United States General Accounting Office

GAO

Report to the Honorable
Russell B. Long, U.S. Senate

December 1986

EMPLOYEE STOCK OWNERSHIP PLANS

Benefits and Costs of ESOP Tax Incentives for Broadening Stock Ownership

GAO/PEMD-87-8

GAO

United States
General Accounting Office
Washington, D.C. 20548

Program Evaluation and
Methodology Division

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December 29, 1986

The Honorable Russell B. Long
United States Senate

Dear Senator Long:

This report is the third in a series responding to your request for information about employee stock ownership plans (ESOPs). The first report, "Initial Results of a Survey on Employee Stock Ownership Plans and Information on Related Economic Trends" (GAO/PEMD-85-11), included data from a survey of ESOPs and relevant background information. The second, "Employee Stock Ownership Plans: Interim Report on a Survey and Related Economic Trends" (GAO/PEMD-86-4BR), provided additional information from our survey and from analyses of data provided by the Internal Revenue Service.

In the present report, we provide our conclusions on four of the issues you asked us to address: the number of ESOPs, the number of participants covered by ESOPs, and the value of assets in ESOP trusts; the factors associated with a company's decision to establish and continue an ESOP; the costs of ESOPs in terms of federal revenues forgone; and the degree to which ESOPs are broadening the ownership of capital assets in the United States. From our analyses, we estimate that as of March, 1986, there were about 4,800 ESOPs active in the United States, and an additional 2,400 similar stock bonus plans. As of 1983, ESOPs covered more than 7 million workers, and held nearly $19 billion in assets. Employers established ESOPs for a number of reasons, but by far the most commonly cited purposes were to provide a benefit to employees, utilize the ESOP tax incentives, and improve productivity. They maintained their plans largely because they experienced specific advantages (especially improved employee morale and tax savings), but usually no disadvantages. The tax incentives for ESOPs cost an estimated $1.7 billion to $1.9 billion per year, or $12.1 billion to $13.3 billion over the period 1977-83. These costs are high relative to the $19 billion in assets participants have accumulated to date, apparently reflecting the dollar for dollar tax credits permitted for contributions to some ESOPs. Finally, ESOPs do appear to broaden the degree of capital ownership within sponsoring firms, but the small number of employees covered and the small percentage of all stock held by ESOP trusts put an upper limit on the extent of overall expansion of capital ownership in the United States associated with ESOPs.

As we arranged with your office, we are sending copies of this report to the Senate Committee on Finance, Senate Committee on Labor and Human Resources, House Committee on Ways and Means and House Committee on Education and Labor, and the Joint Committee on Taxation. Copies also will be made available to others who request them.

Sincerely yours,

Eleanor Chelimsky
Director

Executive Summary

Purpose

Employee Stock Ownership Plans, or ESOPs, have received extensive coverage in the business and popular press and in academic publications in recent years. Much of this attention has focused on controversies over the use of ESOPs to save failing firms or to prevent hostile takeovers. ESOPs are, however, employee benefit plans found in a wide variety of corporate settings. They covered over 7 million participants and held nearly $19 billion in assets in 1983. Congress has provided a number of tax incentives to encourage corporations to establish ESOPs as a way of broadening the base of corporate stock ownership and of providing a tool for corporate finance. The broad issues GAO addresses in this report are whether ESOPs are achieving the goals of broader stock ownership and providing a mechanism for corporations to raise capital, and if so, at what cost. Specifically, at the request of Senator Russell B. Long GAO conducted this study to: (1) obtain an accurate census of ESOP companies, participants and assets; (2) identify factors associated with the establishment and continuation of ESOPs; (3) estimate the revenue costs associated with ESOP tax incentives; and (4) examine whether ESOPs are expanding the ownership of capital assets in the U.S., and to what degree.

Background

Employee Stock Ownership Plans are employee benefit plans recognized under two major pieces of legislation: the Employee Retirement Income Security Act of 1974, and the Tax Reduction Act of 1975. These acts provided tax incentives to encourage employers to establish a form of stock bonus plan that would make employees owners of stock in the corporations employing them. For contributing its own stock, or the cash to buy such stock, to the ESOP trust, the employer can get a tax deduction (for ERISA-type ESOPs) or a tax credit (under the 1975 tax act or successor legislation). At the same time, the amount contributed to each employee's account is tax-deferred income for the employee, as are the earnings on those accounts.

The major purposes of these plans are to broaden the ownership of stock, to provide a mechanism for financing capital growth and the transfer of stock ownership to employees, and to promote improvements in productivity and profitability in sponsoring firms. These goals are based on the belief that the concentration of stock ownership, the dependence of firms on internal sources of funds for corporate finance, and the slow growth of productivity in the U.S. are serious and related problems that can be addressed by making employees owners of stock in the firms that employ them.

Results in Brief

GAO's analysis indicates that ESOPs do provide a broader distribution of stock ownership among covered employees than generally prevails in the U.S. population. But ESOPs cover only a small percentage of employees and hold only a small percentage of outstanding stock. These facts place an upper limit on the likely effects of ESOPs on the overall distribution of stock ownership to date.

ESOP legislation provides for a uniquely tax-favored mechanism of corporate finance in the leveraged ESOP (a type of plan which uses borrowed funds to purchase employer securities from the corporate treasury or stockholders). But only about one-sixth of all ESOP sponsoring firms have utilized these provisions. Among such firms, the funds borrowed through the ESOP have been used primarily to purchase stock from current owners for distribution to ESOP participants' accounts, thus contributing to the broadening of stock ownership. Few firms have used the leveraging mechanism to generate funds for capital expansion.

GAO estimates that the cost of ESOP tax incentives averaged between $1.7 billion and $1.9 billion per year during the period 1977-1983, for a total of $12.1 billion to $13.3 billion over that period.

GAO's Analysis

Number of ESOPs

Based on information provided by the Internal Revenue Service and 2 GAO surveys, GAO estimates that the number of ESOPs active in March, 1986, was about 4,800, and that there were at that time about 2,400 active non-ESOP stock bonus plans, which are similar to nonleveraged ESOPs (plans that do not provide for borrowing to purchase employer securities). (See pages 18 and 19.)

Factors Associated With ESOP Formation and Continuation

Firms establish ESOPs to achieve specific objectives, and maintain them because of advantages they associate with the plans. Large majorities of responding firms reported that they started their plans to provide a benefit to employees (91%), utilize the tax incentives (74%), and improve productivity (70%). Majorities also reported improved employee morale (66%) and tax savings (60%) after establishing the ESOP, although a smaller proportion reported improved productivity (36%). Few employers reported any disadvantages for their companies from having a plan, and even among firms that have terminated their ESOPs or converted them to other plans, only 14 percent cited disadvantages associated with ESOPs as a major reason. (See pages 19-24.)

Revenues Lost Through ESOP Tax Incentives

The tax credit for some ESOPs resulted in most (89 to 98 percent) of the federal revenue losses associated with ESOPs. Only about 26 percent of all ESOPs are of this type, but they tend to be the larger ones. In addition, the tax credit reduces corporate income taxes dollar for dollar with the amount contributed (up to certain limits). ERISA-based ESOP corporations may deduct the amounts contributed, but this reduces their corporate taxes only by an amount equal to the contribution times the marginal tax rate. Overall, the revenue losses of $12.1 to $13.3 billion are high relative to the $19 billion in assets held by ESOPs, reflecting the importance of the tax credits. (See pages 28-31.)

Broadening the Ownership of Stock

In evaluating the extent to which ESOPs may broaden the ownership of stock in the U.S., GAO looked at the nominal ownership of employer stock in ESOP participants' accounts, and also at such other dimensions of stock ownership as the payment of dividends to participants, and the control of or participation in management by employees of ESOP firms.

A median of 71 percent of employees in firms sponsoring ESOPs own stock through their plans; in contrast, only 19 percent of all U.S. families owned stock directly or through mutual funds in 1983, and the wealthiest 0.5 percent of the population owned 46.5 percent of all stock value in these ways in that year. (Taking account of stock held in pension plan trusts would likely reduce the measured degree of concentration of stock ownership). However, ESOP plans covered less than 7 percent of the employed U.S. labor force in 1983, and ESOP trusts held under 1 percent of the value of all U.S. stock in that same year. (See pages 34-36.)

Many firms that sponsor ESOPs do not pay dividends on their stock regularly, and most of the ESOP trusts that receive dividends retain them rather than passing them through to participants. Contrary to the image presented by some well-known cases, ESOPs generally do not result in control of corporations by employees, whether through the ownership of a substantial percentage of all shares or voting shares in the company, or control over seats on the board of directors. (See pages 36-40.)

Some ESOP firms do report more employee involvement in corporate management, but this is largely through informal contacts, and tends to focus on traditional areas of employee participation, such as safety and working conditions, rather than core management functions, such as planning and budgeting. Employees often are encouraged to make suggestions, but usually do not make decisions. (See pages 40-43.)

The leveraging provisions of ERISA have been used primarily to allow ESOPs to purchase the stock of major shareholders (thus contributing to broader ownership) rather than to finance new capital formation. (See pages 51-53.)

GAO's analysis suggests that if ESOPs are to have more than a limited effect in broadening stock ownership, several conditions would need to change. First, more employees would need to be covered by ESOPs. Second, stock ownership through the plans would need to be made more meaningful to participants. This could involve more regular payment of dividends to participants and the encouragement of larger contributions to increase the value of participants' accounts. Additionally, sponsoring firms might be encouraged to provide a bigger role for employees in corporate management. However, the goals of increasing the number and size of ESOPs may be in conflict with expansion of the role of employees in management because many firms might be reluctant to share control with employees, and employees may not have control as a goal. (See pages 44 and 45.)

Recommendations

GAO is making no recommendations as a result of this study.

Agency Comments

GAO obtained informal comments on this report from the Employee Plans/Exempt Organizations Division of the Internal Revenue Service. These comments have been incorporated into the text of the report.

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Glossary

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Abbreviations

CBO	Congressional Budget Office
DEFRA	Deficit Reduction Act (1984)
EPMF	Employee Plan Master File
ERISA	Employee Retirement Income Security Act (1974)
ERTA	Economic Recovery Tax Act (1981)
ESOP	Employee Stock Ownership Plan
GAO	U.S. General Accounting Office
IRS	Internal Revenue Service
OMB	Office of Management and Budget
PAYSOP	Payroll-based tax credit ESOP
PBGC	Pension Benefit Guarantee Corporation
SOI	Statistics of Income Division, Internal Revenue Service
TRASOP	Tax Reduction Act ESOP

Introduction

Employee Stock Ownership Plans (ESOPs) provide tax benefits for corporations and individuals in order to achieve such goals as broadening ownership of stock and improving the ability of corporations to raise capital. At issue is what the ESOP tax benefits cost in lost federal revenues and whether they are achieving their goals. At the request of Senator Russell B. Long (see Appendix I), we have conducted a wide-ranging review of ESOPs.

Definition and Uses of ESOPs

On March 2, 1982, the people of the steel mill town of Weirton, West Virginia, discovered that they faced a threat to their survival as a community. After over 70 years of operation, the Weirton steel mill, the only major employer in the town of 25,000 people, was going to reduce operations drastically, according to an announcement by the mill's owner, the National Steel Corporation. What followed was a search for a way to keep the mill open, and to save the town. What the workers and the community discovered was the ESOP: the Employee Stock Ownership Plan.

This case, and a handful of others like it in other states, have provided the dominant image of ESOPs in the business and popular press. Many reporters, academicians and citizens think of ESOPs primarily as tools to save failing firms. As attention has focused on ESOPs, other uses for these plans have been highlighted. In some financially troubled firms, for example in the airline industry, employees have accepted partial ownership of their employing corporations through ESOPs in exchange for wage and benefit concessions. In other corporations, ESOPs have been set up by management to block hostile takeovers or unionization of workers, or to finance leveraged buyouts. This variety of uses of ESOPs may be seen as indicative of the versatility of these plans or as a distortion of their intended purpose, depending on the perspective of the viewer.

Technically, Employee Stock Ownership Plans are recognized under the Employee Retirement Income Security Act (ERISA) of 1974 or the Tax Reduction Act of 1975 as stock bonus or combined stock bonus and money purchase plan trusts (or, in some cases, as parts of profit-sharing plans). Stock bonus plans or stock bonus and money purchase plans are employee benefits provided by employers. The plans receive cash or other assets (generally employer stock) from employers and generally allocate those contributions to accounts in the name of individual participating employees. A money purchase plan has a specific contribution schedule (such as 5 percent of salary per year), whereas a stock bonus plan can determine each year how much, if any, to contribute. Employees receive a full or partial distribution of the assets in their accounts when they retire, leave the firm, or at the occurrence of other events as specified in the plan. ESOPs differ from most other employee plans in that they are required to invest primarily in securities of the employer, rather than maintaining a diversified portfolio.

Employers are encouraged to establish ESOPs by a series of laws enacted since 1974 that provide tax savings both to employers and to participating employees. As long as ESOPs are "qualified"—that is, as long as they meet numerous requirements of the Internal Revenue Code — the employer and employees may take advantage of these tax benefits. Employers can claim contributions to ESOPs as income tax deductions (or, in certain circumstances, as tax credits). Individual income tax is deferred on the amounts allocated to employees' accounts, and the eventual tax treatment may be more favorable than for wage and salary income.

These inducements for the creation of ESOPs grow out of legislative concerns over the distribution of stock ownership among Americans, the reliance of corporations on financing mechanisms that benefit current stockholders rather than encouraging broader ownership of stock, and the relatively poor productivity growth in the U.S. economy in recent years. Thus, the central purposes of ESOPs are expansion of the numbers of persons owning capital, as represented by corporate stock; the provision of a method of corporate finance that permits workers to share in the ownership of new assets or of existing assets (through transfers of ownership from stockholders to workers); and the improvement of productivity and profitability in U.S. industry expected to result from giving workers a stake in the success of their employing corporation. A brief history of ESOPs is included in Appendix II.

