In question 9 they were to indicate the length of time the plan had been in effect to the nearest month.

The mean of the response was 36.4 months, or about 3 years with a low answer of 6 months and a high of 7 years 9 months.

Question 10. Question 10 asked how many months were required to install the plan. Here the team found a mean of 7.8 months with a high figure of 43 months and a low figure of 0. One answer was a cryptic—"Too Long."

Question 11. Question 11 asked whether a "liquidity analysis" or "dilution study" was done prior to implementing the plan.

46 percent answered Yes.

54 percent answered No.

Question 12. The team asked the responding companies to check the total amount of trust assets in question 12 in categories. Here, the category with nearly 40 percent of the responses was $100,001–$500,000. The remainder were roughly equally divided.

Note here that it is natural to expect the longer the period of time the plans have been in effect, the larger the amount of total trust assets.

Question 13. The term broke the annual contribution sizes of question 13 into six categories.

Over one-half of those responding fell into the range: $50,001–$500,000 which includes two categories:

1. Twenty percent were in the category $25,000 or less.
2. Many companies did not answer specifically, saying that the amounts contributed may vary annually, so they were unable to give an accurate answer.

Question 14. Question 14 asked the form of contribution.

The response was: Stock with 32 percent of the companies, cash with 40 percent, and a combination of stock and cash with 27 percent.

Fifty-three percent responded "yes" when asked if the form of contribution varied.

Of the 47 percent who said "no, it did not vary," some companies indicated that it may vary in the future.

Question 15. Question 15 tried to determine if the ESOP was formed by the conversion of a previous benefit plan. Example: conversion of profit sharing to ESOP.

30 percent responded yes.

70 percent responded no.

When asked if the ESOP was combined with any other benefit plan, 27 percent responded "yes."

The last part of this question asked what types of plans are combined with the ESOPS.

The largest block responding indicated profit-sharing plans (45 percent).

The others included various types of pension plans.

Question 16. Question 16 asked if the plan is leveraged (i.e., has it ever obtained a loan?)

16 percent responded "Yes".

84 percent responded "No".

Unfortunately, the question of whether the companies would consider the possibility of future "leveraging" was not asked, but some companies volunteered the information that they would be "leveraging" in the future.

Question 17. Question 17 asked what types of securities the plan holds.

The responses were: Common, 87 percent; preferred, 10 percent; and, combination common and preferred, 3 percent.

Question 18. Question 18 asked for the vesting requirements.

The responses were divided into three separate categories:

6 percent indicated they had immediate vesting.

9 percent said they had followed the statutory maximum, which is a schedule with total vesting in 15 years.

85 percent had a gradual vesting.

Of the 85 percent majority with gradual vesting, well over half had the standard "10 year and 10-percent per year program," while the remainder had varied periods of from 3 to 12 years for total vesting.

Question 19. Question 19 asked if the plan carries life insurance.
16 percent responded "Yes".
84 percent responded "No".
Of those saying "yes," the majority (over 80 percent) stated the insurance was on key people only.
Question 20. Question 20 asked if the plan provides for a "Put."
42 percent responded "Yes".
58 percent responded "No".
For the average length of time of the "put", the team computed 9 months with a range from 1 month to infinity.
The most frequent figure was 3 months.
The question was asked before the recent requirements of the ESOP regulations.
A "Put" is a mechanism whereby a terminating employee who receives his shares can sell them at market price either to the company or the ESOP for a certain period of time.
Question 21. Question 21 asked how stock is distributed to vested employees upon termination, and what particular requirements the plan has.
The answers set out a great variety of methods which are not delineated in the study.
Some indicated they had not yet had a distribution.
Question 22. Question 22 asked if the plan was audited by independent accountants.
Question 23. Question 23 asked if there was a formal accounting procedures or allocation manual.
66 percent of those responding indicated that there was a formal accounting procedures or allocation manual.
Question 24. Question 24 asked how often a stock appraisal was done and by whom.
The response was that 88 percent have annual appraisals. Of the appraisals performed, 47 percent were done by independent appraisals, 23 percent by auditors, and the rest by others (20 percent). (13 percent of sample were publicly traded stocks.)
Question 25. Question 25 asked who provides the legal services for the plan and the majority indicated they were provided by outside corporate counsel.
Question 26. Question 26 asked who provides administrative services to the plan.
The responses indicate that the work is split about evenly between internal and external groups (40 percent internal, 60 percent external).
Of companies using internal groups, the accounting department does the majority of the work and of the external groups, the professional plan recordkeeper does the majority.
Question 27. Question 27 asked who served as the plan's trustee.
The responses indicated that individuals serve as the plan's trustee 23 percent of the time and the remainder of the trustees are divided equally between institutions and committees (38 percent each).
In questions 24–27 the team asked the respondents to rank on a scale of 1–5 whether they were satisfied with the particular administrative services they were receiving or providing.
In each of these areas; stock appraisal, legal services, general administration and trustee, at least 50 percent indicated they were highly satisfied by checking 5's. So, in all administrative areas, satisfaction was high. It should be noted that some who responded to this question may have been plan administrators themselves.
Questions 28 and 29. Questions 28 and 29 asked about initial and ongoing costs.
It appears that only the figures for total expenses are meaningful, both because of the wide range of responses and because of the difficulty the companies seemed to have in estimating the cost of the work that was done internally.
Note.—There were, in addition, three companies with as many as 40,000 or more employees and their costs were so much greater than any of the others that the team took these figures out for the purposes of calculating the totals.
For question 28, the computed "mean" cost of installation was:
$12,204 with a minimum of $500, and a maximum of $52,000.
For question 29, the mean annual costs were computed to be:
$5,766 with a minimum of $500, and a maximum of $25,000.

Section E and section F

Section E of the questionnaire asked about the realized benefits and advantages and Section F asked about the problems with the plan.

The team asked them to rank each of the factors on a 0–1–2 scale with:

0=Not a factor

1=Less important

2=Important

In section E, regarding Realized Benefits/Advantages

The team had the following results.

The 5 "benefits" with the highest mean response were as follows:

1. Improved Employee Motivation.
2. Tax Advantages.
3. Market for Closely Held Stock.
4. Estate Planning.
5. Cash Liquidity.

The 4 "benefits" with the lowest mean response, starting from the least important, were:

15. Issuance of Stock without registration.

14. Defense against takeover.

13. Recapture of taxes paid in prior years.

12. Divestiture, or acquisition plans.

Section F

In Section F, "Problems with the Plan", the team found two major problems.

1. First, changing governmental regulations.
2. Administrative complexity.

From the initial research the team did prior to the study, it was concluded that dilution would be a major problem, however, in analyzing the data, for the majority of responding companies, it was not a problem.

Note—However, that many of the minority felt they had a serious dilution problem.

Consider also that these last few years have been especially difficult for ESOPs because of the constantly changing regulations, lack of definitive regulations and guidelines from the Internal Revenue Service and the Department of Labor and the inexperience of many plan sponsors and their advisors. Plan sponsors now have the assurance of relatively fixed regulations, as well as many sources of published material on ESOPs.

Section G. Perceived employee reaction

Section G, Perceived Employee Reaction. The team asked not for employee reaction, but for perceived reaction by the person filling out the questionnaire.

