Prepared Statement of
J. Michael Keeling, CAE
President, The ESOP Association
To
Subcommittee on Financial Institutions
And Consumer Credit of
House of Representative
Committee on Financial Services

Hearing on Financing of Employee Ownership:
An Overview

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Statement of J. Michael Keeling, President, The ESOP Association
To Hearing of Subcommittee on Financial Institutions and
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Chairman Bachus, ranking member Congressman Sanders, and members of the Subcommittee. I am Michael Keeling, the President, or Chief Staff Officer, of The ESOP Association, a 501(c)(6) entity based in Washington, DC that represents over 2,400 members nationwide in both advocating for employee ownership through ESOPs, and in educating its members how to operate their employee ownership structure in a manner that maximizes company performance.

Your Subcommittee with jurisdiction over our nation's financing system goes to the roots of employee ownership through ESOPs.

To explain, using a deferred compensation plan recognized under our Federal tax laws to create employee ownership was perfected by the late Dr. Louis O. Kelso, who after years of agonizing over the suffering during the great depression, developed an economic theory to avoid the collapse of capitalism without turning to the oppressive system of Socialism, evidenced in the Soviet Union. Tax incentives for ESOPs were not, however, part of Dr. Kelso's original recommendations to create more owners in America. His core recommendations had to do with ensuring private lending institutions would be incentivized to grant employee ownership loans because of various Federal Reserve Board policies.

(There are tax incentives because his vision caught the imagination of the late Senator Russell B. Long, who served for years as chair of the Senate Finance Committee. As Senator Long often said, "Heck, the only reason there are tax incentives for ESOPs is because I was chair of the tax committee. If I had been chair of another committee, there would have been different incentives.") (Please See Attachment 1.)

So candidly, we ESOP and employee ownership advocates are today where we should be in the eyes of Dr. Kelso—we are before the Congressional committee that oversees our nation's financing system. And we are thankful and excited for this opportunity. We believe that your interest in employee ownership may open up a new chapter that hopefully leads to the 21st Century being the century of more equitable ownership.

My testimony will attempt to do the following:

One, share demographic information about ESOPs to explain who the ESOP companies are, and the trends over the past decade in terms of creating employee ownership through ESOPs.

Two, explain in more detail the common transactions that create ESOP, and some details about those transactions in terms of how they are structured.

Three, review, from my vantage point, the state of financing for ESOPs in America.

And finally, I will conclude with a statement why I believe employee ownership is a phenomena that will only become more prevalent, and why we need to get a handle on how employee ownership develops to help our people reach their potential.

First, though, let me make what is obvious clear. I believe in ESOPs and the vision of The ESOP Association.

Our Vision is "*We believe that employee ownership improves American competitiveness…that it increases productivity through greater employee participation in the workplace…that it strengthens our free enterprise economy and creates a broader distribution of wealth…and that it maximizes human potential by enhancing the self-worth, dignity, and well-being of our people.*

Therefore, we envision an America where employee ownership is widely recognized as a catalyst for economic prosperity…where the great majority of employees own stock in the companies where they work…and where employee ownership enables employees to share in the wealth they help create…

(Please See Attachment 2 that includes recent research highlighting the success of ESOP companies.)

Also, permit me to give a legalistic description of ESOPs, and the regulatory framework in which ESOP companies operate. ESOPs are tax qualified, deferred compensation plans that are primarily invested in employer securities, and unlike all other deferred compensation tax qualified plans, may, by statute, use borrowed funds to acquire the assets for the plans, the assets being employee securities.

Note that other tax qualified plans may, not must, be primarily invested in employer securities, but no other plan has the statutory green light to borrow money to acquire assets.

An example of tax qualified deferred compensation plans that have a similar structure to ESOPs are 401(k) plans. There are two classes of tax qualified deferred compensation plans: ESOPs, the 401(k)s, profit sharing plans, are all known as defined contribution plans. The other class is known as defined benefit plans, and are correctly referred to as pension plans.

All of these plans are governed by laws known as the ERISA laws, which is the set of U.S. laws that govern and regulate what is referred to the nation's retirement savings plans, or the so-called ERISA plans.

The primary Executive Branch regulators of ESOPs are the IRS and the Department of Labor's, Employee Benefits Security Administration. Nearly all ESOPs are audited by both of these agencies within ten years of ESOP creation to ensure that the complex laws and regulations governing ESOPs are complied with.

Of course, I could spend about eight hours describing all these laws and regulations governing ESOPs, but we are not here today for that purpose.

How many ESOPs are there, what kind of companies have ESOPs, and what trends have we witnessed?

I like to say that there are 10,000 corporations in America that sponsor employee ownership through an ESOP. You may see some figures including 11,000, or 12,500, or even 9,500, as frankly, no one really knows.