Types of ESOPs

We identified four main types of ESOPs: leveraged, leverageable, nonleveraged, and tax credit. Leveraged ESOPs were recognized under the Employee Retirement Income Security Act (ERISA) of 1974. They permit the plan trust to borrow funds to purchase employer securities. The employer then makes contributions to the trust sufficient to meet annual principal and interest payments on the loan. Ordinarily, corporations can deduct interest, but not principal, payments from corporate income for tax purposes, but contributions to leveraged ESOPs are fully deductible. In effect, the employer is able through this procedure to borrow money from a financial institution, and to repay that loan with pre-tax dollars by deducting both principal and interest payments.

Leverageable and nonleveraged ESOPs also were recognized under ERISA, but these plans have not used the leveraging procedure. Under the provisions of Treasury Regulation 54.4975-11, ESOP plan documents may or may not provide for leveraging; if they do, the plan is authorized but not required to engage in a leveraged transaction. Leverageable ESOPs make provision for leveraged transactions in their plan documents, whereas nonleveraged ESOPs do not. Thus, nonleveraged ESOPs are nearly indistinguishable from other stock bonus plans, except that stock bonus plans are not required to invest primarily in employer securities. In this report, leveraged, leverageable and nonleveraged ESOPs are referred to as ERISA-type ESOPs. Contributions to all ERISA-type ESOPs are eligible for tax deductions for sponsoring firms, but not for tax credits.

Tax credit ESOPs were established one year later in the Tax Reduction Act of 1975, which permitted an additional investment credit equal to 1 percent of qualified investment in plant and equipment for a contribution of the same amount to an ESOP. These plans were called Tax Reduction Act ESOPs, or TRASOPs. An additional 1/2 percent credit was added in 1976 for companies matching employee contributions to the TRASOP of the same amount. Beginning in 1983, the basis for the credit was changed from investment to 1/2 percent of covered payroll, and these types of plans came to be called payroll-based ESOPs, or PAYSOPs. In this report, TRASOPs and PAYSOPs are referred to as tax credit ESOPs.

A feature distinguishing tax credit ESOPs from other ESOPs concerns when stock in the trust may be distributed to participants. ESOP shares, as assets in other types of plans, may be distributed to the participant (or his or her estate) at retirement, termination or death. For tax credit ESOPs, there is a further requirement that employer securities not be distributed to participants, except in the case of death, disability, separation, or in some cases acquisition by another company, for a minimum of 84 months from the time of the contribution.

For a discussion of the relationship of ESOPs to other types of employee plans, see Appendix III.

Objectives, Scope and Methodology

Based on Senator Long's request, we focused on five major objectives in evaluating ESOPS:

Objective 1

Obtain an accurate count of and describe ESOPS. We conducted a survey of a sample of 2,004 plans that the Internal Revenue Service (IRS) identified from their computer files as having "ESOP features" in order to determine whether these actually were ESOPS. (For details of the sampling and survey procedures used, see Appendix IV.) We carried out this survey between January 31 and June 30, 1985. Initial and interim results were published in previous reports (PEMD-85-11, September, 1985, and PEMD-86-4BR, February, 1986). Combining responses to that survey with other data from IRS computer files has made it possible to report not only on the number of ESOPS, but also on a variety of descriptive measures associated with them. We further supplemented these survey data with more recent IRS data in order to incorporate recently formed ESOPS into our estimates of the total number of these plans.

Objective 2

Identify the factors associated with a company's decision to establish and continue an ESOP. We relied on a second survey of firms with ESOPS to meet this objective. Our second survey, conducted between July and November, 1985, asked firms to report directly about their reasons for establishing, continuing, or terminating ESOPS.

Objective 3

Estimate the cost of ESOPS in lost revenue to the U.S. Treasury. We combined IRS data on annual contributions to, earnings of, and distributions from ESOP trusts with information on applicable tax rates. By varying assumptions and estimating procedures, we were able to produce a range of estimates for tax costs, by type of ESOP.

We did not try to estimate the revenue effects of ESOPS on state and local governments. This issue is beyond the scope of the questions we were asked to address. Moreover, a number of practical problems make it unlikely we could provide reliable estimates of these effects. For example, to estimate the tax costs associated with the treatment of contributions and earnings as deferred income, it would be necessary for us to know which state(s) each employee covered by a plan pays income taxes to, how that state's tax structure is tied to federal tax rules, and what the applicable average marginal rates are.

Objective 4

Measure the degree to which ESOPs are expanding the ownership of capital in the United States. This is one of this study's most challenging objectives. We combined survey results with IRS data in order to chart the growth of ESOP assets and participants over time. We also were able to calculate the percentage of employees who participate in ESOPs in individual firms, and to report on the extent to which employee ownership of company stock has led to reported levels of employee participation in and/or control over the operation and management of sponsoring firms.

To measure the impact of ESOPs on the distribution of capital ownership in the nation as a whole, however, would require an additional and large scale study of stockholding in the U.S. that we have judged to be beyond this project's resources and scope. A review of the existing data on this subject appears in PEMD-86-4BR, and provides baseline data for comparison with the information we have collected on ESOPs (see Chapter 4).

Objective 5

Measure the relationship between the presence of an ESOP and the productivity and profitability of a firm. We are conducting this analysis and will issue a separate report on this issue.

In addition, to these objectives, Senator Long asked us to report, to the extent possible, on whether the establishment and continuation of an ESOP has an impact on the value of a corporation's stock and on the level of dividends paid by the company. We determined that no sound methodology could be developed to answer this question credibly, given that a preponderance of ESOP firms are privately held. Senator Long agreed that we should not pursue this issue. Senator Long also requested that we report on the relationships between establishment and continuation of an ESOP and the sponsor company's employee compensation and benefit levels. We will address this issue in a later report.

The survey data reported here must be interpreted with caution. Survey data cannot be used to establish either motivation or experience directly. The data show only what respondents reported about why they established their ESOPs, and their experiences with the plans. We do not have independent confirmation of these reports. Moreover, we have no way of knowing whether the respondents had the personal knowledge to answer the questions accurately. Finally, some options on the questionnaire were likely to be viewed as sensitive, and this could have led to underreporting of these items. These problems are standard concerns when using survey data, and should be kept in mind in reading the analysis.

We obtained informal comments on this report from the Employee Plans/Exempt Organizations Division of the Internal Revenue Service, and have incorporated those comments into the text of the report. We asked for informal comments in order to meet reporting deadlines.

Number of ESOPs and Reasons for ESOP Formation

Two of our evaluation objectives were to count the number of ESOPS, and to identify the reasons why firms first establish and then maintain or terminate ESOPS. Previous reports (PEMD-85-11 and PEMD-86-4BR) provided estimates of the number of ESOPS and some descriptive information. This chapter includes an updated estimate of the number of ESOPS and an analysis of the reasons for ESOP formation, maintenance and termination.

Number of ESOPs

One set of questions concerns the number of ESOPS of various types currently established, the number of ESOP participants, and the amount of assets held by these plans. Our answers are based on a two-wave survey of a stratified random sample of plans identified as likely ESOPS on computer files maintained by IRS and information provided by IRS on plans formed after the sampling frame was selected. (For details of the methods used and the survey results see Appendix IV.)

We estimate that there were 4,799 ESOPS active as of March, 1986. These include 4,174 ESOPS identified through our 1985 survey and 625 new plans reported to us by IRS. The 95 percent confidence interval for the sample estimate plus the count of new plans provides a range of 4,643 to 4,955 ESOPS. In Appendix IV we discuss how these estimates were derived, and indicate qualifications applicable to them.

The number of firms sponsoring these ESOPS is somewhat lower than the number of plans. This is because some employers sponsor more than one ESOP. We estimate that there were approximately 4,100 firms sponsoring these 4,174 ESOPS, and 605 firms sponsoring the 625 newly-formed ESOPS, for a total of approximately 4,700 ESOP firms.

In addition to the ESOPS, there were 2,405 non-ESOP stock bonus plans, which are nearly indistinguishable from nonleveraged ESOPS, active in March, 1986, for a total of 7,204 ESOPS and non-ESOP stock bonus plans. Many researchers, reporters, business people, trade associations, and others refer to non-ESOP stock bonus plans as ESOPS because they are similar types of plans, but we have focused our study only on ESOPS as defined by law and regulation. Hence, our estimates of the number of ESOPS and of the number of participants in and amount of assets held by these plans differ from those based on the more expansive definition of ESOPS often used by others.

Among the 4,174 ESOPs active at the time of the 1985 survey, an estimated 26 percent were tax credit ESOPs, 16 percent leveraged, 35 percent leverageable, and 22 percent nonleveraged ESOPs.

The active ESOPs identified in the survey covered more than 7 million participants, of which over 6 million (90 percent) were in tax credit ESOPs. (See table 2.1.) These plans had assets in 1983 of nearly $18.7 billion, with $14.8 billion (79 percent) held by tax credit ESOPs. While tax credit ESOPs had the highest amount of assets, they provided less in assets per participant than the other types, with a median of $2,952, compared with $8,660 for leveraged ESOPs, which had the highest median asset value per participant. Detailed descriptive information is provided in PEMD-86-4BR.

Table 2.1: GAO Estimates of Participants and Assets of ESOPs[a]

	Participants		Assets[b]		
Type	Number (thousand)	Percent	Total (million)	Percent	Median/ participant
Tax credit	6,391	90	$14,800	79	$2,952
Leveraged	158	2	1,450	8	8,660
Leverageable	293	4	1,445	8	7,149
Nonleveraged	238	3	961	5	5,098
Other	2	c	1	c	0
Total	**7,083**	**99[d]**	**$18,660**	**100.0**	**$5,226**

[a]Based on plans active in 1983, the last year for which complete data are available.

[b]In constant 1983 dollars.

[c]Less than 0.05.

[d]Total does not add to 100.0 because of rounding.

Reasons for Forming, Maintaining or Terminating ESOPs

Reasons for Forming ESOPs

Respondents were asked to indicate why their companies had established ESOPs. The questionnaire listed 11 commonly cited reasons for ESOP formation in the literature, and respondents had the option of providing other reasons. Each respondent could select as many responses as seemed appropriate. Table 2.2 shows the percentage of ESOPs that checked each response on the questionnaire.

Table 2.2: Reasons for ESOP Formation by Type of ESOP

Reason	Tax Credit	Leveraged	Leverageable	Nonleveraged	Overall
Employee benefit	95%	88%	90%	92%	91%
Tax advantages	77	64	77	74	74
Improve productivity	65	73	74	70	70
Buy stock of major owner	21	59	45	35	38
Reduce turnover	29	36	40	36	36
Transfer majority ownership to employees	23	37	37	32	32
Raise capital for investment	21	26	30	18	24
Decrease absenteeism	13	11	16	14	14
Avoid unionization	7	7	7	9	8
Make less vulnerable to hostile takeovers	6	6	4	5	5
Save failing company	3	8	2	4	4
Exchange for wage concessions	3	1	2	4	3
Take company private	2	4	[a]	[a]	1
Other	10	10	7	8	[a]
Total weighted cases	**1,015**	**579**	**1,250**	**853**	**3,698[b]**

[a]0.5 percent or less.

[b]Weighted subtotals do not add up to overall total because of rounding.

Three reasons — providing an employee benefit, reaping tax advantages, and improving productivity — are by far the most cited ones. This is true both for ESOPs as a whole and for each type of ESOP. By contrast, the more controversial uses of ESOPs — avoiding unionization, making the firm less vulnerable to hostile takeovers, saving failing companies, trading ESOP contributions for wage concessions, and taking the company private — are listed by few of our respondents. Thus, cases such as Weirton Steel, as cited in Chapter 1, are by no means the typical form of ESOP.

There are some differences among types of ESOPs. Tax credit ESOPs were less likely than the other types to have reported forming an ESOP to buy the stock of a major owner or to transfer majority ownership to employees. This probably reflects the fact that tax credit ESOPs are more likely than other types to be associated with larger, usually publicly-traded companies, where there generally is no single major shareholder, and where we would not expect investors to be particularly intent on making employees owners of a majority of stock. In any case, the limited amounts that can be contributed to tax credit ESOPs make them unsuitable for buying out a large proportion of the stock of a sponsoring firm.

It would take very long for the plan to purchase a majority interest given the limited contribution levels permitted.

By contrast, 59 percent of leveraged ESOPs responded that one reason they were formed was to buy stock of a major owner, and 37 percent responded that one of the reasons was to transfer majority ownership to employees, according to our respondents. Leveraged ESOPs tend to be found in smaller, privately-held firms. In fact, 48 percent of respondents from privately held firms reported that buying stock of a major owner was an important reason for ESOP formation, and 37 percent cited transferring majority ownership to employees; among publicly-traded firms, the respective figures were 10 percent and 17 percent. In addition, the tax treatment afforded contributions to leveraged ESOPs makes it possible to generate relatively large amounts of cash to buy up stock in the sponsoring firm. If the leveraged transaction is made when the stock price is low, many shares can be contributed, with the costs and allocations spread out over several years.

Tax credit ESOP respondents also were somewhat less likely than others to indicate that their plans were formed to reduce turnover. ESOPs could reduce turnover by giving employees a stake in the company that stands to grow if the firms prospers. Perhaps tax credit ESOPs are less likely to have this effect because, as we have seen, the holdings for each participant tend to be small.

