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*The ESOP Association of American*

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## EMPLOYEE STOCK OWNERSHIP PLANS: AN ANALYSIS OF CURRENT REFORM PROPOSALS

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Luis L. Granados\*

The Employee Stock Ownership Plan ("ESOP") has become an important and controversial technique of corporate planning since it first gained widespread popular attention.<sup>1</sup> The recent experience of one company provides a good illustration. In 1975, the South Bend Lathe Company stood on the brink of being liquidated by its parent corporation after a series of loss years. Five hundred people would have lost their jobs upon liquidation of the company. But an Economic Development Administration loan enabled the employees to set up an ESOP to purchase the assets of the division and create a one hundred percent employee-owned corporation. Productivity shot up immediately, the company began turning a profit, and the national media heaped praise on what quickly became the greatest ESOP success story.<sup>2</sup> Internal problems developed over the years, however, in spite of the company's generally good business performance. In the summer of 1980, the national media, which had originally sung the praises of the South Bend Lathe ESOP, chortled when the South Bend Lathe employee-owners "hit the bricks" in a protracted and bitter strike.<sup>3</sup>

The South Bend Lathe strike provided ammunition to the critics who question the purported value of ESOP's in improving employee productivity. These critics label the ESOP a "fable" and charge that it harms employers, employees, and the government's ability to raise revenue without producing the positive results intended by its establishment.<sup>4</sup> Advocates, however,

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\* Legislative Counsel, The ESOP Association of America. The opinions expressed in this article are the author's and do not necessarily reflect the opinions of The ESOP Association of America.

<sup>1</sup> The first law specifically referring to the ESOP was the Regional Rail Reorganization Act of 1973, Pub. L. No. 93-236, § 102(5), 87 Stat. 985 (1973).

<sup>2</sup> See, e.g., Ryan, *How and Why U.S. Helped 500 Workers Take Over a Machine-Tool Manufacturer*, Wall St. J., August 16, 1976, at 28, col. 1.

<sup>3</sup> See, e.g., *Trouble in Workers' Paradises*, TIME, Sept. 22, 1980, at 73.

<sup>4</sup> See, e.g., Subcommittee on Employee Stock Ownership Plans, Committee on Employee Benefits, Section of Taxation, American Bar Association, *ESOP's Foibles*, 31 TAX LAWYER 561 (1978).

claim that the ESOP has the potential to revolutionize the American free enterprise system by establishing it upon a basis of true justice and efficiency.<sup>5</sup>

This article surveys the battle between the critics and advocates of the ESOP, and scrutinizes various proposals currently being considered in the legislative arena. Part I examines the philosophy and history of the ESOP, particularly focusing upon the conceptual foundations provided by the writings of Louis Kelso. Part II explicates the various functions performed by the ESOP: as a tool of corporate finance, as an "in-house" market for the sale of stock held by a company's shareholders, and as a means of obtaining additional investment tax credit. Part III analyzes critically six proposed improvements of the ESOP system from both the General Accounting Office's Report and the proposed ESOP Improvements Act. This Part concludes that while each of the six proposals has some merit, the effectiveness of the proposals is limited by their failure to deal with more than the tax aspects of the ESOP controversy.

## I. THE PHILOSOPHY AND HISTORY OF THE ESOP

### A. *The Philosophy Behind the ESOP*

Although the origins of the ESOP philosophy can be traced back to the 19th Century writings of Johann Heinrich von Thunen,<sup>6</sup> the generally-recognized creator of the concept today is the lawyer-economist Louis O. Kelso. Kelso's *Two-Factor Theory: The Economics of Reality* examines the production of economic wealth,<sup>7</sup> arguing that there are two factors at work in the production of goods and services: (1) an individual's labor, and (2) physical tools, or capital. A machine which manufactures widgets "produces" them in the same physical, legal, and moral sense as a person who fashions them laboriously by hand. Naturally, the machine does not do all the work itself; at the very

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<sup>5</sup> See, e.g., Note, *Employee Stock Ownership Plans: A Step Toward Democratic Capitalism*, 55 B.U.L. Rev. 195 (1975); Maxa, *Can We All Own a Piece of the Rock?*, Wash. Post, Dec. 10, 1978, (Magazine) at 4.

<sup>6</sup> *Employee Stock Ownership Plans and General Stock Ownership Trusts, Hearings on S. 3241, S. 3223, H.R. 13882 before the Senate Finance Comm.*, 95th Cong., 2d Sess. 531 (1978) (statement of Bert Metzger).

<sup>7</sup> L. KELSO & P. HETTER, *TWO-FACTOR THEORY: THE ECONOMICS OF REALITY* (1967). See also L. KELSO & M. ADLER, *THE CAPITALIST MANIFESTO* (1958); L. KELSO & M. ADLER, *THE NEW CAPITALISTS* (1961).

least, a person is needed to turn it on. The machine, however, is a separate, identifiable factor in the production of the widget. Kelso's view contrasts directly with that of Karl Marx, who said that labor is the only factor of production, and who viewed machines merely as "congealed labor."<sup>8</sup> This difference is of more than mere academic importance. The Kelsonian view leads to the conclusion that the owner of the machine is justly entitled to the wealth the machine creates, while Marx would say that the laborers who built the machine are the ones who should receive the wealth it creates. In a society where we have machines which produce machines which produce still other machines, the "congealed labor" viewpoint leads to hopeless complication, and to many observers lacks the common sense of the two-factor view.

Assuming for the moment that there are two factors of production, the next question concerns their relative importance. Kelso argues persuasively that the Industrial Revolution must be defined in terms of the steady shifting away from the labor factor and toward the capital factor. While exact quantification of the two factors' relative contribution is impossible, Kelso realistically estimates that as much as ninety percent of the work of production is properly attributable to the capital side. If the number of man-hours required to produce most goods and services without the benefit of modern technology were calculated and compared with the number of man-hours presently required, in many cases the ninety percent figure would seem conservative. In any event, Kelso is almost certainly right that the trend of modern technological development is toward an ever-increasing role for the capital factor.

The fundamental contradiction in our economy, Kelso further argues, is that our outtake system is "out of synch" with the realities of our input system. The vast majority of people derive their income almost solely from their contribution of labor, owning virtually no capital whatsoever. If there are truly two factors of production and capital is in fact the ever-increasing factor, and if the vast majority of participants in the economy are relegated to deriving their income from the ever-diminishing factor of production, then it is little wonder that we have an economy racked by tensions and periodic breakdowns.

There is no question but that the ownership of American capital is concentrated in the hands of the few. Federal government figures show that one percent of the American people own over fifty percent of privately-held corporate wealth, while six per-

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<sup>8</sup> Kelso, *Karl Marx: The Almost Capitalist*, 43 A.B.A.J. 235 (1957).

cent of the people own over seventy percent of it.<sup>9</sup> There is also no question that this maldistribution causes much of the social difficulty in America today. Kelso's and Marx's differing views on the nature of production lead them to differing views on the resolution of the maldistribution problem. Marx would expropriate capital property (away) from present owners, because he does not concede their right to own it. Marx would ultimately abolish the concept of property itself. Kelso, on the other hand, says that the solution lies not in destroying the institution of private property, but in spreading it out. Kelso maintains that this should not be done by confiscating from the haves and giving to the have nots, since that would be inconsistent with his view that property owners have a genuine right to their property. Instead, he focuses on the ownership of the *future* capital wealth society will produce.<sup>10</sup> Virtually all of this growth is financed by some variety of credit. Therefore, Kelso and his associates have devised various credit mechanisms which foster broad ownership of newly-created wealth by average citizens, to replace or at least supplement present mechanisms, which tend to concentrate the ownership of new wealth into the hands of the existing ownership base. The ESOP represents the most well-known of the Kelsonian mechanisms.

### *B. The History of the ESOP*

The concept of broad ownership of productive capital runs through the writings of the leading thinkers of the American Revolution, and through the land policies of the first hundred years of the nation's existence.<sup>11</sup> The Revenue Act of 1921<sup>12</sup> first recognized the tax exempt status of stock bonus plans; five years later, the tax exempt status of pension plans was similarly recognized.<sup>13</sup> The Internal Revenue Service, in a 1953 Revenue Ruling,<sup>14</sup> first allowed leveraging by a stock bonus plan to provide the employer with financing repayable with pretax corporate

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<sup>9</sup> STAFF OF JOINT ECONOMIC COMMITTEE, 94TH CONG., 2D SESS., BROADENING THE OWNERSHIP OF NEW CAPITAL: ESOP'S AND OTHER ALTERNATIVES 7 (Comm. Print 1976).

<sup>10</sup> The Department of Commerce estimates that between \$3 and \$5 trillion of such growth will be needed in the next decade. See U.S. NEWS & WORLD REPORT, May 27, 1974, at 22-23.

<sup>11</sup> See, e.g., Act to Secure Homesteads to Actual Settlers on the Public Domain, 12 Stat. 392 (1862).

<sup>12</sup> § 219(f), 42 Stat. 227, 247 (1921).

<sup>13</sup> Revenue Act of 1926, § 219(f), 44 Stat. 9, 33, 34 (1926).

<sup>14</sup> Rev. Rul. 46, 1953-1 C.B. 287.

dollars, laying the groundwork for the leveraged ESOP.

Kelso established his first ESOP in 1956, in order to save a small newspaper from takeover by a national chain. Over the next few years, the number of ESOP's grew very slowly, due to unfamiliarity with the idea in business circles.

