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House Ways and Means Committee
1102 Longworth House Office Building
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Following is a statement from The ESOP Association for the Ways and Means Committee's April 17, 2012 hearing: Hearing on Tax Reform and Tax-Favored Retirement Accounts.

The statement is being submitted by

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The ESOP Association is the national trade association for companies with employee stock ownership plans (ESOPs). The Association's primary members are U.S. corporations that sponsor ESOPs. The mission of The ESOP Association is simple: To advocate for, and educate about, employee ownership through the ESOP model.

Statement follows:

Chair Camp, Ranking Member Levin, and distinguished members of the House Committee on Ways and Means, I am J. Michael Keeling, President of The ESOP Association, the national 501(c)(6) trade association for U.S. corporations that sponsor employee stock ownership plans, or ESOPs, with nearly 1,500 U.S. corporations that sponsors ESOPs as our primary members, and just under 1,000 persons who provide specialized services to ESOP sponsors as secondary members.

Today's hearings are part and parcel of the Committee's commitment to study our entire Federal income tax laws, in a systematic process, before launching a detailed re-write of those laws. Clearly, the tax code's provisions that encourage private sector employers to fund, wholly or partially a "savings" vehicle to provide income for employees when they retire from work, or become disabled, are major provisions of current tax law. Not to review these laws, in terms of impact on Federal revenue compared to why prior Congresses put these laws into place would be a huge dereliction of duty; it is pleasing to see that this Committee continues to meet its obligations as it has since the income tax laws were first enacted in the second decade of the 20th century.

Today, I do not dwell on the reasons why Federal tax law encourages both retirement savings growth and more widespread ownership of productive assets through the ESOP model of ownership, as I know the ESOP community will have ample opportunity to present to the Committee members, and their staffs reasons that the ESOP model has created in the vast majority of instances more retirement savings for ESOP participants in companies that are more productive, more profitable, and more sustainable, while providing locally controlled U.S. jobs. We have the macro data to back up these statements, such as the recent General Social Survey 2010 that evidences that during the Great Recession of 2008/09, employees of employees stock owned companies were four times **less** likely to be laid off than employees of conventionally owned companies. The percentage to be specific were employees of employee stock owned companies were laid off during the Great Recession at rate of less than 3% whereas employees of conventionally owned companies were laid off at a rate of just over 12%.

Again, we will dig into the track record of ESOP companies when the Committee begins to dig into the details of what to do, if anything, about current ESOP laws in the tax code.

What I want to share with the Committee today is history of how ESOP laws developed, and how they were supported by leading political figures of both those holding so-called conservative views of government, and those holding so-called liberal views.

Clearly, the Ways and Means Committee of the 21st Century does not have to do what the Ways and Means Committee of the 20th Century did with regard to ESOPs and employee ownership. But knowing what your colleagues of this oldest Committee in Congress did over nearly 100 years will assist your review.

Interestingly, the first time the Ways and Means Committee undertook a major review of Federal tax law, in the 1920 and 1921 period, in reaction to the first tax laws after the ratification of the 16^{th} Amendment of the Constitution, a major point of debate and discussion was how to treat company stock that U.S. corporations were putting aside for their employees.

Yes, using company stock to help employees meet their retirement income needs pre-date the Federal income tax law, and Social Security law.

For you see, back in the last half of the 19^{th} Century, as the Industrial Revolution took hold in our nation, corporations grew and their work forces grew. Leaders of these corporations, such as Railway Express, Montgomery Ward, Sears and Roebuck, Procter and Gamble, to name a few, came to see that loyal employees were reaching ages when their active working days were coming to a close; but these employees had nothing to support them once their jobs terminated. So, the leaders of these "new" national corporations begin to set aside company stock for the employees to have when they retired.

The basic premise of the first income tax law was, and it still is the basic rule, that all income of whatever nature and from whatever source is subject to the Federal income tax.

So the debate in 1921 was the value of the stock these corporations were setting aside for employee's taxable income to the employees the year it was set aside, and was the value of the stock a compensation cost that was a deductable cost of business for the corporation?

After much back and forth, it was decided that the stock value was not current income to the employees, and was a cost of compensation. The law arising in 1921 labeled the scheme as tax qualified deferred compensation, and it was what is now labeled a "stock bonus plan".

Frankly, the stock bonus plan is an ESOP that has not financed its acquisition of employee stock for the employee's retirement savings.

So, literally, the first retirement savings plan recognized in the Federal tax code was a stock bonus plan.

While the Ways and Means Committee added many rules about how a tax qualified deferred compensation plan should be managed in the 30s, 40s, 50s and 60s, really today what is considered the defining law for tax qualified deferred compensation plans are the tax laws in what is known as the Employee Retirement Income Security Act, or ERISA, passed in the mid-70s.