There was no discernable overall change between the employee opinion of the plan at the time of installation and current employee opinion.

The mean response in both cases was 3.8.

However, many firms indicated a change in opinion since installation. Some indicated the employee opinion had improved and some that it had dropped.

In the third question, the current employee understanding of the plan was not perceived to be good.

At best it can be described as "fair" with a mean response of 2.9 on a scale from 1 to 5.

The team received one comment suggesting that ESOPs be wrtten in "English".

The responses to the question about the plan's ability to compete with other benefit plans in keeping or attracting personnel was:

3.4 on the 1 to 5 scale

Section H. Overall evaluation

In the Overall Evaluation, Section H, the team asked whether the plan was living up to expectations and how important the plan was to the company.

In both cases, the response was 3.8 in a scale of 1 to 5.

The responses to the question, "How complicated do you consider your plan?", had a mean response roughly in the middle and was given a numerical assignment of 3.2 on the 1–5 scale.

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The last question was

"Would you install one again?"

The response on a scale of 1–5 had a mean of 4, and this was the highest mean the team had in these last two sections of the questionnaire.

The responses showed that the majority was, indeed, very happy and would install one again. BUT some of those who commented gave very strong negative opinions.

Ordering the complete survey

The actual survey is extremely informative, and may be ordered from the ESOP Council of America, 11661 San Vicente Boulevard, Los Angeles, California 90049, Attention: Robert W. Smiley, Jr. The Council would welcome suggestions for further studies.

STATEMENT OF O. C. DAVIS, CHAIRMAN, PEOPLES GAS CO.

Peoples Gas Company submits for the record this statement of its Chairman and Chief Executive Officer, Mr. O. C. Davis, to express its support for S. 3241, the "Expanded Employee Stock Ownership Act of 1978," which was introduced by Chairman Long on June 23, 1978.

Peoples Gas Company is the parent corporation of an integrated system engaged in the production, interstate transmission, and local distribution of natural gas. We supply approximately 75% of the gas consumed in the Chicago metropolitan area.

The concept of employee stock ownership is one that the Committee on Finance has been influential in developing and strengthening over the past five years. The Finance Committee's amendments which established the TRASOP concept in the Tax Reduction Act of 1975 and which honed the concept through technical amendments in the Tax Reform Act of 1976 enabled Peoples Gas Company to be among the first in the nation to establish an investment credit ESOP. Peoples Gas Company regards its Plan, the Peoples Gas System Employe Stock Ownership Plan and Trust, as an unqualified success. For the plan year ending September 30, 1976, the first year of the Plan's existence, there were 6,110 participants in the Plan, representing 89.9% of all Peoples Gas System employees. The employer contribution for this plan year amounted to over $2.2 million, representing an average allocation to each participant of $374.19 or 10.16 shares of Peoples Gas Company stock. For the plan year ending September 30, 1977, there were 6,085 participants in the Plan representing 90.1% of all System employees. The total employer contribution for this year decreased to approximately $1.2 million, paralleling the reduction in the System's available investment tax credit for that year. The Plan has been very favorably received by all Peoples Gas System employees. All available information indicates that it is regarded as a very valuable employee benefit.

We welcome the opportunity to submit this testimony in support of the concept of employee stock ownership plans in general, and S. 3241 in particular. These hearings are particularly timely for our company in view of our testimony before the House Committee on Ways and Means last March during its hearings on the Administration's tax reform proposals.

We believe that S. 3241 will help alleviate the economic problems facing our country as a result of capital shortages and concentrated equity ownership. The additional investment tax credit will be especially important to the capital intensive natural gas industry and, in particular, to our company.

America's natural gas industry is the most efficient energy distribution system in the world. Everyday our transcontinental network of pipelines, storage facilities and local distribution lines moves massive quantities of clean nonpolluting energy from producing wells directly to consumers, efficiently and inexpensively. We in the gas industry are aware of our responsibility to maintain the integrity of natural gas as a national asset, and the major role we must play in helping this country meets its long-term energy requirements.

Until a few years ago, the ready availability of natural gas enabled our industry to supply our customers with a premium fuel at bargain-basement prices. Now, as existing low cost supplies of natural gas become depleted, unprecedented capital investments will be required to develop new sources of gas—traditional and nontraditional—in order to permit us to maintain service to our markets.

The capital needs of Peoples Gas Company will also increase substantially over the next 10 years because of the large capital requirements for projects necessary to maintain service to our markets and to enable us to explore for and develop new sources of gas. We are making large capital commitments to develop alternatives to traditional sources, such as synthetic natural gas and liquefaction facilities to permit foreign natural gas to be imported, liquefied, stored, and regasified. Consequently, Peoples Gas Company's estimated investment requirements will amount to more than $6 billion over the next decade, which constitutes a tripling of the investment accumulated over our 120 years of existence.

In view of these future needs, we support the proposed 2% investment tax credit for ESOPS. The enhanced ESOP investment tax credit will benefit our employees by providing them with increased savings; our company, by providing it with needed capital to maintain and expand our ability to serve our customers, and by providing our employees with an increased sense of ownership, and our customers, by providing them with better service. Accordingly, we believe that S. 3241 will make a substantial contribution to the great challenge of raising the capital needed to help insure a healthy future for America's energy requirements.

Peoples Gas Company supports the expansion of the ESOP concept as an important factor in broadening equity ownership and increasing employee incentive. While we are part of a capital intensive industry, we recognize the needs of other less capital oriented companies in broadening their stock ownership and increasing employee incentives. Thus, we also support the extension of the ESOP availability to labor intensive employers by providing a tax credit of up to 1% of wages paid each year provided an equivalent amount is contributed to an ESOP.

We thank the Committee for this opportunity to express our support for the concept of employee stock ownership, and urge you to act favorably on S. 3241 this session. The expanded use of ESOPs will greatly help in broadening equity ownership, increasing employee incentives, and alleviating the problems of capital formation.

Statement of the National Retail Merchants Association

The National Retail Merchants Association ("NRMA") is submitting this comment in respect of S. 3241, the "Expanded Employee Stock Ownership Act of 1978", introduced by Senator Long ("the bill"). The NRMA is a nonprofit trade association representing over thirty-five thousand leading department, chain and specialty stores in the United States, many of which are operated by small retailers. The aggregate annual sales volume of our members is in excess of $95 billion.

Most retailers are labor-intensive enterprises and retailers employ a large percentage of the nation's labor force. In 1976, retailing enterprises had a payroll of $79 billion and employed approximately 13.4 million workers, one out of every six employees in the nation. Between 1970 and 1976 nine million new jobs were created by all sectors of our national economy; more than two million of these new jobs, nearly one out of four, were in the retailing sector. Additionally, our industry operates on a profit margin which is relatively low in comparison to most other labor-intensive industries. Retailing is required to employ its caiptal resources predominantly in payroll, inventory, receivables and other current working capital requirements, which are generally ineligible for Tax Reduction Stock Ownership Plan ("TRASOP") benefits because the capital expenditures are generally ineligible for the investment tax credit. (TRASOP was implemented by the Tax Reduction Act of 1975, allowing an increase of 1 percent in the investment credit on qualifying property if an employer contributes an equivalent amount to an employee stock ownership plan "ESOP").) In sum, retailing has essentially been denied the benefits to be derived from TRASOPs because retailing is a labor-intensive industry.