The much-needed breakthrough finally came in late 1973 when Kelso "converted" Senate Finance Committee Chairman Russell Long. The Senator immediately pushed through an amendment to the Regional Rail Reorganization Act of 1973—a response to the collapse of the Penn Central—which would have provided for employee ownership of the newly-created Conrail Corporation. The bill as amended cleared the full Senate, but the Conference Committee diluted the ESOP amendment to a mere study,<sup>16</sup> which ultimately rejected the idea as impractical.<sup>16</sup>

In 1974, a threat arose to the existence of the ESOP. The original versions of the Employee Retirement Income Security Act ("ERISA") would have prohibited an employer corporation from extending its credit to an ESOP Trust to enable it to obtain a loan for the purpose of acquiring employer securities.<sup>17</sup> This provision would have effectively eliminated the leveraged ESOP. Senator Long, however, succeeded in amending this section of ERISA to provide an exception for ESOP's.<sup>18</sup> Also in 1974, Senator Long amended the Trade Act to require a preference for ESOP firms in the government's efforts to assist firms in foreign trade impacted industries. Finally, Long continued his efforts in 1975 by championing the Tax Reduction Act Stock Ownership Plan ("TRASOP") in the Tax Reduction Act of that year. The 1976 Internal Revenue Service's proposed ESOP regulations<sup>19</sup> posed another threat: ESOP advocates claimed that the extremely restrictive regulations would have a "chilling effect" on the establishment of ESOP's. Congress, however, publicly rebuked the IRS for attempting to frustrate congressional intent,<sup>20</sup> and spelled out exactly what form Congress wanted the regula-

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<sup>16</sup> See H.R. REP. NO. 93-744, 93d Cong., 1st Sess. (1973), reprinted in [1973] U.S. CODE CONG. & AD. NEWS 3306, 3310.

<sup>17</sup> Joint Economic Committee, *Hearings on Employee Stock Ownership Plans Before the Joint Economic Comm.*, 94th Cong., 1st Sess. 49-73 (1975). But see *id.* at 264-355 (rebuttal by L. Kelso and N. Kurland).

<sup>18</sup> S. 1179, 93d Cong., 2d Sess. (1973).

<sup>19</sup> I.R.C. § 4975(d)(3).

<sup>20</sup> Prop. Treas. Reg. §§ 54.4975-7(b), 54.4975-11, 41 Fed. Reg. 31,833 (1976). See also Department of Labor Prop. Reg. §§ 2550.407d-6, 2550.408b-3, 41 Fed. Reg. 31,870 (1976). All four proposed regulations were later adopted with substantial amendments. See Treas. Reg. §§ 54.4975-7(b), 54.4975-11 (1980), and 29 C.F.R. §§ 2550.408b-3, .407d-5, .407d-6 (1979).

<sup>20</sup> See note 23 *infra*.

tions to take.<sup>21</sup> The final regulations largely adhered to these recommendations. In a Revenue Ruling in 1979, moreover, the IRS took the significant step of recognizing the ESOP as a "technique of corporate finance."<sup>22</sup>

The ESOP concept appears frequently in current legislation. Besides technical amendments,<sup>23</sup> there is a growing trend in Congress to tie federal aid to businesses to the establishment of ESOP programs. For example, the controversial Chrysler bailout bill<sup>24</sup> and the 1979 legislation authorizing federal funding for Conrail and the Delaware & Hudson Railway<sup>25</sup> required establishment of an ESOP as a condition of federal assistance. The Small Business Employee Ownership Act of 1980 authorizes the Small Business Administration ("SBA") to provide loan guarantees to ESOP's for financing corporate growth;<sup>26</sup> the Act also expands on the SBA's loan authority by permitting loan guarantees to ESOP's for the purpose of acquiring fifty-one percent control of a company. Further, the 1980 authorization bills for the Economic Development Administration ("EDA")<sup>27</sup> would have established a preference for ESOP projects in the allocation of EDA funds.<sup>28</sup> Finally, some states have attempted to encourage the growth of ESOP's. The states of Delaware, Maryland, Michigan and Minnesota have enacted legislation favorable to the ESOP concept.<sup>29</sup> Maryland's "Broadened Ownership Act," for example, establishes support for the ESOP as official state economic policy, and requires several state agencies to report annually on their progress in implementing the policy. Although states have moved into this area, most ESOP development will undoubtedly occur within the federal arena.

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<sup>21</sup> H.R. REP. NO. 94-1515, 94th Cong., 2d Sess. 539 (1976), *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 4118, 4234.

<sup>22</sup> Rev. Rul. 79-122, 1979-1 C.B. 204, 206.

<sup>23</sup> The Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763 (1978), and the Technical Corrections Act of 1979, Pub. L. No. 96-222, 94 Stat. 194 (1980), made a number of technical modifications in the law relating to ESOP's. More technical amendments may be added by the Miscellaneous Revenue Act of 1980, Pub. L. No. 96-605, 96th Cong., 2d Sess. (1980).

<sup>24</sup> Chrysler Corporation Loan Guarantee Act, Pub. L. No. 96-185, 93 Stat. 1324 (1980).

<sup>25</sup> Regional Rail Reorganization Act of 1973, Pub. L. No. 95-611, 92 Stat. 3089 (1978).

<sup>26</sup> Pub. L. No. 96-302, 94 Stat. 833 (1980).

<sup>27</sup> See The ESOP Association of America Newsletter, Nov. 1980, at 3.

<sup>28</sup> *Id.*

<sup>29</sup> 1979 Del. Laws J. Res. 20; 1979 Md. Laws J. Res. 1; 1980 Md. Laws, chs. 119, 598, 821, and 847; MICH. COMP. LAWS ANN. § 450.751 (1980 Supp.); Act of March 15, 1974, ch. 157, 1974 Minn. Laws 233 (codified in scattered sections of MINN. STAT. ANN. §§ 290.01 - 92.04 (West 1967)).

## II. THE ESOP SYSTEM

Kelso and his associates have developed many new forms of credit mechanisms to spread out the ownership of newly-formed capital; the most well-known by far is the ESOP. The ESOP gives a corporation's employees shares of stock in their employer without requiring them to put up their own money for it. That sounds like a giveaway, but it is not. Capital, unlike consumer goods and services, *pays for itself*. As one of the two factors which produces wealth, capital generates income. That income is generally sufficient to repay the cost of acquiring the capital within three to seven years. Responsible corporate managers generally do not undertake capital projects unless they have solid reason to believe that the project will pay for itself in that amount of time. Thus, the ESOP is not a "giveaway"; the employees simply "pay for" the capital out of the earnings the capital itself generates. In other words, they "earn" their capital accumulations by gaining access to the flow of future profits to pay the cost of the capital being acquired.

In technical terms, an ESOP is a "stock bonus" plan, or a "stock bonus" plan combined with a "money purchase" plan, "qualified" under the Internal Revenue Code. A "stock bonus" plan is simply a plan for compensating employees with stock instead of with cash; a "money purchase" plan is a plan in which the employer contributes annually a fixed percentage of the employee's annual compensation.<sup>30</sup> "Qualified" means that the plan complies with the participation, vesting, distribution, fiduciary responsibility, reporting and disclosure, etc., rules of ERISA<sup>31</sup> and Section 401 of the Internal Revenue Code. Corporate contributions to stock bonus plans are deductible by the corporation;<sup>32</sup> employees are not taxed until they receive their benefits, usually at retirement or other termination of employment.<sup>33</sup> ERISA provides elaborate rules for all stock bonus and other types of deferred compensation plans to follow, in order to protect the interests of employees.

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<sup>30</sup> 26 C.F.R. § 1.401-1(b)(1)(iii) (1980).

<sup>31</sup> Pub. L. No. 93-406, 88 Stat. 829 (codified in scattered sections of 26, 29, 42 U.S.C.) [hereinafter cited as "ERISA"].

<sup>32</sup> I.R.C. § 404.

<sup>33</sup> I.R.C. § 402.



### A. *The Functions of the ESOP*

The ESOP is a specialized type of stock bonus plan, because ESOP's are permitted to borrow money to buy employer stock, and the employer is permitted to guarantee such loans.<sup>34</sup> The ESOP, while a very flexible device, has three principal functions: (1) as a tool of corporate finance, often called the "leveraged ESOP," whose distinguishing feature is the borrowing of funds by the employee Trust to purchase newly-issued equity of the employer company; (2) as an "in-house" market for the stock of closely-held companies; and (3) as a means of obtaining an additional one and one-half percent Investment Tax Credit, in addition to the basic credit of ten percent of corporate investment in "qualified" plant and equipment, as defined in Sections 46 through 50 of the Internal Revenue Code. ESOP's which take advantage of the Investment Tax Credit provisions are often called "TRASOP's," for "Tax Reduction Act [of 1975] Stock Ownership Plan."

1. *The ESOP as a tool of corporate finance*—A hypothetical example might help explain the finance function of the ESOP. Suppose Corporation X wants to build a new plant for \$10 million. Under conventional debt financing, it would simply borrow the \$10 million, provide sufficient guarantee of repayment to satisfy the lender, use the money to build the plant, and then use the profits from the new plant to pay back the lender. The excess of the profits generated by the new plant over the payments made to amortize the loan makes the deal attractive to the corporation.

ESOP financing adds a third entity to the transaction—an ESOP Trust. The Trust, not the corporation, borrows the money from the lender; the corporation guarantees that it will make payments to the Trust in amounts sufficient to amortize the loan. The Trust then uses the borrowed funds to purchase newly-issued shares of employer stock, at fair market value as determined by a qualified appraiser. That gets the money into Corporation X, which uses it to build the new plant. The new plant generates profits, which are used by Corporation X to make payments to the Trust, which immediately uses the money to repay its obligation to the lender. The payment schedule from the Corporation to the Trust may be essentially the same as it would be directly to the lender under conventional debt financ-

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<sup>34</sup> I.R.C. § 4975(d)(3).

ing.<sup>35</sup> The corporate obligation is essentially the same whether or not ESOP financing is used.