10,000 is a good number to stick with absent some major burst of ESOP creation as we saw in the mid-80's.

There are several reasons why it is not possible to know the true number of ESOPs; again, I could take at least an hour discussing this point.

Of the 10,000, I would estimate that 96 to 98% are sponsored by private companies, or companies that are not traded on any stock exchange. This mix is similar to the mix of the U.S. economy measured by the ratio of the public to private businesses.

Having said that, in the late 80's, there was a set of tax incentives that encouraged large public companies to set up ESOPs as their preferred tool of stock compensation. Those laws were changed in 1989, and in 1993 accounting standards were changed for ESOPs—a combination that motivated the large public companies to use either 401(k) plans to compensate employees with a stakehold in the company, or to use broad based stock option or stock purchase programs. Compensating employees with company stock, however, in one form or another, has been common in U.S. corporations since the 19th Century, long before the income tax laws.

Another point, if this nation decides that employee stock ownership is good, and should include a majority of Americans, as us ESOP advocates believe, then policies need to be developed that establish the best way to create employee owners in the large public corporations that employ nearly 50% of the American workforce.

As a side bar comment, federal laws since 1990 have promoted employee ownership in private companies, but not really in large public companies. While it is hard to argue that all the members of Ways and Means sat down in the late 80's and decided ESOPs were good in small private companies, and not so good in large companies, there is a definite image in the tax committees, and the labor committees of Congress, that employee ownership can create a very special environment in a workplace where management and non-management are up close and personal, but it is not so magical in companies operating around the world with thousands and thousands of employees. Let me assure you, however, there are leaders of large companies that reject with vigor the view that employee ownership is meaningless in their companies.

These 9,600 to 9,800 private ESOP companies are a little bigger than the average U.S. private company. We estimate based on our membership data probably those companies average 150 to 250 employees.

What kind of industries do these ESOP companies represent? Our data from a 2000 survey of our members indicates approximately 35% are manufacturing, 15% distribution, 12%

construction, 8% professional, and 7% services, with other industries represented by smaller numbers. We know that classifications are being altered, and fewer businesses are being labeled manufacturing. We also believe the number of ESOP companies in the service industry is growing, as this segment becomes a larger part of the American economy.

Why and how did these private ESOP companies come about?

Ever since the late 50's, when Dr. Kelso began to promote employee ownership, the most common reason for creating an ESOP has been to provide a buyer for an exiting shareholder of a private company.

Think about it, and any small business advisor will agree, at some point the owners of a private company have to convert their shares to cash, or as they say "take their chits off the table." The options for cashing in the stock of a private business are not particularly pretty—going public is out of the question for 80 to 90% of the small businesses because of size and culture, selling to a competitor can be very painful to someone who built a business from scratch, and liquidation is admitting failure. On the other hand, rewarding those who did so much to make the business a success, the employees, has a satisfying aspect. Since 1984, and enhanced in 1986, tax laws enacted by Congress make the ESOP exiting shareholder transaction the most favored of the ESOP transactions as measured by tax benefits. (Please refer to Attachment 3 for more information on the tax benefits related to ESOP exiting shareholders.)

As a result, our data indicates 75 to 80% of the ESOPs in America were created in what we call an exiting shareholder transaction.

The second most common transaction, and candidly in listening to Congressman Sanders' opening remarks, this transaction might be more direct to the concerns he has with American jobs being lost, is what we call the ESOP spin-off transaction. We have data that indicates about 20% of the ESOPs in America were ESOP spin-off transactions. For example, Congressman Sherman is familiar with such an ESOP company that used to be in his district — CPI, Inc., Chatsworth, California.

An ESOP spin-off transaction often follows this scenario: One day the plant manager gets a call from the home office of a big corporation saying, "You don't fit our strategic plan, or you don't make enough money," or something similar, and "We are putting you up for sale." After composing him or herself, the plant manager calls in the bookkeeper, or controller, to break the news, "We are on the block, and who knows what will happen to us." They talk, and will frequently say, "Boy, why can't we control our destiny, why can't we buy the company?" But, the two of them, or perhaps the top salesperson in addition, just do not have the credit or the cash on hand to buy such a business for $10 to $100 million dollars. So they say, "Let's talk to the union business agent," as often these are businesses that are unionized. So in come the union reps, and somehow or another the idea of employees and management buying through an ESOP develops. And it is done.

Now, there is a great deal of money spent, and blood, sweat and tears before the ESOP buys the plant, and today I think you will hear stories where the financing just did not work, as sometimes these plants are also in financial distress.

And while the majority of these 200 or so ESOP spin-off transactions per year do not involve a plant in distress, when it does, there can be trauma in the local community, and often the lenders insist on pay cuts and benefit cuts to help finance the ESOP.