General Comments

Essentially the bill seeks to remedy the situation as regards TRASOPs for labor-intensive industries and would provide employers with a tax credit equal to the greater of (i) one percent of the wages paid each year to employees or (ii) two percent of property qualifying for investment tax credits, provided that property in an equivalent amount is contributed to an ESOP. At least one-half of the amount contributed to the ESOP must be newly-issued employer securities. The predominant reasons for such a program are to aid capital formation and offset the serious shortage of capital in the United States. Furthermore, by en-

couraging the establishment of ESOPs, employees will enjoy greater financial and job security by reason of the improved capital position of their employers. Giving employees a share in the ownership of their own company will underscore to employees the need for a symbiotic relationship between labor and management, if an enterprise is to prove successful. Such programs serve the common interests of all involved. Additionally, ownership of corporate institutions will become more widespread, an aid to societal stability. The NRMA supports these goals and believes that the bill will help achieve them.

Indeed, the proposal of Senator Long must be greeted favorably by the retailing industry and all other labor-intensive industries. Finally an attempt is being made to provide labor-intensive industries with incentives similar to those afforded to heavy industry and manufacturers. Given the President's and Congress' endorsement of the principle of tax equity, the bill must be met with praise and should be enacted. The retailer is an integral and necessary component of our economic society and deserves treatment similar to that accorded manufacturers. Manufacturing and retailing are the two engines of the economy—at opposite ends of commerce, but geared together. The one converts materials into consumable products; the other distributes these products to consumers. Both manufacturing and retailing add value to each product. Without mass retail distribution there could be no mass production and no mass consumption. An efficient retail distribution system creates a market and exerts a strong "pull through" effect on manufacturing. Conversely, an inefficient retail distribution system will have a dampening effect by increasing final costs and impeding the flow of merchandise. Thus, to favor one type of enterprise over the other violates principles of tax equity subscribed to by the President and Congress. The bill properly seeks to remedy this situation with regard to TRASOPs.

RECOMMENDATIONS

There are a few provisions in the bill, however, which call for comment and constructive suggestions. The bill provides that if the credit exceeds an employer's tax liability in a given year, the excess credit cannot be carried back to prior years but only can be carried forward to the next succeeding year and no further. This provision is, in our opinion, inadequate due to the operating loss and capital loss carryback and carryforward provisions of the Internal Revenue Code ("Code"). For example, an employer may have a loss in one year which results in a carryover, thereby eliminating the proposed credit for two consecutive years. Therefore, it is suggested that any excess credit be afforded the same treatment as an unused investment tax credit. Thus, an excess credit should be carried back three years and carried forward seven years. See Code Section 46(b)(1). At the very least, should a carryback provision be deemed undesirable, a carryforward period of seven years should be provided.

Under the bill, the employer securities contributed to these plans must have voting power and dividend rights "no less favorable than the voting power and dividend rights of other common stock" of the employer. It is suggested that this standard may prove too rigid in the case of companies with complex stock structures and many classes of common stock. Instead, it is suggested that the employer securities must be simply common stock. To the extent the voting power or dividend rights of the employer common stock contributed to the plan are not as favorable as rights of other employer common stock, the value of the contributed stock will be less and a greater amount of such employer securities will have to be contributed to the plan. Thus, a requirement that the employer securities merely constitute common stock will simplify matters for certain employers without prejudicing the interests of employees. It may be feared, however, that certain corporations might take advantage of such a provision by creating new classes of common with severely diluted voting or dividend rights. In order to prevent this, an additional requirement is suggested, that at least fifty percent of the class of common stock contributed to the plan be held by persons unrelated to the principal shareholders. Indeed, a similar provision is contained in Section 407(e) of the Employee Retirement Income Security Act of 1974 in respect of the type of employer marketable obligations that may be held by a plan.

One final favorable comment is warranted. The proposed amendment of Code Section 2039, to exclude from the gross estate amounts which the recipient did not elect to receive as a lump-sum distribution under Code Section 402(e)(4)(B), represents a significant improvement in statutory language. The present Code language leaves unclear whether amounts which could have been received as lump-sum distributions, but were not in fact so received, are excludable from

the calculation of gross estates. The language proposed in Section 2 of the bill clarifies that the exclusion will not apply only if, in actuality, a lump-sum distribution was received. The NRMA endorses this change in the Code.

The NRMA urges adoption of this proposed legislation. It will serve to benefit both employees and employers. Furthermore, the bill will help the United States meet its critical capital needs in the coming years. Representatives of the NRMA would be pleased to work with members of the Finance Committee and its staff on this excellent piece of legislation.

ACHIEVING MOTIVATION THROUGH EMPLOYEE STOCK OWNERSHIP—SPEECH GIVEN BY BERT L. METZGER, PRESIDENT, PROFIT SHARING RESEARCH FOUNDATION, AT THE FIRST ANNUAL CONFERENCE OF THE ESOP COUNCIL OF AMERICA ON MAY 8, 1978 IN LOS ANGELES, CALIF.

It is indeed my pleasure to be here today to speak about ways to achieve motivation through employee stock ownership. I thank Bob Smiley and the other people connected with the ESOP Council for inviting me. I do not thank them for putting me on the program right after Senator Russell Long, Louis Kelso, and Mike Wallace.

CAPITAL SHORTAGE

Capital is virtually on strike in the U.S. today. For over a decade, investment has been taxed and regulated almost into oblivion. The result, according to Richard L. Thomas, President of the First National Bank of Chicago, is a fundamental imbalance between a rising labor force and the tools needed to employ people productively. Real business fixed investment (in 1972 dollars) per each new worker added to the labor force has fallen dramatically in sequential periods over the last 25 years. The result was inevitable—less output and real income for the worker—low productivity—and consequent difficulty of the U.S. competing successfully in international markets.

It is my contention today that ESOPs properly designed and communicated can play a major role in turning this around. High productivity requires a successful marriage between advanced technology and skilled, motivated labor. ESOPs can contribute by expanding capital, broadening its ownership base, and serving as a system incentive to top performance.

THE FIRST ESOP

Let us take a few moments to go back in time to the conceptualization of the first ESOP. When was the first ESOP started? Was it back in September, 1974 when ERISA was signed into law? No. How about the year earlier when the Regional Rail Reorganization Act was passed? No. Perhaps we should place the start in 1958 when Louis Kelso and Mortimer Adler authored *The Capitalist Manifesto.* They would certainly say, "No!" Perhaps the distinction should go to Peninsula Newspapers, Inc. for initiating its profit sharing/share ownership program in 1954. Quite an event undoubtedly, but really not the first ESOP. What if we went back to 1953 to Revenue Ruling 46 which allowed a qualified trust, not just an ESOP but any qualified trust, to borrow money to buy stock. Is this the punctum initiale of ESOP? No.