There is one big difference, however. In conventional debt financing, debt repayments attributable to interest are deductible for tax purposes, but amounts attributable to repayment of principal are not. *All* payments to the ESOP are deductible, however, even those attributable to principal repayments.<sup>36</sup> This makes quite a difference: given a fifty percent effective tax rate, Corporation X will have to gross \$20 million to repay the \$10 million principal of the conventional loan, but need gross only \$10 million to repay the loan with pretax dollars through the ESOP. That difference, plus the productivity improvements that frequently accompany the ESOP, make the ESOP route seem safer and more attractive from the lender's standpoint, and may in some cases lead to faster amortization of the loan.<sup>37</sup>

The employees of Corporation X receive their stock interests according to the elaborate rules of ERISA and Subchapter D of the Internal Revenue Code. First, the employee must become a "participant" in the plan.<sup>38</sup> This is generally accomplished by meeting the requirements specified in the plan, which may require up to one year of service and/or the attainment of age twenty-five. (In most cases, the Corporation may exclude part-time employees from participation). Each year, the stock or cash that has been contributed to the Trust (except for that which has been debt-financed and not yet "paid for") is "allocated" to the separate accounts of each participant. When the Trust has acquired the stock with the proceeds of a loan, the stock is only allocated to individual accounts as the loan is paid off; *e.g.*, when ten percent of the loan is repaid, ten percent of the stock is "released" for allocation.<sup>39</sup> This allocation is normally made proportionate to employee compensation, so that an employee who earns \$20,000 per year will receive an allocation twice as large as an employee who earns \$10,000 per year. The employee, however, is not fully entitled to his or her entire account. The pro-

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<sup>35</sup> Conrad, *ESOP: Finance Tool, Employee Benefit, Pensions and Investments*, Sept. 25, 1978, at 33, col. 1.

<sup>36</sup> I.R.C. § 404(a).

<sup>37</sup> If new stock has been issued, on the other hand, there will be a dilutive effect to the calculation of earnings per share, since there will be an increase in the number of shares outstanding which forms the denominator for the ratio. Whether or not this dilutive effect will actually reduce the earnings per share from the pre-ESOP period depends upon the rate of increase in company earnings—the numerator of the ratio—resulting from the new investment.

<sup>38</sup> I.R.C. § 410.

<sup>39</sup> Pension Excise Taxes, 26 C.F.R. § 54.4975-7(b)(8) (1980).

portion to which the employee is entitled is determined by the "vesting" schedule.<sup>40</sup> There are a wide range of options for permissible vesting schedules, which can delay one hundred percent vesting for up to fifteen years. In a typical plan, an employee will be zero percent vested for his first three years of employment. After the third year the employee will become thirty percent vested, after the fourth year forty percent vested, up to the tenth year, after which he or she will be one hundred percent vested, or fully entitled to the stock which has been accumulating in his account each year. When the employees leave the company, they have the right to the value of the vested portion of their account. They also have the right to demand the actual shares,<sup>41</sup> although in most closely-held companies both the employee and the employer prefer a distribution of the fair market value of the shares in cash instead. If the employee does receive shares, which are not of a type traded actively in securities markets, ESOP regulations guarantee a put-option to sell them back to the company or the Trust for their fair market value, which the company or Trust is permitted to pay in installments over a five-year period.<sup>42</sup> The employee is not taxed on the allocation or vesting of shares in his or her account, but is taxed at the time of distribution, *unless* the employee immediately "rolls over" the distribution into an Individual Retirement Account (IRA).<sup>43</sup> Special ten-year income averaging is also available for lump-sum distributions.<sup>44</sup>

While the stock is held in the Trust, any dividends paid on it can immediately be "passed through" to the employees to provide them with additional income. Alternatively, they can be used to accelerate repayment of the loan, or used within the Trust to purchase stock or other investments for purposes of liquidity.<sup>45</sup> In the case of a leveraged ESOP, voting rights on publicly-traded shares must be "passed through" to participants—in the words of the statute, each participant in the plan must be "entitled to direct the plan as to the manner in which employer securities . . . are to be voted." For non-publicly traded shares, it is only necessary to pass through the voting rights "with respect to a corporate matter which (by law or charter) must be decided by more than a majority vote of outstanding common

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<sup>40</sup> I.R.C. § 411.

<sup>41</sup> I.R.C. § 409A(h).

<sup>42</sup> Treas. Reg. § 54.4975-7(b)(10) to (11) (1980).

<sup>43</sup> I.R.C. § 402(a)(5).

<sup>44</sup> I.R.C. § 402(e)(1).

<sup>45</sup> Tax Reform Act of 1976, Pub. L. No. 94-455, § 803(h), 90 Stat. 1520, 1590.

shares voted." Such issues are typically "major" issues, such as merger, liquidation, etc.<sup>46</sup>

2. *The ESOP: "in-house" market*—With or without leveraging, an ESOP can be used as an "in-house market" for the sale of stock held by a company's shareholders. Owners of closely-held companies often have a difficult time finding a buyer for their shares when they want to retire. An ESOP can be used to create a buyer, keep the corporation in friendly hands, and boost productivity—all at the same time.<sup>47</sup>

Suppose the sole owner of Corporation X wants to convert shares to cash over a period of years in anticipation of retirement. One course of action would be to sell out to a conglomerate, which has drawbacks that are by now well-known.<sup>48</sup> An alternative would be to establish an ESOP, according to the rules described above. The Corporation would contribute cash each year to the ESOP, which would use the cash to purchase shares from the owner at fair market value. The owner is taxed at regular capital gains rates; by contrast, had the stock been sold directly back to the corporation, the owner may be taxed at much higher dividend rates.<sup>49</sup> The owner need not pass through voting rights except on extraordinary corporate issues, thus retaining control of the company through his or her own stock plus the right to select the trustees. If the owner wishes to sell out before the Trust has sufficient money to pay him, the ESOP can simply borrow the money to pay the owner with the corporation guaranteeing the loan.

3. *Tax Reduction Act Stock Ownership Plan*—Some of the three to four thousand companies which have established ESOP's have taken advantage of a provision of the Tax Reduction Act of 1975 to create something called a "TRASOP."<sup>50</sup> That provision has now been codified as Section 409A of the Internal Revenue Code, and the name of the plan has been officially changed to "Tax Credit Employee Stock Ownership Plan," although use of the term TRASOP persists.<sup>51</sup> This provision permits companies to take an additional one percent investment tax

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<sup>46</sup> I.R.C. § 409A(e).

<sup>47</sup> See SENATE FINANCE COMM., 96TH CONG. 2D SESS., EMPLOYEE STOCK OWNERSHIP PLANS: AN EMPLOYER HANDBOOK 23 (Comm. Print 1980).

<sup>48</sup> See HOUSE SMALL BUSINESS COMM., CONGLOMERATE MERGERS: THEIR EFFECTS ON SMALL BUSINESS AND LOCAL COMMUNITIES, H.R. REP. NO. 96-1447, 96th Cong., 2d Sess. (1980).

<sup>49</sup> The seller must comply with the requirements of Rev. Proc. 77-30 to qualify for capital gains treatment. See 1977-2 C.B. 539.

<sup>50</sup> Pub. L. No. 94-12, § 301(d), 89 Stat. 38 (1975).

<sup>51</sup> Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763.

credit for money or stock contributed to an ESOP (in lieu of taking the deduction; a company cannot take both). That is, if a company purchases property qualified for the investment tax credit, and if it contributes employer securities to an ESOP as defined in Section 409A, it can take an investment tax credit of eleven percent, rather than the normal ten percent, of the qualified investments. Furthermore, the company can take yet an additional one-half percent credit, for a total of eleven and one-half percent, to the extent that participants make voluntary matching contributions to the Trust. This is very attractive to companies eligible for the investment tax credit, because it is essentially a free gift from the taxpayers to their employees. Many ESOP proponents admit that this is an expensive and inefficient way to promote the ESOP concept, but it has at least accomplished its purpose of generating interest in the idea, as well as providing additional incentive for capital formation. TRASOP's are subject to several restrictions not imposed on other ESOP's, such as a rule requiring immediate one hundred percent vesting.

### III. PROPOSED IMPROVEMENTS OF THE ESOP SYSTEM

#### A. *The General Accounting Office Report*

The General Accounting Office ("GAO"), at the request of the Senate Finance Committee, conducted a study of the operation of ESOP's. The GAO issued a highly negative report in June, 1980, entitled *Employee Stock Ownership Plans: Who Benefits Most in Closely Held Companies?*<sup>52</sup> The study covered thirteen unnamed closely-held government contractor corporations that had set up ESOP's, (although there is reason to believe that some of the plans studied were not actually statutory ESOP's),<sup>53</sup> concluding that the interests of ESOP participants were adversely affected in several ways. First, the companies sold or contributed stock to their ESOP's at inflated prices, based on appraisal valuations that lacked independence and/or did not properly consider all relevant factors. Overvaluation of stock is

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<sup>52</sup> THE COMPTROLLER GENERAL, GENERAL ACCOUNTING OFFICE, *EMPLOYEE STOCK OWNERSHIP PLANS: WHO BENEFITS MOST IN CLOSELY HELD COMPANIES?* (HRD-80-88) (1980).

<sup>53</sup> *Id.* at 22. Only 2 of the 13 plans studied contained the put option requirement mandatory for all statutory ESOP's. This leads many observers to believe that the other 11 plans were simply conventional stock bonus plans.

prohibited by ERISA,<sup>54</sup> tending to mislead participants about the true value of their accounts. The report noted that the failure of the Department of Labor to publish valuation regulations as contemplated by ERISA had contributed to the problem. Second, participants were generally not permitted to vote or direct the voting of company stock allocated to their ESOP accounts. The Report recommended legislation to require a full "pass-through" of voting rights on stock allocated to participant's accounts.

Third, participants were not assured of a market for company stock distributed by the ESOP. The possibility arose that employees might be given stock which became useless to them because they would be unable to find a buyer for it. The Report recommended legislation to require plan provisions for mandatory put-options, at fair market value, to be issued for all company stock distributed from the plan. GAO also questioned the contribution that ESOP's make to improving productivity, called for a more vigorous program of ESOP audits, and in general implied that the whole ESOP concept is not worth the revenue loss it causes. Critics of the Report questioned both the methodology employed and the objectivity of its standards of evaluation.<sup>55</sup> Many of the GAO criticisms, however, point to problems with current ESOP law which deserve discussion.