Sometimes diversified 401(k) assets are used to help finance the purchase of the new corporation's stock, or rarely, but it has happened, pension plan assets are used. (This is a risky step under ERISA by the way.)

Let me note that when there is direct and immediate economic pain for employees in exchange for owning the company, the company will have a very big hurdle to get the majority of employees comfortable with employee ownership. The negativism about the employees owning the company through an ESOP will grow if after a few years business looks better, but wage and benefit concessions are not restored.

My last statements, by the way, can be applied to any analysis of United, Polaroid, Weirton, and many other unhappy ESOP stories, including Vermont Abestoes, to a degree.

And for the other 5% of the ESOP transactions that are out there, we just put them in the miscellaneous category. For example, the United ESOP creation does not fit into either of the two major categories, nor do the remaining handful of pure ESOPs in large public companies.

But we are reviewing financing, and how do common ESOP exiting shareholders transactions get financed?

Well, the financing for the vast majority of exiting shareholder ESOPs, is usually pretty simple, with the understanding that the sale of the major block of stock, particularly those having to comply with ERISA, tax, and general business law, can become very complex. Usually, the decision to create an ESOP exiting shareholder transaction involves the corporation going to a regular bank, taking a loan of less than $10 million, loaning that money to the ESOP, and the ESOP using the money to purchase the stock from the exiting shareholder. In smaller companies, the seller shareholder often guarantees the loan in addition to the corporation's agreement to pay.

Certainly, as the value of the transaction goes beyond $10 million, and we have seen ESOP exiting shareholder transactions in some cases go up to $100 to $150 million, you might have mezzanine financing in addition to the prime lender, and maybe even an investment banking firm that specializes in being a partial investor in an employee-owned structure. The remaining management may invest money in transactions of the size referenced.

Since a spin-off transaction might involve a business in trouble, another source of funds, might be local execs of the distressed company taking second mortgages, borrowing on credit cards, and the like, to help finance the purchase of the company. Also, in a distressed buyout, state economic development funds, are available, or the state can guarantee the loan. Sometimes funds for the key due diligence needed to convince other lenders to loan to the employee group comes from a state agency.

Let me note also, a unique lender to ESOPs, in both exiting shareholder transactions, and spin-off transaction, is the National Co-op Bank, or its affiliates. I believe the Co-op Bank somehow falls under the jurisdiction of this committee.

Before talking about whether money is available for ESOP transactions, let me note that there are really two ways to borrow money to purchase stock for an ESOP. And here, unfortunately, I might get into some insider baseball ESOP jargon. What we saw in the 1974 through 1986 timeframe were transactions that were not technically “leveraged” ESOPs, which means the ESOP was not a party to a borrowing transaction. The Association chair, George Ray, on the next panel, will give an example of the non-leveraged ESOP transaction. In this transaction, the company borrows money, buys stock from the exiting shareholder usually, puts the stock in the treasury of the corporation, and each year makes a contribution to, really, an old-fashioned stock bonus plan, which the law has sanctioned since 1921, that has value by creating a tax deduction more or less equal to the annual payment to the lender. I would say, and I feel comfortable in saying this, in 1984, out of the then 350 or so ESOP companies members of the Association, 80 to 85% were non-leveraged ESOPs.

Then, in 1984, and even more so in 1986, Congress created a slew of tax incentives for doing a leveraged ESOP. Some of these incentives were repealed or curtailed in the late 80’s and early 90’s. Attached is a summary of the current law tax incentives that are available for a leveraged ESOP. So, since 1986, our data shows that nearly 80% of our Association’s members are leveraged ESOPs, or if they have paid off their debts, leverageable ESOPs.

What is meant here is that the ESOP obtains the block of stock all at once with borrowed funds that attaches debt to the stock that is held in suspense by the ESOP. As debt is paid, shares are released to the employee’s accounts. The release is based on the acquisition cost of the shares, so with a leveraged ESOP, the employees gain the boost in share value as the leverage goes down, just like the Wall Street LBO dealmakers. (Please refer to Attachment 4 on ESOP Financing.)

On the other hand, as we see the capital gains tax rate go down, we may begin to see the 1974 to 1984 style ESOP come back, where the corporation takes the leverage, and the employees get the shares allocated not at the acquisition price, but at the market price. The non-leveraged ESOP has had fewer legal hassles compared to the leveraged ESOP under ERISA.

Is there money available for ESOP transactions? Please note my vantage point—most of the ESOP companies I deal with already have an ESOP, and are very successful companies, candidly, both before and after the ESOP was created.

But, I’ve been working with ESOP and ESOP situations since 1982. In the early 80’s up until the mid-80’s, it was not uncommon to get calls from lawyers, business advisors, and company executives, trying to do the basic ESOP exiting shareholder transaction, asking me, "where can we get financing?"