Let us go back even further and speak with Isidore Goodman, former head of the Pension Trust Division of the Internal Revenue Service. He would say that the big impetus to stock bonus and profit sharing plans came with the enactment of the tax revision bill of 1942 but he would also remind us that Congress gave its special blessings and exemptions to profit sharing and stock bonus trusts way back in 1921. Notice I did not say pension plans. It was only when Congress became confused about the differences between an individual account plan and a defined benefit pension plan that, around 1929–1930, Congress conferred like tax benefits upon pension plans. Even so, 1921 was not the beginning of ESOP.

To get back to the first ESOP, we must go back in time to 1840–1850 and visit with Johann Heinrich Von Thünen, an eminent economist in Germany, who lived at the time of Karl Marx.

Marx viewed the terrible conditions in the English factories at the time of the industrial revolution and reached certain conclusions. He noted that almost all of the wealth being created by the productive process was going to the few at the top—the few owners of capital—while everyone else was receiving a bare subsist-

ence wage—a hand-to-mouth existence. Karl Marx predicted that this system would never endure because people simply would not tolerate it. He predicted that the masses would rise up, expropriate private captial property, and transfer this ownership to the government. The government would own all capital property and administer it on behalf of the people—regulate the distribution of the profits of this capital ownership to the benefit of everyone. So prophesied Karl Marx.

Von Thünen agreed with Marx about the nature of the problem, but disagreed with him on the solution. Von Thünen warrants our consideration today because he is highly regarded as the father of "marginal productivity" theory and was the first economitrician (applying mathematics to economics). Von Thünen, however, believed his wage theory was his greatest contribution to economics.

Von Thünen asserted that Marx was proposing a dangerous political solution to an economic problem. An economic problem should be solved in the economic sphere, not the political sphere. A political solution, according to Von Thünen, would violate individual human rights and distributive justice. Von Thünen warned that Marx was simply substituting the concentration of wealth in a few political hands for concentration of wealth in a few private hands. Von Thünen stated emphatically that total economic power in the hands of those with total political power would destroy personal freedom. "Do not eliminate private capital property ownership," advised Von Thünen, "but rather turn the coin over and find ways to make everyone a capitalist." Therein lies Von Thünen's central message—ownership for all!

Does that sound familiar? Make everyone a capitalist! That was Von Thünen's message to the world over 125 years ago.

What did Von Thünen do with his theory? He applied it as an "economic model" on his agricultural estates to test its validity. He paid his people a competitive wage like the farmers of his day. In addition, he entered into an agreement with his employees that if the farm became more profitable and successful, he would share this profit with them. In each subsequent profitable year, Von Thünen lived up to this agreement and shared farm profits with those who helped earn it. However, instead of paying this profit to his employees in cash, Von Thünen reinvested this money—in the worker's name—in equipment and technology which would make the farm more productive.

Notice Von Thünen's ingenious linkage between technology and employee motivation. He shared profits to motivate his employees to make the farm more profitable and used part of the profit to reinvest in the farm to make the farm more productive. He reinvested this profit—this "efficiency gain"—that would not have existed except for the sharing program—in the farm in the worker's name, not in his own name. He created a marriage, if you will, between advanced technology (broadly owned) and skilled, motivated labor. That is the key to high productivity in our society today—a synergistic union between capital and labor. Two factors, not one.

Under Von Thünen's program, each employee had an indivdual account and the worker's pro-rata share of the profits was credited to this account each year. The interest on this reinvested profit share was paid out each year in cash to the worker. As the principal grew larger each year, the amount paid out in cash—as an "investment wage"—increased accordingly. When the worker retired or left the farm, he received his personal capital estate.

This was Von Thünen's technique for creating capitalists on a broad basis—deferred profit sharing linked to ownership of the farm/company for which employees work.

In today's parlance, Von Thünen had created an individual account plan, a defined contribution plan, a non-leveraged ESOT funded by profit sharing, a second income plan with pass-through of dividends/interest to participants.

There you have it! An economist and a practical businessman created the first ESOP—Von Thünen. He offered it as an answer—an alternative—to Karl Marx. He tested it and it worked. During the remainder of his lifetime and for several generations thereafter Von Thünen's "profit sharing ESOP" proved its worth.

In fact, Von Thünen was so pleased with the results that he had engraved on his tombstone his "wage formula" for a successful business—$\sqrt{AP}$. "A" means that very worker must get at least a subsistence wage (a consumptive wage) for performing his functional activity in industry. In addition, he must get a "P"—a productivity/profitability-linked wage (an investment wage) to encourage him to maximize his performance and his ultimate benefits.

Let us leave Germany now, aware that we have learned a valuable lesson from Von Thünen. We must solve economic problems in the economic sphere. We

must build incremental capital ownership into employees and individuals throughout the nation as the best way to preserve and enhance individual freedom and dignity.

RAISING EMPLOYEES' WILL TO WORK

New York University recently issued an impressive study on Work, Productivity, and Job Satisfaction supported by a grant from the National Science Foundation.[1] Several tomes were produced under this grant not only discussing principles but also reporting innovative practices. Out of all of this material, two paragraphs struck me as particularly important.

The key to having workers who are both satisfied and productive is motivation—i.e., arousing and maintaining employees' will to work effectively. Motivation is the key to having workers who are productive, not because they are coerced but because they are committed.

Of all the factors which help to create highly motivated/highly satisfied workers,, the principal one seems to be that effective performance be recognized and rewarded—in whatever terms are meaningful to the individual, be it financial, psychological, or both.

Those two paragraphs say a lot. The key is motivation. It is up to management to arouse and maintain the employees' will to work efficiently. Excellent performance must be rewarded in terms meaningful to the employee—him or her, not you.

Let's face it. No one can motivate any other person. Motivation is an engine that the worker turns on inside himself. He turns on and maintains his own motivational machine. The most management can do is create a climate in which this kind of "turn-on" will occur. This is where profit sharing/share ownership fits in—as a way to create a sharing climate in which excellence is recognized and rewarded financially and psychologically.

TEN PRINCIPLES OF MOTIVATION THROUGH ESOPS

1. Recognition of essential nature of employee stock ownership

First, management must recognize the essential nature of its ESOP. An ESOP can be a technique of corporate finance, a way to increase cash flow and working capital, a system for creating an inhouse market for shares of existing owners in a closely-held company, an estate planning device. An ESOP can be a lot of things. It can be a retirement income plan, a death benefit program, a way of transferring ownership to the employee group. Okay! It can be all of these things.

Nevertheless, an employee stock ownership program must primarily be an employee incentive program. It should produce incentive effects or it is not worth the cost of setting up the ESOP. The principal justification from the company and owner points of view for having an ESOP and providing employees with a stake in ownership is that it will generate more profits, more productivity, more harmonious relations. The business will be better off in the long run. That is the key!

2. Top management commitment

A commitment to the principles of cooperative production, sharing, and ownership must start at the top and permeate the entire organization. It is not enough for top management to get deeply involved in all the behind-the-scenes planning aspects—i.e., evaluation of the ESOP concept, feasibility studies, liquidity studies, plan development, and the like. Management must also give its overt support to the ESOP program. The program must be communicated to the work force in such a way that it is perceived by employees to have top management backing.

3. Plan features designed to motivate

Plan features should be designed to motivate, flexible enough to meet individual needs.