1. *The valuation of employer stock*—The value assigned to employer stock contributed or sold to an ESOP is critically important. If the ESOP trustee causes the plan to purchase stock at a price greater than its true value, the purchase may be a violation of fiduciary duties, rendering the trustee personally liable to the plan participants.<sup>56</sup> If the employer contributes stock to an ESOP and claims a deduction<sup>57</sup> based on an inflated price, then the deduction will in part be disallowed. If the ESOP purchases stock from a principal shareholder or the employer at a price greater than fair market value, the seller is subject to an excise tax of five percent of the amount involved; an additional tax of one hundred percent is imposed if the transaction is not "corrected."<sup>58</sup> Undervaluation can be as bad as overvaluation. The law requires that for a leveraged ESOP, terminating partici-

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<sup>54</sup> ERISA, *supra* note 31, § 408(e)(1), 29 U.S.C. § 1108(d) (1976).

<sup>55</sup> Memorandum from Ronald L. Ludwig, Chairman, Legal Advisory Committee, The ESOP Association of America, to Sen. Russell B. Long, July 16, 1980 (on file at University of Michigan Journal of Law Reform).

<sup>56</sup> ERISA, *supra* note 31, §§ 404, 409, 29 U.S.C. §§ 1104, 1109 (1976).

<sup>57</sup> I.R.C. § 404(a).

<sup>58</sup> I.R.C. § 4975(a)-(b).

pants be given a put-option to sell the shares they receive back to the employer or the plan at "fair market value."<sup>59</sup> If the securities are undervalued, then the participant may have a cause of action against the plan.

The law provides little guidance to the closely-held company on how to value its stock for purposes of ESOP transactions. For publicly-traded companies, the market price of the stock on the appropriate day is the readily determinable measure of value.<sup>60</sup> But closely-held companies are given only the guidance of ERISA Section 3(18)B defining "adequate consideration" for prohibited transaction purposes as "the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary." These regulations, however, have not yet been proposed, and their proposal does not seem to be imminent.

This lack of standards puts ESOP companies in a predicament. Although today in practice a good faith independent appraisal will provide a certain degree of protection from liability, employers still face legal sanctions if their valuation is too low, and even stiffer sanctions if it is too high. Appraisers, while roundly criticized by the GAO for failing to value stock properly, have never been told what standards they are expected to apply. Audits and lawsuits focusing on valuation have begun to proliferate, and the resulting confusion and uncertainty act as a deterrent to businessmen considering establishment of an ESOP.

In the absence of the promised ESOP valuation regulations, practitioners have been relying on Revenue Ruling 59-60, which discusses valuation of closely-held stock for estate and gift tax purposes. As one valuation expert has aptly put it, this ruling is "more philosophical than instructional."<sup>61</sup> It defines fair market value as "the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts," and it lists eight factors which should be considered in the computation.<sup>62</sup>

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<sup>59</sup> Treas. Reg. § 54.4975-7(b)(11)(iii) (1980).

<sup>60</sup> ERISA, *supra* note 31, § 3(18)(A), 29 U.S.C. § 1002 (1976).

<sup>61</sup> EBPR Research Reports, vol. 28, no. 40, October 3, 1980 (Weekly News Digest), at 6 (statement of M. Lee).

<sup>62</sup> Rev. Rul. 59-60, 1959-1 C.B. 237. The eight factors are:

- (a) The nature of the business and history of the enterprise from its inception.
- (b) The economic outlook in general and the condition and outlook of the specific industry in particular.
- (c) The book value of the stock and the financial condition of the business.

The GAO Report described several cases in which the valuation of stock transferred to an ESOP could be questioned.<sup>63</sup> In some instances, no one made an independent appraisal, and the Board of Directors or some other interested party simply determined the valuation. In others, the GAO faulted the valuation for failure to consider properly the relevant factors of Revenue Ruling 59-60. One appraiser computed company earnings after deleting the effect of a subsidiary for which the parent company acted as guarantor to all debt and the subsidiary's entire line of credit. Other appraisers used inconsistent approaches in different companies, such as capitalizing pretax earnings for some companies and post-tax earnings for others, or capitalizing earnings before ESOP contributions in some cases, and after ESOP contributions in others. One appraiser utilized four different methods in four different years for the same company; a subsequent IRS-sponsored appraisal concluded that the value in one of the years had been overstated by 632 percent.

In response to these valuation irregularities, GAO called on the Department of Labor to issue valuation regulations "as soon as possible."<sup>64</sup> This suggestion has merit, as it would help to remove a cloud of uncertainty from the valuation area. But the content of such regulations is, of course, at least as important as the fact of their issuance. A poorly-designed set of regulations for valuations of ESOP stock would make the ESOP a highly unattractive tool for business planning; moreover, the 1976 attitude of the agencies to the ESOP concept raises fears about future valuation regulations. If the Kelsonian vision of broad private ownership is to be achieved, these valuation regulations must be fair to ESOP companies and easily administered—otherwise, the growth of the ESOP will be slowed or halted.

Fairness requires that the regulations not result in an undervaluation of an ESOP company's stock. There are numerous ways in which this could happen, a full discussion of which would exceed the scope of this article. But one example would

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- (d) The earnings capacity of the company.
  - (e) The dividend-paying capacity.
  - (f) Whether or not the enterprise has goodwill or other intangible value.
  - (g) Sales of the stock and the size of the bloc to be valued.
  - (h) The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

*Id.*

<sup>63</sup> GAO report, *supra* note 52, at 8-21.

<sup>64</sup> *Id.* at 19.



be the treatment of minority vs. majority voting blocs. Some valuation experts argue that where the ESOP only controls a minority interest in a firm, the value of the stock it holds should be discounted by some arbitrary percentage to reflect this lack of control.<sup>65</sup> Others contend that there should be a "premium" for a controlling interest over and above the "straight" value of the stock, rather than a discount for a minority interest,<sup>66</sup> or that there should be no adjustment at all based on the proportion of shares held. Insofar as the multiplier used in the capitalization of earnings approach is based on the price/earnings ratios of similar but publicly-traded companies, it seems that the "minority discount" approach would lead to inaccuracies, when the stock being traded is *all* held by minority interests. The important point is to keep in mind the congressional intent to encourage ESOP's in conjunction with important public policy reasons for doing so. Furthermore, the drafters should recognize that erring on the side of undervaluation does *not* protect the interests of employees. An employee who receives a put-option to sell stock back to the company at a price lower than the stock is actually worth has not been protected very well.

Fairness does not represent the only goal that the drafters should keep in mind. Simplicity and ease of application are also critically important. In the majority bloc vs. minority bloc issue discussed above, simplicity would dictate that *neither* a premium nor a discount should be applied. Valuation is an art more than it is an exact science, and as such it can be debated endlessly. But businessmen have no time for endless debate, nor can they often afford to pay for a valuation study so thorough as to mute all questioning and criticism. Businessmen need a readily ascertainable number they can use to determine whether the ESOP makes sense for the situation they are in; if they cannot get such a number, however, they will lose interest in the ESOP. This concern seems particularly important for small businesses.<sup>67</sup>

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<sup>65</sup> Address by J. Zukin, speech outline printed in course materials prepared for Georgetown University Law Center Continuing Legal Education Program, ESOPs, TRASOPs, AND OTHER EMPLOYEE STOCK OWNERSHIP PLANS (Sept. 20-21, 1979), at 14.

<sup>66</sup> [1977] PENSION & PROFIT-SHARING (P-H) ¶ 1061.

<sup>67</sup> The drafting of regulations governing the valuation of nonpublicly-traded stock for ESOP purposes seems to provide a perfect example of a situation in which the new Regulatory Flexibility Act, Pub. L. No. 96-1354, 94 Stat. 1164 (1980) (to be codified at 5 U.S.C. §§ 601-12), should be applied. This Act recognizes that compliance with complex regulations can be relatively more burdensome for small businesses than for large ones, and requires agencies to develop alternative, simpler regulations to apply to small business. Nowhere is the need for simplification for small businesses greater than in the valu-

Regardless of the ultimate decision on which valuation methods should be employed, there must be a change of attitude on the part of the agencies overseeing the process. ESOP's are now subjected to "special scrutiny" by the agencies, which translates into "high likelihood of being audited." Such a policy naturally diminishes the attractiveness of the ESOP for businessmen, even though they may have every intention of valuing their stock fairly. Much more appropriate, given the intent of Congress and the public policy arguments for encouraging the ESOP, would be a more constructive attitude towards responding to requests for guidance, and exercising leniency for past actions where good faith can be shown. An important component of this new attitude would be a willingness to issue "no-action" letters with regard to the acceptability of valuations—a practice the IRS now refuses to engage in. Such "no-action" letters would provide employers with the certainty they require in the conduct of a business. Another such component would be *prospective* application of any changes in a company's valuation procedures which the IRS mandates after an audit, in cases where good faith can be shown (*e.g.*, where the appraisal has been done by a truly independent professional appraiser). Prospective application, rather than the current practice of assessing for back taxes and penalties, would assure that businessmen would not suffer the consequences from sanctions, while at the same time assuring that proper procedures are used in the future. In short, a "crackdown" is not the answer; what is needed is constructive guidance to those who do want to follow the law, if only they could determine what it is.

2. *Voting rights pass-through*—An ESOP is set up as a trust in which the trustees have legal ownership of the trust assets and the beneficiaries have equitable ownership. As legal owners, the trustees of a qualified plan generally have the right to exercise the voting power of the stock held by the trust, so long as they do so under the fiduciary standards of trust law incorpo-

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ation area. A good starting point for such a discussion might center on what has been called an "asset value approach," similar to book value except that it uses fair market value of the assets instead of historical costs. This approach might also be more readily understandable by employees than the capitalized earnings approach where the multiplier is determined with reference to market fluctuations over which employees have no control. An asset value approach would be inappropriate in many situations, however, especially in a non-capital-intensive company. But in a large class of cases which ought not be too difficult to define, an asset value approach would provide a useable (albeit imperfect) measure of value. A regulation which defined this class of cases and permitted use of an asset value approach therein would be consistent with the spirit of the Regulatory Flexibility Act.

rated in ERISA.<sup>68</sup> A special exception to this rule is made for the ESOP, however, and for all other "eligible individual account plans" (e.g., stock bonus and profit-sharing plans) in which more than ten percent of the assets are invested in employer stock.<sup>69</sup> If a statutory ESOP or TRASOP holds publicly-traded employer stock, each participant must be entitled to direct the trustees how to vote the employer stock allocated to his or her account on all corporate issues. If any "eligible individual account plan" holds non-publicly traded employer stock, each participant must be entitled to direct the trustees how to vote the stock in his or her account on corporate issues which, by state law or by corporate charter, must be decided by more than a majority of the outstanding common shares voted.<sup>70</sup> Typically, such issues involve major corporate changes such as mergers or dissolutions. The new Small Business Employee Ownership Act<sup>71</sup> and the proposed regulations thereunder<sup>72</sup> would impose even more stringent standards on ESOP's seeking to qualify for Small Business Administration ("SBA") loan guarantees. ESOP's holding even non-publicly traded stock would have to "pass through" voting rights on all corporate issues. Of course, once participants receive their stock distribution in any case, they become the legal as well as the equitable owner of the stock, thereby acquiring the right to vote it in the normal manner.

