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The University of Texas School of Law

The Shelf Project

Revenue-Raising Proposals to Defend the Tax Base

Repeal Tax Incentives for ESOPs

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Repeal Tax Incentives for ESOPs

By Andrew Stumpff and Norman Stein

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The proposal would repeal special tax incentives given to employee stock ownership plans, as well as the exemption granted to those plans from the investment diversification requirement of the ERISA.

The proposal is made as a part of the Shelf Project, a collaboration among tax professionals to develop and perfect proposals to help Congress when it is ready to raise revenue. Shelf Project proposals are intended to raise revenue without raising rates because the best systems have the lowest feasible tax rates and taxes that are unavoidable. Shelf projects defend the tax base and improve the rationality and efficiency of the tax system. A longer description of the Shelf Project is found at "The Shelf Project: Revenue-Raising Proposals that Defend the Tax Base," *Tax Notes,* Dec. 10, 2007, p. 1077, *Doc 2007-22632*, or *2007 TNT 238-37*.

Shelf Project proposals follow the format of a congressional tax committee report in explaining current law, what is wrong with it, and how to fix it.

This proposal would require all qualified retirement plans to have well-diversified investments. It would repeal the special tax incentives given to employee stock ownership plans. ESOPs represent bad public retirement policy because they concentrate employees' retirement funds in a single investment. The single investment, moreover, is employer stock, so that if the employer goes bust, both the career and the investment nest egg of the employee disappear. The proposal would repeal all subsidies for ESOPs and plan-held employer stock in general, including section 1042, which allows deferral of gain on sale of stock to an ESOP; section 404(k), which allows a corporation to deduct dividends paid on ESOP stock; and section 402(e)(4), which excludes net unrealized appreciation of employer securities distributed in-kind from qualified retirement plans. ESOPs would be subject to the diversification requirement otherwise applicable to ERISA plans.

A. Current Law

1. Origin of the ESOP.[1] ESOPs are employer-sponsored retirement plans that invest mostly in the employer's stock. Although the idea of deferred compensation plans investing in employer stock found its earliest statutory expression in the Revenue Act of 1921, the modern ESOP movement was born in the 1950s when a San Francisco lawyer, Louis O. Kelso, developed a set of eccentric economic theories, including that it was crucial for society to arrange for large-scale stock ownership by average working people. In his 1958 book, *The Capitalist Manifesto*,[2] Kelso argued that the United States should adopt a set of radical policy proposals that included a massive increase in estate and gift tax rates; imposition of a requirement that all American corporations effectively distribute all their earnings annually to their shareholders as dividends; and encouragement of employers to adopt what was then called by Kelso the "equity sharing plan," but came later to be known as the ESOP.

Kelso's views were dismissed by economists and most of his agenda, and all his economic theories quickly forgotten. The part about ESOPs was not forgotten, however, because in the 1970s Kelso was able to convince the then Senate Finance Committee chair, Russell Long, that the plans should be encouraged by the government.

The idea with ESOPs is that workers become capitalists: They effectively become the owners of the companies they work for. This was vital, Kelso thought, because the value of the wages laborers could earn for their work was and would continue to be in historic, drastic decline. Workers therefore needed some other source of income to support themselves. Under Kelso's proposals, this replacement income would come from the ESOP, the "Second Income Plan" that would put the workers on the same footing as business owners, able to earn a share in the profits earned by capital rather than labor. (Kelso's economic worldview was eventually named binary economics by him and his followers, to reflect the idea of these dual sources of income.)

Kelso found an audience in Long, who sympathized with the situation of working people[3] but was politically

[1]The history summarized here is recounted in greater detail in Andrew Stumpff, "Fifty Years of Utopia: A Half-Century after Louis Kelso's *The Capitalist Manifesto*, a Look Back at the Weird History of the ESOP," 62 *Tax Lawyer* 419 (Winter 2009). That article also provides sources for the events described here.

[2]Coauthored with Mortimer Adler.