As the basic ESOP law has stabilized over the past decade, and as the outstanding track record of the vast majority of ESOP private companies becomes more obvious, most lenders, or many a bank, is willing to make ESOP loans.

Bluntly, I no longer get calls saying, "Where can I get money?" If I do, maybe one every two or three years.

I do know, however, that in the spin-off transactions, one does see problems with getting money for the feasibility and due diligence work that needs to be done to convince any lender to make a loan. I believe the other panel members will review some of these situations in more detail.

Before concluding, one cutback in law in 1989, and then another in 1995, did hurt the financing of ESOPs in general, and these spin-off transactions specifically, where perhaps underwriting a loan has more risk.

From 1984 until 1989, a lender could exclude 50% of its interest income from an ESOP loan from its (the lenders) federal income. From 1989 to 1995 the lender could exclude 50% of its interest income from federal taxes if the ESOP owned 50% or more of the company. You can imagine the lenders liked these tax incentives, and in the real world, competition among banks to do ESOP loans caused banks to offer loans at rates lower than similar loans to non-ESOP corporations. But the tax committees, needing revenue, thought this tax break for banks was inappropriate in the name of employee ownership.

May I also add we ESOP advocates believe that the accounting standards hinder ESOP financing, as the standards create balance sheets and income statement too different from the cash flow statements.

As with any business, financing issues for an ESOP company does not end with the creation of the ESOP.

The ESOP companies that are private, which are nearly all ESOP companies, have a unique financing issue – an obligation that grows bigger and bigger as the ESOP company matures, to convert the employees' stock to cash. We call this "repurchase obligation." Let us be clear. We want every employee to get fair market value for her or his stock when she or he leaves the company. But facts are facts – the majority of ESOP companies are so successful buying back the shares can after 5, 10, 15, 20 years can drain the company at the wrong time of needed capital. Financing this obligation currently is done out of cash flow, from cash contributed to the ESOP over ten years, or corporate owned life insurance, which of course is controversial. Some ESOP advocates speak of the need to create a semi-public fund to assist companies finance their repurchase obligations.

Finally, let me say again I am a believer in ESOPs. I believe the ESOP is the most efficient tool for creating employee ownership, and can be used by companies with a variety of cultures. In other words, the ESOP can do what we want with our drive to create a more equitable economy, to create a more humane workplace, and to enhance the potential of each individual without relying on a one-shoe-size-fits-all model.

Having said that, The ESOP Association has always prided itself in being reasonable and malleable in all of our public policy positions. I think you would hear that from our friends on the Ways and Means and Finance Committees—passionate, hard charging, yes, but reasonable when it comes to accepting that times change and laws change. As long as we are pointed in the direction of more employee ownership, we ESOP advocates will not fall on our swords over details.

And, the importance of getting it right for employee ownership is huge in my opinion. While what I am about to say might be more appropriate before the Education and Workforce Committee, I think the thought transcend any Congressional committee jurisdiction.

Think about it: Less than 160 years ago, in our own nation, sadly and tragically the relationship between owner and worker was often defined as owner-slave. At the turn of the 20^{th} Century, if a man or woman belongs to a labor union, often he or she was beaten, or denied work. Less than 60 years later, the relationship between management and organized labor dominated how labor in all workplaces was treated in terms of pay and benefits. But then fifty years later, in 2000, less than 11% of the private work force belonged to labor unions, and with the growth of what Peter Drucker labels as the knowledge worker, there is no reason to expect this to change, absent new developments in the world of work.

So, what is the message? The message is that anyone who thinks that the relationship of owner, employee and capital remains the same, or that it can be reconstituted as it was even 25 years ago, that person just doesn't understand what is happening in the world of work.

Whether you agree with his politics, or his recommendations for tax laws and health care laws, I believe that Chair Bill Thomas said it best in the opening remarks he made on April 11, 2001, during the House consideration of the Enron-ERISA reaction legislation. I believe the basic statement is unassailable. He said,

"There has been a quiet revolution going on in the United States, and it was so quiet that a lot of people did not notice…The quiet revolution that I am talking about is the change that has occurred over the last half century, speeding significantly in the last third of the 20^{th} century…that is…there is becoming less and less of a distinction between workers and owners. As…more and more companies are being owned by the workers."

So, distinguished members of the Subcommittee on Financial Institutions and Consumer Credit, you are right to say let's make sure that this trend of more employee ownership is financed properly, and that everyone, not just the tax committees, and the labor committees, get with the trend of growing employee ownership; and let us have the legal, financial, and accounting system that makes the Vision of ESOP advocates a reality.