Several points need to be made about leveraged ESOPs. First, a smaller percentage of these respondents compared to others reported forming plans because of tax advantages. This is surprising, given the special tax incentives for leveraged ESOPs. But our survey did not include leveraged ESOPs formed after the strong 1984 incentives took effect. Among newer plans this might be a more common reason for formation. Second, only about 26 percent of leveraged ESOP respondents indicate that raising capital for investment was a major reason for formation, despite the fact that this is one of the theoretical and apparent reasons for adopting a leveraged ESOP. This is more than for nonleveraged or tax credit ESOPs, but not much more. Finally, leveraged ESOPs are somewhat more likely than the other types to report having formed to save failing companies, although only 8 percent cited this reason. That leveraged ESOPs may be more likely than others to be used for this purpose is not surprising given the ability to borrow through the trust; what may be surprising, given press coverage of ESOPs, is that so few cite this reason at all.

Reasons for Maintaining ESOPs

We did not ask respondents why they maintained ESOPs. In effect, such a question would have amounted to asking them why they did not terminate the plans or convert them to other types of plans. It is usually difficult for respondents to explain why they did not take particular actions. Instead, the reasons for ESOP maintenance are inferred by asking respondents to indicate the advantages and disadvantages their firms derived from having these plans. The responses are displayed in tables 2.3 and 2.4.

Table 2.3: Advantages of Having ESOPs by Type of ESOP

Advantage	Tax Credit	Leveraged	Leverageable	Nonleveraged	Overall
Improved employee morale	74%	75%	60%	61%	66%
Tax savings	55	51	66	65	60
Higher productivity	34	42	38	31	36
Reduced turnover	25	42	35	34	33
Better management- employee relations	27	28	24	25	26
Capital for investment	16	22	32	24	24
Improved profitability	16	26	30	20	23
Decreased absenteeism	6	11	10	9	9
Other	8	9	6	4	6
None	9	5	9	8	8
Total weighted cases	**1,019**	**573**	**1,240**	**825**	**3,657**

Table 2.4: Disadvantages of Having ESOPs by Type of ESOP

Disadvantage	Tax Credit	Leveraged	Leverageable	Nonleveraged	Overall
Dilute value of stock	10%	10%	20%	23%	16%
Repurchase liability	6	20	19	22	16
Lose control of company	1	3	7	5	4
Poor performance of stock	4	4	2	2	3
Difficulty getting loans	0	2	1	1	1
Other	11	15	17	18	15
None	72	57	49	52	57
Total weighted cases	**995**	**567**	**1,221**	**803**	**3,586**

A comparison of the last row in each table may suggest why most ESOPs have been maintained. Only 8 percent of respondents indicated no advantage gained by their firms from having an ESOP, and 57 percent cited no disadvantage. That is, there was little incentive to abandon an already-established ESOP.

The major advantages of ESOPs, according to the respondents, are improved employee morale and tax savings. A majority of respondents from each type of ESOP cited each of these reasons. Tax credit and leveraged ESOP respondents were more likely than those from leverageable and nonleveraged ESOPs to cite improved morale as an advantage, but they were less likely to cite tax savings. This is surprising, given the special tax advantages afforded tax credit and leveraged ESOPs; our data do not permit us to explain these findings.

While both tax savings and higher productivity are cited as major advantages of ESOPs, for each group of respondents a smaller percentage cites these advantages than indicated that the plan was formed for this reason. This is the case especially for productivity; whereas 70 percent of respondents indicated the plan was formed to achieve this end, only about half as many (36 percent) claim their firms actually realized such an advantage. This disparity may reflect a lack of information on productivity among respondents; many firms, especially smaller ones, do not measure productivity systematically, so could not provide information on changes in productivity before and after ESOP formation.

Finally, respondents from leveraged and leverageable ESOPs were more likely than those representing tax credit ESOPs to note improved profitability as an advantage of their plans. The links between ESOPs on the one hand and profitability and productivity on the other are not well understood, but it may be that tax credit ESOPs offer fewer incentives for such improvements than other types because of the relatively small amounts of stock they provide individual participants.

The majority of plans — 57 percent — reported no disadvantages for their sponsoring firms. For the remaining firms, the most commonly cited disadvantages were the dilution of stock value and repurchase liability. Respondents from leverageable and nonleveraged ESOPs were especially likely to cite dilution of stock value, and the ERISA-type ESOPS were more likely than tax credit ESOPs to note repurchase liability as a problem. The latter finding is expected because of the preponderance of privately-held firms in ERISA-type ESOPs. These sponsors must provide a put option, under which they agree to buy back stock after distribution to participants. For publicly traded firms, the presence of a market for their stock obviates the need to repurchase. Since most tax credit ESOPs are in publicly-traded firms, they would not be expected to experience this disadvantage to the same extent as the other types.

About 15 percent of respondents indicated there were "other" disadvantages to their companies from sponsoring ESOPs. Many firms found the required paperwork for an ESOP to be burdensome. Some complained that the paperwork had to be redone with each change in ESOP legislation.

Reasons for Terminating ESOPs

About 15 percent of the plans sampled were not active by the time of our survey. These respondents were asked to indicate why they had terminated, converted, or discontinued contributing to their ESOPs. The results are shown in table 2.5. The major reason cited for eliminating ESOPs was adverse business conditions, noted by 32 percent of respondents. This had little to do with the plans themselves. Similarly, mergers (13 percent), changes in ownership (12 percent), and liquidation of the firm (5 percent) had more to do with business than with the plans as such.

Table 2.5: Reasons for Terminating, Converting or Discontinuing Contributions to an ESOP

Reason	Tax Credit	Leveraged	Leverageable	Nonleveraged	Overall
Adverse business conditions	11%	39%	30%	53%	32%
Burdens of ERISA	10	32	22	20	18
End of TRASOP credit	46	0	3	1	15
Disadvantages of ESOPs	4	28	19	13	14
Merger	22	14	4	11	13
Change in ownership	13	0	9	16	12
Liquidation of company	6	0	10	0	5
Collective bargaining agreement	0	0	3	0	1
Other	14	10	40	26	24
Total weighted cases	**243**	**66**	**238**	**247**	**765[a]**

[a]Weighted subtotals do not add to overall total because of rounding.

But 18 percent of these respondents cited the burdens of ERISA as a reason for curtailing their ESOPs, and another 15 percent, the elimination of the tax credit for TRASOPs. These reasons are specifically associated with ESOPs. The burdens of ERISA response is reflected as well in many of the "other" responses that mention paperwork as a problem. But fewer than 14 percent of these respondents indicated disadvantages of ESOPs per se as a reason for terminating, converting, or ending contributions to an ESOP, and some of those citing the end of the TRASOP credit converted their plans to PAYSOPs.

Summary and Conclusions

Based on updated information, there were an estimated 4,799 active ESOPS as of March, 1986, and another 2,405 non-ESOP stock bonus plans. The 4,174 active ESOPS in our 1985 survey covered over 7 million participants, and held assets of nearly $18.7 billion in 1983. Although tax credit ESOPS included 90 percent of ESOP participants and held 79 percent of ESOP assets, they provided the smallest median asset balance per participant ($2,952), whereas leveraged ESOPS provided the highest median assets per participant ($8,660).

The major reasons cited for establishing ESOPS were to provide an employee benefit, to gain tax advantages, and to improve productivity. ESOPS appear to be maintained because they provide certain specific advantages to employers; most commonly noted were improved employee morale and tax savings. Few respondents could find no advantages to their companies from having ESOPS, and the majority of respondents saw no disadvantages. Even among those who terminated, converted or stopped contributing to ESOPS, few cited the disadvantages of ESOPS as a reason; the most common reasons were adverse business conditions and the burdens of ERISA, which apply to all employee plans. These results suggest that employers who establish ESOPS do so because they derive some specific benefits from them and see few, if any, disadvantages.

Costs of ESOPs

The costs of incentives for ESOP formation come in the form of tax revenues forgone by the federal government. This chapter includes first a review of the major tax benefits for corporations and individuals attached to ESOPs, and then estimates of the federal tax revenue losses associated with each benefit. ESOP incentives have resulted in the loss of between $12.1 billion and $13.3 billion in tax revenues over the period 1977-83, an average of $1.7 billion to $1.9 billion per year.

Tax Benefits for ESOPs

The tax provisions of primary concern in this report are those permitting tax credits or deductions from income for corporate contributions to ESOPs, and those involving the deferral of individual income taxes for employees on those contributions and the earnings of the plan trusts.

Corporate Tax Credits

Beginning with the Tax Reduction Act of 1975, Congress has provided for a tax credit for contributions to TRASOPs and PAYSOPs, as described in Chapter 1. This credit is scheduled to expire on December 31, 1986.

Corporate Deductions From Taxable Income

For ESOPs recognized under the terms of ERISA, there is no tax credit, but employers may deduct from their taxable income the amounts they contribute to the plan. This gives ESOPs the same corporate tax treatment afforded other employee benefit plans, such as defined benefit pension plans and profit sharing plans. But in the Economic Recovery Tax Act (ERTA) of 1981, Congress extended a special tax benefit to leveraged ESOPs. Ordinarily, contributions to stock bonus and profit sharing plans are deductible only up to 15 percent of covered payroll. Under the terms of the ERTA changes, contributions to leveraged ESOPs to cover principal payments on a loan are deductible up to 25 percent of payroll, with no limit on the deduction to cover interest payments.

Deferrals of Individual Income Taxes

As with other employee plans, participants pay no taxes on the amounts contributed to their accounts by their employers or on the earnings generated by funds in their accounts until they receive those funds, for example at the time of retirement. Not only are taxes on this current income deferred, but participants accumulate funds which compound (through earnings) on a pre-tax basis. Moreover, at the time of distribution participants may pay less in taxes on these funds than they would have had they gotten this compensation as salary and wages. There are 2 reasons for this. First, retired workers generally have lower incomes than they had when they were active workers. Under current tax law, this means that for many workers income received during retirement will be taxed at a lower marginal tax rate than it would have been during the working years. (The 2 rate structure in the 1986 Tax Reform Act could make this result less likely.) Second, retirees may be able to "roll over" their benefits into other tax deferred or tax exempt uses.

Recent Incentives Not Covered in This Report

Congress included a number of new tax incentives for ESOPs in the Deficit Reduction Act of 1984 and the Tax Reform Act of 1986. These provisions had not been in effect long enough at the time of our review to estimate their effects on federal revenues. They are described in Appendix II as a matter of interest.

Although we are not yet able to estimate the dollar amounts of revenue costs attributable to these changes, we can note how some of these provisions are likely to increase those costs. First, lending institutions and regulated investment companies now are able to exclude from their taxable incomes 50 percent of the interest they earn on loans to ESOPs. If this provision were to result in large amounts of money being borrowed through leveraged ESOPs, the tax costs of the program would increase substantially. Second, the corporate tax deduction for dividends passed through to participants (or used to pay off leveraged ESOP loans) will result in revenue losses. This could become a major contributor to tax costs, though to date few firms have used this provision.

Revenue Loss Estimates

In estimating the revenues lost to the federal treasury through the tax incentives for ESOPs, we began with the simplest assumptions about tax behavior and tax incidence. Then, more complex assumptions were used to refine these estimates. This procedure resulted in the generation of likely upper and lower bound estimates of the revenue losses associated with ESOP tax incentives.

Basic Assumptions Underlying Estimates

Each of the three initial assumptions tends to maximize the value of the estimated cost of ESOPs:

All Corporate Contributions to ESOPs Were Eligible for Tax Advantages and All Employers Claimed Them

The revenue loss estimates are based on the value of contributions to and earnings on ESOP trusts reflected in IRS files. Some of these contributions may have exceeded the limits of eligibility, may have been disqualified for some other reason, or may not have been claimed by employers.

But experts in ESOP administration report that corporations rarely contribute more than is eligible for special tax treatment. We found no evidence that contributions are disqualified by IRS, or that sponsors fail to claim applicable credits or deductions.

Applicable Tax Credits or Deductions Were Claimed in the Year of Contribution

In the case of tax credit ESOPs, credits for contributions made in any year that are in excess of the amount of taxes owed by the corporation may be carried back to previous years or forward to future years to offset tax liabilities in those years. Currently, the tax credit can be carried back three years or forward up to 15 years. If the credit is not used by the end of the 15-year carry-forward period, any unused portion of the contribution may be taken as a tax deduction, regardless of the otherwise maximum payroll limit on total employee plan deductions. But available data do not permit the identification of the amounts carried over or the years, if any, in which they are claimed.

Behavior Would Not Change in the Absence of the Incentives

This is a standard assumption in tax expenditure analysis. It means that if the incentive did not exist, then the tax credits and the taxes due on deducted and deferred income would be collected as tax revenue. It is not fully realistic because corporations could get similar tax savings through uses of their funds that took advantage of other provisions of the tax code, but it simplifies the task of generating baseline estimates of the revenue losses associated with tax provisions, such as those relating to ESOPs. (Later this assumption will be relaxed to reflect other aspects of tax law.)

Upper Bound Estimates of Revenue Losses

For each type of tax incentive — credit, deduction, deferral — we used a somewhat different estimating technique. This reflects the fact that each type of incentive works quite differently. A complete discussion of the estimation methods used is presented in Appendix V.

The estimated federal revenue losses for ESOPs over the period 1977-83 were more than $13.3 billion, as shown in table 3.1 (an average of $1.9 billion per year). Of this amount, $11.8 billion, nearly 89 percent, can be accounted for by tax credit ESOPs. This constitutes the upper bound estimate of the likely revenue losses associated with ESOP tax incentives. This $13.3 billion in revenue losses includes corporate income tax savings of more than $9.6 billion, of which more than $8.7 billion can be accounted for by the tax credits for TRASOPs and PAYSOPs. In addition, employees have deferred individual income taxes amounting to more than $4.2 billion, of which $553 million may have been recovered through taxes on distributions. This results in a net of nearly $3.7 billion in deferred individual taxes over the period, of which $3.1 billion is associated with participants in tax credit ESOPs.