In our experience, broad coverage programs work better than narrow limited coverage plans. There is no point in setting up an ESOP or a profit sharing plan to do for executives what is already being done for them in other ways. Broad coverage programs should include middle management people, salaried personnel, and hourly (nonunionized and/or unionized) as well, if possible.

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[1] Raymond A. Katzell and Daniel Yankelovich, et al., *Work, Productivity, and Job Satisfaction* (New York: New York University, 1975). Supported by grant from National Science Foundation.

Plans should be non-integrated (with Social Security) and should not skew all the benefits toward the top. If you want an integrated pension plan, okay—skew benefits to the top through your pension plan. Do not do it through a profit sharing plan or an ESOP.

Your plan should welcome new participants after short service periods. ERISA has pretty well taken care of that for us, because today you certainly have to get 1,000-hour employees into your plan in a non-discriminatory fashion within 12 to 18 months, with no other restrictions than age 25. In most cases, I would urge you to eliminate the age factor because I do not like to see ERISA impact adversely on young people. If young people join your company at age 20 or 18, why should they have to wait 5 or 7 years before they get into your ESOP? If you want them to be productive in a year or two, reward them as members of your team.

Most ESOPs allocate contributions on compensation, and that is a reasonable basis for allocation—a better basis than service—when we are discussing motivation and performance. Compensation can be defined to reflect base pay or total compensation. If a company has other incentive programs—i.e., individual piecework incentives and/or small term incentives—it is possible to include these cash bonuses in total compensation. ESOP contributions can then be allocated on the basis of total compensation with a doubling or tripling of the incentive force of the plan. High performers are rewarded through interlocking programs.

I will discuss company contributions to ESOPs later. Suffice it to say here that a "formula approach" is superior to leaving the contribution to the discretion of management each year. Employees as a general rule do not favor discretionary bonus plans that depend upon decisions by management, over which they have no control and to which they are not privy. Employees should know ahead of time their basis for sharing—whether it be a percentage of pay or a percentage of profit.

Vesting has also been pretty well determined by ERISA. Long-drawn out vesting schedules over a 20 to 25 year period, coupled with an age requirement, are a thing of the past. Neither ERISA nor employees tolerate today the "golden handcuff" approach to vesting benefits. We are in an age where participants should and now do acquire a substantial, growing stake in accumulating benefits year by year—with full vesting in 5 to 15 years. Motivation and rapid vesting go hand in hand.

Puts should be incorporated into your ESOP if necessary to assure that participants will not end up with a bundle of stock and have no market for it. The company, in its turn, should have the right of first refusal if such is appropriate in the given case.

The wisdom of passing voting rights on to participants on own company shares in/credited to their accounts is debatable. Particularly in closely-held companies, a strong case can be made for the company founder(s) or present management maintaining corporate control. However, where possible, especially in publicly-held companies, there are a number of cogent reasons for providing participants with pass-through voting rights. Many large companies with profit sharing trusts heavily invested in own company stock pass through voting rights to plan members. These companies provide proxy statements and annual reports to participants in advance of stockholder meetings—use this as a fine opportunity to communicate with employees about the progress of the business and their part in making it more successful. Plan members, in their role as employee shareholders, can be involved and exercise a meaningful influence over decisions that affect them and their company.

Life being what it is, you gain something and lose something in everything you do. ESOPs have a unique exemption under ERISA to borrow money to accelerate stock acquisition, to use credit to buy equities. Although only 15–20 per cent of companies with ESOP's have currently leveraged their ESOP's, nevertheless it seems you have to pay for this privilege. A straitjacket has been prepared by Congress and the regulatory agencies for your plan and your ESOP must be fitted into it. ESOP's lack the flexibility most profit sharing plans have vis-a-vis several plan features.

Partial withdrawals by participants during employment would be one example. A plan which meets a wide range of employee needs is likely to have greater motivational value. Most profit sharing plans include well-designed partial withdrawal privileges which give plan members significant access to funds—for

stated purposes—without unduly diluting retirement income or capital accumulation objectives of the plan. Young people may wish to use part of their profit sharing to buy a home; those around age 45 may need profit sharing money to cope with financial or medical emergencies. Access to cash when participants need it—for purposes which contribute to their long-term security—makes profit sharing benefits tangible and currently valuable, not "pie in the sky" 40 years down the road at retirement.

ESOPs have difficulty incorporating partial withdrawal features because all disbursements from an ESOP have to be made in own company stock "in kind." The participant must sell the stock immediately (either back to the ESOP or on the open market) to generate the cash needed for his withdrawal purpose—with adverse tax consequences.

Another point. Many ESOPs are not designed to invest exclusively in own company stock. No more than 67–70 per cent of the portfolio is intended to be in own company shares. The balance is in fixed-income investments or cash equivalents with an eye to meeting the liquidity requirements of the trust upon disbursement.

Under most ESOPs, employees do not have any investment choice. They do not have investment options with respect to the portion of their account in company stock nor in diversified investments. ESOP participants cannot even reduce their market exposure in the years very close to their retirement by shifting their balances out of company stock into more conservative funds.

Under profit sharing, this investment choice flexibility is frequently extended to plan members. Several funds are set up—e.g., an equity fund, a bond fund, an own company stock fund, and/or a guaranteed principal plus interest fund. Participants are granted options over "new money" coming into their accounts from company/employee contributions, and, in addition, have transfer-of-balance privileges at any age or at least in the 5–10 year period immediately prior to retirement.

A good example of this investment choice flexibility is reflected in the Savings and Investment (profit sharing) Plan of Eastman Kodak Co.[3] Each participant has an annual choice over how he wants his deferred money invested. He may have it deposited all in one fund, equally between any two funds, or equally among all three funds:

Fund A—Kodak common stock;

Fund B—Diversified group of securities, including fixed interest-bearing securities, preferred and common stock, and participant loans;

Fund D—Fixed income fund—a group annuity contract with an insurance company.[4]

Participants may also direct the trustee to transfer part or all of the current value of their account(s) to another fund(s). This can be done only once in a calendar year but can be done by a participant at any age.

At the end of 1976, 73 per cent of Eastman Kodak's profit sharing portfolio was invested, by employee investment choice, in Eastman Kodak's own stock (Fund A). Fund D was second in popularity, followed in the distance by Fund B.

Under ESOP regulations, restrictions are also imposed in the area of final disbursements. If an ESOP participant retires, he must be paid his account balance in own company stock, even if he immediately turns around and sells the stock back to the ESOT. This can be a very cumbersome procedure. If a plan member had a $10,000 account with only $6,000 invested in company stock, the ESOT trustee might have to borrow $4,000 worth of company stock from the other participants to distribute $10,000 in stock to this retiree. The next minute the trustee might buy back the $10,000 in stock at a higher acquisition cost for the ESOT than its prior average acquisition cost. Other, more manageable, techniques are sometimes available.

Most ESOPs do not permit installment payments from the trust or allow for the purchase of annuities—even though these disbursement modes might better meet the needs of retiring participants in certain situations.

In other words, there are a number of areas where ESOPs do not have the flexibility of profit sharing plans. This plan feature strait-jacket for ESOPs is most unfortunate. Plan features should be designed to motivate.

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[3] Bert L. Metzger. *Profit Sharing in 38 Large Companies: Piece of the Action for 1,000,000 Participants* (Evanston, Ill.: Profit Sharing Research Foundation, 1978).