While there is little criticism of the pass-through requirements for publicly traded stock, almost no one is happy with the present arrangement for closely-held stock. Many closely-held ESOP employers are adamantly opposed to any such pass-through whatsoever. On the other hand, the GAO,<sup>73</sup> the Treasury Department,<sup>74</sup> and others<sup>75</sup> recommend that there be full voting rights passed through on *all* corporate issues. The issue, unfortunately, has become an emotional one, with repeated as-

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<sup>68</sup> ERISA, *supra* note 31, § 404, 29 U.S.C. § 1104 (1975).

<sup>69</sup> I.R.C. § 401(a)(22).

<sup>70</sup> I.R.C. § 409A(e).

<sup>71</sup> Pub. L. No. 96-302, 94 Stat. 850 (1980).

<sup>72</sup> 45 Fed. Reg. 61,637 (1980) (to be codified at 13 C.F.R. §§ 122, 202-7).

<sup>73</sup> GAO report, *supra* note 52, at 24.

<sup>74</sup> *Hearings Before the Subcomm. on Private Pension Plans and Employee Fringe Benefits of the Senate Finance Comm.*, 96th Cong., 1st Sess. 230 (1979) (statement of Daniel Halperin, Deputy Ass't Sec. for Tax Policy, Dep't of Treasury).

<sup>75</sup> *See, e.g., Proposed Amendments to the Internal Revenue Code of 1954 to Provide for the Non-Recognition of Gain on the Proceeds from the Sale of Small Business Stock to an Employee Stock Ownership Plan if those Proceeds are Reinvested in such Stock: Hearings on H.R. 7604 and H.R. 7606 Before the House Ways and Means Comm.*, 96th Cong., 2d Sess. (1980) (statement of N. Kurland).

sertions on both sides substituting for rational analysis. Such an analysis is badly needed if the ESOP movement is to avoid being sidetracked by the voting rights controversy.

The arguments in favor of voting rights pass-through are straightforward. Since control is a fundamental attribute of ownership, the proponents argue, a stock "ownership" program which does not convey voting rights is a fraud. If the employees are truly to share in the rights and responsibilities of capital ownership, and if a substantial portion of their capital (and thus of their future financial security) is to be tied up in the ESOP, then they should have a say in how that capital is to be managed. Furthermore, the pass-through proponents argue, if one of the goals of the ESOP is to improve employee motivation, participation, and productivity, then voting rights pass-through is a must, for without it there would be no real change in the "wage serf" status of the employees. Those opposed to voting rights pass-through, however, counter with a number of equally strong arguments. The right to have a say in the company cannot be accomplished by voting rights, they argue, in the vast majority of closely-held ESOP cases where the principal owners retain a controlling interest in the firm. Pass-through in such cases would be a meaningless ritual, since the outcome of the vote is predetermined. The opponents also dismiss the productivity impact of voting rights pass-through. They point to the utter lack of empirical proof that the legalistic exercise of voting rights has any effect on productivity,<sup>76</sup> arguing that pass-through is only one of many ESOP-related steps a firm could take to enhance employee participation. The South Bend Lathe strike, discussed in the introduction, has been used as an example of what is wrong with the ESOP; but since the South Bend Lathe ESOP did in fact pass-through voting rights on all corporate issues, it is actually an example of a case where pass-through of voting rights did *not* improve the operation of the firm.

The leading argument against voting rights pass-through, however, is the dampening effect it would have on the growth of the ESOP. Many owners of closely-held companies have devoted their careers to building up their firms and are willing to share the fruits of their success with their employees; but they are not willing to give up control of their assets. Understandably, these

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<sup>76</sup> See Survey Research Center, Univ. of Michigan, *EMPLOYEE OWNERSHIP* (Report to the Economic Development Administration, U.S. Department of Commerce, Project No. 99-6-09433, 1979). A regression analysis of the firms studied in this project actually showed a *negative* relationship between voting rights and profitability.

owners see themselves as best able to run the company, and are reluctant to turn over control of the assets on which their own personal financial health hinges to a group of often less-educated employees who, pre-ESOP, at least, have shown little interest in the success of the company. The owners fear the prospect of "management by committee," even though pass-through would not necessarily lead to this. They also recognize the potential conflict of interest on the part of employee-owners who have the power to set their own wages. Theoretically, such employees might choose to plow all of the company's profits into wage increases, leaving nothing for the equity owners of the company who are not employees.

Two other important practical considerations arise in a consideration of voting rights pass-through for small, closely-held companies: (1) the added paperwork and procedural burdens, and (2) the disclosure of confidential information. The IRS has not yet issued regulations to interpret the statutory requirement, although proposed regulations on this subject are expected to be issued soon. In 1979, the IRS issued regulations governing voting rights pass-through for TRASOP's, and ESOP companies have been relying on them for guidance.<sup>77</sup> The forthcoming regulations could possibly put closely-held ESOP companies in the same position as publicly-held companies in terms of procedural requirements for proxy voting, etc., as set forth in state corporate law;<sup>78</sup> the employer or the ESOP trustees would also be subjected to liability for technical violations of these extensive requirements. Closely-held companies, moreover, might have to make the same information disclosures to their employee-owners that publicly-held companies are required by corporate and federal and state securities laws to make to outside shareholders, and the same types of liability would attach for misstatements or omissions in the information disclosed.<sup>79</sup> The time, the expense, the subjection to liability and the loss of confidentiality entailed by these requirements are major reasons why many businesses prefer to remain closely-held rather than "going public." If installing an ESOP resulted in these kinds of headaches for all closely-held business managers, then we could expect to see a curtailment in the number of new ESOP's.<sup>80</sup>

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<sup>77</sup> Treas. Reg. § 1.46-8(d)(i) (1980).

<sup>78</sup> See, e.g., Conn. Gen. Stat. Ann. §§ 33-333 to 33-339 (West 1960, Supp. 1980).

<sup>79</sup> See, e.g., Securities Exchange Act Rule 14a-9, 17 C.F.R. § 240.14a-9 (1980).

<sup>80</sup> A recent internal survey by the ESOP Association of America, the national trade association of ESOP companies, indicated the intensity of employer opposition to the pass-through requirement. See The ESOP Association of America Newsletter, Sept.,

The appeal of the arguments on both sides of the pass-through question, along with the controversy and bitterness it has engendered, suggest the importance of searching for some sort of new "middle ground," providing employee-owners some say in management without causing the serious problems resulting from the present arrangement. This article does not recommend any one specific compromise position; discussion of such a compromise, however, might begin with a consideration of one or more of the following elements:

*a. Reflect the lack of voting rights pass-through in the valuation of the stock.* Suppose Smith has a share of XYZ Corporation stock in her ESOP account which she cannot vote until she receives her distribution at retirement, and Jones has an identical share of stock which he can vote while it remains in his ESOP trust account. Arguably, what Jones has is "worth" more than what Smith has, since he has more extensive legal rights. If so, then Smith's share should have a lower valuation than Jones', and XYZ should receive a lesser tax deduction for its contribution of Smith's share to the ESOP than it does for its contribution of Jones' share. This analysis could resolve the whole pass-through controversy by simply requiring an arbitrary discount (*e.g.*, fifteen to twenty percent) to be applied to the valuation of employer stock held by the ESOP if the plan does not provide for voting rights pass-through. The discount would apply for purposes of corporate contributions to the plan, but would not apply for plan transactions with third-party sellers, or to terminating employee sales of stock back to the company or the plan. ESOP's which did choose to pass through voting rights, however, would not be subject to the discount requirement.

*b. Pass-through voting rights on vested shares only.* Most ESOP's have a "vesting" schedule which provides that employees who quit before normal retirement age may have to forfeit some or all of the shares allocated to their account. Under ERISA, employees may have to participate in the ESOP for as long as fifteen years before they are fully vested in the shares allocated to their account.<sup>61</sup> Yet voting rights pass-through today is based on allocated stock, rather than on vested stock, which can lead to the anomaly of a participant casting votes to affect the future of a company using stock which will be for-

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1980, at 1. Eighty-three percent of the respondents recommended that it be repealed, and 65 percent offered to lobby their representatives in Congress to that end. Many of the respondents indicated that they planned to terminate their ESOP's, or to curtail drastically their levels of contribution.

<sup>61</sup> I.R.C. § 411.

feited on the following day. Restricting pass-through to vested stock would make it somewhat more palatable to employers, while still giving employee-owners, especially those who have demonstrated a longer-term commitment to the company, a say in how the company should be run.

*c. Limit the issues on which voting rights must be passed-through.* This approach is actually the one being used now for closely-held companies, although the delineation of the issues on which the vote must be passed-through is not a very satisfactory one. Pass-through is required "with respect to a corporate matter which (by law or charter) must be decided by more than a majority vote of outstanding common shares voted."<sup>82</sup> Such issues are generally "major" ones, such as merger or liquidation. Pass-through advocates are dissatisfied because such issues come up rarely, if ever, in most companies; employers are dissatisfied because such issues are precisely the ones where their need for control and the danger of making a mistake are the greatest. Furthermore, since in some states a super-majority is required, these represent issues on which an ESOP with a minority interest could frustrate the will of the majority.