Table 3.1: Upper Bound Estimates of Revenue Losses Associated With ESOPs, in Millions, 1977-83

Source of loss (gain)	Tax Credit ESOPs	ERISA-type ESOPs	Total
Corporate income taxes	$8,710	$417	$9,628
Personal income taxes			
Deferred on contributions	2,814	567	3,381
Deferred on earnings	783	73	856
Paid on distributions	(503)	(50)	(553)
Net personal	3,094	589	3,683
Total	**11,805**	**1,506**	**13,311**

Lower Bound Estimates of Revenue Losses

Lower bound estimates of revenue losses for ESOPs resulted from relaxing some of the assumptions made above. The most important change involves an assumption that if all the tax benefits of ESOPs were not available, firms would modify their behavior in response to other incentives in the tax code. The simplest modification would involve making contributions to other tax-favored employee benefit plans, such as pension or profit sharing plans.

This change likely would not affect the results for tax credit ESOPs. The TRASOP additional investment tax credit was based on the amount a corporation invested in plant and equipment. As long as a corporation had taxable income against which to apply the credit, the contributions to the TRASOP were matched dollar for dollar by reduced taxes. Similarly, the PAYSOP credit offers a full tax subsidy that cannot be matched by other plans. These tax benefits can not be captured through contributions to other types of employee plans.

Tax credit ESOPs often are grafted onto other employee plans or added to a package of such benefits. Sometimes the sponsoring firms already are making contributions to these other plans up to the limits they can deduct. Therefore, we can not justify an assumption that without the tax credits these contributions would have gone to non-ESOP plans. This leads to the conclusion that the entire amount of tax loss estimates associated with these types of plans must be assigned to the ESOP incentives.

In the case of ERISA-type ESOPs, however, it appears that contributions to them could be made to other types of plans or could be replaced by wages and salaries, subject to most of the same deduction rules. This implies that these ESOPs entail no extra revenue losses above those owing to their status as qualified employee plans. Therefore, for leverageable and nonleveraged ESOPs, tax losses can not be ascribed specifically to the ESOP incentives.

This line of reasoning does not extend to leveraged ESOPs. Contributions to these plans in part pay principal and interest on the loans used to finance the original stock purchase by the plan. The sponsoring corporation is allowed to deduct the full contribution to the plan, including these loan payments, within limits. As noted above, these limits have been less restrictive since 1981, allowing full deductibility of that portion of the contribution covering interest payments, and a deduction equal to up to 25 percent of payroll to cover principal payments.

Ordinarily, a firm can deduct interest payments on loans. Thus, the deductibility of contributions to ESOPs to cover interest payments does not constitute a special tax preference for ESOPs. Only the deduction permitted for that portion of a contribution covering principal payments is unique to the leveraged ESOPs. Therefore, only these payments are considered in making revenue loss estimates. We assumed that each leveraged transaction is paid off over ten years, with one-tenth of the principal paid each year.

Finally, in the case of distress buyouts, it is assumed that in the absence of the leveraging provision the firm would not be in business and would pay no taxes. Therefore, distress buyout firms are assumed to add nothing to the revenue losses. By keeping firms in business, these ESOPs may generate tax revenue, but our data do not allow us to estimate this effect.

These assumptions about the treatment of corporate contributions to ESOPs must be applied to the individual income tax revenue loss estimates as well. That is, if a contribution cannot be ascribed uniquely to the ESOP provisions for corporate tax purposes, the same must apply to individual taxes. This means that for tax credit ESOPs, no change is assumed in estimates for employee deferred taxes. For ERISA-type ESOPs, however, these deferrals flow from the usual deferrals available under all benefit plans, not from the special provisions for ESOPs. Even for leveraged ESOPs, the deferral of personal income taxes on contributions to and earnings on employee accounts cannot be ascribed to the special

ESOP provision for deductibility of principal because those principal payments go to the financial institution that proferred the loan. Thus, no special ESOP-related federal revenue cost attaches to these individual accounts.

With these changes in assumptions, revenue losses were reestimated using the methods described in Appendix V. The total amount of revenue loss declines from $13.3 billion to $12.1 billion, as shown in table 3.2 (and the average annual loss declines from $1.9 billion to $1.7 billion). Of this, $11.8 billion, more than 98 percent, is accounted for by credits for tax credit ESOPs, the remainder by deductions for contributions to cover principal payments on loans to leveraged ESOPs. These may be regarded as lower bound estimates of the revenues lost because of the tax credits and deductions applicable to ESOPs.

Table 3.2: Lower Bound Estimates of Revenue Losses Associated With ESOPs, in Millions, 1977-83

Source of loss (gain)	Tax Credit ESOPs	ERISA-type ESOPs	Total
Corporate income taxes	$8,710	$227	$8,938
Personal income taxes			
Deferred on contributions	2,814	•	2,814
Deferred on earnings	783	•	783
Paid on distributions	(503)	•	(503)
Net personal	3,094	•	3,094
Total	**11,805**	**227**	**12,032**

Whichever set of assumptions we use, it is clear that nearly all of the revenue losses are related to tax credit, not ERISA-type ESOPs. The major revenue losses for the latter type of plans stem from the deductibility of contributions to employee plans in general and are not specific to the status of these plans as ESOPs. Only the deductibility of contributions to leveraged ESOPs to cover principal payments on loans are attributable to ERISA-type ESOPs.

Summary and Conclusions

In reviewing ESOP tax incentives, we found that the federal revenue losses associated with these provisions of the tax code amounted to $12.1 billion to $13.3 billion over the period 1977-83, an average of $1.7 billion to $1.9 billion per year. The tax credits for TRASOPs and PAYSOPs accounted for 89 to 97 percent of the total.

These incentives are designed, in part, to broaden the ownership of corporate stock by encouraging firms to contribute their own stock to individual accounts of their employees. In addition, they include novel features intended to provide a source of finance for the transfer of stock from current owners to employees, and for capital formation. In the following chapters GAO evaluates the extent to which these incentives have been successful in meeting these goals.

Broadening the Ownership of Capital Through ESOPs

One of the major goals of the ESOP tax incentives is to promote a broadening of the ownership of capital as represented by shares of stock. In this chapter we report on the extent to which ESOPs may contribute to broader stock ownership and on a number of dimensions of that ownership. Specifically, we look not only at the nominal ownership of stock, as represented by participant account balances, but also at two other aspects of stock ownership: receipt of dividends and control of or participation in corporate management. Each of these dimensions has a different legal status, as discussed below.

ESOPs and the Distribution of Stock Ownership

In a previous report (PEMD-86-4BR), we noted that stock ownership in the United States is highly concentrated. Periodic surveys of consumer finances by the University of Michigan Survey Research Center indicate that fewer than 30 percent of U.S. families own any stock, either directly or through mutual funds (excluding pension fund holdings). For 1983, the latest data available at the time of our review, the survey shows that only 19 percent of families owned stock directly or through mutual funds. (However, if pension fund and insurance company holdings were taken into account, then a higher percentage of families own stock than these figures indicate.)

In addition to relatively few families owning stock, these surveys indicate that the distribution of the value of corporate stock is skewed in favor of the very wealthy. According to data in a recent Joint Economic Committee report based on a Federal Reserve Board study, in 1983 the wealthiest 1/2 of 1 percent of the population owned 45.6 percent of the value of all corporate stock held directly or through mutual funds. (Less than half of total stock value in 1983 was held in these forms, however. Including pension funds and insurance company holdings probably would result in a lower estimate of concentration.) In fact, the distribution of stock ownership is even more concentrated than that of total wealth. The same wealthiest 1/2 percent of the population owned 26.7 percent of total wealth (net worth) in 1983. (See table 4.1.)

Several factors place an upper bound on the extent to which ESOPs may affect the overall distribution of stock ownership, however. First, there are relatively few ESOPs, 4,799 in 1986. Second, although there were more than seven million workers participating in ESOPs in 1983, these accounted for less than 7 percent of the employed labor force for that year of 102.5 million. Third, the value of total assets for all ESOPs in 1983, about $18.7 billion, was less than 1 percent of the $2,151.5 billion in total stock outstanding at that time. Thus, only a very small share of all stock has been acquired by employees through ESOPs, and only a small proportion of all workers has benefited to date. Still, within firms with ESOPs there is a broad distribution of stock through these plans.

ESOPs and Dividend Income From Stock Ownership

One of the benefits often associated with stock ownership is the income derived from dividends paid to stockholders. While nothing in the ESOP legislation requires dividend payments to participants, the provisions of the Deficit Reduction Act (DEFRA) of 1984 making such payments tax deductible to the corporation provide incentives for firms to make such payments.

One of the major arguments for passing through dividends as current income is that this will encourage a sense of ownership on the part of participating employees and lead to a stronger commitment to the success of the firm, in terms of productivity and profitability. On the other hand, employees may benefit from leaving any dividends in the trust because taxes are thereby deferred, and the value of each employee's account is enhanced. Thus, each employee may have a different perspective on the value of dividend pass through, depending on his or her financial aims.

In practice, firms differ widely in the extent to which they pay dividends on their stock. Among firms that sponsor tax credit ESOPs, 58 percent of respondents indicate that they pay out dividends all the time. (See table 4.2.) But among the sponsors of other types of ESOPs, only 20 percent to 26 percent pay dividends this regularly. This difference largely reflects the preponderance of publicly-traded companies among tax credit ESOP sponsors; publicly-traded firms in general are more likely to pay dividends on stock than are privately held firms.

Table 4.2: Distribution of Dividends to ESOPs

	Tax Credit	Leveraged	Leverageable	Nonleveraged	Overall
All the time	58%	26%	21%	20%	32%
About 3/4 of the time	3	2	2	1	2
About 1/2 of the time	2	2	2	3	2
About 1/4 of the time	2	8	5	9	6
Never, no provision	35	61	70	66	58
Total weighted cases	**1,004**	**579**	**1,222**	**802**	**3,606**

Dividends Are Usually Retained in the Trust

Typically, dividends paid on stock held in ESOP trusts has been retained in the trusts rather than distributed as current income. Table 4.3 shows that among those plans that did have dividends paid on their employer stock prior to June, 1984, 86 percent retained the dividends in the trust rather than distributing them to participants. This figure was substantially the same for all types of ESOPs.

Table 4.3: Distribution of Dividends Prior to June, 1984 Among Plans With Dividends Paid

	Tax Credit	Leveraged	Leverageable	Nonleveraged	Overall
Dividends retained in plan trust	86%	85%	87%	89%	86%
Dividends distributed to participants	12	9	4	2	8
No dividends paid prior to June, 1984	2	6	9	9	5
Total cases	**584**	**204**	**340**	**239**	**1,367**[a]

DEFRA Changes Have Had Little Effect on Dividend Payouts

In part to provide an incentive for more ESOP employers to pass dividends through to participants, and to coordinate an elimination of "double taxation" for capital income with a broadening of ownership, Congress included in DEFRA a provision allowing corporations to deduct from taxable income the amount of cash dividends paid to ESOP participants, either directly by the corporation or indirectly through the ESOP trust. To determine whether this change in the law has had any effect, respondents were asked how they have handled dividend payments since DEFRA was passed. Table 4.4 shows the responses among the corporations that reported having paid dividends into the ESOP trust that were retained by the trust prior to 1984. As of late 1985, when the survey was taken, respondents reported that nearly 95 percent of these ESOPs that received dividends after June, 1984, continued to retain them in the plan trust; less than 5 percent changed procedures and passed through the dividends, despite the tax incentive to do so.

Table 4.4: Distribution of Dividends After June, 1984 Among Plans That Retained Dividends Prior to June, 1984

	Tax Credit	Leveraged	Leverageable	Nonleveraged	Overall
Dividends retained in plan trust	95%	92%	92%	100%	95%
Dividends distributed to participants	5	8	8	0	5
Total weighted cases	**514**	**136**	**259**	**180**	**1,089**

Control of Corporations Through ESOPs

Employee control over or participation in the management of corporations through ESOPs is not an explicit goal of ESOP legislation, but it is another dimension of ownership. There has been substantial discussion in the press and in academic circles of the potential for employee control and participation through ESOPs. For example, some students of employee ownership have argued that such control or participation could be important in contributing to any productivity gains that ESOPs might engender. The rationale is that employees who are directly involved in managing their companies will be committed to success, and will contribute to that success by cooperating with management on productivity-improvement projects, developing suggestions for improving corporate performance, and refraining from making excessive wage and benefit demands on the company.

On the other hand, a concern that employees might have excessive influence over management decisions has been cited as an impediment to the formation of ESOPs in more firms. For example, some corporate managers and financial institution decision makers have expressed concerns that if they were able to control management decisions, workers might opt to increase wages and benefits at the expense of investment in the long-term growth of the company.

In any case, the extent of employee interest in control over or participation in management, whether through ESOPs or through any other mechanism, is unknown. One recent survey of employees at 37 ESOP firms found some interest among employees in participation in management, at least on such issues as social events, working conditions and work procedures.[1] Our data, collected from corporate management, do not address this issue.

[1]Corey Rosen, Katherine J. Klein and Karen M. Young, Employee Ownership in America: The Equity Solution (Lexington, Mass.: Lexington Books, 1986), pp. 89-99.