But important to note is that in the late 40s, and here details are a little fuzzy as private letter rulings were not public until a tax law enacted in 1977, an Alaskan company asked the IRS if it could borrow money to obtain the assets for its stock bonus plan, which was holding employer securities. The IRS said yes, and the "leveraged" employee stock ownership plan was born, though not labeled an ESOP.

From the late 40s until the early 70s, a small number of these leveraged stock bonus plans were established, as it was easy to see how it presented an excellent way for an owner to exit his or her business without abandoning loyal employees, while enabling the exiting shareholder to cash our her or his "chits", without selling to competition, or liquidating his/her assets.

I know other witnesses will go over the general history of ERISA, and how ERISA had roots in concerns over investments by certain large defined benefit pensions seemed to be helping organized crime, and how the collapse of several large defined benefit plans heavily invested in company stock left unionized work forces without any retirement income.

The Congressional and White House push to address these concerns of the 1950s and 1960s led to the creation of ERISA, which of course began in the House.

The first version of ERISA was drafted by your House Committee, Education and Labor in the early 70s, and bluntly was focused almost entirely on defined benefit plans. A key rule adopted by the Committee was any retirement savings plan, or tax qualified deferred compensation plan, could not hold more than 10% of its assets in company stock.

When the Ed and Labor version was sent over to the House Ways and Means Committee, American businesses, many of whom had sponsored stock bonus plans since the 19th century, woke up, and persuaded Ways and Means to a make distinction between a plan that promised a benefit, or a defined benefit, and a plan that made no specific promise to the employee as to the level for the benefit, but did promise to make a certain contribution each year, if certain business results were reached—in other words, profit sharing plans, of which stock bonus plans were one.

So the defined contribution plan was born, and it was permitted to hold company stock beyond the 10% limit on company stock imposed on defined benefit plans.

The legislation moved on, and reached a Conference between the House and Senate, and there decisions were made to permit, under certain very regulated circumstances, a stock bonus plan to borrow money to acquire company stock for the plan. And the name "employee stock ownership plan", or ESOP was codified into the tax code's ERISA section, as well as the labor section of ERISA.

This is just a brief history of how ESOPs were created formally under ERISA that lays out that the idea of rewarding employees with company stock did not just fall from the sky in the mid-70s, but was actually a most time honored method of providing retirement income for employees.

Let us fast forward to the last quarter of the 20th Century, when the work of the Ways and Means Committee on ESOP issues became quite intense, especially in the period from 1987 through 2001.

While many of the early laws in the 1976 through 1986 period promoting retirement savings and ownership through ESOPs were driven by the leadership of the late Senator Russell B. Long, the legendary top Democrat of the Senate Committee on Finance, the truth is that he did not have an unfettered pathway, as Ways and Means members in Conference often altered and even pushed back on some of his ESOP proposals adopted by the Senate. But today, the focus is on what Ways and Means has done over the years with regard to ESOPs, not what the Senate Finance Committee did.

Before looking at the 1987 through 2001 period, a short detour is in order with regard to the last time Ways and Means reformed the tax laws in a major tax reform effort—the 1985 and 1986 time frame.

While the Democrats of 1985 and the Republicans of 1985 could hold differing views on details of what should be in the tax laws, in 1985 there was a major, obvious coming together of President Ronald Reagan and the Democrats who controlled the House, to rewrite Federal tax laws, to make them more simple, and to lower tax rates.

After this general agreement, the Reagan Administration developed a comprehensive tax reform proposal, labeled by the pundits, members of Congress, and lobbyists as "Reagan I".

Reagan I was a trial balloon, and the Administration welcomed the private sector, or better put, private sector interest groups also known as lobbyists, to interact with the Treasury Department where the heavy lifting was done to draft Reagan I.

Interestingly, Reagan I did not have any provision about ESOPs. The tax experts at Treasury knew that President Reagan, dating back to his days as a radio commentator, was a huge fan of ESOPs, as was the important Louisiana Senator Russell Long. So frankly they punted on ESOPs, waiting to hear from the White House and Senator Long on what was an acceptable way to handle ESOPs.

Now, keep in mind, after just nine years of ESOPs as a formal tax qualified deferred compensation plan, there had been some controversy among retirement income gurus in both the public and private sector, as the data showing the strength of ESOP companies as providers of jobs and retirement income was not as obvious in 1986 as it is today. The strongest voices were candidly among Department of Labor ERISA experts; in a rather odd twist, the Treasury officials asked the Department of Labor people to come up with a recommendation about ESOPs in what was released in 1985 as Reagan II.

Here is what Reagan II said about ESOPs: It proposed that all the tax benefits that were added for ESOPs in the 1984 tax law known as DEFRA be retained, not reduced or eliminated, but that ESOPs no longer be an ERISA plan. While purely speculation on my part, I assume the DOL thinking was the strength of ESOPs in the tax committees was too strong to unravel tax preferences for ESOPs, but since ESOPs were concentrated in company stock, ESOPs should not be retirement savings plans.

Next, Ways and Means had long and lengthy hearings on Reagan II, that some called Treasury II.