[3]He was the son of Louisiana Governor Huey Long, one of the most famous populist politicians in American history.

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distrustful of more traditional means of redistributing income through such government interventions as progressive tax rates and welfare programs. Over a lengthy dinner (that became famous in ESOP circles) in Washington in 1973, Kelso was able to persuade Long that encouraging ESOPs would result in a more equitable distribution of wealth without undermining the free market or confiscating from society's haves.

Given the power landscape of the Senate, Long was in a position, at least at times, to effectively achieve the enactment of legislative provisions single-handedly. It happened that in 1973 the proposal that would become ERISA was in the final stages of consideration. The proposed legislation included a new set of fiduciary rules to govern the investment of employee benefit plan assets, which borrowed heavily from modern portfolio theory. A central principle among these rules was the requirement of diversification: Those in charge of investing a retirement plan's assets would be obligated to see that those assets were diversified rather than concentrated in one or a small number of investments. This rule would have rendered ESOPs effectively illegal because those plans by definition involve investment exclusively or nearly exclusively in the stock of the employer. After having dinner with Kelso, Long successfully undertook to arrange for ERISA to include an exception to the diversity requirement for ESOPs.[4]

Kelso and Long did not stop with protecting ESOPs from extinction, however. Personally convinced of the correctness of Kelso's views, Long went on to engineer several special incentives for employers to adopt ESOPs. For a time these included, most powerfully, a tax credit enacted as part of the Tax Reduction Act of 1975, known as the TRASOP credit.[5] The tax credit and some other provisions were eventually repealed after Long lost his committee chairmanship and later retired, but other special tax provisions remain (as of course does the ERISA exemption that permits ESOPs to exist), and some new ones were enacted even after Long's retirement.

2. Current ESOP statutory incentives and related law. Section 1042 allows a person selling stock to an ESOP to defer gain on the sale if specified requirements are met. Section 404(k) permits a corporation to deduct dividends paid on ESOP stock, and section 72(t)(2)(vi) exempts those dividend distributions to individuals from the 10 percent tax on premature distributions from qualified plans.[6] Section 4975 and ERISA section 408 contain exceptions to the prohibited transaction rules permitting sales of stock to ESOPs, as well as loans to leveraged ESOPs that would otherwise be subject to excise tax.

As noted above, ERISA section 404(a)(2) provides an exemption for ESOPs from the diversification requirement otherwise applicable to ERISA plans.

Section 402(e)(4) provides for exclusion of net unrealized appreciation of employer securities distributed in-kind from qualified retirement plans, a provision that further encourages ownership of employer stock by retirement plans. The appreciation is subject to tax only on the shares' later disposition by the recipient, at capital gains rates, and can result in a permanent exclusion from income if the stock is held until death and thus qualifies for a step-up in basis.

The most recent addition to the cornucopia of special ESOP tax provisions are two that have permitted ESOPs to invest in S corporation shares of their sponsors. Before 1998, S corporation stock could not be owned by a qualified deferred compensation plan, and in any event, the earnings of those shares would have been subject to the tax on unrelated business income. In the Small Business Job Protection Act of 1996 and the Taxpayer Relief Act of 1997, however, Congress permitted ESOPs to hold the stock of an S corporation plan sponsor[7] and it exempted income from that ownership from the unrelated business income tax.[8]

The special ESOP provisions are estimated to represent a tax expenditure of nearly $2 billion for fiscal 2010.[9]

B. Reasons for Change

1. ESOPs are not necessary to, and do not, increase workers' wealth. Although expanding the wealth of average workers was Kelso's initial reason for promoting ESOPs, that argument is no longer heard very much from ESOP supporters, perhaps because experience has shown Kelso's wide-ranging views, never taken seriously by economists, to be wrong. Kelso's overall goal of broad capital ownership has been partially realized, although in a different way than he envisioned. Defined contribution plans — particularly section 401(k) plans — are now the dominant retirement plan form in America. Defined contribution plans can and typically are invested in an array of diversified funds of stocks. Employee indirect ownership of capital has thus skyrocketed.[10] This development, however, has not led to the enrichment of American workers. By contrast, the evidence appears to show that the switch to defined contribution plans (from the traditional defined benefit plans that were more

[4] *See* ERISA section 404(a)(1)(C) and (a)(2).