ESOPs Usually Own a Small Percentage of the Corporation's Stock

One measure of the extent to which employees may control a corporation through an ESOP is the proportion of the stock in the company that is owned by the ESOP trust on behalf of employees. The data presented in table 4.5 make clear that few ESOPs own a large share of the outstanding stock of their employing corporations. According to survey respondents, the median ESOP owns only 10 percent of the total stock of sponsoring companies, with leveraged ESOPs holding an average of 20 percent, and tax credit ESOPs only 2 percent. Moreover, only 24 percent of ESOPs own more than 25 percent of the stock in their sponsoring firms (less than 2 percent owning all of the corporate stock). Among leveraged ESOPs, 42 percent own more than a 25 percent interest in their firms (of these, only 6 percent own all of the sponsor's stock). Among tax credit and nonleveraged ESOPs, only about 5 percent own more than 25 percent interest in their companies.

Table 4.5: Ownership of Sponsoring Corporations by ESOPs

	Tax Credit	Leveraged	Leverageable	Nonleveraged	Overall
Own up to 25 percent	95%	56%	68%	77%	75%
Own more than 25 percent	5	44	32	23	25
Total weighted cases	**838**	**506**	**1,061**	**648**	**3,052**
Median percent of stock owned	**2%**	**20%**	**15%**	**13%**	**10%**

ESOPs Control Only Some Voting Stock

Nearly 70 percent of ESOPs hold employer stock with voting rights (see PEMD-86-4BR). As the data in table 4.6 indicate, however, the proportion of the voting strength in sponsoring firms' stock held by ESOPs is even smaller than the proportion of all stock owned by these plans, reflecting the fact that some of the stock held by ESOPs does not carry voting rights. The median for all plans is only 2 percent of total voting strength, with a high of 10 percent for leveraged ESOPs. Only 7 percent of all ESOPs control more than 25 percent of the voting strength in their firms, including a high of 30 percent among leveraged ESOPs, and a low of 4 percent for tax credit ESOPs. Voting rights associated with stock in ESOP accounts may be passed through to participants or exercised by plan trustees without participants' direction, depending on the type of plan, whether the firm is publicly or privately traded, and laws in the state of incorporation. We found that 66 percent of tax credit ESOPs passed through full voting rights to participants, compared with 33 percent of leveraged, 30 percent of leverageable, and 25 percent of nonleveraged ESOPs.

Table 4.6: Voting Strength of ESOPs in Sponsoring Corporations

	Tax Credit	Leveraged	Leverageable	Nonleveraged	Overall
Own up to 25 percent	96%	68%	72%	85%	81%
Own more than 25 percent	4	32	28	15	19
Total weighted cases	**847**	**491**	**1,034**	**633**	**3,005**
Median percent of voting strength	**1%**	**14%**	**10%**	**5%**	**5%**

ESOPs Do Not Control Boards of Directors

Some accounts of firms with ESOPs have stressed the accompanying representation of rank and file employees on the corporations' boards of directors. Many observers see this situation as an impediment to the adoption of ESOPs by firms that do not sponsor them currently. According to our respondents, nearly 97 percent of ESOP firms have boards of directors, but only 4 percent of these include union or other nonmanagerial employee representatives on these boards. In no case did a sampled firm report having a board on which employee representatives constituted a majority.

ESOPs May Lead to Increased Employee Participation in Management

While ESOPs do not appear to vest control over corporate management in the hands of rank and file employees, they may provide opportunities for increased employee participation in corporate decision making. We asked our respondents about the extent of such participation. The data reported here are based on the responses of managers, and do not necessarily represent the views of nonmanagerial employees.

Some Firms Report More Employee Participation

As the data reported in table 4.7 indicate, more than two-thirds responded that employee participation in management was about the same after ESOP formation as before. But more than one-quarter reported more involvement, with only one percent indicating that involvement had decreased. There is little difference in the pattern of responses by type of ESOP.

Table 4.7: Nonmanagerial Employee Involvement in Company Decision Making Before and After ESOP Formation

	Tax credit	Leveraged	Leverageable	Nonleveraged	Overall
More now	24%	27%	31%	25%	27%
About the same	69	71	65	69	68
Less now	2	0	0	2	1
Not ascertained	5	2	4	4	4
Total weighted cases	**936**	**552**	**1,174**	**786**	**3,447[a]**

[a]Weighted subtotals do not add to overall total because of rounding.

For the most part, any increased participation by nonmanagerial employees seems not to have been institutionalized within the companies. Among those firms reporting that there was increased employee participation, fewer than one-quarter reported that this increased participation was channelled through formal structures such as committees or task forces, or through a combination of formal and informal means. Instead, more than three-quarters of the respondents indicated that employees' increased managerial involvement took place in informal settings, such as casual meetings or conversations. (See table 4.8.) But there is a significant difference between leveraged and other types of ESOPs. Among leveraged ESOPs, 42 percent of those reporting increased participation indicate that it occurred in formal structures, or a combination of formal and informal settings. For each of the other types of ESOPs, this figure is only about half as high. It is not clear from the data why there is this difference, but a plausible explanation would be that the extra financial commitment implied in leveraging encourages sponsoring firms or employee representatives, including unions, to seek more employee input into corporate management.

Table 4.8: Nature of Increased Nonmanagerial Employee Involvement in Decision Making

	Tax Credit	Leveraged	Leverageable	Nonleveraged	Overall
Formal	3%	27%	16%	17%	15%
Mixed formal and informal	14	15	5	3	8
Informal	83	58	77	80	76
Not ascertained	0	0	2	0	1
Total weighted cases	**226**	**151**	**362**	**198**	**937**

Participation Occurs on Selected Issues

As the data in table 4.9 indicate, work groups or committees involving nonmanagerial employees tend to deal with four major issues: safety; working conditions, job design and quality of working life; maintaining good management-employee relations; and reducing costs. While the precise percentages vary by type of ESOP, these four consistently top the list for all types. By contrast, product quality circles, the development of new products or services, strategic or long range planning, and budget or financial control are the bottom four issue areas for all types of ESOPs. This pattern suggests that in these firms nonmanagerial employee input occurs largely in traditional areas of employee participation. The central managerial functions, especially budgeting or financial control and long term planning, are not areas in which ESOP employees are involved, except among a small minority of the firms surveyed. It may be that the level of involvement on these issues is higher in ESOP firms than in other corporations, but the data do not address this possibility.

Table 4.9: Issues on Which Nonmanagerial Employees Have Input Into Decision Making

	Tax Credit	Leveraged	Leverageable	Nonleveraged	Overall
Safety	51%	34%	40%	38%	42%
Working conditions	36	38	33	28	34
Management-employee relations	38	30	36	25	33
Reducing costs	33	31	29	29	30
Product quality circles	25	18	15	17	19
New products	14	19	12	16	14
Planning	10	14	17	8	13
Budget or finance	13	10	10	8	11
Other	3	3	2	2	3
None	32	34	29	40	33
Total weighted cases	**899**	**533**	**1,147**	**767**	**3,345[a]**

[a]Weighted subtotals do not add to overall total because of rounding.

Employees Tend to Be Asked for Suggestions Rather Than Decisions

Among the firms that report nonmanagerial employee participation in decision making on any of the issues listed in table 4.9, the extent to which employees actually make decisions is somewhat restricted. As shown in table 4.10, nearly all firms elicit suggestions from employees. But in only 10 percent do employees make decisions on any of these matters on their own, and in fewer than one-third do they share decision-making with management. Again, this may be higher than in non-ESOP firms, but the data do not allow us to address this issue.

Table 4.10: Type of Decision Making Participation by Nonmanagerial Employees

	Tax Credit	Leveraged	Leverageable	Nonleveraged	Overall
Make suggestions	98%	96%	94%	94%	95%
Share with management	20	36	42	35	33
Decide on their own	9	10	6	17	10
Other	1	4	0	0	1
Total weighted cases	**573**	**298**	**648**	**375**	**1,834**

There are differences among the types of ESOPs, however. Tax credit ESOPs report much less shared decision-making than do other types. This may reflect the fact that tax credit ESOPs tend to be in larger, presumably more bureaucratic corporations than are the other types, and that these plans own very little of the firms' stock. On the other hand, a higher proportion of nonleveraged ESOPs than of the other types report that employees make decisions on their own. It is not clear from the data why this group of ESOPs should report autonomous employee decision making more frequently than other ESOPs. Leveraged ESOPs, even though they are more likely to provide formal means for employee input, are not more likely than other ESOPs to allow employees to make management decisions on their own.

Summary and Conclusions

This review of the role of ESOPs in broadening the ownership of capital in the U.S. leads to several conclusions. First, the distribution of stock ownership within ESOPs appears to be broader than is the case in the population at large. Whereas only a minority of U.S. families own stock directly or through mutual funds, and the wealthiest families own a large share of that stock, most employees of firms with ESOPs have ownership of shares in those firms. This broadening may be attributed to the requirements of ESOP regulations, which are similar to those of other employee plans receiving favorable tax treatment. In any case, the overall effect of ESOPs on the distribution of stock ownership is bounded because there are relatively few plans, covering a small proportion of workers, and controlling a small percentage of stock.

Second, most ESOPs do not yet distribute dividends to participants, even though there are tax incentives to do so. But these incentives took effect only a few months before our survey, so their full impact cannot yet be evaluated. Still, most ESOPs do not provide the recurring financial rewards of ownership that some theoreticians have suggested are important to stimulate employee efforts at improving corporate performance.

On the other hand, the participants in those firms that pay dividends which are retained in the ESOP trusts do build up long-term financial assets.

Third, ESOPs generally do not imply employee control over the sponsoring firm. There is some evidence of increased participation by nonmanagerial employees in corporate decision making in some firms, but this usually has not been formalized, and generally deals with areas of traditional employee input. There is little evidence that ESOPs involve radical changes in corporate control in favor of employees. The ESOP legislation does not articulate as an objective the shifting of control of firms over to employees or changing patterns of corporate decision making. In this sense, our findings on these issues do not constitute an evaluation of the degree to which ESOPs are meeting legislative goals. But some theoreticians have based their support for ESOPs and similar mechanisms on models urging greater employee control and participation for various reasons. Most such theoreticians may be disappointed by these results, but corporate managers, financial advisors and others who had feared that ESOPs would lead to employees taking control of firms and eroding profitability may be pleased.

For ESOPs to have more of an effect on the distribution of stock ownership than they have to date, our results suggest that several conditions would need to change. First, a substantially larger percentage of U.S. workers would need to be covered than the 7 percent of the work force participating in ESOPs at the time of our survey. The expiration of tax credit ESOP legislation on December 31, 1986, seems likely to reduce the number of ESOP participants sharply, however, because 90 percent of all ESOP participants are covered by this type of plan.

Second, if stock ownership is to be made more meaningful to employees, the benefits of that ownership may need to be made more immediate than is often the case currently. Most of the ESOPs we studied seem to use their plans as retirement-related employee benefit plans. This is quite natural given that most ESOPs were established under the basic retirement law. But retirement programs are designed to protect workers in old age; their benefits are remote, especially for younger employees. Workers are not likely to make a strong connection between such benefits and capital ownership.

One way to strengthen this connection may be to ensure that employees participating in ESOPs realize some of the benefits of ownership immediately. The payment of dividends on a regular basis may be one way to accomplish this. Congress created an incentive for the pass through of dividends to employees in the Deficit Reduction Act (DEFRA) of 1984, allowing employers to deduct from taxable income dividends passed through to ESOP participants. The initial results of this change have not been dramatic, and while it is too early to reach any conclusions based on our partial results, it is true that these are not encouraging. On the other hand, employees interested in deferring tax payments and building asset values in their accounts might well prefer not to have dividends distributed to them currently.

The link between ESOPs and employees' sense of capital ownership also could be strengthened by large contributions that will make the ESOP a major owner of the firm. Congress addressed this issue, too, in DEFRA. Under the act, the owner of a company may defer capital gains tax on the sale of stock to an ESOP, but only if the ESOP emerges from the sale with at least a 30 percent ownership share of the firm. Another provision encourages the estates of deceased major stockholders to transfer shares to the ESOP by permitting the ESOP to assume estate tax liabilities up to an amount equal to the value of the shares transferred. It is too early to assess the effects of these provisions, however.

Finally, to increase employees' sense of capital ownership, it may be useful to explore incentives that would encourage sponsoring firms to provide a more direct role for employees in the management of ESOP firms or in decision making in areas relevant to their work. Several studies of the relationship between ownership and economic performance suggest that participation may be an important factor in achieving the goals of improved productivity and profitability in firms with ESOPs. The data on this issue are not conclusive, however. We will address it more fully in our next report.

It should be recognized that increasing the numbers of ESOPs and strengthening the roles of ESOP participants in the management of their companies may be conflicting goals. That is, many firms may be reluctant to adopt an ESOP if they also must share some degree of management prerogatives with employees. Our data do not address this issue directly, but the relatively limited role that employees currently play in most ESOP companies suggests that strengthened participation is not a major goal for management, and may not be a goal of participants, either.

One of the surprising findings of our study is that so few ESOPs have taken advantage of the leveraging provisions of the tax code to raise funds, either to buy out major stockholders or to finance capital formation. Only about 16 percent of ESOPs have used the leveraging mechanism. It is not clear why this incentive has not stimulated more ESOP formation to date.

It has been suggested that financial institutions have been reluctant to lend to ESOPs because of their concerns about excessive employee control over the firms' management. Our findings suggest that the problem of employee control may be largely hypothetical, even in firms with leveraged ESOPs. In any case, Congress has tried to address this concern with a provision in DEFRA that exempts from taxation 50 percent of the interest income financial institutions earn on loans to ESOPs. Our data do not permit us to estimate the effects of this provision on the formation of leveraged ESOPs to date, though our discussions with experts in the banking industry indicate some efforts by major institutions to become involved in leveraged ESOPs.