A different type of limitation on issues subject to pass-through might be more desirable for both groups. One example would be to permit the ESOP participants only to elect one or more board members, possibly (though not necessarily) in proportion to the number of shares held by the ESOP. The debate between the merits of a "republican" form of government as opposed to a "pure democracy" is an old one; this proposal would assume that the republican form is most appropriate for the employee ownership situation. (Or at least it would assume that the republican form is all that should be *required*; companies could elect to open some or all issues to employee-owner vote, at their discretion). Under this scenario, employee-owners would not have to evaluate complex and critical issues of corporate policy. They would simply have to choose one or more trusted, capable representatives to the body that *does* deal with these issues. This proposal would greatly cut down on the need for disclosure of information and complex proxy voting procedures. It may also be less threatening than the present law to managements considering the establishment of an ESOP. And, whether the employers realize it now or not, this arrangement may also provide them with a mechanism for receiving valuable input from their employees which they are not now benefiting from.

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<sup>82</sup> I.R.C. § 409A(e).

*d. Statutorily limit the amount of paperwork and disclosure required for the exercise of whatever voting rights must be passed-through.* If closely-held ESOP companies are ever subjected to the same types of paperwork, disclosure, and liability as publicly-held companies in the area of stock voting, the attractiveness of the ESOP will be substantially diminished. Even the threat that such a regulation might someday be imposed creates an uncertainty which can deter a small businessman from setting up an ESOP. A meaningful statutory limitation on the amount of paperwork and disclosure required in connection with voting rights pass-through, standing alone, would probably not be enough to satisfy businessmen's objections to the ESOP, but in conjunction with one or more of the other proposals listed here, it would help. A right to inspect certain corporate records might be considered as an alternative to a general disclosure requirement.

*e. Limit pass-through to cases in which the ESOP owns a majority of company stock.* In the typical company, pass-through is a meaningless and costly ritual, since the principal owner retains more than enough stock to win every vote. A law recognizing this simple fact would save ESOP companies a considerable amount of aggravation and expense without in any way depriving employees of control they might otherwise have exercised.

*f. Limit pass-through to stock which has been acquired with some form of government subsidy.* The case for pass-through seems to be stronger when direct government subsidies, such as SBA or EDA loan guarantees or extra tax credits, have been used to enable the ESOP to acquire employer stock. A possible compromise might be to require full pass-through in these cases, but not require pass-through in other cases where the company only receives from the government a tax deduction for amounts expended to compensate its employees.

*g. Provide a more generous "grandfather clause."* Many businessmen are particularly incensed because they established ESOP's under one set of laws, only to have the laws changed by the Revenue Act of 1978 to require voting rights pass-through by closely-held companies. A provision exempting all ESOP's established before a certain date in the future (e.g., January 1, 1985) from the mandatory pass-through requirement would satisfy this particular objection.

*h. Permit certain other types of worker participation models to substitute for voting rights pass-through.* Voting rights may not be the only way or even the best way for workers to



exercise the proper degree of control over their workplaces. Scanlon plans and Japanese-style quality control circles<sup>63</sup> have been used in many companies to boost productivity and to provide workers with the dignity that advocates of pass-through hope to achieve. The law could be written to provide that a good-faith effort to establish and operate such a plan would exempt an ESOP company from the pass-through requirement. Such a law would be harder to monitor, but the difficulty in doing so would not be insurmountable. The law, moreover, would provide companies with more flexibility, and encourage the growth of another movement which seems to hold great promise for the American economy. The requirement of Section 505 of the Small Business Employee Ownership Act<sup>64</sup> that "there will be periodic reviews of the role in the management of such concern of employees to whose accounts stock is allocated," and the requirement in the proposed regulations<sup>65</sup> interpreting this Act that such review be annual, are healthy and constructive steps in this direction.

*i. Provide for additional ESOP incentives to counterbalance the disincentives of voting rights pass-through.* If Congress wants to encourage ESOP's but require pass-through all at the same time, they should make the ESOP so attractive that businessmen would be willing to endure voting rights pass-through in order to have one. There are many ways that have been discussed in which this could be done, *e.g.*, establishing a two-tiered Federal Reserve discount rate which would lead to the ready availability of a three percent prime rate for bank loans to ESOP's.<sup>66</sup> Some would argue, however, that these proposals are meritorious in their own right and that ESOP firms should not have to pass-through voting rights in order to get them.

These proposals are, of course, not the only ways in which the voting rights pass-through dilemma might be resolved. Some combination of the above proposals, however, can be developed to satisfy most of the concerns that have stunted the growth of the ESOP. The resolution to this dilemma requires a retreat from emotionalism on both sides and a careful crafting of an

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<sup>63</sup> See *Hearings on Quality of Production and Improvement in the Workplace, Before Subcomm. on Trade of the House Ways and Means Comm.*, 96th Cong. 2d Sess. 123-33 (1980) (statement of William Tanaka).

<sup>64</sup> *Supra* note 26.

<sup>65</sup> 45 Fed. Reg. 61,638, 61,640 (1980) (to be codified at 13 C.F.R. § 122.206(c)).

<sup>66</sup> See Kurland, *Kelsonian Monetary Weapons for Fighting Inflation*, reprinted in *Hearings on H.R. 3056—Small Business Employee Ownership Act Before the Subcomm. on Access to Equity Capital and Business Opportunities of the House Small Business Comm.*, 96th Cong., 1st Sess. 15-29 (1979).

appropriate method by which employee-owners can exercise control over their capital.

3. *Marketability of employer stock*—Another GAO criticism of ESOP's in closely-held companies concerned the ability of ESOP participants to sell their shares once they receive their distributions. IRC Section 409A(h) requires that when non-publicly traded stock is acquired with the proceeds of a loan to the ESOP, (a "leveraged ESOP"), the stock must be subject to a "put-option" permitting the recipient to sell it back to the employer or trust, at specified times, at fair market value. For stock acquired by a means other than an acquisition loan, however, no such put-option is required. While most companies realize that they have a moral obligation to repurchase unmarketable stock distributed to their employees, there exists no legal requirement for them to do so in a nonleveraged ESOP. This lack of a requirement may tempt companies into offering less than fair market value for their employees' stock. GAO's study of thirteen companies did find one case in which such an unfair purchase occurred.<sup>87</sup>

GAO recommended that Congress require a put-option at fair market value on all nonpublicly traded stock distributed from an ESOP.<sup>88</sup> This suggestion, while addressing a real problem with good intentions, does not fit the need precisely. The proposal, on the one hand, does not go far enough. Nonpublicly traded stock can be distributed just as easily from a conventional stock bonus plan or a profit sharing plan as from an ESOP, yet the GAO does not suggest that any steps be taken to remedy this situation. Any extension of the legal requirements for marketability of stock distributed from a qualified plan should be broad enough to cover all such plans, not just ESOP's. Otherwise, the ESOP will be discriminated against vis-a-vis other types of plans. The GAO suggestion, on the other hand, may go too far in protecting the interests of the terminating employee, with the effect of jeopardizing the interests of the employees who remain in the plan. The put-option as presently constituted is not the only way, nor necessarily the best way, in which marketability of the employer stock may be assured. Before the Revenue Act of 1978, the duration of the put-option was for a full fifteen months after the employees received their stock. Employees had every right to wait until just the right point when they could get the highest possible price for selling the stock back to the company

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<sup>87</sup> GAO report, *supra* note 52, at 23.

<sup>88</sup> *Id.* at 27.

or the plan; the employer had no choice but to buy it back within fifteen months of the distribution. Although beneficial from the terminating employee's standpoint, this situation seemed less appealing from the company or the plan's standpoint, since it might have to pay a higher price for the stock than it would prefer to. The Senate Conference Report to the Revenue Act of 1978 relaxed that requirement somewhat by breaking the time period during which the put-option could be exercised into two parts. Under the terms of the Senate Report, the option extended for six months after the employee received the stock. It then lapsed, until the end of the employer's tax year, when the valuation of the stock would be updated. After being advised of this new valuation, the terminating employee would then be given an additional three months in which to exercise the put-option. At the end of this period, the option expired.

An approach could be devised which would be both simpler and fairer to the employer and plan, and at the same time resolve the marketability problems highlighted by the GAO Report. Under this approach, a terminating employee would simply be given the option at termination of receiving the stock or its fair market value (as of the most recent valuation) in cash. Existing rules permitting distributions in installments would be preserved in order to help ensure plan liquidity. There would be no extended period of time in which the terminating employees could "speculate" as to the direction of the stock price; they would simply make up their minds at the time of termination.

A special problem arises in the case of a company entirely, or almost entirely, owned by its employees, which wants to remain that way. Such a company might well want to have the right to repurchase stock for itself or its plan from employees who terminate, thus keeping all of the stock "in the family." Unfortunately, under present ESOP regulations the company cannot be assured of this right. Although a right of first refusal on the stock distributed from the plan is permitted, this is not enough to provide such a guarantee. The employee cannot be compelled to sell his stock back to the employer or the Trust; moreover, if an outside party offers more for the stock than the employer or Trust is willing to pay, the ESOP's control position can be substantially eroded.

Legislation along the lines of a bill introduced in the 96th Congress, H.R. 7848, ought to be enacted which would, in the case of an ESOP that owned all or substantially all of the employer's stock, permit the Trustees to decide whether stock or its

equivalent fair market value in cash would be distributed to the employee upon termination. This flexibility is presently denied to ESOP's on the grounds that a "stock ownership plan" should permit an employee, who so desires, to actually own the stock outright at some point. While this may be a legitimate consideration in the typical ESOP which only owns a small portion of the company, such legitimacy fades when weighed against the continuity objectives of the one hundred percent ESOP-owned company—the law should recognize this distinction.