What did the ESOP community say, or more specifically, what did The ESOP Association say about the ESOP provisions of Treasury/Reagan II?

Interestingly, the ESOP witness before Ways and Means said that the Association had no underlying problem with ESOPs not being ERISA plans, but that if the Committee agreed with Reagan II, the Committee should include in the ESOP laws of the tax code provisions related to vesting, discrimination, fiduciary obligations of the trust, limits on contributions for highly paid, distributions rules etc that were all part of existing laws in ERISA, as these were provisions that protected employees.

In no surprise, the staff of Ways and Means, and the Joint Committee on Taxation, said to themselves—"what the heck, why move ESOPs out of ERISA legal and regulatory schemes, but then impose on ESOPs the very same legal and regulatory schemes?"

So, when the chair of Ways and Means made his proposal to the Committee, the late Dan Rostenkowski, he left ESOPs in ERISA, but eliminated most of their tax preferences in what was known as Rostenkowski I, or "Rosty I".

The Ways and Means Committee then sat down for days marking up what was known as "Rosty I". Chair Rostenkowski had a rule, primarily driven by the then Budget Act, that any change in Rosty I offered by a member had to be revenue neutral. In the many hours of mark up, recall is that only three amendments were adopted by the full Committee amending Rosty I that were not offset with increasing taxes elsewhere to pay for the amendment.

One of the three revenue losing amendments was an amendment restoring the ESOP tax preferences adopted in 1984, offered by former Congressman Beryl Anthony; it was adopted on a voice vote, with no public declaration of opposition.

(Note, to fit into the revenue matrix, Congressman Anthony's amendment sunsetted the ESOP tax preferences after five years; but still, other similar proposals, except for two, were defeated by voice or roll call vote during the mark up of Rosty I.)

(Also note, while tweaking some of the 1984 and earlier tax preferences for ESOPs in Conference, the majority of the 1984 preferences for ESOPs were made permanent in the Conference Committee work on the 1986 Tax Reform Act, with little or no debate.)

Senator Long retired at the end of 1986, and in the period from 1987 through 1994, the Ways and Means Committee, both the full committee, but primarily its Oversight Subcommittee, held at least six hearings on ESOPs. Nearly all were in the context of reviewing ESOPs as takeover defense tactics during the hey day of hostile corporate takeovers in the late 80s. Two hearings did review an idea that an employer could not sponsor a defined contribution plan such as an ESOP as a primary retirement savings plan, but only as a second plan, so to speak, to a defined benefit plan.

In 1995, the Senate Finance Committee repealed a ESOP tax benefit related to lenders getting a break for loans to ESOPs, and that provision was adopted by the House Ways and Means Committee in a 1996 bill, which was included in then Chair Archer's mark in a last minute effort to have a revenue neutral reduction in small business taxes to offset the costs of an increase in the minimum wage.

Now we come closer to current history, as since 1986, when the individual tax rate became lower than the C corporation tax rate, there has been a push to open up more rules permitting S corporations, or pass through entities. Part of the agitation was to have S corporations for the first time to sponsor an ERISA plan, such as an ESOP, that could hold employer stock.

In 1998, it was the Ways and Means Committee that adopted a workable provision of tax law that permitted an S corporation to sponsor a leveraged ESOP. The amendment was offered by former Congresswoman Nancy Johnson, and was adopted by the Ways and Means Committee with no opposition.

Since 1998, approximately 5,000 U.S. corporations that are S corporations sponsor an ESOP. Approximately 1,000 belong to The ESOP Association.

As it is not unusual with tax law provisions that are unique, the first S ESOP law was abused by flim flamers. In the ESOP case it was primarily actors and athletes setting up one person or two persons ESOPs.

In its 2000 budget proposal for FY 2001, the Clinton Administration proposed a major reduction in the benefit for being an S ESOP corporation.

The ESOP community came to the Ways and Means Committee with a proposal to stop the flim flamers that was not as drastic as what the Clinton Administration had proposed, and the Ways and Means Committee, adopted as set fourth in Chair Thomas's mark, a proposal put forward by former Congressman Jim Ramstad. The Ramstad amendment, a very tight anti-discriminatory rule related to how much key people could have in their ESOP accounts, ended the flim flannery.

So, what is my point Mr. Chairman and Ranking Member Levin, and others distinguished members of the Committee?

The point is that the Ways and Means Committee has a long, and complete record of reviewing ESOP law, and has always come down in support of ESOPs as a retirement savings plan, and as the Federal courts have said over and over, as an ownership plan.

The ESOP community only asks that you do the same kind of serious review of ESOP companies and their providing of retirement savings benefits, and their contribution to sustainable jobs, and higher performing companies that your predecessors did in putting together primarily the 1986 Tax Reform Act, an other tax laws after 1986.

We look forward to your questions, your review and the dialogue that will take place during your work on tax reform over the next 18 months or so.

Thank you for permitting the submission of this statement.