Our results suggest that the major influence of ESOPs for participants is likely to be related to the value of the investment they constitute rather than the degree of control over or participation in the management of firms they confer. It was not one of the objectives of this study to examine the success of ESOPs as investments as opposed to other forms of investment. We will, however, address a related question in our final report: Have ESOPs improved the productivity and profitability of sponsoring firms?

The Leveraged ESOP as a Mechanism of Corporate Finance

The special tax advantages Congress has provided to ESOPs include a mechanism for raising capital. That mechanism is the leveraged ESOP. In this chapter we examine the way leveraged ESOPs work, both in theory and in practice.

Leveraged ESOPs in Theory

The leveraged ESOP idea was developed by Louis Kelso during the 1950s, and was recognized under the special provisions of ERISA adopted by Congress in 1974. (See Appendix II.) Kelso has argued that corporations tend to raise funds for capital formation and other purposes in ways which insure that gains in growth and productivity will benefit current owners of stock, who constitute a relatively narrow stratum of wealthy persons. By relying on internal sources of funds and borrowing, corporations tend to operate in a closed system of finance that reinforces the ownership of resources by a relatively small segment of the population. By contrast, the leveraged ESOP permits corporations to raise funds in a way which promotes the broadening of stock ownership.

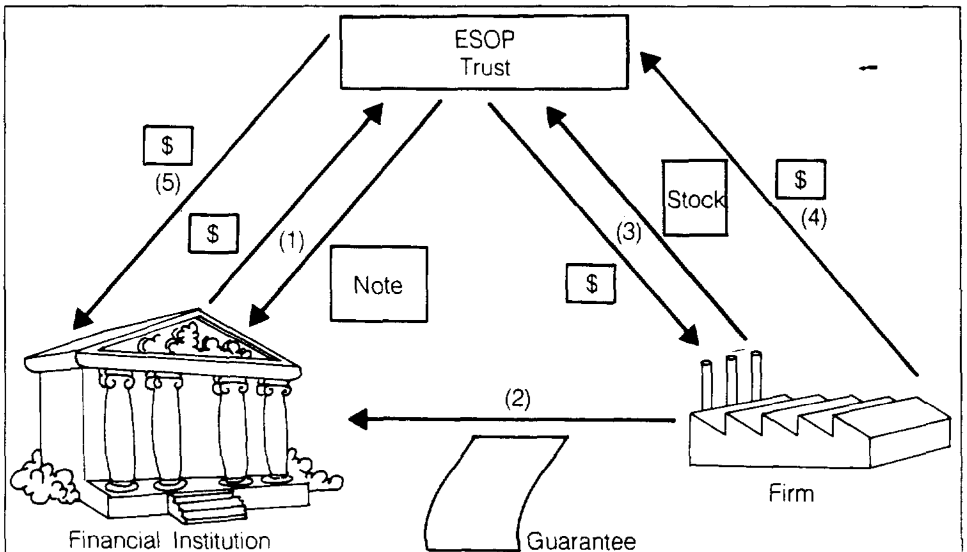
Kelso's original idea was that leveraged ESOPs would borrow to pay for newly-issued shares of corporate stock. The corporations would use the money raised through this stock sale to finance capital formation — the purchase of new plant and equipment or the modernization of existing facilities. Thus, ownership of capital, as well as the capital itself, would be expanded by making employees the owners of new capital rather than by redistributing the ownership of existing capital.

In fact, however, ESOP loans can be used for a variety of purposes under ERISA that do not always expand the stock of capital. Corporations can use the funds to pay off other loans or meet other financial obligations. Owners of stock in closely-held firms, for which there often is not a readily accessible market, can sell their shares to the ESOP. This may be especially useful if the stockholder intends to retire or has need of ready cash. Or employees can use leveraged ESOPs to save their jobs by using loan proceeds to purchase firms that otherwise would go out of business, often called a "distress buyout." While these uses of leveraged ESOPs do not involve the formation of new capital, they do promote broader stock ownership among the employees of sponsoring firms.

How the Leveraged ESOP Works

Leveraged transactions may take a variety of forms, depending on how the specific deal is structured. Figure 5.1 is a schematic diagram designed to show how such a transaction might work. First, a financial institution is found that is willing to proffer a loan to the ESOP trust in return for a promissory note (1). Typically, this note will be guaranteed by the sponsoring corporation (2). The trustees of the ESOP use the loan funds to purchase stock from the corporate treasury (3). The corporation now may use the funds to meet its financial obligations. Meanwhile, the stock in the ESOP trust is held in a suspense account and may be used as collateral for the loan. As the loan is paid off, shares are allocated to participants' accounts according to a formula provided for in the plan documents. To pay off the loan, the corporation makes annual contributions or dividend payments to the ESOP trust (4) at least equal to the amount of the annual payment for principal and interest the trust must pay the financial institution (5).

Figure 5.1: How a Leveraged Employee Stock Ownership Plan Works



(1). Financial institution lends cash to ESOP trust in return for promissory note.
(2). Sponsoring firm guarantees note.
(3). ESOP trust purchases stock from sponsoring firm.
(4). Firm contributes cash to ESOP trust.
(5). ESOP trust uses cash to make principal and interest payments on loan.

Advantages of Financing Through Leveraged ESOPs

From the corporation's point of view, the main advantage of financing through an ESOP is that the funds used to repay the debt are treated as contributions to an employee plan for tax purposes. This means that these funds are deductible from pre-tax corporate income, so that both the principal and the interest on the loan are paid with pre-tax dollars;

ordinarily, only interest payments are deductible. In effect, this lowers the cost of borrowing to the corporation.

To increase the attractiveness of this mechanism, Congress provided in the Economic Recovery Tax Act of 1981 that deductible contributions to a leveraged ESOP could exceed the usual limits on contributions to other stock bonus and profit sharing plans. Corporations now can exclude from income contributions equal to up to 25 percent of covered payroll to make principal payments, and an unlimited amount to make interest payments, on loans made through an ESOP. The usual limit for other plans is 15 percent of covered payroll.

Financial institutions also may benefit from ESOP financing in several ways. First, because loans will be paid out of pre-tax profits, borrowing corporations ought to be better able to meet their loan obligations, other things being equal. In addition, however, Congress has provided a specific incentive for lenders in the Deficit Reduction Act of 1984 and the Tax Reform Act of 1986. Under the terms of those acts, commercial lending institutions and regulated investment companies may deduct from income 50 percent of the interest they receive on loans used to acquire stock for an ESOP.

Disadvantages of Financing Through Leveraged ESOPs

The major disadvantage of leveraged ESOP financing, according to some, is the requirement that employees receive stock in the company as part of the transaction. Some concerns have been raised that the issuance of new stock to the ESOP trust could result in diluting the value of existing shares held by other stockholders. Some corporate executives may be reluctant to make their employees owners of the corporation, even in part. And some banks may be reluctant to lend to corporations in a way that makes employees owners, fearing for the stability of the company and its ability to repay the loan. In part, the Deficit Reduction Act provisions making half of interest earnings tax free addressed the concerns of commercial lenders by providing a premium for ESOP-financed loans. Banks may be sharing this benefit with ESOPs by charging lower interest rates on loans to ESOPs than on loans to other borrowers.

Among the other disadvantages of ESOPs are the special accounting rules that apply to them, and the repurchase liability that they may face when participants leave the plans.

Leveraged ESOPs in Practice

As envisioned by Kelso, the leveraged ESOP would borrow funds to purchase new stock from the sponsoring corporation, which would use the money for the formation of new capital assets. This would give employees an ownership interest in this capital, without taking away from the equity position of existing owners (stockholders) of the corporation. The legislation does not require that leveraged ESOPs work this way, however, and we found that most do not.

Leveraged ESOPs Tend to Purchase Stock From Existing Shareholders

Among the leveraged ESOPs responding to the survey (representing 492 weighted cases), only 12 percent purchased newly-issued or treasury shares of stock from the sponsoring corporation. The majority, 76 percent, used at least part of the proceeds of the loan to buy outstanding shares from other stockholders. Often, as reported in Chapter 2, a major reason cited for ESOP formation is to buy the stock of a major stockholder or owner. (Fourteen percent reported purchases from other sources, and 5 percent indicated the question was inapplicable.) Thus, few leveraged ESOPs actually are established to purchase newly-issued stock.

Some Leveraged ESOPs Are Used to Finance Capital Formation

For the small percentage of ESOPs that have leveraged using newly-issued stock, however, most corporate sponsors did use the funds borrowed for capital formation. Among the 59 weighted cases we identified in the survey, 49 percent indicated that at least some of the funds raised were invested in new plant or equipment, and 14 percent said that the funds were used to repair or modernize existing plant or equipment, at least in part. The most common use of ESOP loan funds other than the purchase of new plant and equipment was to pay off corporate debt, cited by 30 percent of plans. Only 10 percent reported using the funds to cover current operating costs. In addition, 27 percent cited other uses, and 8 percent indicated no knowledge of how the funds were used.

Leveraging in Cases of Distress Buyouts

A special use of the leveraged ESOP provisions of the tax code has been to support the purchase by employees of corporations (or parts of corporations) about to go out of business or to be closed down by a parent corporation. Under these conditions, employees, often including managers, arrange to buy out the company to keep it open and to save their jobs. Many of these transactions, such as the Weirton Steel case, have been reported widely in the press, and for many people this may be the only use for ESOP incentives they know about. While only 4 percent of ESOPs have been established to save the sponsoring company from going out of business (see Chapter 2), nearly one-third of these cases are leveraged ESOPs.

Students of these transactions differ over whether leveraged ESOPs should be used to keep in operation a firm or plant that otherwise would have closed. Some suggest that, following traditional economic theory, failing operations ought to be allowed to go out of business to promote the overall efficiency of the economy. To the extent that leveraged ESOPs channel funds to failing operations, they argue, those plans may divert money from more promising uses, thus reducing overall efficiency and, in the long run, the size of the economic pie. Others say that this view is shortsighted because it fails to take account of social costs and benefits external to the operation in question. For example, they argue that it is necessary to consider the effects of a plant closing not only on the employees of the plant, but on the business and public institutions that depend on that plant in the community or region.

Deciding these theoretical issues is beyond the scope of this report. What is reported here are empirical data showing the sources of stock purchased by leveraged ESOPs in distress buyouts, and how the sponsoring corporations used the funds raised through these transactions. That is, we discuss not whether distress buyouts should be allowed, but what happens when they occur.

We found from 32 weighted cases (data were missing on 7 others) that 91 percent of ESOPs involved in distress leveraged buyouts purchased stock of existing shareholders and none purchased treasury stock. (Nine percent purchased from other sources.) In a total of 28 of these cases (data were missing on 11 others) we found that none used the funds to invest in new plant or equipment and only 17 percent to repair or modernize existing plant or equipment. Eleven percent used at least some of the funds raised to cover operating costs, but none to meet corporate debt payments. Essentially, these firms borrowed money through ESOPs to buy out the previous owners (individuals or parent corporations) in order to keep the businesses in operation. They may have retained existing capital in operation, but they usually did not add to the capital stock through these leveraged transactions.

Two additional observations must be made about these cases. First, 42 percent of the 28 respondents indicated that at least some of the funds were used for purposes other than those indicated on the questionnaire. Second, 40 percent said they did not know how all the funds raised were used. These responses reflect the complexity of the financial arrangements involved in distress buyout transactions. In large measure, the money raised through the transaction would have gone to the previous owners of the business, so that none of the uses indicated on the questionnaire would be applicable, and respondents would not know how the funds were used by the sellers of the firm.

Summary and Conclusions

Leveraged ESOPs were designed by Louis Kelso as a way of providing simultaneously for the financing of capital formation and the broadening of stock ownership among corporate employees. However, ERISA permits a much wider range of uses for leveraged ESOPs than capital formation alone, provided that employees benefit from stock ownership through the plans.

In practice, most leveraged ESOPs are formed to buy stock from current stockholders, allowing current owners, especially of closely-held firms, to convert their holdings into cash for retirement or other purposes. Among the minority of ESOPs that used leveraged transactions to purchase corporate treasury stock, however, most did use at least some of the funds for capital formation. In a few cases, leveraged ESOPs have been used to save firms (or units of firms) from ceasing operations, thus keeping some existing capital in use, though not financing new capital formation.

The leveraging provisions of ERISA, then, have been more effective at broadening ownership through the transfer of stock than at achieving the same end through new capital formation.

Request Letter

RUSSELL B. LONG
LOUISIANA

United States Senate
WASHINGTON, D.C. 20510

June 22, 1984

The Honorable
Charles A. Bowsher
Comptroller General
General Accounting Office
Washington, D. C. 20548

Dear Mr. Bowsher:

I am concerned over the lack of information on employee stock ownership plans (ESOPs). A member of the minority staff of the Committee on Finance has had useful discussions with staff from your Program Evaluation and Methodology Division on methodological problems in identifying, classifying and collecting data on ESOP firms.

It would be extremely helpful if GAO could develop and, if practical, implement a methodology for studying the following:

1. How to obtain an accurate census of ESOP companies, participants and assets, and provide other descriptive statistics for a representative sample of ESOPs.

2. How to identify the factors associated with a company's decision to establish and continue an ESOP.

3. Whether ESOPs are expanding the ownership of capital assets in the United States, and to what degree.

4. Whether companies with ESOPs experience an improvement in productivity and profitability, and what ESOP-related factors influence that experience.

5. The cost of ESOP incentives in terms of tax expenditures, including any possible "feedback effects" attributable to such incentives.

The Honorable
Charles A. Bowsher
June 22, 1984
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To the extent possible, it would also be helpful to know whether the establishment and continuation of an ESOP has an impact on the value of a corporation's stock and/or on the level of dividends paid by the company. In addition, to the extent possible, it would be useful to know the relationship between establishment and continuation of an ESOP and the sponsor company's employee compensation and benefit levels.