[4] Fund C invested in U.S. government securities was frozen in 1975, closed to further contributions or transfers from other fund(s).

4. Link to profits

Much publicity recently has been given to conversions of profit sharing plans to ESOPs. This does not reflect disillusionment with profit sharing. This reflects disillusionment with the stock market. We have not seen a retreat from profit sharing. We have seen a change in investment philosophy—from a profit sharing plan with diversified investments to profit sharing ESOPs with primary emphasis on own company stock. In effect, we are seeing profit sharing ESOPs and EPSOP's (*E*mployee *P*rofit *S*haring and *O*wnership *P*lans) created akin to the kind created by Von Thunen.

Many major U.S. corporations have profit sharing trusts heavily invested in own company shares (EPSOPs, if you will). Profit Sharing Research Foundation's major study of Profit Sharing in 38 Large Companies shows that 36 out of the 38 companies invest at least to some extent in own company stock. In fact, in 17 out of the 38, company shares represented from 60 percent to 100 percent of the total portfolio. At the end of 1976, $5.9 billion out of $9.9 billion (60 percent of the total) was invested in own company shares. The concepts of profit sharing and stock ownership are very consonant.

Medium-sized and small companies have more difficulty under profit sharing investing in their own stock and this is where ESOPs are coming into greater play.

There are four ways to fund an ESOP—gift, thrift, cost, or gain. Gifts of own company stock to employees are laudable but rare. Thrift in today's inflationary economy is hard to achieve and inadequate to the task. We can barely keep up with required contributions to Social Security.

Cost, or a money purchase concept—e.g., 10 percent of compensation of participants each year irrespective of profit levels—can be used but this entails high annual charges against the business unrelated to its ability to pay. This is neither cost effective nor cost predictable (in light of inflationary wage increases). Even more serious, a fixed percentage of compensation constitutes a give-away program! You lose a great motivational dimension in your plan if year after year you contribute a fixed percentage of pay irrespective of the efficiency and profitability of the company. Whether the company succeeds or not, you simply give participants 10 percent of pay. Now admittedly, the company contribution is converted into own company stock and you have created the stock ownership incentive but you have lost the sharing incentive.

This contrasts sharply with the philosophy of profit sharing which views the company contribution as an *earned reward* in relation to the organizational efficiency of the business. If the profit is there, and you made it with employee cooperation, they get it! If you do not make it, they do not get it. Then you have a double incentive working for you—sharing current profits with employees through profit sharing and long-term growth through stock ownership.

Even leveraged ESOPS can be profit sharing ESOPs by agreeing to share a specific percentage of profits with your people—e.g., 20 percent of before-tax profits—with a minimum contribution each year adequate to amortize the outstanding loan over the designated period.

5. Communication/economic education

The study of ESOPs recently completed by 5 graduate students from UCLA emphasized many positive aspects of ESOPs but also threw light on some negative ones.[4]

"Many companies indicated no difference in the level of employee motivation resulting from the plan. The greatest number of these claimed that the complexity of the plan and the difficulty of making an intangible benefit appear real was responsible for the apparent indifference or confusion on the part of the employee. . . ."[5]

"Even in those companies where perceived employee response was considered good, management stressed the importance of an on-going educational program to sell the ESOP concept."[6]

The success of the plan in motivational terms depends vitally on how well the plan is communicated. In effect, you must create a "new language" between

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[4] Matthew J. Bonaccorso, Sheridan M. Cranmer, David G. Greenhut, Daphne T. Hoffman, and Niel Isbrandtsen, *Survey of Employee Stock Ownership Plans: Analysis and Evaluation of Current Experience* (Los Angeles, California: University of California, Los Angeles, Graduate School of Management, December, 1977).

[5] *Ibid.*, page 19.

[6] *Ibid.*

management, employees, and stockholders—a common language for building understanding and mutual goals. Creating a new language is not easy!

You may or may not have seen the movie, *Close Encounters of the Third Kind.* Accompany me, if you will, to Devil's Tower and Sky Harbor. In the relevant scene, scientists from earth have made contact with extra-terrestrial people. The scientists are attempting to communicate with these creatures from outer space by using a newly created mathematical/musical language. The exchange in the movie and on the soundtrack is called "The Conversation." Listen!

"The Conversation" from *Close Encounters of the Third Kind.* Commentary by speaker during playing of tape: "The first link, they have developed the first link! See they are beginning to communicate; it is not coming easily but . . . they are achieving it. Now they are swinging, they are communicating. They are exchanging concepts and feelings."

Ladies and gentlemen, you have just witnessed the creation of a new language! What I am implying is that you must develop a new language and learn how to communicate in a meaningful way with your employee shareholders. You can not use the same anachronistic dialogue befitting an adversarial relationship as you strive to move to a cooperative relationship.

Many things must be done!

The purposes and features of the plan must be understood and appreciated by the participants. To bring this about, appropriate materials, such as summary plan descriptions, graphic booklets, annual reports, slide/sound presentations, individual account statements, and the like must be prepared. Meetings with employees should also be held—large or small groups depending on the size of your business. In other words, you should use the standard techniques of written, audio-visual, and verbal communication to convey the objectives and provisions of your plan. All very important . . . but not enough!

It is one thing for participants to know plan provisions and another thing for them to perceive enough about the company to develop a close identification with it. Employees should understand the history of the organization, where it came from and where it is going, what have been its achievements and what have been its failures. How can employees identify with the corporate family unless they know quite a bit about its heritage and its tradition?

What is the corporation's raison d'etre? Why does the organization exist? What is its primary purpose? What product or service is the company offering to the public that it can produce faster, better, or cheaper than anyone else?

What is your company's value to society? If you want to turn people on, particularly young people, you had better give them something worthwhile to which they can dedicate themselves. If you want them to stretch, grow, contribute, and perform, your corporate image should immediately convey to their minds the value of your company to society. This may be strictly a commercial value—the satisfaction of a legitimate human need at a price people can afford to pay—but, in any case, it must generate pride within your people to know they are part of this worthwhile endeavor.

Once a year, the President of the U.S. delivers a "State of the Union" message. Why should not corporate persidents deliver "State of the Company" messages several times a year to their employees? How is your company progressing? What are your competitors doing? What are their strengths and why are they taking some of the business away from you? What can management and employees do about it?

How are people supposed to help you win in any activtity unless they know the score? They must know the score on an ongoing basis—not just at the end of the game—but inning by inning, quarter by quarter. In sports, if players did not know the score till the end of the game, can you imagine them winning the game? Not even the Los Angeles Dodgers could do that!

Talk about communicating. It should go even beyond all of the above. Business leaders should be communicating about the whole private enterprise system, the American economy, and what it is all about. What is a free market economy? How much does a typical manufacturer make in a free market economy? Is it the twenty-eight to thirty-two cents on the dollar that the average American, German, or Englishman believes? Certainly not! It is five to six cents on the dollar. What is the average return on investment. Is it 40 to 50 per cent that some college students say is justified? Certainly not! On an after-tax basis, it is 12 to 14 per cent return on equity.