Attachment 1
Advantages for Business Planning

Introduction

In order to broaden the ownership of capital to provide employees with a stake in the ownership of their employing corporation and to provide a unique means of financing to corporations, Congress has granted a number of specific incentives meant to promote increased use of the ESOP concept. This is especially true for leveraged ESOPs, which through the use of borrowed funds provide a more accelerated transfer of stock to employees. These ESOP incentives provide numerous advantages to the sponsoring employer and can significantly improve corporate financial transactions. In 1997, Congress also created a unique tax incentive for S Corporations sponsoring ESOPs

Deductibility of ESOP Contributions

As with all tax-qualified employee benefit plans, contributions to ESOPs are tax deductible to the sponsoring corporation, up to certain limits. These contributions can be either in cash (which is then used by the ESOP to buy employer securities) or directly in the form of employer securities. Where employer securities are contributed directly, the employer may take a deduction for the full value of the stock contributed. By doing so, the employer actually increases its cash profits by the value of the taxes saved through the deduction.

The deductibility of contributions to an ESOP becomes even more attractive in the case of a leveraged ESOP. Under this arrangement, an ESOP takes out a cash loan from a bank or other lender, with the borrowed funds being paid to the sponsoring employer in exchange for employer securities. Since contributions to a tax-qualified employee benefit plan are tax deductible, the employer may thereafter deduct contributions to the ESOP that are used to repay not only the interest on the loan, but principal as well. This makes the ESOP an attractive form of debt financing for the employer from a cash flow perspective. Each year, the company can deduct contributions of amounts up to 25% of covered payroll, plus any dividends on ESOP stock (see "Deductibility of Dividends" below) that are used to repay the loan. Further, any contributed amounts used to repay the interest on the loan are deductible without any limit at all. [In an S corporation structure, the deduction would be limited to 25% of the plan sponsor's eligible payroll].

C Corporation ESOP Incentives*

<u>ESOP Tax Deferred Rollover, or I.R.C. 1042 Transaction</u>

An additional ESOP incentive available in C Corporation allows a shareholder, or shareholders, of a closely held company to sell stock in the company to the firm's ESOP and defer federal income taxes on the gain from the sale. In order to qualify for this "rollover," the ESOP must own at least 30% of the company's stock immediately after the sale, and the seller(s) must reinvest the proceeds from the sale in the securities of domestic operating corporations within fifteen months, either three months before, or twelve months after the sale. The seller, certain relatives of the seller, and 25% shareholders in the company are prohibited from receiving allocations of stock acquired by the ESOP through a rollover. Generally, the ESOP may not sell the stock acquired through a rollover transaction for three years.

The ESOP rollover provides a substantial tax advantage that might otherwise be unavailable to current or retiring owners of C Corporations. Normally, a direct shareholder's options would be to sell shares back to the company, if such a transaction is feasible, or to sell out to another company, either for cash or for a block of shares in the other company. Selling to an ESOP, on the other hand, allows the seller to exchange interest in the company for a safely diversified portfolio of securities--or the stock of a single new company--without paying any taxes on the transaction. The seller's tax basis in the employer stock which were sold will be carried over to the replacement property. If the replacement property is held until death, however, a stepped-up basis for those securities is provided under current established tax laws.

In addition to the substantial tax advantages, selling to the ESOP preserves the company's independent identity. A sale to an ESOP also provides a significant financial benefit to valued employees and can assure the continuation of jobs. Moreover, selling to an ESOP allows the seller to sell all or just a part interest in the company, and to do this gradually or all at once.

To qualify for rollover treatment, the stock sold to the ESOP must be common or convertible preferred stock of a closely held domestic corporation and must have been owned by the seller for at least three years.

Often this type of transaction is referred to as a 1042 transaction, because Internal Revenue Code Section 1042 establishes this unique tax benefit.

Deductibility of Dividends

Employers structured as C corporations are also permitted a tax deduction for certain dividends paid on ESOP stock. The deduction is available for dividends paid in cash to employee. Beginning January 1, 2002, the deduction is available for dividends on ESOP stock the individual elects to reinvest back to the plan for more company stock. This provision allows companies to share current benefits of stock ownership with their employees to complement the long-term benefits of capital ownership. Dividends paid to employees are taxable as current ordinary income to employees.

A deduction is also available for dividends paid on ESOP leveraged stock to the extent that the dividends are used to reduce the principal, or pay interest on an ESOP loan incurred to buy that stock. Dividends used in this manner are not counted towards the 25% contribution limit for leveraged ESOPs. Some ESOPs have purchased convertible preferred stock rather than common stock to assure a relatively reliable stream of dividend income to be used in servicing the loan.

These tax-deductible ESOP dividends are sometimes referred to as 404(k) dividends, because Internal Revenue Code section 404 (k) established this unique tax incentive.