This evaluation should provide a better understanding of the various uses of ESOPs in the United States, and enable those interested in the subject to learn more about how ESOP financing can be made more effective in achieving national goals.

It is expected that your designated representative will have access to Internal Revenue Service tax returns, records and other return-related information necessary to conduct this evaluation. It is possible that this task could also require access to similar information about non-ESOP firms or benefit programs for comparison purposes.

It would be useful to have findings of this review completed by Spring, 1986. I would, however, like to discuss a schedule for briefings on the preliminary findings. If you have any questions, please call Jeff Gates, Minority Counsel to the Committee on Finance, at 224-5315.

Sincerely,

Russell B. Long

RBL/jrg

History of ESOPs

Although current ESOPs date from 1974[1], efforts to enable employees to participate in the ownership of their work places have a much older history in the United States. By the 1920s, stock bonus plans had been established in many American firms. Although many of these plans withered in the aftermath of 1929's Great Crash, their numbers increased again in the years after World War II. By the early 1980s, the pre-ERISA stock bonus plans were rapidly being displaced by ESOPs.

Kelso's Theories and the ESOP Idea

Employee ownership in the form of ESOPs draws its principal inspiration from the work of San Francisco attorney Louis Kelso. In The Capitalist Manifesto[2], written with philosopher Mortimer Adler, and several later books, Kelso blamed many economic problems on the highly skewed distribution of stock. Kelso argued that it is because most American workers do not own stock that they press constantly for wage increases, which have inflationary effects, and are unsympathetic to profits, which are much more conducive to the economy's good health. Kelso felt that these problems could be eliminated if American workers were enabled to become stock owners and began to receive a "second income" from stock dividends in addition to their wages.

To encourage a broader distribution of stock ownership, Kelso proposed a new approach to corporate finance. Kelso believed that a major cause of the existing skewed distribution of stock ownership was that new capital investment was financed out of savings rather than through the expansion of equity ownership. As a result of this practice, newly formed capital becomes the property of a class of existing capital owners rather than adding new capital owners. Kelso therefore recommended policies that would encourage corporations to finance new investment in a way that would enable employees to become owners of new capital in their firms. To finance this broadened ownership, Kelso recommended a "leveraging" arrangement in which an employee trust would obtain a bank loan to purchase newly-issued shares in the firm and would gradually pay off the loan with the income earned by this new capital. Thus, workers would gain the financial capacity to acquire

[1] The first legislative provision for ESOPs appeared in the Regional Rail Reorganization Act of 1973 establishing CONRAIL. It required that the final plan for the reorganization of rail lines in the Northeast include consideration of the use of an ESOP to help finance the new corporation.

[2] Louis O. Kelso and Mortimer Adler, The Capitalist Manifesto (New York: Random House, 1958). See also Kelso, The New Capitalists: A Proposal to Free Economic Growth From the Slavery of Savings (New York: Random House, 1961), and Kelso and Patricia Hetter, How to Turn Eighty Million Workers into Capitalists on Borrowed Money (New York: Random House, 1967).

stock, a capacity usually limited to the class of current owners of capital.

Kelso's ideas had little practical impact until he was introduced to Senator Long in 1973. Senator Long was then Chairman of the Senate Committee on Finance. At that time, the Finance Committee was considering what was to become the Employee Retirement Income Security Act (ERISA) of 1974. As a result of Senator Long's efforts, ERISA gave official recognition to ESOPs as qualified employee benefit plans, and exempted them from the general prohibition against leveraging.

ESOP Legislative History After 1974

Since they were recognized in ERISA in 1974, ESOPs have generated a considerable amount of legislative activity, averaging more than one piece of federal legislation per year in the ensuing years. A chronological listing of these acts appears below. The discussion here is confined to the major legislative events in the history of ESOPs.

Establishment of Tax Credit ESOPs

After ERISA had recognized the leveraged ESOP in 1974, a major focus of ESOP legislation became the tax credit ESOP. In their early years, tax credit ESOPs were known as TRASOPs, an acronym for Tax Reduction Act Stock Ownership Plan. The Tax Reduction Act of 1975 offered corporations a 1 percent addition to their 10 percent investment tax credit if they made a contribution to a TRASOP that was equal to or greater than the 1 percent credit. The Tax Reform Act of 1976 allowed employers to take an additional 1/2 percent investment tax credit if they contributed that additional amount to the TRASOP by matching employee contributions to the TRASOP that were equal to or greater than the credit amount. The Economic Recovery Tax Act of 1981 called for TRASOPs to be phased out at the end of 1982 and replaced by PAYSOPs, a new payroll-based tax credit for ESOPs. Since 1983, companies with PAYSOPs have received a tax credit up to 1/2 percent of payroll for contributions to a PAYSOP of at least that amount. No employee contributions are required under PAYSOPs. PAYSOP legislation expires in 1986. In this report we use the term "tax credit ESOPs" to denote either TRASOPs or PAYSOPs.

Expansion of Participants' Rights and Privileges

Other legislative provisions have stipulated various rights that should accompany the stock that employees receive through an ESOP. Legislation enacted in 1978 required that put options be attached to the stocks distributed by ESOPS in closely held firms. A put option requires that the sponsoring employer repurchase stock from a retiring or terminated participant or from the estate of a deceased participant in the absence of a market for the stock. It was feared that, without these options, a retired employee would have no means of selling the stock received from closely held firms.

Some more controversial legislation has had to do with employees' rights to vote the stock held in their names by the ESOP trusts. The Revenue Act of 1978 required ESOPs in publicly traded firms to "pass through" to employees full voting rights, and also required privately held firms to provide such rights on major corporate issues. This provision has subsequently aroused a good deal of opposition, but none of the bills to repeal pass through voting rights had yet been enacted at the time of this review.

There have also been numerous efforts to make it possible for dividends on ESOP shares to be passed through as current income to ESOP participants as envisioned in Kelso's theory. The Tax Reform Act of 1976 specifically authorized ESOPs to pass through dividends to their participants. In practice, however, most ESOPs have not taken advantage of this opportunity. Employers may be reluctant to distribute current dividends to ESOP participants because of the administrative cost and the problem of distributed dividends being taxed doubly (first as corporate income, and second as personal income). Provisions enacted in the Deficit Reduction Act of 1984 encourage dividend pass through by allowing corporations to deduct cash dividends that they pay on ESOP shares, provided that those dividends are passed through to the participants.

Recent Incentives for ESOPs

The Deficit Reduction Act of 1984 included several other provisions designed to offer new encouragement for ESOPs. One allows banks to exclude from their income 50 percent of the interest they earn on ESOP loans. Another permits owners to defer taxes on capital gains that result from the sale of stock of a closely held company to an ESOP. The act also permits employers to assume an estate's tax obligation in return for an equal amount of stock being transferred from the estate to an ESOP. Together, these provisions may provide a powerful set of incentives encouraging the further spread of ESOPs.

The Tax Reform Act of 1986 includes a number of provisions related to ESOPs. The legislation repeals the tax credit for PAYSOPs effective December 31, 1986. It provides additional tax benefits for other types of ESOPs by (1) permitting the exclusion from an estate's value of 50 percent of the qualified proceeds from the sale of employer stock to an ESOP,

(2) allowing a deduction from corporate income for dividends paid on stock in an ESOP when they are applied to repayment of ESOP loans, and (3) extending the 50 percent exclusion on interest income earned on ESOP loans to regulated investment companies (and permitting such loans to be structured as loans directly to the corporation). Finally, the legislation changes qualification requirements for ESOPs somewhat.

ESOPs and Other Employee Benefit Plans Compared

The Employee Retirement Income Security Act of 1974 divides employee benefit plans into two major groups, as follows:

1. defined benefit plans
2. defined contribution plans

a. stock bonus plans
b. money purchase plans
c. profit sharing plans

Defined benefit plans are the plans most commonly referred to by the term "pension plan." These plans specify in advance the amounts that participants are to receive in retirement — either a fixed amount per year of service, a fixed percentage of earnings, or a fixed percentage of earnings per year of service. Benefits to individual employees are paid out of one common fund, to which strict fiduciary standards apply. For example, defined benefit plans are permitted to invest no more than 10 percent of their assets in securities of the sponsoring employer. Plans must meet federal standards as specified in ERISA and other legislation in order to take advantage of the favorable tax treatment associated with qualified plans. The plans are subject to minimum funding standards and are guaranteed by the Pension Benefit Guarantee Corporation (PBGC).

Defined contribution plans, in contrast, make no promise to pay any specific amount of benefits to their participants. Employers pledge only to make regular contributions to the accounts of individual participants and to pay out to participants upon their retirement or other specified event whatever is in their accounts. Thus, defined contribution plans are sometimes referred to as "individual account plans" or as "capital accumulation plans." Defined contribution plans can be of three major types: profit sharing plans, stock bonus plans, and money purchase plans. Money purchase plans differ from qualified profit sharing plans primarily in that they guarantee a fixed contribution per year, whereas contributions to a profit sharing plan are based on profits and therefore vary from year to year. If specifically provided for in the plan documents, there is no limit on the amounts that any of these funds can invest in employer securities, except that a money purchase plan is limited to investing a maximum of 10 percent in such securities unless it is part of an ESOP. However, plan fiduciaries are required by law to make "prudent" investments and this is usually interpreted to mean that they should seek a diversified portfolio. These plans are not subject to minimum funding standards, nor are they covered by the PBGC.

ESOPs as Defined Contribution Plans

Under ERISA, ESOPs are defined as stock bonus plans or as combined stock bonus and money purchase plans that in either case are "designed to invest primarily in qualifying employer securities." These plans may receive stock or cash used by the plan officials to buy stock. A money purchase plan has a specific contribution schedule (such as 5 percent of salaries per year) while a stock bonus plan can determine each year how much to contribute. Since 1977 Treasury Department regulations have permitted ESOPs to be a portion of a profit sharing plan or of a stock bonus plan. ESOPs may also provide for employee contributions.

ESOPs also should be differentiated from two other non-ERISA types of employee benefit programs. One of these is the employee stock purchase plan. Although such plans have never recovered the popularity they enjoyed in the 1920s, they remain quite common. Stock purchase plans offer employees discounts to purchase their employers' stock. The Internal Revenue Code requires that: (1) the shares be sold to employees at 85 percent or more of their current market price; and (2) these discounts be available to all or at least most employees.

The second type consists of a variety of more narrowly distributed stock programs including stock option programs, phantom stocks, stock appreciation rights, performance shares, and restricted stock. While many of these programs are quite widespread, they are used almost exclusively to motivate senior executives and other "key employees." Thus, they play little or no role in expanding capital ownership, and instead tend to increase the stock holdings of employees who may already be major owners of stock.

Sampling and Stratification for ESOP Surveys

Much of our data on individual ESOPs and the firms that sponsor them were gathered through a two-wave sample survey conducted in 1985. The first questionnaire was used largely to determine whether plans were in fact ESOPs. This permitted us to identify employers to receive our second, more detailed questionnaire. In this appendix we outline our sampling and stratification procedures and discuss the implications of the response rates we obtained.

Sampling for Our Survey

To obtain an accurate count of ESOPs, we conducted a survey of a sample of 8,891 plans identified by IRS from the Employee Plan Master File (EPMF) as having "ESOP features" according to the information provided on Form 5500 filings by plan trustees. A plan was included in this group if its Form 5500 indicated the presence of ESOP features for any year between 1979, when the question was first asked, and 1983, the last year for which IRS had complete data.

We selected a stratified random sample of 2,004 of these 8,891 plans. The nine strata we used were defined by numbers of participants (10,000 and more; less than 10,000), and by the value of plan assets in eight different ranges. These strata are defined in table IV-1.

Table IV.1: Strata and Sampling Fractions for ESOP Survey

Stratum	Participants	Assets ($000)	N	n	Sampling Fraction
1	10,000+	$30,000+	60	60	1.000
2	10,000+	0-30,000	69	69	1.000
3	0-10,000	30,000+	75	75	1.000
4	0-10,000	10,000-30,000	175	100	0.571
5	0-10,000	1,000-10,000	1,556	325	0.209
6	0-10,000	200-1,000	2,526	400	0.158
7	0-10,000	50-200	1,960	350	0.179
8	0-10,000	0-50	1,562	325	0.208
9	0-10,000	0	908	300	0.330
Total			**8,891**	**2,004**	

The top three strata we sampled at 100 percent, and the other six strata at rates varying from 15.8 percent to 57.1 percent. The number of cases in each stratum was selected to insure that our overall results would be generalizable to all plans to within 5 percent at the 95 percent level of confidence. However, actual sampling errors vary for specific analyses. We estimate that for those tables based on questionnaire data where the estimated number of leveraged ESOPs (the analytical category of ESOP with the smallest number of cases) is at least 491, results are generalizable to within a maximum of 3.3 percent. For tables where the number of leveraged ESOPs is less than 491, we estimate that results are generalizable to within a maximum of 4.4 percent. Finally, for the results reported in Chapter 5, which are based on an estimated population of 39 cases, we estimate that results can be generalized to within a maximum of 5.6 percent.

We decided to use the sample survey technique because of the ability to estimate the number of ESOPs accurately to within 5 percent without incurring the costs of surveying all 8,891 possible ESOPs. Data for each case is weighted according to the stratum from which the case was drawn. The sampling fraction (percent sampled) and the response rate (percent of questionnaires received) for each stratum form the basis for the weights used in our analysis.