### B. *The ESOP Improvements Act*

Unimpressed by the GAO's assertions, in July of 1980, Senator Long introduced S. 2982, the "Employee Stock Ownership Improvements Act of 1980."<sup>89</sup> The bill stood little chance of passage because of the congressional preoccupation with the stalemate on the general tax-cut legislation, but is important nonetheless because it brought together a number of tax proposals that would provide an enormous stimulus to the growth of the ESOP movement. In a speech about his proposals on September 26, 1980, Long flatly declared that "In the long run, I think they all will pass."<sup>90</sup> Among the more significant provisions of the bill are sections which would expand the TRASOP by giving employers an alternative tax credit equal to one percent of their covered payroll, as an alternative to the present formula of one percent of investments qualified for the investment tax credit; provide a corporate deduction for dividends paid on employee stock held by an ESOP or TRASOP; and provide for "tax-free rollover" (a deferral of taxation) on sales of small business stock to an ESOP or TRASOP, if the sale proceeds are reinvested in other small business stock within eighteen months.

1. *The payroll-based ESOP tax credit*—The ESOP Improvements Act contains a number of provisions intended to increase dramatically the incentive for business to establish ESOP's. The Tax Reduction Act of 1980 approved by the Senate Finance Committee on September 15 incorporated one of these provisions, the payroll-based ESOP tax credit.<sup>91</sup> This provision

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<sup>89</sup> S. 2982, 96th Cong., 2d Sess.; see also 118 Cong. Rec. S. 10018 (daily ed. July 18, 1980) (statement of Sen. Long). Earlier introduced as S. 1240, 96th Cong., 1st Sess. [hereinafter cited as the ESOP Improvements Act].

<sup>90</sup> Pens. Rep. (BNA) October 6, 1980, at A-24.

<sup>91</sup> SENATE FIN. COMM., REP. ON H.R. 5829, TAX REDUCTION ACT OF 1980, S. REP. NO. 940, 96th Cong., 2d Sess. 104-05 (1980).

would extend the benefits of the TRASOP to labor-intensive employers. Under present law, the TRASOP credit is tied to the investment tax credit. A company can take an investment tax credit of ten percent of its investment in certain qualified depreciable property.<sup>92</sup> It can also take an additional one percent credit if it transfers employer securities equal in value to one percent of its qualified investment to the TRASOP, or if it transfers an equivalent amount of cash to the TRASOP which is used by it to purchase employer securities.<sup>93</sup> The company can take yet another one-half percent credit, for a total credit of eleven and one-half percent, to the extent that employees make "matching" contributions to their TRASOP accounts.<sup>94</sup>

Hundreds of companies, including many in the Fortune 1000, have established TRASOP's<sup>95</sup> to take advantage of what is essentially a "free gift" from the taxpayers to their employees. By its nature, however, a TRASOP is only useful to a company that can take a significant amount of investment tax credits. If the qualifying investments for such credits are not very large, then one and one-half percent of them that would go into the TRASOP would be so miniscule that it would not be worth the trouble of setting up the plan. The vast majority of American companies do not have enough qualifying investment to make the TRASOP worthwhile.

A provision in the Tax Reduction Act of 1980 would permit employers to take a tax credit based on a percentage of their covered payroll, as an alternative to basing the credit on qualifying investment. The percentage would be one-half percent for 1981, three-quarters percent for 1982, and one percent for 1983, after which the credit would expire unless extended or made permanent by the Congress. This would enable all employers to establish a TRASOP with a meaningful (though not large) amount of stock in each employee's account. Capital-intensive companies, however, would still receive more favorable treatment under the tax code by retaining the option of basing their credit on qualifying investments, should that result in saving them a larger amount. The IRS has suggested that if the payroll-based credit is adopted, then the investment-based credit

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<sup>92</sup> I.R.C. §§ 38, 46.

<sup>93</sup> I.R.C. §§ 46(a)(2)(E), 48(n)(1)(A).

<sup>94</sup> I.R.C. §§ 46(a)(2)(E), 48(n)(1)(B).

<sup>95</sup> Hewitt Associates, *Survey of Tax Reduction Act ESOP's*, April, 1979, reprinted in Course Materials for Georgetown University Law Center Continuing Legal Education Program, *ESOP's, TRASOP's, and Other Employee Stock Ownership Plans* (1979).

should be repealed.<sup>96</sup> This suggestion makes a good deal of sense.

The tax credit approach in general seems to be a very expensive way to go about encouraging employee ownership. Federal revenues must be decreased by one dollar for every dollar of employee ownership created. Certainly, there is a sharply defined upper limit on how far the federal government can go with this approach. The IRS estimated that a bill similar to S. 2982 could cost the government over \$4 billion dollars annually by 1985.<sup>97</sup> There may well be other ways in which the government can encourage employee ownership without incurring such a large revenue loss, which would be preferable to expanding the use of tax credits. On the other hand, by extending a "taste of ESOP" to companies and workers who would otherwise not have considered it, the payroll-based credit may spread enthusiasm for the concept which will lead to expansion beyond the amounts for which the credit is available. Furthermore, if there is to be a general tax-cut in 1981, it is only appropriate that employee ownership be one of the causes benefited by the cut; the payroll-based tax credit is certainly a direct way to go about accomplishing this purpose.

2. *Dividend deductibility*—Another section of the ESOP Improvements Act would begin the process of re-defining the nature of the American business corporation in a very healthy and constructive manner. The provision looks innocent enough; it simply provides that dividends paid on employer securities held by an ESOP be tax-deductible to the employer corporation if they are distributed currently to the participants, as is possible under an ESOP.<sup>98</sup> The Joint Committee on Taxation estimated the revenue impact of this proposal as "indeterminate but should be small." The philosophical implications, nonetheless, are enormous. In effect, this section would end double taxation of the corporate profits of employee owners.

Under the Kelsonian view, the owner of capital ought to be entitled to receive the income his or her capital produces. Since the pretax annual earnings on invested capital generally exceed twenty percent,<sup>99</sup> the average citizen should be able to obtain credit to purchase capital, repayable in a reasonably short period of time with the earnings created by that capital. Two

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<sup>96</sup> *Supra* note 74, at 227.

<sup>97</sup> *Id.*

<sup>98</sup> *Supra* note 89.

<sup>99</sup> L. KELSO & P. HETTER, TWO-FACTOR THEORY: THE ECONOMICS OF REALITY, *supra* note 7, at 76.

“filters,” however, interfere with the flow of earnings back to the capital owner. One of these is the corporate law doctrine expressed in the landmark case of *Dodge v. Ford Motor Co.*,<sup>100</sup> to the effect that stockholders may not generally compel corporate management to pay out earnings in the form of dividends. Kelso vehemently disagrees, maintaining that this holding undermines the institution of private property.<sup>101</sup> The other “filter” blocking the free flow of capital earnings back to capital owners is the double taxation of corporate profits. Capital earnings are taxed at federal rates of forty-six percent plus whatever state-level rates apply at the corporate level; the remaining earnings which pass from the corporation to its owners in the form of dividends, are taxed a second time at unearned income rates as high as seventy percent at the federal level, plus whatever state tax rates apply. Since little earnings remain to repay the loan used to acquire the stock, most average citizens could not obtain such a loan. Thus we have the historic irony of a populist-inspired tax system which actually serves to prevent any real broadening of the ownership of capital wealth.

The ESOP as it stands today goes part of the way toward restoring the rights of capital owners by permitting (in essence) corporate tax-free financing, as discussed earlier in this article. Dividend deductibility would carry the process one step further, by eliminating the corporate level tax on capital earnings paid out to the capital owners. Thus, a corporation which earned one million dollars and paid all of it out in dividends would pay no corporate level tax. This would still not solve the problem created by the *Dodge* doctrine, but it would be a step in the right direction.<sup>102</sup>

The IRS opposes this proposal of the ESOP Improvements Act on the grounds that it is a piecemeal approach to the overall question of the integration of corporate and personal income taxes now being studied, and that ESOP's should not receive

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<sup>100</sup> *Dodge v. Ford Motor Co.*, 204 Mich. 459, 170 N.W. 668 (1919).

<sup>101</sup> L. KELSO & M. ADLER, *THE CAPITALIST MANIFESTO*, *supra* note 7, at 210-213.

<sup>102</sup> Kelso's view of the corporation is best exemplified in Subchapter U of the Internal Revenue Code, added by the Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763. This chapter authorizes the creation of something called a “General Stock Ownership Corporation,” (“GSOC”). The GSOC would be a taxfree business operation, specially chartered by a state and owned by the citizens of that state on an individual basis, which is required to pay out at least ninety percent of its earnings in the form of dividends to its stockholders. Many non-Kelsonian economists agree that an economy where full dividend payout was the norm would operate its capital markets more efficiently, rather than having capital earnings tied up by corporate managements with an interest in having those earnings plowed back into their own companies. See J. BALLENTINE, *EQUITY, EFFICIENCY, AND THE U.S. CORPORATION INCOME TAX* (1980).

special treatment in this area.<sup>103</sup> The IRS position fails to recognize the ownership-broadening purpose of the provision. By limiting integration to ESOP's, the bill would tip the scales in favor of broadened ownership, in furtherance of a policy which ought to be central to American economic planning in the 1980's. The "overall integration" proposals now under consideration by the IRS would largely take the form of tax credits to individuals for dividends received; such a plan would set the existing distribution of capital wealth in concrete. Furthermore, the IRS ignores the important productivity impact of the proposal. If dividend payments to employees become "painless" they can be used as a sort of immediate cash bonus system tied directly to company earnings and to the employee's ownership stake in the company. More companies will be able to move toward the model pioneered by the Allied Plywood Corporation in Virginia, where workers receive generally three times as much in variable-level dividends and bonuses as they do in fixed wages.<sup>104</sup> This set-up leads to an unusually well-motivated workforce, as well as to a healthier corporate financial picture because of the lower fixed costs. It also provides insurance against layoffs, since the company can simply cut its dividends and bonuses in lean months.

The problem with the dividend deductibility provision in the bill is that it does not go far enough. For a one hundred percent ESOP-owned firm, the bill would be of great benefit, because it would become completely "painless" to pay out dividends. But in the much more common situation where the ESOP holds only a minority interest, the firm will still be reluctant to declare dividends because the majority of those dividends would not be deductible. The company could issue a separate class of stock to the Trust and simply pay dividends on that class to avoid this problem. This is a complicated and somewhat messy solution because among other things, it would raise new problems of valuing the stock. If the ESOP class of stock is more likely to receive dividends than the original class of stock, then it might well have an even higher value than the original class. How much higher? That would depend on the company's dividend-paying policies, which could change over time, thus changing the basis for the differing valuations between the two classes of stock. Furthermore, outside holders of the original class of stock might

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<sup>103</sup> *Hearings on Private Pension Plans, supra* note 74, at 216.