[5] TRASOP stands for "Tax Reduction Act stock ownership plan." For more details about this tax credit, see S. Sacher et al., *Employee Benefits Law* (American Bar Association, 2d ed. 2004) 314, at n. 77.

[6] Section 72(t) generally imposes a 10 percent tax on qualified-plan distributions before the year in which the recipient attains age 59½. This provision is designed, in a rough-justice sort of way, to recapture the tax expenditure embedded in the distribution if it is received before a person reaches retirement age and to discourage preretirement distributions

(Footnote continued in next column.)

from qualified plans. (The ESOP dividend income, however, does not qualify under section 1(h)(11) as net capital gain. Section 1(h)(11)(B)(ii)(III).)

[7] Section 1361(c)(6).

[8] Section 512(e)(3).

[9] *See* Analytical Perspectives, "Budget of the United States Government for Fiscal Year 2009," at 291 (Table 19-1, Line 145), *available at* http://www.whitehouse.gov/omb/budget/fy2009/pdf/spec.pdf.

[10] It has been further observed that widespread stock option grants, particularly to technology company employees, arguably usurped part of the role Kelso had envisioned for ESOPs. Corey M. Rosen, John Case, and Martin Staubus, *Equity: Why Employee Ownership is Good for Business*, 53 (Harvard Business School Press, 2005).

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common in Kelso's day and that in no way involve worker ownership of capital, in the sense he meant) has entailed a reduction in overall retirement wealth.[11]

The Capitalist Manifesto's central premise, moreover, seems also to have been proven wrong over the last half-century. Technology has not destroyed the value of labor. Those without access to large amounts of capital continue to be able to earn a living by working. Although income disparity is great and has grown, workers in even the bottom quintiles of income are still better off in real terms than their 1970s counterparts,[12] for example, and this change has occurred despite the decline in the strength of organized labor during exactly the same time frame, which Kelso saw as a crucial artificial crutch propping up the status quo.[13]

At the most fundamental level, Kelso's arguments fail a basic test of economic realism. As a matter of mathematics, the wealth of have-nots cannot be increased without some combination of (i) reallocating wealth from the haves or (ii) increasing the amount of overall wealth available to both the haves and the have-nots. ESOPs are not intended, at least directly, to do the first thing — redistribute wealth from the wealthy — and there is no evidence that they have done so. As for the second thing — improved productivity because of ESOPs — as discussed below, (1) employee stock ownership has not been shown to improve productivity; (2) even if it had, employee stock ownership should not be accomplished through the retirement system; and, (3) finally, if employee stock ownership did improve productivity and should be accomplished through the retirement system, by definition there is no need for the government to subsidize ESOPs — it should merely permit them.

2. Stock ownership does not improve worker productivity. The argument for ESOPs now seems mainly premised on the view that a company's adoption of an ESOP improves worker morale and productivity.[14] As an initial matter, the evidence for this is questionable. Some studies (not sponsored by the ESOP industry) suggest that ESOPs have no effect on a company's success.[15]

In general, even outright ownership of stock — particularly small amounts of stock — is probably too attenuated to affect the motivation and performance of employees.[16] Most of the volatility of stock serves no incentive purpose. It appears that about 80 percent of the volatility in a share of publicly traded stock arises from industrywide or stock-market-wide factors over which management has no control. Thus, even if an employee could claim responsibility for *all* the relative value changes in the stock of the corporate employer, 80 percent of the change in stock price would still be random with respect to the merit of that employee. As to the (at minimum) 80 percent of volatility that is beyond an employee's control, stock is like a lottery ticket that rewards or penalizes only luck or lack thereof.

