Order Code RS21526
May 20, 2003

Employee Stock Ownership Plans (ESOPs): Legislative History

nam e redacted
Presidential Management Intern[1]
American Law Division

Summary

Employee Stock Ownership Plans (ESOPs) are defined contribution plans primarily invested in the employer's securities. Employee stock plans in the form of an ESOP pre-date the 1974 Employee Retirement Income Security Act (ERISA).[2] ERISA, however, was the first law to recognize ESOPs. Congress has routinely revisited ESOPs and amended the IRC to reflect policy. The 1975 Tax Reduction Act created a tax credit for ESOPs. The Revenue Act of 1978 added new formalities to ESOPs through creation of IRC § 409A. In the mid-1980s, the 1984 Tax Reform Act created new and substantial tax incentives for employers maintaining ESOPs for employees. Two years later, the 1986 Tax Reform Act emphasized the retirement objective of ESOPs by imposing a 10% penalty tax on withdrawals made prior to age 59.5. The Omnibus Budget Reconciliation Act of 1989, however, repealed or limited multiple ESOP tax incentives. The Small Business Job Protection Act (SBJPA) of 1996 widened the availability of ESOPs by allowing S corporation shareholders to participate. To prevent abuse of S corporation ESOPs, the Economic Growth and Tax Relief Reconciliation of 2001 Act initiated a 50% excise tax on prohibited allocations by S corporation ESOPs. Finally, the Job Creation and Worker Assistance Act of 2002 increased the contribution limits of many qualified retirement plans, including ESOPs.

Currently, an estimated 10 million employees participate in Employee Stock Ownership Plans (ESOPs).[3] ESOPs are defined contribution plans primarily invested in the employer's securities. These plans are believed to further motivate employees since their financial interests are more directly linked to their employers. Both employees and employers benefit from certain tax advantages. In addition to providing employees with

[1] This report was produced under the general supervision of Marie Morris, Legislative Attorney.

[2] P.L. 93-406.

[3] CRS Report RL30038, *ESOPS: A Description and Economic Analysis*, by (name- redac t e d).

retirement benefits and additional work incentives, ESOPs can also serve a variety of corporate finance objectives including capital formation and greater cash flow. Today, an ESOP must satisfy the requirements of both Internal Revenue Code (IRC) § 401(a) and IRC § 4975(e)(7).[4]

Employee stock plans in the form of an ESOP pre-date the 1974 Employee Retirement Income Security Act (ERISA).[5] ERISA, however, was the first law to recognize ESOPs and modified the IRC to reflected ESOP provisions.[6] ERISA was passed in order to protect the interests of participants and beneficiaries of pension plans in the private sector.[7] This legislation responded to instances where pension funds had been underfunded, went insolvent, or had been mishandled.[8] Viewed broadly, the legislative purpose was to provide employees with a source of retirement income, expand employee stock ownership, and to grant businesses a tax-favored method of financing.[9] An early proponent of ESOPs, Louis Kelso, believed that ESOPs would raise the incomes of lower-income families through a more equal distribution of income-producing capital.[10] Also, through employer and employee shared tax advantages, ESOPs would increase aftertax lifetime income.

Congress has routinely revisited ESOPs and amended the IRC to reflect policy. The Tax Reduction Act of 1975 created a corporate tax credit for ESOPs.[11] This 11% credit was available to the corporate taxpayer with respect to qualified investment where at least one percent of the qualified investment is contributed to an ESOP. Congress attached conditions to this temporary credit[12] including immediate vesting for employee participants and a seven-year distribution moratorium. Shortly thereafter, the Tax Reform Act of 1976[13] provided for employee stock options (whether or not they qualified under the IRC) granted after May 20, 1976 to be governed by the existing tax treatment of nonqualified stock options.[14]

---

[4] *See also* IRC § 409.

[5] P.L. 93-406, amending IRC § 401, § 72, and § 46 among others and adding IRC § 4972, § 6057, § 6058, and § 6059 among others.

