Statement for the Record

ATTN: Working Group on Individual Income Tax

The following statement is submitted by The ESOP Association located at 1726 M Street, NW, #501, Washington, D.C., 20036, phone 202-293-2971. The person who drafted the following statement is J. Michael Keeling, President, The ESOP Association, email michael@esopassociation.org.

The ESOP Association is a 501(c)(6) business trade association with approximately 2,800 members. Its mission is to educate and advocate for broad-based employee ownership among U.S. employees via the ESOP model.

This statement provides a brief history of employee stock ownership plans (ESOPs) and evidence that the ESOP model of employee ownership is spot on with six of Chair Hatch's seven principles for comprehensive tax reform, and arguably exceeding the seventh principle.

The seven principles for comprehensive tax reform are:

1. Economic Growth
2. Fairness
3. Simplicity
4. Permanence
5. Competitiveness
6. Promoting Savings and Investments; and
7. Revenue Neutrality

What Is an ESOP?

Unique among ERISA plans, an ESOP, by law, must be primarily invested in the highest class of stock of the plan sponsor and the stock may be acquired with borrowed funds. In practical terms, the plan sponsor may take on 'debt' to acquire shares of the sponsor, and not be engaged in a prohibited transaction if the shares are acquired by the ESOP trust at a price no greater than the fair market value.

Brief Historical of ESOPs

The ESOP model of employee ownership actually has its roots in a compensation practice from the 19th Century. (A recent book, **The Citizen's Share**, Blasi, Freeman, and Kruse, Yale Press, wrote a very convincing case, pages 1 – 56, that our founding fathers, such as Washington, Jefferson, Adams, Hamilton, et al, believed in broad ownership of productive assets as being essential to the survival of a democracy. President Lincoln's views, as evidenced by the Homestead Act, were also in sync with our founding fathers' views.)

As the U.S. economy moved into the industrial age, corporations with nationwide reach, and large numbers of employees emerged — Procter & Gamble, Montgomery Ward, and others. Leaders of these companies realized that some employees would work for many years, reach an age requiring retirement, and retire with no income. There was no 19th Century safety net for retirees, and leaders of a number of national firms decided to set aside company stock for the employees to have when they retired, and to "cash in."

After World War I, and the ratification of the 16th Amendment to the Constitution authorizing a national income tax, Congress recognized that taxing income was not so simple, and that many issues had arisen because the basic definition that income is anything of value received by an individual, and the general rule that an income tax should tax anything of value.

In response to questions of what income should be taxed, Congress developed the very first true income tax code, the Code of 1921.

In developing the Code, those firms that were setting aside stock for their retiring employees came to the House Committee on Ways and Means and asked — "Is the stock set aside for an employee's retirement taxable when set aside, and is the value of the stock an employer's compensation cost?"

The Ways and Means Committee decided no, it was not current income to the employee, but would be taxed when the employee realized the previously deferred income; and yes, the set aside was compensation, and thus a cost of business for the employer and thus deductible for income tax purposes.

Thus, the first deferred compensation plan recognized by Congress was the "stock bonus plan," the forerunner of today's ESOP.

Fast forward to post War World II and owners of privately-held businesses began to consider how to "exit" their businesses and "cash" in their non-tradable stock in the company they started and which had become successful because of the hard work of the company employees. While somewhat lost in history due to the fact that until the mid-1970s private letter rulings were not public documents, an owner in Alaska, followed by others, obtained permission from the IRS, in a non-public letter ruling, that the company could "buy" his stock with borrowed money, have the stock placed in the company's stock bonus plan, and have the stock allocated to the employees as the debt was paid off.

A true visionary in San Francisco, California, Dr. Louis O. Kelso, developed a comprehensive economic philosophy in using such a method for funding stock bonus plans to expand ownership in a capitalistic society and to facilitate capitalization of for-profit businesses. He and his law firm colleagues led the way in expanding the use of this method blessed by the letter rulings, and many correctly note that the first "ESOP" was the sale by exiting shareholders of the *Monterrey Press* north of San Francisco in 1957 to an ESOP.