3. The pain of underdiversification. Retirement policy is concerned with ensuring workers have enough resources to retire. Promotion of employer stock ownership is concerned, at least in part, with something else. From the standpoint of pure retirement policy, as opposed to that of worker ownership, ESOPs are a terrible idea because they concentrate employees' retirement funds in a single investment. What would be bad enough under simple portfolio and diversification theory — no investor is advised to put all his money in a single stock[17] — is magnitudes worse when that single stock is that of the employees' *employer*. In that case, the indefensible investment risk posed by stock concentration is compounded by a further indefensible increase in the employees' overall risk: If something bad happens, the employees stand to simultaneously lose both their jobs and their retirement funds.

Unfortunately, this concern is no longer theoretical. Companies that maintained ESOPs when their stock became worthless include Enron, WorldCom, Bear Stearns, Lehman Brothers, the Tribune Company, and many others.

If we prefer that a greater share of America's employee compensation be paid in the form of employer stock, it would be better to replace salary or bonuses, rather than retirement assets, with stock.

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[11]Olga Sorokina, Anthony Webb, and Dan Muldoon, "Pension Wealth and Income: 1992, 1998 and 2004," 8-1 BRIEFS (Center for Retirement Research at Boston College, Jan. 2008), *available at* http://crr.bc.edu/images/stories/Briefs/ib_8_1.pdf.

[12]Center on Budget and Policy Priorities, "Income Inequality is Again on the Rise" (Oct. 17, 2005), *available at* http://www.cbpp.org/10-17-05inc.htm.

[13]*See* David S. Broder, "The Price of Labor's Decline," *The Washington Post*, Sept. 9, 2004, at A27. It might be stipulated here that the crushing inequality of American income makes it hard not to sympathize with what Kelso was trying to do, even if ESOPs seem not to be the right way to do it.

[14]*See, e.g.*, Rosen et al., *supra* note 8. *See* the Web site of the National Center for Employee Ownership, *available at* http://www.nceo.org/library/corpperf.html, for a survey of research that in various contexts supports a link between employee ownership and enhanced productivity.

[15]Henry Hansmann, "When Does Worker Ownership Work?" 99 *Yale L.J.* 1749 (1990); Note: "Money for Nothing and Leverage for Free," 97 *Colum. L. Rev*. 740, 752 at n. 82 (1997). For a general summary of the arguments, see B. McDonnell, "ESOPS' Failures: Fiduciary Duties When Managers of Employee-Owned Companies Vote to Entrench Themselves," 2000 *Colum. Bus. L. Rev*. 199, at 235. (Concluding that "the empirical literature on ESOPs and worker ownership suggests that ownership alone does little to improve productivity. While some studies do find improvement, others do not, and the latter are analytically sounder than the former.")

[16]Calvin H. Johnson, "Stock Compensation: The Most Expensive Way to Pay Future Cash," 52 *SMU L. Rev*. 423 (1999) (slightly revised version in *Tax Notes*, Oct. 18, 1999, p. 351, *Doc 1999-33549*, or *1999 TNT 200-77*). That article sets forth in greater detail the persuasive argument that stock is an inefficient means of compensating employees.

[17]There may no investment principle on which there is clearer consensus. *See* Harry Markowitz, *Portfolio Selection: Efficient Diversification of Investment* (John Wiley & Sons, 2d ed. 1991); Paul A. Samuelson, "General Proof that Diversification Pays," 2 *J. Fin. & Quantitative Anal*. 1 (1967), among many others.