*A C Corporation is liable for federal income tax imposed on the corporation's taxable income

S Corporations*

Beginning in 1998, when an ESOP is a shareholder of a S Corporation, the federal tax or its share of its S Corporation sponsor's taxable income is deferred until distributions to the ESOP participants. This statutory provision means that an S Corporation owned 100% by an ESOP pay no current federal tax on its income. And, even if not 100% owned by an ESOP, the S corporation with an ESOP is able to have long-term deferral of federal taxes as its income pro-rated to the ESOP. [Note, complex anti-abuse rules govern this unique ESOP incentive, and close review is required before utilizing the incentive].

*The individual shareholders of an S Corporation are liable for federal tax on each pro-rated share of the S Corporation's taxable income – i.e. there is no federal corporate income tax on S Corporation taxable income.

For further information on any of the aforementioned research, please contact The ESOP Association at 202-293-2971 or via email esop@esopassociation.org

Attachment 2

Employee Ownership and Corporate Performance

1. The most comprehensive and significant study to date of ESOP performance in closely held companies was conducted by Dr. Joseph R. Blasi and Dr. Douglas L. Kruse, professors at the School of Management and Labor Relations at Rutgers University, and funded in part by the Employee Ownership Foundation. The overwhelmingly positive and remarkable results indicated that ESOPs appear to increase sales, employment and sales/employee by about 2.3% to 2.4% over what would have been anticipated, absent an ESOP. According to Dr.'s Blasi and Kruse, ESOP companies are also more likely to continue operating as independent companies over the course of several years. In addition, it is substantially more probable that ESOP companies have other retirement-oriented benefit plans than comparable non-ESOP companies.

2. In 2002, The Employee Ownership Foundation, conducting its 11th Annual Economic Performance Survey, found that approximately 71% of ESOP Association company respondents had outperformed both Dow Jones Industrial Average (DJIA), as well as the NASDAQ, in 2001. In addition, for the 11th consecutive year, a majority of surveyed ESOP companies cited an overall increase in productivity and performance, as well as reported that ESOP implementation was a good decision for the company. This survey was conducted in summer 2002 among corporate members of The ESOP Association.

3. Research done by the Washington State Department of Community, Trade and Economic Development of over 100 Washington not publicly-traded ESOP companies compared to 500 not publicly-traded non-ESOP companies showed that the ESOP companies paid better benefits, had twice the retirement income for employees, and paid higher wages than their non-ESOP counterparts. Wealth and Income Consequences of Employee Ownership: A Comparative Study from Washington State, Kardas, Peter A., Scharf, Adria L., Keogh, Jim, November, 1998.

4. Research conducted by Professor Hamid Mehran, while he served on the faculty of the J.L. Kellogg Graduate School of Management, Northwestern University, of nearly 400 publicly traded companies with significant ESOPs both before and after the adoption of the ESOP, compared to non-ESOP companies in similar lines of businesses, showed that the rate of return for the ESOP companies was 2.7% higher, 60% of the ESOP companies experienced share price increases upon announcement of the ESOP program, and 82% indicated that the ESOP had a positive impact on business results.

5. In 1995, Douglas Kruse of Rutgers University examined several different studies between ESOPs and productivity growth. Kruse found through an analysis of all studies that "positive and significant coefficients [are found] much more often than would be expected if there were no true relation between ESOPs and productivity." Kruse concludes that "the average estimated productivity difference between ESOP and non-ESOP firms is 5.3%, while the average estimated pre/post-adoption difference is 4.4% and the post-adoption growth rate is 0.6% higher in ESOP firms. Kruse cites two studies as part of his research: Kumbhakar and Dunbar's 1993 study of 123 public firms and Mitchell's 1990 study of 495 U.S. business units in public firms. Both reports found significant positive effects of greater productivity and profitability in the first few years after a company adopted an ESOP.

6. In 1995, the U.S. Department of Labor released a study entitled "The Financial and Non-Financial Returns to Innovative Workplace Practices: A Critical Review." This study found that companies that seek employee participation, give employees company stock and train employees can positively affect American corporations' bottom lines. In addition, the report cited three studies that analyzed "the market reaction to announcements of ESOPs which found significant positive returns to firms which implemented ESOPs as part of a broader employee benefit or wage concession plan." The three studies are: Chang's 1990 "Employee Stock Ownership Plans and Shareholder Wealth: An Empirical Investigation"; Dhillon and Ramirez' 1994 "Employee Stock Ownership and Corporate Control"; and Gordon and Pound's 1990 "ESOPs and Corporate Control." citation at (202) 293-2971 or E-mail: esop@esopassocation.org.

For further information on any of the aforementioned research, please call The ESOP Association at 202-293-2971, visit www.esopassociation.org, or via e-mail esop@esopassociation.org.