By the mid-1950s, many, both conservative and liberals, were seeing abuses in the area of pensions, or tax qualified deferred compensation plans, which the tax laws sanctioned and encouraged. Evidence was overwhelming that some pension funds were investing in organized crime activities. Then there was the collapse of major U.S. employers, leaving employees with no retirement income as promised. As a result, a drive in Congress to "reform" the tax and labor laws governing tax qualified deferred compensation plans, or "retirement savings plans," led to the enactment of ERISA in 1974.

During Congressional work on these "tax qualified deferred compensation plans," a major influence on tax policy of that era, Senator Russell B. Long, long time chair of the Senate Committee on Finance became a champion of the economic philosophy of Dr. Kelso, and made sure the new ERISA law sanctioned ESOPs.

His support for the ESOP model grew stronger with each passing year, and his leadership led to major enactment of tax laws promoting the creation and operation of ESOPs. The bulk of these laws passed in 1984, in legislation referred to as DEFRA, and the perfection of those laws was in the Tax Reform Act of 1986.

Many of these laws of the 1980s remain in the Code, and were evidenced and endorsed repeatedly by the Finance Committee members in hearings, and tax law legislation of the late 80s through the late 90s, even after Senator Long retired in 1987.

To be noted, a major partner with Senator Long promoting ESOPs in the 80s through 1988, was former President Ronald Reagan, who often spoke of his view that widespread ownership of productive assets was the core of maintaining equitable wealth ratios in a capitalistic society.

And, after Senator Long retired, his successor in the Senate, former Senator John Breaux, led the expansion of ESOP law in the 1996-1997 tax bills permitting S corporations to sponsor ESOPs. Since Senator Breaux's work to expand ESOPs, the number of 100% ESOPs that are S corporations has exploded. (There are out of the estimated 10,000 ESOP companies, an estimated 3,000 are 100% ESOP.)

In sum, the work you are doing is part and parcel of a long, supportive policy of the Finance Committee's developing laws to have average pay employees, or workers if you will, be owners as being good for the employees, good for their employer, and good for the wellbeing of our economy and democracy.

ESOPs and the Seven Principles

1. Economic Growth: The laws, most originating in the Committee on Finance, that encourage the creation and operation of employee owned companies utilizing the ESOP model, are not industry specific; thus unlike many special tax rules that benefit certain taxpayers, there is no one area of the economy to claim, or discredit the claim that law x, or y, or z, caused the industry, or set of industries, to grow and provide more jobs.

But there is considerable evidence that ESOP companies outperform similar conventionally owned businesses in terms of profitability, productivity, sales, job sustainability, with the jobs in the United States.

One macro statistic that underlies the view that ESOP companies are more likely to be providing growth arises from data from the General Social Survey of 2010 that employee stock owned companies laid off employees at a rate of less than 4% during the Great Recession of 2008—2010, whereas conventionally owned companies laid off employees at a rate of greater than 12%. While one can do some speculation why as a rule employee stock owned companies were able to keep average pay employees on the payroll during the Great Recession, a common sense view would be that these companies were performing better than conventionally owned companies.

Any economist would agree that the more people work and have income, the more the economy can grow, as people with money from their jobs, buy things—from big ticket items such as a car, to a small ticket item such as chewing gum.

And, as Attachment 2 displays, there is a law, that originated in the Senate, 90 Stat. 1520, P.L. 94-455, Section 803, that clearly states Congress has passed laws to encourage ESOPs in order to strengthen the free enterprise system because the method of creating ESOPs solves the problems of securing capital funds for necessary capital growth. Capital growth and economic growth are interchangeable.

Attachment 1 summarizes the data that the reason Congress passed laws to encourage capital, or economic growth, has been met over the past 40 plus years. In fact, given the experience of this nation with the limited number of ESOP companies, a strong case can be made that there should be more employee owned companies via the ESOP model if the Congress wants to see more economic growth, particularly in the global economy in which we live.

2. Fairness: The core attraction of ESOPs is having policy to increase the wealth of average pay employees, not just the already wealthy, without "taking " from those who have wealth and who may have done the most to create successful businesses that provide jobs and opportunity. The fairness attraction of "shared" ownership is a fact, as noted by leaders from George Washington to Abraham Lincoln to Ronald Reagan, and many others.