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Because ESOPs are so contrary to sound retirement policy, and although the focus of the Shelf Project and this article is on tax measures, we venture to make the additional nontax suggestion that Congress repeal the exception for ESOPs from the diversification requirement in ERISA section 404(a)(2). All retirement plans should be required to adhere to the basic risk-reduction principle of investment diversification. At the very least, ESOPs should be restricted to publicly traded companies, since ESOPs for private companies are subject (in addition to all the problems enumerated above) to the possibility of being manipulated to buy stock from insiders at artificially high prices.[18] Also, some other potentially protective features that apply to ESOPs for public companies are missing in the private context. Private companies are not subject to the public reporting and disclosure obligations of federal securities law. This leaves participants without sufficient information about their investment exposure under the retirement plan to permit them to knowledgeably hedge their risks through other investments. Moreover, without the scrutiny and attention paid by analysts and the investment community to public companies, private company managers may be freer than their public counterparts to take risks in making business decisions on behalf of the company, an acute concern for ESOP participants whose ability to retire is tied up in company stock. (In the public context, meanwhile, ESOPs and other plans holding stock in the plan sponsor have created an unavoidable tension between ERISA's fiduciary rules and securities laws, the former requiring plan fiduciaries to act on nonpublic information and the latter prohibiting the same individuals from acting on insider information.)

4. No reason to subsidize ESOPs. As noted, the principal claim now made for ESOPs and employee stock ownership is that they motivate workers to be more productive. If that is true, subsidies are unnecessary. The market itself would reward those companies whose employee stock ownership programs cause them to outperform their rivals. After 35 years of subsidy, indeed, the fact that *all* extant companies are not now employee-owned might be regarded as definitive proof that ESOPs do not provide the claimed benefits. It is ironic that a movement founded on the idea of spreading the benefits of the capital market does not trust that very market to identify and reward an advantageous compensation arrangement and that it instead views expensive and artificial government intervention as necessary.

C. Conclusion

The ESOP provisions actively subsidize — at significant cost to the American taxpayer — patently inadvisable retirement policy in pursuit of a goal of employee ownership whose benefits remain unproven and for which subsidies should in any event by definition not be necessary. That these provisions found their way into the code in the first place, and the manner in which they did, stands as something of an indictment of the legislative process. They should be repealed.

Explanation of proposal. The proposal would repeal section 1042 (allowing deferral of gain on sale of stock to an ESOP); section 404(k) (allowing a corporation to deduct dividends paid on ESOP stock); section 402(e)(4) (excluding "net unrealized appreciation" of employer securities distributed in-kind from qualified retirement plans[19]); ERISA section 404(a)(2) (exempting ESOPs from the diversification requirement otherwise applicable to ERISA plans); all the related definitional and other provisions found in sections 409 and 4975 and ERISA section 407; and sections relating to ESOPs holding S corporation stock.

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[18]*See Columbia Law Review, supra* note 13.

[19]This provision applies to distributions of some employer securities from any qualified plan, not only ESOPs. The provision should be repealed for all plans. As we have already observed, the provision permits the conversion of what otherwise would be an ordinary income distribution from a qualified plan into capital gain and also permits a permanent exclusion of appreciation if the stock is held to death. This not only costs revenue, but at the margins provides a tax reason for employees to favor investment of retirement savings in employer stock rather than other investments.

There are two additional problems with the special tax treatment of employer stock received in a lump sum distribution. First, section 401(a)(9) generally requires that participants in qualified plans and IRA owners begin receiving distributions after the year in which they attain age 70½. The purpose of this requirement is to ensure that the tax subsidy for qualified plans is used to produce retirement income and not simply to produce a tax-advantaged estate. Yet a participant who receives employer stock in a lump sum distribution can delay indefinitely what are, effectively, distributions of the appreciation on the stock, whether it developed while the stock was appreciating in the plan or after distribution. And, as just noted, if the participant holds the stock until death, the appreciation will escape income taxation permanently.

A related problem is that a tax-sensitive former participant has an incentive to hold the distributed employer stock for a lengthy period, which can mean that a substantial part of his retirement savings will be invested in equity in a single corporation. Investment professionals would caution that older people (particularly those without a source of income from labor), should generally minimize their risk by reducing their investment in equity, especially undiversified equity exposure. So deferral of tax on the unrealized appreciation of employer securities encourages at least some participants to have large, undiversified equity exposure at a time in their lives when they should not be exposed to excessive investment risk. Moreover, the questionable rationale for employee ownership of employer stock — that it increases employee productivity — lacks even arguable relevance when held by retirees.

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