Attachment 3

The ESOP Tax-Free Rollover, Or 1042 Transaction for C Corporations

One of the most effective tax provisions passed to encourage the growth of ESOPs is the tax-free rollover, allowed to certain shareholders or groups of shareholders in privately-held companies who sell stock to an ESOP. Note, this tax provision is available only if the stock involved is stock of a C Corporation.

This issue brief provides a summary of the mechanics and rules of the tax-free rollover and related matters. (Often referred to as a 1042 transaction, after the Internal Revenue Code Section that governs the transaction.)

Why Sell To An ESOP?

A retiring owner, or shareholder of a privately-held C Corporation who wishes to sell his or her stock, faces some potentially unwelcome choices. Often the seller is forced to choose between selling to outside investors, if any are available; exchanging stock with another company in a merger; or selling stock back to the company, if such a transaction is feasible.

None of these options is taxed as favorably as a sale to an ESOP. And unlike a sale to an ESOP, any other choice may result in unwanted consequences for the company's independent existence and the jobs of employees. A rollover sale to an ESOP establishes a market for future selling shareholders, rewards current employees, and maintains the independence and local ownership of the business. A sale to an ESOP allows an owner to sell out gradually, withdrawing from the business to whatever extent desired, or quickly.

Structuring An ESOP Rollover

A shareholder who sells qualified securities to an ESOP incurs no taxable gain on the sale if two conditions are met. First, immediately after the sale the ESOP must hold either 30% of each class of outstanding stock of the corporation or 30% of the total value of all classes of outstanding stock issued by the corporation. Second, within a 15-month period beginning three months prior to the date of sale, the seller or sellers must purchase qualified replacement property. If the cost of the replacement property is less than the amount derived from the sale of securities to the ESOP, the difference is currently taxable.

For purposes of meeting the 30% requirement, sales of qualified securities by two or more parties may be treated as a single sale if these sales are part of a single transaction. Once the 30% requirement is met, a shareholder who sells any amount of stock to the ESOP in the future is eligible for the tax-free rollover.

The rollover must be elected in writing on a timely filed tax return for the taxable year of the sale. Temporary Treasury Regulations Section 1.1042-1T sets forth the procedure for making the "statement of election" of tax-free treatment and the "statement of purchase" of the new securities.

The seller's basis in the new securities will be adjusted by the amount of gain not recognized as a result of the election. Also, the holding period of the employer securities is "tacked on" to the holding period of the replacement securities. In other words, if the seller bought or received company's stock in year 1 at $10 per share, and sells it to an ESOP in year 10 at $100 per share, the taxable basis in the replacement property is reduced from $100 to $10, and the seller is considered to have held that replacement property for 9 years, for tax purposes. If the replacement securities purchased with that $100 then rises in value to $200 over the next six years and are sold in year 15, the taxable gain is $190, not $100, and the seller will be considered to have held those shares for 15 years, not six years.

Thus the ESOP rollover allows a selling shareholder to defer, not eliminate, taxes on the sale, enabling the seller to invest and earn with money that would have been taxed away. If the replacement property should go into the seller's estate, however, then its basis will be "stepped up" to the property's current value, and the tax on the sale will effectively have been eliminated.

Defining Some Terms

Two technical phrases need to be defined. These are "qualified securities" and "qualified replacement property".

"Qualified securities" are those securities that may be sold to an ESOP. In a privately-held company these include common stock of a C Corporation with voting and dividend rights equal to the classes of common stock having the greatest voting and dividend rights, which is issued by a domestic corporation with no outstanding securities readily tradable on an established securities market. The securities must have been held by the seller for at least three years and cannot have been received by the seller in a distribution from a qualified retirement plan or a transfer under a stock option granted by the company.

"Qualified replaced property" includes any security issued by a domestic (or U.S.) operating corporation that is not the corporation that issued the qualified securities that were sold to the ESOP (or a member of the same controlled group of corporations), and which does not receive more than 25% of its gross receipts during the taxable year in which it is purchased from passive investment (this requirement disqualifies mutual funds). Government securities, and securities acquired by an underwriter, do not qualify. An operating corporation is one whose assets are used in the active conduct of a trade or business. Passive investment income has the same meaning as under the S corporation rules. The replacement securities must be acquired by purchase. Securities acquired by way of gift, inheritance, or property transfer pursuant to a stock dividend don't qualify.

When qualified replacement property is sold, the gain is currently taxable, and may not be deferred by selling to another ESOP, and investing in new qualified replacement property.

<u>Restrictions On The ESOP Stock</u>

No portion of the assets attributable to qualified securities sold to an ESOP through a tax-free rollover may be allocated to the taxpayer seeking tax-free rollover treatment, any person who is related to that taxpayer, or any other person who owns more than 25% of the value of any class of qualified securities of the issuing corporation. If the ESOP disposes of the acquired employer securities within three years after acquiring them, a 10% excise tax is imposed on the employer. The excise tax applies if the total number of shares held by the ESOP is less than before the disposition, or if the value of the ESOPs's share of the company ceases to meet the 30% requirement.

