Statement for the Record for House Ways and Means Committee April 17, 2012 Hearing on "Tax Reform and Tax-Favored Retirement Accounts"

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S Corporations and Employee Stock Ownership Plans – A Good Match For Retirement Security

Overview

Employee-owned S Corporations or "S-ESOPs" work to meet two key U.S. economic challenges: (1) inadequate retirement security for workers and families and (2) insufficient national savings for the economy as a whole. An S-ESOP is a business that provides flow-through tax treatment to its shareholders, and in which the shares of the business are owned by the employees' qualified defined contribution retirement plan, otherwise known as an "Employee Stock Ownership Plan" (ESOP). Taxes on the appreciated value of the stock in the ESOP are deferred until the employee eventually sells his or her shares while in retirement. This tax treatment is similar to that of a traditional defined benefit or defined contribution retirement plan.

The pass-through nature of the S-ESOP structure enables the company to avoid the double-tax on savings inherent in the corporate tax system, while using those funds for the direct benefit of employees. In the S-ESOP structure, business income is taxed at retirement, close to when these savings are consumed, and at ordinary income rates. The tax treatment of S-ESOP firms reduces the bias against saving in the U.S. tax system and provides a structure under which worker-participants at S-ESOPs build savings for a more secure retirement.

In addition to helping workers and their families prepare for retirement, the S-ESOP organizational form contributes to increased national savings and, as a result, to stronger investment, economic growth and job creation. A 2010 study I co-authored for the Employee-owned S-Corporations of America (ESCA) found that S-ESOP firms were more resilient in the face of the recent recession, with better employment performance than non-ESOP firms.[1] Expanded opportunities for S-ESOPs would provide the benefits of this structure to more working Americans.

Employee-Ownership and Superior Retirement Plan Coverage

S-ESOPs make substantial contributions to workers' retirement security and promote "employee ownership." Here, employees own the company and they build their retirement security with set-aside funds in their ESOP accounts. This stands in stark contrast with the fact that, according to the Employee Benefit Research Institute, only half of Americans in 2008 worked for an employer that provided employees with any kind of retirement savings plan, and not much more

[1] Phillip Swagel and Robert Carroll, March 2010. "Resilience and Retirement Security: Performance of S-ESOP Firms in the Recession."

than 40 percent of workers participated in such plans. A 2008 University of Pennsylvania study found that S-ESOPs contribute substantially in new savings to their workers beyond the income of what these workers would have otherwise earned.[2]

Studies have also found that 80 percent of S-ESOP firms offer workers retirement savings plans beyond the ESOP. In addition, employees of S-ESOP firms have employer-provided retirement contributions that are often times superior to those received by employees of firms in the overall economy. Moreover, S-ESOP employee-owners have substantially more resources accumulated for their retirement than typical workers at other firms. Among the findings of my recent study are:

- Employer contributions to retirement benefits rose by 18.6 percent for all employees in the S-ESOP firms surveyed. This compares to 2.8 percent growth of contributions by all employers to employee retirement plans.

- The employee-owners of S-ESOP firms accumulate substantial amounts for retirement. The value of S-ESOP assets per active participant was $100,000 in 2008, compared to only $45,500 for the average 401(k) account for the overall economy.

Conclusion

Tax policies for retirement saving can be viewed through both the "micro" lens of how to improve retirement security for individual families and through the "macro" lens of how to boost overall national savings, thereby improving U.S. growth and job creation. On the individual level, the looming fiscal challenges facing the United States likely imply that families must anticipate having greater responsibility for preparing for retirement, because the U.S. government will be less able to participate directly in providing for retirees. Firms organized as S-ESOPs enhance the retirement security of their workers, as contributions by the employer together with growth in the value of the stock over time can provide a powerful boost to employees' retirement savings, while contributing to increased national saving and U.S. economic vitality. This is good for workers, businesses, and American taxpayers as a whole.

About the Author:

Phillip L. Swagel is a professor at the University of Maryland's School of Public Policy, where he teaches classes on international economics and is a faculty fellow at the Center for Financial Policy at the Robert H. Smith School of Business. Mr. Swagel was Assistant Secretary for Economic Policy at the Treasury Department from December 2006 to January 2009. He is an advisor to the Employee-owned S Corporations of America.

[2] Steven F. Freeman and Michael Knoll, July 2008. "S Corp ESOP Legislation Benefits and Costs: Public Policy and Tax Analysis," University of Pennsylvania, Center for Organizational Dynamics, Working Paper #08-07.