[6] CRS Report RS20686, *Employee Stock Ownership Plans (ESOPS) and S Corporations: Proposals in 2000*, by David L. Brumbaugh.

[7] CRS Report RL31507, *Employer Stock in Retirement Plans: Investment Risk and Retirement Security*, by Patrick J. Purcell.

[8] *Id*.

[9] Brumbaugh at 1. *See also* Senate Committee on the Budget. *Tax Expenditures. Compendium of Background Materials on Individual Provisions*. Prepared by the Congressional Research Service. Washington, U.S. Govt. Print. Off. 1998. p. 379-380.

[10] Kelso, Louis O. *Readings in Binary Economics: The Foundation of the ESOP*. 1988. p.44-46.

[11] P.L. 94-12, amending IRC § 46.

[12] This credit was available for qualified investment made between January 22, 1975 and December 31, 1976.

[13] P.L. 94-455, amending IRC § 422.

[14] *Id*. at § 603.

The Revenue Act of 1978 added new formalities to ESOPs through creation of IRC § 409A.[15] This section, titled Qualifications for ESOPs, articulated definitions and requirements for a plan to qualify as a "Tax Credit ESOP."[16] On a related note, the 1978 Act also formalized 401(k)s through creation of IRC § 401(k). The year 1981 brought passage of the Economic Recovery Tax Act (ERTA).[17] The ERTA supported ESOPs through increasing the deduction limits applicable to employer contributions used to repay a loan made from an ESOP. As previously noted, ESOPs also serve corporate financial objectives that other employee benefit plans cannot, such as the ability to take out loans from the plan. Prior to 1981, some corporations were leveraging ESOPs by combining them with a money purchase pension plan. This had the effect of raising the deductible limits on employer contributions from 15% to 25%. Passage of ERTA eliminated the need for this strategy.

In the mid-1980s, the 1984 Tax Reform Act created new and substantial tax incentives for employers maintaining ESOPs for employees.[18] Notably, employers were allowed deductions for dividends paid in cash under a qualifying ESOP.[19] Also, IRC § 133 was created to permit qualified financial institutions to exclude 50% of the interest on loans to ESOPs.[20] Two years later, the 1986 Tax Reform Act emphasized the retirement objective of ESOPs by imposing a 10% penalty tax on withdrawals made prior to age 59.5, discouraging premature withdrawals.[21] The year 1988 brought certain technical corrections to the 1986 Act, articulating what transactions qualify for deferral of recognition of gain, clarifying that the nonallocation period begins on the date of the sale of securities and ends on the later of 10 years or the date of the plan allocation attributable to the final payment of acquisition indebtedness.[22] Also, the 1988 Act clarified the election rights of employees who were at least age 55 and had 10 years of service to diversify their plan.[23] This ability to diversify holds particular importance in today's climate of stock value fluctuations.

---

[15] P.L. 95-600, § 141.

[16] *Id*. at § 141(o)(3).

[17] P.L. 97-34.

[18] P.L. 98-369.

[19] P.L. 98-369 § 542, amending IRC § 1042.

[20] *Id*. at § 543.

[21] P.L. 99-514. This 10% tax is in addition to the normal federal income tax on distributions from a qualified plan.

[22] P.L. 100-647.

[23] P.L. 100-647, § 1011, amending IRC § 401(a)(28).

In an effort to create revenue gains,[24] the Omnibus Budget Reconciliation Act of 1989 repealed or limited multiple ESOP tax incentives.[25] The IRC § 133 exclusion had new restrictions placed on it, added plan reporting requirements, placed additional restrictions on deductible dividends paid to employees, and repealed IRC § 2057 which pertains to an estate tax deduction for certain employer securities sales to ESOPs.[26]