For further information on any of the aforementioned research, please contact The ESOP Association at 202-293-2971 or via email esop@esopassociation.org

Attachment 4
ESOP Financing

Introduction

Using an ESOP in conjunction with debt financing has so many unique characteristics that it is called "ESOP financing." In this issue brief, some of the basic characteristics of ESOP financing are discussed and compared with conventional debt financing. In many financing situations, ESOPs have very desirable advantages.

An ESOP qualified under Sections 401(a) and 4975(e)(7) of the Internal Revenue Code is the only type of employee benefit plan which may be used to borrow money, provided that the loan is primarily for the benefit of the participants, the interest rate is reasonable and the only collateral the ESOP offers is the qualifying employer securities purchased with the loan proceeds. The general outline is simple: the ESOP borrows money and purchases an agreed upon number of shares at their fair market value from the employer or existing shareholders. The shares purchased with the borrowed funds are placed in a suspense account, and may be used as collateral for the loan. As the loan is repaid, the shares in the suspense account must be released from pledge, and allocated to individual employee accounts on a pro rata basis.

In the basic leveraged ESOP three different structures are possible. In the first case, the ESOP simply gives a note to the lender. This note is usually accompanied by a guarantee from the employer that it will make contributions to the ESOP sufficient to enable it to amortize the loan, and may be secured by a pledge of the ESOP's newly acquired shares, or, if the lender requires it, a pledge of the corporation's assets.

Second, if the lender prefers, the loan may be made directly to the corporation, and the corporation may then make a "substantially similar" loan to the ESOP. This may reassure some lenders who are uncomfortable about lending directly to ESOPs.

A third alternative involves the company making the loan, but instead of reloaning it to an ESOP, the company simply sets up a non-leveraged ESOP and makes contributions of stock to it over the years of loan repayment which equal the amount of the loan payment. This allows the company to receive the cash flow benefits of ESOP financing below and also results, in a company with a rising value in the ESOP, holding a smaller percentage of the company at the end of the loan repayment than in the first two cases.

All three of these alternatives share the cash flow benefits of ESOP financing that are described below.

The Cash Flow Benefits of ESOP Financing

The most fundamental characteristic of ESOP financing is that it increases the total cost of borrowing but significantly decreases the cash cost of borrowing. This results from the fact that principal payments as well as interest payments are deductible when repaying an ESOP loan, and that ESOP financing involves transferring employer stock to the ESOP.

A brief example will serve to illustrate the cash flow benefits of ESOP financing. Suppose a company, taxed at the 35% rate, wants to borrow one million dollars. The firm arranges conventional financing at 10% interest and makes annual equal principal payments over five years. In exchange for $1 million, the corporation assumes debt repayment obligations which look like this:

Conventional Debt Case
(1000s)

	(1)	(2)	(3)	(1+2+3) After-Tax Cash
Year	Principal	Interest	Deduction	Cost
1	$200	$100	($35)	$265
2	$200	$80	($28)	$252
3	$200	$60	($21)	$239
4	$200	$40	($14)	$226
5	$200	$20	($7)	$213
Total	$1000	$300	($105)	$1195

In contrast, if the company had used a leveraged ESOP to accomplish the same purpose, its repayment obligations would look like this:

ESOP Financing Case
(1000s)

Year	(1) Principal	(2) Interest	(3) Deduction	(1+2+3) After-Tax Cash Cost
1	$200	$10	($105)	$195
2	$200	$8	($98)	$182
3	$200	$60	($91)	$169
4	$200	$40	($84	$156
5	$200	$20	($77)	$143
Total	$1000	$300	($455)	$845

What is not shown in the chart above is in the ESOP financing case the ESOP ends up with $1 million in stock. Thus, the total after-tax cost of the ESOP financing is $1,845,000 as opposed to $1,195,000 for the conventional debt, but the after-tax cash cost of the ESOP financing case is only $845,000, less than the face value of the loan.

From a lender's perspective that is $350,000 pre-tax dollars the company does not have to earn to repay the loan. In other words, ESOP financing makes a company better risk for a lender, because the loan is amortized entirely with pre-tax dollars, which enhances the company's ability to repay the debt considerably.

Conclusion

ESOP debt will lower net earnings and net profits during the period of loan amortization because the cost of interest plus principal plus ESOP contribution exceed the interest and principal payments of conventional financing. Cash flow, however, is greater than it would have been with conventional debt financing; thus an ESOP loan enhances a company's debt servicing ability.

For further information on any of the aforementioned research, please contact The ESOP Association at 202-293-2971 or via email esop@esopassociation.org