<sup>104</sup> *Hearings on H.R. 3056—Small Business Employee Ownership Act Before the Subcomm. on Access to Equity Capital and Business Opportunities of the House Comm. on Small Business, 96th Cong., 1st Sess. 34 (1979)* (statement of N. Kurland).



become justifiably upset if they saw the employee-owners being paid substantial dividends while they themselves were receiving little or nothing.

Another solution, which would require a change in the ESOP Improvements Act, would be to define an "ESOP company" as a company with a specified percentage of employee ownership, e.g., twenty percent (or, perhaps, twenty percent in 1981, to be increased by one percent each year thereafter for the next thirty years). For such companies, *all* dividends paid would be deductible. In addition to the advantages listed so far, this approach would also create a powerful incentive for existing owners to set up ESOP's to get dividend deductibility for their own stock. If Congress is not willing to go quite this far, it should at least consider amending the bill to provide for deductibility on stock distributed to terminating employees from the ESOP.

Yet another approach would avoid use of the term "dividend" altogether. There is nothing to prevent a company from paying a quarterly or monthly cash bonus to employees, the overall size of which would be tied in some way to company profitability, and taking a business expense tax deduction for the payment. If the IRS, however, determined that such payments were made substantially in proportion to the stock holdings of the employees, even within the ESOP, then in all probability the deduction would be disallowed because the payments would be treated as a constructive (or "sham") dividend. If the Internal Revenue Code were amended to permit the payment of such bonuses in proportion to employees' stakes in the ESOP, the double tax would be avoided by this somewhat circuitous route. Dividend deductibility would be a much "cleaner" approach, however.

3. *Tax free rollover*—Perhaps the most significant change that would be made by the ESOP Improvements Act is one that would have only a minimal revenue impact. Section 11 of the bill would provide for optional nonrecognition of gain on the sale of small business stock to an ESOP, if within eighteen months the proceeds are reinvested in the stock of another small business. The gain would not be recognized until the stock acquired with such proceeds had been sold. At that time, the gain would be measured from the shareholder's original basis in the shares sold to the ESOP. The treatment would be very similar to that of a homeowner who sells his house and buys another, and pays no tax until such time as he sells a house and fails to buy another.<sup>105</sup>

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<sup>105</sup> I.R.C. § 1034.

This bill would correct a serious injustice in the tax code which has created a very unhealthy situation. The principal owner of a closely-held small business, even a profitable one, frequently experiences difficulty in finding a buyer for his shares when the time comes to retire or to move on to another challenge. One option open to the owner is to merge into a conglomerate, taking conglomerate shares in return for his own; another option would be to sell the owner's shares to an ESOP, as described earlier in this article. The tax treatment of these two options is highly discriminatory in favor of going the conglomerate route. The seller, who pays no tax at the time of this transaction, gets a "tax-free rollover" as described above, and is not taxed until the sale of the conglomerate shares received in the exchange. By contrast, the owner who sells shares to an ESOP is taxed immediately. With such a difference in tax treatment, it is little wonder that there are so many more conglomerate mergers than there are sales to ESOP's.

While not all conglomerate mergers are necessarily bad, the questions raised by the recent House Small Business Committee Report on *Conglomerate Mergers—Their Effect on Small Business and Local Communities*<sup>106</sup> and other studies have strongly indicated that, at the very least, it is bad public policy to favor conglomerate mergers over sales to ESOP's. The ESOP Improvements Act would help to correct this discrimination. And because it is a deferral rather than a forgiveness of taxation, it would also have a very small revenue impact—only about \$25 million, according to the Treasury Department.<sup>107</sup> A case can be made that this one small change would represent a quantum leap in the attractiveness of the ESOP to the small businessman, and would cause the creation of thousands of new ESOP's. The ability to take money out of a corporation tax-free, coupled with the productivity and financing advantages of the ESOP, should make it almost irresistible to many open-minded small businessmen. Furthermore, the requirement that the proceeds be reinvested in another small business will create a large pool of capital actively searching for small businesses in which to invest, promoting yet another important public policy. Dollar-for-dollar, this proposal may prove to be the most powerful incentive that Congress could fashion to broaden the ownership of Ameri-

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<sup>106</sup> H.R. REP. No. 1447, *supra* note 48.

<sup>107</sup> Letter from John G. Wilkins, Deputy Dir., Off. of Tax Analysis, Off. of the Secretary of the Treasury, to Mr. Corey Rosen, Sen. Select Comm. on Small Business, February 22, 1980 (on file with University of Michigan Journal of Law Reform).

can capital in the 1980's.

There are two ways in which the attractiveness of this provision could be enhanced even further. One such way would be to permit rollover into a Small Business Investment Company ("SBIC") in addition to rollover into another small business. The SBIC<sup>108</sup> securities would provide a high degree of liquidity for the investor, and the flow of funds into SBIC's would be channeled into an increased capital pool for small businesses. Another, much more ambitious approach would be to permit rollover on the sale of *any* stock to an ESOP, if the proceeds are reinvested in a small business or an SBIC. Offering this advantage to stockholders of America's major corporations would put great pressure on those corporations to form ESOP's so that stockholders could take advantage of the rollover provision. It would also generate a tremendous flow of funds into the small business sector. Since small business creates the vast majority of new American jobs,<sup>109</sup> this capital influx could go a long way toward easing persistently high national unemployment.

Other bills were proposed in 1980 that would extend rollover treatment to *all* sales of small business stock, with appropriate reinvestment of proceeds.<sup>110</sup> Needless to say, the revenue impact of this proposal would be quite a bit larger—twenty-eight times larger, according to the Treasury Department.<sup>111</sup> Congress should restrict this favorable treatment to sales to ESOP's in order to maximize its value. Across-the-board rollover would do little if anything to broaden ownership, and broadening ownership, as the Joint Economic Committee has stated, must be an important priority in the 1980's.

## CONCLUSION

This article discussed six proposals regarding changes in the law affecting ESOP's, each of which has at least some merit. It is important to note, however, that each of them deals with a provision of *tax* law—either the tax qualification requirements of the ESOP, or additional tax incentives that might be offered to companies who set one up. The simple reason for this concentration is that the champion of ESOP on Capitol Hill has been Sen.

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<sup>108</sup> 15 U.S.C. §§ 681-94(b) (1976).

<sup>109</sup> 126 CONG. REC. S10020 (daily ed. July 28, 1980) (statement of Sen. Long).

<sup>110</sup> See, e.g., S. 653, 96th Cong., 2nd Sess. (1980).

<sup>111</sup> Memorandum to Joint Tax Comm. from Peter Davis (July 12, 1979) (on file with University of Michigan Journal of Law Reform).

Russell Long, former Chairman of the Senate's tax-writing committee. But the ESOP is not and was never intended to be primarily a tax gimmick. The ESOP is much more than that—it is a way of restructuring the system of capital credit so that it works with a degree of justice and efficiency unheard of today. Tax laws are only one element affecting the structure of the capital credit system. Ultimately, perhaps soon, the question of credit and who should get it will have to be dealt with in a more direct manner.

Ideally, tax laws should be designed to raise revenue, not to implement social policy. If it is a desirable social policy to restructure the system of capital credit so that more people may have access to it, then that policy should be implemented directly and not by tinkering with the tax laws. Part of the problem with using a more direct approach has been the mystique surrounding the term "credit allocation." Credit allocation is a pernicious doctrine, argues the Federal Reserve and others, that must never be allowed to creep into national policy. Yet the fact of the matter is that we already *have* a highly structured system for allocating capital credit. Simply put, capital credit is allocated to people who have the money to pay for it. People who do not fit into this category, as a general rule, cannot get it. The allocation system is quite rigid on this point.

Capital credit is quite different from other types of credit, *e.g.*, credit used to finance the acquisition of consumer goods and services. Unlike consumer credit, capital credit pays for itself. It therefore ought to be possible—even easy—to devise a method for extending it to people who lack the financial means to pay for it. Unfortunately, our present system of credit allocation works in the opposite direction, and channels capital credit toward the people who need it the least.

Such was not always the case. In the 19th century, when land represented the principal form of capital, America had a conscious policy of spreading access to the ownership of capital as broadly as possible. Had present thinking been prevalent then, the West would undoubtedly have been carved up into vast feudal estates owned by a handful of wealthy Easterners and Europeans. Instead, under the Homestead Act and the liberal land policies which preceded it, America became a nation of independent capital owning families, and achieved a prosperity unheard of prior to that time. An "Industrial Homestead Act" for the 1980's would have to focus on the central controller of the capital credit system, the Federal Reserve. By establishing a two-tiered discount rate, with a lower tier directed toward fos-

tering broadly-owned new capital, the Federal Reserve could move forcefully toward a re-allocation of capital credit along more rational lines.<sup>112</sup>

What are the prospects for the ESOP, and the broadened ownership movement of which it is a part, in the 1980's? The answer is far from clear. Russell Long will no longer be chairman of the Senate Finance Committee, where he was able to do so much to promote the cause. On the other hand, President Reagan during the campaign on at least one occasion stated the position as eloquently as anyone ever has:

Could there be anything resembling a free enterprise economy, if wealth and property were concentrated in the hands of a few, while the great majority owned little more than the shirts on their backs? . . . Could any country be a land of free men and women, where the pride and independence of property ownership was reserved to the few, while the majority existed in dependency and servility? It should be clear to everyone that the nation's steadfast policy should afford every American of working age a realistic opportunity to acquire the ownership and control of property in a growing national economy. . . . The nation's next president should call upon Congressional leaders like Senator Long to work with him to ensure that all Americans have a fair chance to become owners of property.<sup>113</sup>

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<sup>112</sup> See Kurland, *supra* note 94.

<sup>113</sup> Reagan-Bush Committee Memorandum, Oct. 31, 1980 (on file with University of Michigan Journal of Law Reform).