The most distressing phenomenon I observe is that management people—who have the greatest stake in their employees knowing the economic facts of life—

are unfortunately so busy about the business of business that they do not have (take) the time to create and protect a climate in which business can thrive.

All around the world the private enterprise system is under attack and is carying out for constituents. What an opportunity business leaders with profit sharing/share ownership systems in their companies have to demonstrate that a "broadly-owned, sharing capitalism" will produce a higher standard of living for more people than any other system ever conceived by man.

6. Sharing productivity/profit gains with employees

You must share productivity gains with your people through your ESOPs.

Most hourly-paid employees believe that they do not derive and direct benefit from increasing productivity. They feel stockholders and managers benefit—the "other guy" benefits—but not themselves. In fact, wage employees are inclined to think that the other guy benefits at their expense. Increasing productivity, to hourly-rated people, means that they will be automated out of their jobs, have to work harder (speed-up), and/or will work themselves out of their jobs that much faster. Higher productivity conveys job insecurity—it is perecelved as moving the worker that much faster toward the back door.

You must overcome these negative, but very legitimate, concerns among your employees. You must convince them that through your stock ownership program, productivity is definitely recognized and rewarded. Yours is a sharing company. That point should come through loud and clear.

7. Importance of each tem member

Every member of your team is important. Everyone on the team has a significant position to play or he should not be on the team. Respect his contribution, call for it, and you will get it.

8. Employee involvement.

Involve your employees. Not enough companies create structural changes within their organizations (when they introduce a system incentive program like an ESOP) to that employees can help them run a more efficient, productive business.

In September, 1977 I participated in a Work in America Institute conference in New York. Carl Frost from Michigan State University emphasized at the conference Scanlon plan techniques for employee involvement. These techniques are extremely worthwhile and can be employed to great advantage by ESOP companies.

Production Committees are organized in every department of the company. Each committee consists of the foreman/supervisor and an employee elected by his own peers. The committee's special responsibility is to solicit and process suggestions for cost reductions, productivity improvements. Ideas which make sense and lie within the jurisdiction of the committee are immediately put into effect. If a suggestion involves major changes in engineering, layout, product cost, packaging, and the like, other resource people are brought into the discussion.

All suggestions are sent to the company's Screening Committee. This committee is made up of the chief executive officer and his key staff people. On a monthly basis, the Screening Committee reviews all ideas put into effect at the Production Committee level and discusses concepts that require further input and refinement.

Through these structural modes, a climate is created conducive to continuous changes for the better.

McCormick & Company, Inc. uses a Multiple Management Board System to generate beneficial results. Problem-solving teams are created which work to effect productivity increases, quality improvements, better ways to do things.

Tailor participative modes to your own company but get your people involved. How else are we going to compete with the Japanese who already have 7,000,000 workers organized into quality control circles? Seven million Japanese trying to cut costs are hard to beat. No wonder the U.S. dollar continues to slide as against the Japanese yen.

9. Diversity of security resources

I get very distressed when people like Joseph Califano, Secretary of Health, Education and Welfare (HEW), suggest that the private retirement income system in this country be completely wiped out in favor of an expanded Social Security program. This would be tantamount to concentrating all of our long-term security resources in one very leaky vessel. Von Thünen warned us about political solutions to economic problems.

Private qualified defined contribution and defined benefit plans provide diversification of retirement income resources. They build economic strength into the individual, making him less dependent on governmental programs.

Also, under individual account plans like profit sharing and ESOP programs, individuals can affect the ultimate amounts in their accounts ((at least to some degree) by superior work performance. These plans provide motivation at the level of the enterprise where wealth is created. There is little or no motivational value in Social Security. Nobody ever worked harder so he could get a larger Social Security check.

Please do not get me wrong! I believe Social Security has its place in the spectrum of retirement income resources, but I feel all of us aware of the value of private plans should collaborate to protect/improve the spectrum.

10. Hierarchy of incentives

Fish determine the bait!

Remember that sage observation in evaluating the motivational value of your ESOP. Individuals differ considerably. They respond to different incentives, even at different stages of their lives.

A fully deferred ESOP, with no withdrawals during employment, with benefits paid only after a member retires or terminates, has its own unique appeal. It provides a long-term, stock ownership incentive—perhaps as strong (or stronger) in its own right as (than) a short-term cash incentive.

Nevertheless, because of the great variations between people, it it frequently advantageous to have other performance reward systems operative alongside your deferred ESOP. My advice is to permeate your company with an incentive philosophy. Create a "hierarchy of incentives" from individuals on up—through small teams, departments, plants— to the entire corporation.

Shoot your organization through with incentives from bottom to top—some cash, some deferred; some psychic, some financial; some short-term, some long-term. Share profits, responsibility, and ownership. Turn your people on to high productivity.

CAN CAPITALISM SURVIVE?

We are striving to do something extremely dramatic—something that has never been done before in the history of the world.

In all industrial societies, ownership has always been concentrated in the hands of a few—a few private hands, a few bureaucratic political hands, or (now under the Meidner proposal for Sweden) possibly in a few union leader hands.

We have an opportunity today to create a society where we do not have concentrated ownership, but diffused ownership among millions of our people.

A while ago, *Time* magazine presented an article entitled, "Can Capitalism Survive?" After analysing the history of capitalism and all the pros and cons about the system, the article ended with the rather depressing prognosis: "It is the worst system—except for those other systems that have been tried and failed."

I maintain that capitalism can survive if it is a "sharing capitalism"—with broad numbers of our people having a direct stake in efficiency profits and in ownership of the companies for which they work.

A "sharing capitalism" can not only survive, but thrive.

FEDERATED DEPARTMENT STORES, INC.,
Cincinnati, Ohio, August 22, 1978.

Hon. RUSSELL B. LONG,
U.S. Senate, Russell Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: I would like to take this opportunity to transmit to you the enthusiastic endorsement of Federated Department Stores, Inc. for S. 3241, your proposal to make employee stock ownership plans more attractive to labor intensive companies such as ours. We have had a profit sharing plan through which we encourage and aid employee stock ownership for many years, to which we added an employee stock ownership plan, with nearly 31,000 employees now participating. The changes in the tax laws you have proposed in S. 3241 would make it possible for us to expand this latter plan substantially, which we believe to be beneficial both to our employees and to our Company.

It has been our experience that widespread employee ownership of shares in their company produces exactly the kind of benefits I'm sure you envisioned when you first advanced the TRASOP idea several years ago: a better understanding of the capitalistic system through broader participation in it. It is also our belief that employee stock ownership is a powerful motivator to better performance, an important result when increased productivity is so badly needed in virtually every sector of the American economy today.

I have discussed this matter with our Chairman, Ralph Lazarus, and it is my understanding that he is so enthusiastic about the plan he hopes to call on you shortly to reemphasize personally our support for your proposal and our strong feeling that adoption of it would add materially to the feeling of participation in American business that is at the heart of the survival of our economic and political system.

Sincerely yours,

BORIS AUERBACH.

[From Pensions & Investments, Sept. 25, 1978]

THEY'RE HERE TO STAY—ESOP: FINANCE TOOL, EMPLOYEE BENEFIT

(By Jonathan M. Conrad)

Three or four years ago, an officer of a lending institution or a bank trust department attempting to explain the ESOP concept to a corporate treasurer might have found his listener confusing ESOP's with Aesop's Fables. You would have to assume, of course, that the lending officer or trust officer knew enough about ESOP's to explain them in the first place.