3. Simplicity: The primary beneficiary of employee ownership via the ESOP model, the average pay employee, does not face complexity of any significance due to the fact s/he has a share of ownership of the company where she/he works because of participation in an ESOP. Certainly, when the employee owner cashes out of an ESOP, she/he faces the matter of paying taxes on his/her money. And to claim the ESOP model is too complex for the company sponsor of an ESOP compared to its benefits would be a stretch.

4. Permanence: Congress, both House and Senate, have consistently maintained for over 40 years the core laws, and benefits of ESOP. Yes, during the second half of the 1980's, Congress tweaked some of the 1984/1986 special tax benefits for ESOPs, but <u>all</u> the key benefits were maintained. In the late 1990's, Congress added law to permit S corporations to maintain

ESOPs. This 1996/1997 pro-ESOP law was tweaked in 2001 to stop anyone from creating a flim flam S ESOP, but the S ESOP law's intent is still maintained.

And is the permanence of ESOP law an oversight by the Congressional tax committees? No, as evidenced by fact that the Tax Reform proposal released February 26, 2014, by former Chair of the House Ways and Means Committee, Dave Camp after over a year of closed door review of current Federal tax law, did not alter any specific ESOP law. And evidence is strong that the majority members of Ways and Means were presented options by staff to diminish ESOP tax laws, as staff did so for all special tax laws, as is the standard procedure in a tax reform effort.

5. Competitiveness: Years of research, by reputable academics and think tanks, make an overwhelming case that ESOPs are more competitive than conventionally owned companies. As already noted Attachment 1 provides more details about the macro data evidencing that employee owned companies are more competitive, but highlights are: In *Shared Capitalism at Work*, edited by two Rutgers University professors—Blasi and Kruse—and a Harvard professor—Freeman—it was evidenced that employee owned companies had harder working employees that work harder, had a low turnover, had greater job security, better labor management relations; work by Dr. Brent Kramer in his dissertation for City University of New York evidenced that majority employee-owned companies, using size and sales comparables, had an over 8% average of more sales per employee; and in the late 20th Century, in a review of closely held ESOP companies, which are the majority of American businesses, for over a decade, with 1100 ESOP companies compared to similar 1100 conventionally owned companies, evidenced that the ESOP companies had better sales, and were more likely to remain in business over an eleven year period.

6. Promoting Savings and Investments: Data collected by various researchers in the field of retirement savings indicated that on average, ESOP account balances are greater than other retirement savings, in defined contribution plans. Data collected from ESOP companies collected each year by The ESOP Association indicates the average account balances—keeping in mind averages are for those relatively "new" employee with only a few years of allocations to their accounts, and, for example the balances of long-term employees of ESOP participants, is over $200,000, whereas data released by a variety of retirement savings researchers indicate average balances in the popular 401(k) plans to be approximately $85,000. (While anecdotal, and thus not impressive to "researchers" the author of this document, Michael Keeling, President of The ESOP Association has visited personally in over 500 ESOP companies the past two decades, and has heard many, many times of distributions from ESOPs to average pay employees in the $500,000 to $1 million plus range.)

7. Revenue Neutrality: There is no way, based on the historical methods used by government revenue estimators, by employees of the Executive and Congressional branch of our government, not to says special ESOP tax benefits are revenue losers to the tune of around $2 billion each year.

But, once it became evident that during the Great Recession that employee stock owned companies laid off people at a rate of less than 4% compared to conventionally owned

companies that laid of employees at a rate of more than 12% in the same time line, one had to step back and say, “Wait a second—what if there had been no employee stock owned companies during the Great Recession, and the companies all laid off employees at a rate of more than 12% how much money would Uncle Sam not collect—in other words, how much money did ESOP companies save Uncle Sam during the Great Recession as ESOP companies had more people paying income taxes, Social Security taxes, and Medicare taxes in the 2010 period? Using an average income tax rate of 8% for the average pay worker, the National Center for Employee Ownership calculated that these ESOP companies, by keeping people at work, because they are more competitive, put into Uncle Sam’s Treasury over $14.5 billion more than if they had worked for those companies with 12% plus lay off rates, or approximately seven times more revenue than the $2 billion revenue loss because of the ESOP laws encouraging the creation and operation of ESOP companies.