The Small Business Job Protection Act (SBJPA) of 1996 widened the availability of ESOPs by allowing S corporation shareholders to participate.[27] S corporations are a type of corporation, possessing no more than 75 shareholders, that is accorded tax treatment different than traditional ("C") corporations.[28] Congressional motivation for this provision was to encourage employee ownership of closely-held businesses.[29] This Act also repealed IRC § 133, eliminating the ability of lenders to exclude from their gross income 50% of the interest earned on a loan to an ESOP or to an employer sponsoring an ESOP.[30] One motivation for repealing the interest exclusion was that the Joint Committee on Taxation estimated that $505 million additional tax dollars would be added to revenues for the ensuing five fiscal years.[31] Other revenue motivated provisions incorporated in this 1996 Act include applying the Unrelated Business Income Tax (UBIT) to an ESOP's share of S-corporation earnings.[32]

The application of the UBIT tax did not last long, as it was repealed as part of the Taxpayer Relief Act of 1997.[33] Congress was concerned about possible double taxation of S corporation ESOPs, conceivable since all S corporation income is subject to taxation at the shareholder level in addition to the short-lived UBIT tax.[34] To address these concerns, the 1997 Act allowed S corporation ESOPs to distribute cash to plan

---

[24] The 1989 Act was expected to generate $8.45 billion for the inclusive fiscal years 1990 to 1994. U.S. Congress. Joint Committee on Taxation. *Estimated Revenue Effects of Conference Agreement on Revenue Provisions of H.R. 3299, the Omnibus Budget Reconciliation Act of 1989*. JCX-74-89, November 21, 1989.

[25] P.L. 101-239.

[26] P.L. 101-239, § 7301- § 7304.

[27] P.L. 104-188.

[28] For example, S corps do not pay corporate income tax on their net income (in other words, income from an S corporation allocable to an ESOP is not subject to immediate taxation), but they are not allowed tax deductions for stock dividends.

[29] Senate Report 104-281, p.66.

[30] P.L. 104-188, § 1602. *See* Senate Report 104-281, p.114.

[31] U.S. Congress. Joint Committee on Taxation. *Estimated Budget Effects of Conference Agreement on H.R. 3448, Small Business Job Protection Act of 1996*. JCX-47-96. August 1, 1996. p.5. $505 million is a collective amount for those fiscal years. *See also* Senate Report 104-281, p.114.

[32] House Report 104-737, p.231.

[33] P.L. 105-34, § 1523.

[34] House Conf. Report 105-220, p.745.

participants[35] and extended an exception to S corporation ESOPs previously only available to traditional ESOPs.

Congress continues its routine examination and alterations to the operation and requirements of ESOPs. In 2001, the Economic Growth and Tax Relief Reconciliation Act addressed the Congressional concern of inappropriate tax deferral opportunities for S corporation ESOPs and instances where S corporation ESOPs were primarily benefitting only the highly compensated employees.[36] Consequently, this 2001 Act initiated a 50% excise tax on prohibited allocations by S corporation ESOPs. Similarly, individuals who own 10% of the shares, or deemed part of a 20% "shareholder group" (individual and family members together) will be considered a "disqualified person" and merit a 50% excise tax on any synthetic equity[37] the disqualified person owns. Also, this Act increased the contribution limits of many qualified retirement plans, including ESOPs.[38] Most recently, the Job Creation and Worker Assistance Act of 2002 made certain technical revisions to the 2001 Act, such as amending provisions for catch-up contributions and vesting standards.[39]

Conclusion

Since formal recognition of ESOPs, Congress has continually examined and modified the tax treatment of ESOPs and adjusted the qualification requirements. From initially seeking to recognize a new method of retirement savings that businesses had gotten behind, today Congress strives to balance tax policy objectives, the need for corporate support, revenue concerns, abuse prevention, and long-term fiscal security for employees.

---

[35] Note that the employee must have right to require the employer to purchase the securities.

[36] P.L. 107-16.

[37] A synthetic equity refers to any stock option, warrant, restricted stock, deferred issuance stock rights, or similar interest.

[38] P.L. 107-16, § 611, amending IRC § 415.

[39] P.L. 107-147, amending IRC § 411 and IRC § 414 among others.