But times have changed for ESOP's, or Employée Stock Ownership Plans. Now, more than ever, they make good sense to business as a tool of corporate financing as well as a flexible deferred compensation plan. And they've gained new momentum with the passage of new regulations under the Internal Revenue Code.

Briefly, an ESOP is a type of deferred compensation program under which a company, through a financing vehicle, borrows or contributes money to buy the company's stock. The stock is then allocated to employees on a predetermined basis, usually dependent on payroll and time or service. For its part, the company gets special tax benefits, which help to pay for the stock as well as improve the company's cash flow.

As readers of this newspaper are probably aware, the ESOP concept was invented several decades ago by Louis O. Kelso, a San Francisco attorney, and the author of many works on the diffusion of capital ownership. About four years ago, Kelso presented his concept to the Senate Finance Committee and immediately gained the support of its powerful chairman, Senator Russell B. Long (D.-La.). After that presentation, ESOP's were included in two important pieces of legislation—the Employee Retirement Income Security Act of 1974 (ERISA) and the Tax Reduction Act of 1975.

TAX LAW CHANGED

In the case of the latter, ESOP's were given a boost because the legislation helps ESOP's facilitate the purchase of stock by granting sponsoring companies and extra 1 percent (along with the usual 10 percent) investment tax credit if the extra 1 percent is contributed to an ESOP. This type of ESOP, sometimes referred to as a TRASOP, can be a "free lunch" for any corporation with sufficient capital expenditures that is willing to take advantage of the extra 1 percent. Moreover, the Tax Reform Act of 1976 extends the life of the additional 1 percent for investments made previous to January 1981.

And Senator Long's recently introduced Expanded Employe Stock Ownership Act of 1978 (S. 3241) would increase the tax credit to 2 percent for contributions to the ESOP trust, and the credit would become a permanent provision of the tax code. In addition, the new bill would provide a 1 percent tax credit based on payroll as an alternative for companies that traditionally do not make significant capital expenditures, such as service companies. The bill would make dividends paid on stock in the ESOP tax deductible, as well. It also would increase the incentives for establishing leveraged ESOP's.

But enough of the background. How do ESOP's work?

In the case of a leveraged ESOP, principal amortization as well as interest paid on the loan essentially becomes tax deductible as a tax item (normally only interest is tax deductible).

To be certain, the leveraged ESOP is not a panacea; but an ESOP does provide financing capabilities not found in other deferred compensation plans. Given the right corporate situation, an ESOP is an extremely creative financial tool which can be used to finance new corporate capital formation.

Figures 1 and 2 are illustrations of two classic ESOP's—new capital formation through a leveraged ESOP and the creation of a market for the stock of a privately held corporation, as well as the transfer of ownership.

Essentially, a leveraged ESOP works as follows: a company designs an ESOP to qualify as an employee stock ownership plan under Section 401A and 4975 (E)(7) of the Internal Revenue Code.

The company then proposes and requests an ESOP loan from a bank or other commercial lender. The ESOP gives a note to the lender and, in turn, the lender can request that the corporation establishing the ESOP guarantee the loan to the trust. Moreover, with the new IRS regulations, the lender can now look to the corporation for payment with the normal financial covenants usually found in term loan agreements. It is also possible to take security from the company to secure the loan to the ESOP. In addition, the company may be viewed by a lender to be stronger financially once cash flow improves with the ability of the company to take principal of the loan as a tax deduction.

An ESOP should not necessarily be recommended to a company to be used as its sole qualified pension plan—unless, that is, Congress someday creates an insurance scheme to guarantee the value of the ESOP assets. Many critics rightly have argued that investing all of an employe's retirement security in employer securities is too risky for a pension plan. But an ESOP can be a good complement to pension plans as well as another employe benefit with incentive qualities tied to employe-employer performance.

Accordingly, the company usually appoints an ESOP committee and the committee in turn directs a trustee or trustees (in many cases a bank trust department) to invest the money available to the trust in newly issued stock at fair market value or tender for shares on the open market. Once the trust is in place, the corporation can take a tax deduction on any contribution to the trust, including principal, to pay down a loan to the trust. However, the tax deduction on contributions to the trust may not be larger than 15 percent of the covered payroll or, where there is a combination of stock bonus and money purchased pension plans, one of which qualifies as an ESOP, the maximum annual corporate deduction is 25 percent.

As repayment of the loan is made, shares of company stock are allocated to the employe on a predetermined basis, depending on length of service, etc. The employe becomes entitled to increments of stock over the period of the loan; however, the stock is allocated among employes although not distributed at the time of purchase by the trust so that potential appreciation starts the first year the stock is acquired by the trust. If the vesting of employe rights were deferred, to the extent permissible under application regulations, an ESOP could reduce turnover by "locking" employes into the plan.

Finally, the company, by way of the trustee, can elect to pass through or not to pass through voting rights. Moreover, the ESOP can be structured so that dividends can be passed through to employes as a second source of income or maintained by the trust to accumulate tax free with the rest of the assets until retirement, at which time the employe's share is taxed on a long-term capital gains basis.

Where will ESOP's go from here?

A U.S. Chamber of Commerce survey recently estimated that benefit costs such as pensions, insurance, vacations, etc. are rising twice as fast as wages. Benefit costs for all employers grew 165 percent between 1965 and 1975, while salaries increased 85 percent.

POPULARITY GROWS

An ESOP is a type of employe benefit. More importantly, perhaps, it is a vehicle for capital formation, and one which might help hold the line on further benefit increases.

While they do not suit all companies, ESOP's are likely to become more attractive to more and more companies in the U.S., particularly if relevant legislation and regulations continue to be favorable.

Already a recently formed ESOP Council of America has hundreds of members including some of the country's major corporations. The National Association of ESOP Companies has been formed with over 40 member companies, employing over 9,000 participants. Grafton Publications Inc. in New York is gearing up to produce an ESOP Newsletter and leading legal ESOP practitioner Jack Curtis recently has been appointed to Senator Long's committee.

This form of employe benefit also presents opportunities for the owner of a closely held company to sell his stock. As Neil Wassner, ESOP pioneer and partner in charge of the merger and acquisition department of Main, Lafrentz & Co. points out, "In order for a stock redemption to qualify for lower capital gains treatment, it is necessary to meet some difficult Internal Revenue standards. By having the trust purchase his stock, the shareholder will, under particular circumstances, be certain to receive capital gains treatment and can even get a ruling to protect himself in some circumstances."

The new IRS regulations released last September clarified most of the technical ambiguities for ESOP's that had created "holding patterns" for many companies interested in these plans. Ronald Ludwig of San Francisco, a legal ESOP practitioner helped draft the IRS legislation. "The uncertainty is now over because we have definitive rules relating to ESOP loan requirements," he declared. "The objectionable restrictive provisions are no longer a major concern to closely held corporations."

On a philosophical level, however, diffusion of capital for a private market economy is thought to be most important if not absolutely essential to the future health of the economic environment in this country. ESOP's could prove to be a palatable medicine to help keep this nation healthy.

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