Yes, ESOP tax benefits may not be revenue neutral, but the fact is that ESOP companies pay a lot more to Uncle Sam than conventionally owned companies because ESOP company employees are more likely to have sustainable jobs triggering tax payments to Uncle Sam.

Thus to say ESOP laws are hurting Federal revenue collection is not supported by solid evidence gleaned from the General Social Survey of 2010.

Conclusion: Laws to promote the creation and operation of employee owned companies through the ESOP model are more than justified because ESOP laws meet the seven criteria set forth by Chair Hatch to use when judging are the laws good for America? Bottom line, ESOPs are more productive, more sustainable, with jobs controlled by U.S. interests, providing better retirement savings for average pay workers than other savings plans, and making our nation more competitive.

Employee Owner Impact Corporate Performance Positively Overwhelming Evidence ESOP Companies More Productive, More Profitable, and More Sustainable, Providing Locally Controlled Jobs

- During the Great Recession, employee stock owned companies laid off employees at a rate of less than 3%, whereas conventionally owned companies laid off at a rate greater than 12%. (Data source: 2010 General Social Survey.)

- Because employees of ESOP companies were four times more likely to retain jobs during the Great Recession, Federal government recognized savings of over $14 billion in 2010 compared to tax payments foregone by laid off employees of conventionally owned companies; in other words for every $1 in tax expenditures to promote employee stock ownership, the Federal government collected $13 in taxes. (Data Source: 2010 General Social Survey analyzed by National Center for Employee Ownership.)

- A survey of 1,400 ESOP companies in 2010 evidenced the average age of the companies' ESOPs were 15 years, and the average account balances for employees were nearly $200,000, much higher than data reported for average 401(k) account balances. (The ESOP Company Survey, 2010, of The ESOP Association's Corporate members.)

- According to 2012 General Social Survey, 13% of employees of employee stock-owned companies were thinking of seeking employment elsewhere, whereas 24% of the employees of conventionally-owned companies were considering leaving their current job.

- In the summer of 2014, the Employee Ownership Foundation released results from the 23rd Annual Economic Performance Survey (EPS) of ESOP companies. Since the Employee Ownership Foundation's annual economic survey began 23 years ago, a very high percentage, 93% of survey respondents, have consistently agreed that creating employee ownership through an ESOP was "a good business decision that has helped the company." It should be noted that this figure has been over 85% for the last 14 years the survey has been conducted. In addition, 76% of respondents indicated the ESOP positively affected the overall productivity of the employee owners. In terms of revenue and profitability --- 70% of respondents noted that revenue increased and 64% of respondents reported that profitability increased. In terms of stock value, the majority of respondents, 80%, stated the company's stock value increased as determined by outside independent valuations; 18% of the respondents reported a decline in share value; 2% reported no change. The survey also asked respondents what year the ESOP was established. Among those responding to this survey, the average age of the ESOP was 16 years with the average year for establishment being 1998.

- More than half of the ESOP companies have two retirement savings plan (primarily a 401(k)), whereas more than half of all companies have no retirement income savings plan. (Analysis of forms 5500, and Bureau of Labor Statistics by the National Center for Employee Ownership, funded by the Employee Ownership Foundation.)

- The average ESOP company (less than 200 employees) has sales $9 million more per year than its non-employee owned comparable competition. (June 2008 Dissertation, Dr. Brent Kramer, CUNY.)

- A study of 1100 ESOP companies over eleven years compared to 1100 comparable conventional owned companies evidenced the 1100 ESOP companies had better sales, more employment, and were more likely over the period to remain independent businesses by 16%. (Most detailed study of ESOP companies by Dr. Joseph Blasi, and Dr. Douglas Kruse, tenured professors, Rutgers University School of Labor and Management, 1999.)

This Is The Law!

90 Stat.1520, P.L. 94-455

(h) Intent of Congress Concerning Employee Stock Ownership Plans. – The Congress, in a series of laws (the Regional Rail Reorganization Act of 1973, the Employee Retirement Income Security 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 trust and employers to take the necessary steps to implement the plans, and which otherwise block the establishment and success of these plans. (Pub. L. 94-455, 90 Stat. 1520)