To complete our count of ESOPs, we gathered quarterly reports from IRS on new ESOPs formed after our 8,891 plan sampling frame had been selected. According to this information, 625 plans filed for and were granted qualification as ESOPs between the time the sampling frame was established in 1984 and March, 1986. Assuming these plans were implemented upon qualification, this accounts for the total of 4,799 active ESOPs reported in Chapter 2. The same information from IRS indicates that 918 plans requested and were granted qualification as stock bonus plans during 1984-86. Including the 1,487 non-ESOP stock bonus plans we identified as active up to 1984, this accounts for a total of 2,405 such plans.

The estimates of 625 new ESOPs and 918 new stock bonus plans are subject to an unknown amount of error because some plans may not have been implemented, and because others may not have applied for qualification. In addition, we have not verified that all ESOP applicants file the proper form identifying them as ESOPs, nor that IRS accurately records such filings on its computer tapes.

Responses to Our Surveys and Possible Bias in Our Estimates

The responses to our first survey, by stratum, are presented in table IV-2. The response rates for the strata with the smaller plans (strata 6 through 9) were lowest. This introduces some possible bias into our estimates by underrepresenting smaller firms. Because small firms more often have ERISA-type ESOPs (leveraged, leverageable, and nonleveraged) as opposed to tax credit ESOPs, and are more frequently privately-held rather than publicly traded, we may have introduced some bias along these major analytical dimensions. This possible bias should have little effect on estimates of participants, assets and revenue losses, however, because the underrepresented plans are small and therefore have minimal effects on these variables.

Table IV.2: Response Rates for ESOP Questionnaire 1

Stratum	Participants	Assets ($000)	n	Received	Percent Received
1	10,000+	$30,000+	60	59	98.3%
2	10,000+	0-30,000	69	65	94.2
3	0-10,000	30,000+	75	71	94.7
4	0-10,000	10,000-30,000	100	97	97.0
5	0-10,000	1,000-10,000	325	297	91.4
6	0-10,000	200-1,000	400	323	80.7
7	0-10,000	50-200	350	265	75.7
8	0-10,000	0-50	325	226	69.5
9	0-10,000	0	300	213	71.0
Total			**2,004**	**1,616**	**80.6**

Moreover, many of the non-respondents appear to be firms no longer in business. A total of 153 questionnaires were returned to us by the Post Office as undeliverable. Each time a questionnaire was returned to us, we requested that IRS search for a new address from their tax records, then mailed questionnaires to those new addresses. In 14 of these cases, IRS could find no new addresses for firms, however, and in 20 others mail was again returned from the new address. Information provided by IRS indicates that 6 firms filed for bankruptcy.

The responses to our first survey allowed us to identify ESOPs for our more detailed analysis. These responses are given in table IV-3. Of the 1,616 plans responding, 1,113 were ESOPs. We considered only these cases in conducting our second survey. These are the tax credit, leveraged, leverageable, nonleveraged, and other ESOPs enumerated in the first five categories in the table. We also present some results in this report on stock bonus plans, but this information is based only on data from the first questionnaire and the EPMF.

Table IV.3: Responses to Esop Questionnaire 1

Response	Number	Percent
Tax credit ESOP	385	23.8%
Leveraged ESOP	150	9.3
Leverageable ESOP	326	20.2
Nonleveraged ESOP	242	15.0
Other ESOP	10	.6
Stock Bonus Plan	24	1.5
Non-ESOP Plan	428	26.5
No Such Plan	7	.4
Out of Business (no information)	28	1.7
Undetermined Type of Plan	10	.6
Refused to Respond	5	.3
Total	**1,616**	**100.0**

Where we were unable to determine whether a plan was an ESOP from the information on the survey, we used follow-up telephone calls to elicit further information. In addition, we were able to get information from plan documents on 26 cases from the Department of Labor to help us identify the status of plans. In only a few cases were we unable to determine whether the plan was an ESOP.

The 1,616 responses to our first survey allow us to generalize the results to a population of 7,042 plans. The remaining 1,849 plans, represented by our nonrespondents, either are not ESOPs or cannot be identified without further information. If the same pattern of responses held for these cases as for the actual respondents, then we would estimate that there were 5,188 active ESOPs among the 8,891 plans from which we originally drew our sample, accounting for a total of 5,813 active ESOPs as of March, 1986. The 95 percent confidence interval for our sample estimate plus our count of new ESOPs results in an estimate of 5,635 to 5,991 active ESOPs as of March, 1986.

To gather information on the sample of ESOPs we had identified, we sent a second, more detailed questionnaire to 1,083 sponsoring corporations. This is fewer cases than the 1,113 ESOPs we identified. A total of 23 firms sponsored more than one plan in our sample; where this was the case, we entered data from the same questionnaire into the records for each plan to maintain the generalizability of findings. In 7 instances, firms had provided enough information to identify their plans as ESOPs, but had indicated they would be unable to provide more information. We did not send second questionnaires to these companies.

We received 860 responses to our second survey, a response rate of 77.3 percent (see table IV-4). The response rates for the strata varied from 90.6 percent to 62.3 percent. We used follow-up procedures similar to those used on the first questionnaire, including telephone calls to obtain questionnaires and to clarify responses. Again, the smaller plans were less likely to respond, amplifying any bias that might have been introduced by the lower response rates in these strata for the first survey.

Table IV.4: Response Rates for ESOP Questionnaire 2

Stratum	Participants	Assets ($000)	n	Received	Percent Received
1	10,000+	$30,000+	46	40	87.0
2	10,000+	0-30,000	61	55	90.2
3	0-10,000	30,000+	44	36	81.8
4	0-10,000	10,000-30,000	64	58	90.6
5	0-10,000	1,000-10,000	215	180	83.7
6	0-10,000	200-1,000	247	190	76.9
7	0-10,000	50-200	186	137	73.7
8	0-10,000	0-50	137	93	67.9
9	0-10,000	0	114	71	62.3
Total			**1,113**	**860**	**77.3**

We should emphasize that even among the smaller plans the response rate to our surveys is quite high compared to most mail surveys. Our sample appears to be the largest, most representative sample of ESOPs studied to date, and permits us to be confident of the accuracy of our findings.

Computation of Revenue Loss Estimates

This appendix includes an outline of the methods we used to estimate the revenue losses associated with ESOPs, and a discussion of how these methods differ from those of the Office of Management and Budget, the Congressional Budget Office, and the Statistics of Income Division of the IRS.

Computational Methods

GAO developed methods to deal with the different types of ESOPs and with the differences between employers and employees. These methods are based on the contributions made to ESOPs annually, the earnings of ESOP trusts, and distributions of trust funds to participants, as reflected in IRS data files.

Corporate Tax Credits

For the corporate tax savings on contributions to TRASOPs and PAYSOPs, we assumed that the entire contribution would be taken as a credit. Given that the credit provides a dollar-for-dollar reduction in taxes owed, it seems clear that the entire amount of the contribution must be regarded as income lost to the treasury. (The 1986 Tax Reform Act eliminates this credit.)

Deductions From Corporate Income

When a corporation takes a deduction from corporate income for a contribution to an ESOP, the amount of tax that is not paid is equal to the value of the contribution multiplied by the corporation's marginal tax rate. Available data do not permit identification of the tax bracket for each firm in the sample, but most analyses of the revenue implications of tax provisions assume that corporations are all in the top marginal bracket. For the years through 1978, the applicable rate for this bracket was 48 percent; beginning in 1979 it was reduced to 46 percent. Our estimates of the losses associated with deductions to ERISA-type ESOPs use these marginal tax rates for the applicable years. (Some small firms may have lower marginal rates, creating a slight upward bias in the estimates. Tax reform legislation lowers this rate to 34 percent.)

Deferrals of Personal Income

For participants, the contributions made by their employers to their accounts in ESOPs are a form of income, as are the earnings the trust makes on its assets. But, this income is not taxed until the participant takes a distribution from the trust at retirement, death or separation. We conferred with a tax expert to determine the marginal tax rates to apply to the income and the distribution amounts identified in the IRS files. Based on this expert advice, we assume that, on average, contributions to and earnings of ESOP trusts would have been taxed at an average marginal rate of 28 percent across all participants, and that distributions would have been taxed at a rate of 23.75 percent. The annual revenue loss from this source is estimated as the difference between the taxes deferred on contributions and earnings and the taxes paid on distributions. (Changes in tax rates included in the Tax Reform Act of 1986 will change the applicable rates both for deferrals and for distributions.)

Data for Revenue Loss Estimates

The Employee Plan Master File maintained by the IRS provides data on contributions to, earnings of, and distributions from ESOP trusts as reported on Form 5500 filings by employers. These data items appear to be in the file only for the period since 1977, and the data for 1984 appear incomplete. Therefore, revenue loss estimates are limited to the period 1977-83.

Beginning in 1980, plans with fewer than 100 participants have been permitted to file Form 5500-R for two of every three filing years, except under certain circumstances. Form 5500-R does not include many of the financial items needed to carry out this tax analysis. GAO has used interpolation techniques to estimate contributions, earnings and distributions data for those instances in which data were missing for one year but not for the immediately preceding and following years. The procedure used was to take half the sum of the entries for the years immediately before and after the missing year. Where data were missing for two or more consecutive years, however, no interpolation was made. This underestimates the revenue loss estimates, but, because only the smallest plans file Form 5500-R, the underestimate is likely small.

Estimation of Principal Payments on ESOP Loans

For the lower bound revenue loss estimates, it was necessary to estimate the amounts contributed to leveraged ESOPs to cover principal payments on ESOP loans. We assumed that each loan was paid out over 10 years, with equal principal payments each year. Therefore, 10 percent of the principal amount of each ESOP loan was subtracted from the contribution for that plan for each year following the date of the loan. The appropriate marginal tax rate then was applied to the remainder to estimate the lost corporate tax revenue for that year, summing across all leveraged ESOPs.

Differences Between Our Estimates and Others

Our estimates of the revenue losses associated with ESOPs differ somewhat from those found in publications of the Congressional Budget Office, Office of Management and Budget, and Statistics of Income Division of the Internal Revenue Service. These differences result from differences in the treatment of certain items and estimating techniques.

Treatment of Contributions to ERISA-type ESOPs

In making their estimates of tax expenditures, CBO and OMB consider only what are defined as special exclusions, exemptions or deductions, special credits, preferential rates, or deferrals of tax liabilities. These are regarded as departures from the "normal" tax structure. The credits for contributions to tax credit ESOPs are treated as such departures, and the cost in lost corporate income tax revenues is estimated for them.

But ERISA-type ESOPs are treated under the heading of "pension, profit sharing, etc. plans." For these types of plans, the OMB and CBO estimates do not include any amount for corporate tax expenditures. This is because the deductibility of business expenses, including those for contributions to employee plans, is defined as part of the normal tax code, not a special deduction. In this report, however, we estimate the revenue implications of these deductions because the deductibility of contributions to employee plans, including ESOPs, reduces the net cost of the contributions to the sponsoring corporations, and thus provides a tax incentive to set up and maintain such plans. The tax revenue not collected because of this incentive is the cost to the federal government.

Different Estimating Techniques

The procedures we used for estimating tax revenue losses also differ from those of OMB and CBO. Their concern is with projecting future revenue losses, and to do this they apply predictive models that incorporate specific assumptions about economic trends and corporate and individual behavior. Our analysis relies on the historical record of contributions to, earnings of and distributions from ESOP trusts available in the EPMF. The differences in these procedures result in somewhat different estimates. For example, OMB and CBO estimated the cost of the ESOP tax credit to be $1.25 billion in corporate income taxes forgone in 1983, whereas we estimated this amount to be $1.23 billion.

In this regard, our techniques are similar to those used by SOI, which reports data on ESOP tax credits annually. However, our estimates also differ from those of SOI. For the period 1977-82 (their analysis for 1983 was not complete at the time of our review), SOI estimated that firms claimed $6.3 billion in ESOP credits, whereas our estimate is $7.7 billion.

This difference is explained by two facts: (1) we assumed all contributions were claimed in the year of contribution, whereas SOI relied on tax returns showing the amounts actually claimed each year, excluding amounts carried over; (2) somewhat different sampling frames were used in drawing the two samples.

Glossary

Employee Stock Ownership Plan (ESOP)	An employee plan and trust established to receive stock of an employer and other assets for allocation to the individual accounts of participating employees.
ERISA	The Employee Retirement Income Security Act of 1974, which first provided a definition of ESOPs and recognized the ability of such plans to use leveraging to purchase employer securities.
Leverageable ESOP	An ESOP that is permitted to leverage under the terms of the plan documents but has not done so by a given date.
Leveraged ESOP	An ESOP in which money is borrowed by the ESOP trust for the purpose of buying stock of the employer. The stock may be held as security by the lender and released for allocation to participant accounts as the loan is paid off.
Nonleveraged ESOP	An ESOP other than a tax credit ESOP that is not permitted to leverage under the terms of the plan documents. Although these plans do not take advantage of the special tax credit or leveraging provisions of the tax code, employers may establish them to take advantage of a number of other tax incentives for contributions under section 415 of the code. Also, some employers may be unaware that they may establish and maintain a stock bonus plan that is not an ESOP.
PAYSOP	An ESOP eligible for tax credits based on employee payroll; replaced TRASOPs in 1983.
Tax Credit ESOP	An ESOP originating in the Tax Reduction Act of 1975, which allows employers to claim a tax credit for contributions to an ESOP. From 1975 through 1982, the credit was based on an employer's eligible investment credit; a 1 percent credit could be claimed for contributions up to that amount, and an additional 0.5 percent could be claimed for contributions that matched employees' contributions up to that amount. Since 1983, a credit of 0.5 percent of employee payroll has been allowed.

TRASOP

An ESOP eligible for tax credits based on the investment tax credit provisions of the Tax Reduction Act of 1975, the Tax Reform Act of 1976, and the Revenue Act of 1978.