ESOPs Before and After the Revenue Reconciliation Act of 1989

An Honors Thesis (HONRS 499)

by

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**Introduction**

Employee stock ownership plans have gained attention in the past few years due to the many corporations that have put these qualified plans into use. ESOPs are contribution plans that invest primarily in the employer’s securities and are used by employers as financing vehicles. When an ESOP is put into use the employer, first, borrows funds from a financial institution. The employer then guarantees the debt or commits to contribute amounts to an ESOP to cover the debt. As the loan is repaid, the shares are allocated to individual employee accounts. Studies have indicated that the total worth of worker-owned stock in public corporations exceeds $150 billion which demonstrates how popular ESOPs have become.

ESOP programs have many appealing features for a corporation that uses them. First of all, ESOPs offer tax breaks to the corporation. (Groves 1990) Also, substituting these stock plans can reduce the cash compensation that the corporation must pay to its employees which keeps the lid on labor costs. Stock can be used to fund bonuses, pension and savings plans and even for retirement medical plans. In times when cash is unavailable, ESOPs offer another incentive to the employers. ("The Real Strengths of Employee Ownership" 1991) ESOPs make companies more competitive, increase productivity and raise morale when wage increases are not available. Studies have shown that two-thirds of the members of ESOP programs have improved productivity after the ESOP was introduced.
(“The Real Strengths of Employee Ownership” 1991) ESOPs also help prevent hostile takeovers of the corporation. These programs put the stock into friendly hands of the employees instead of selling the company to foreigners which lowers the potential for a takeover attempt. (Parham 1991) Finally, and one of the most important aspects, is the fact when workers own a significant share of their company, they want a voice in what happens in the corporation. In this respect, ESOPs reduce worker apathy and encourage the workers to give 100 percent because they have a stake in what happens. (“The Real Strengths of Employee Ownership” 1991) These factors and others have contributed to the increase in popularity in ESOPs.

**ESOPs Before the RRA of 1989**

ESOP financing was quite different before the Revenue Reconciliation Act of 1989. Many more tax benefits were offered to the sponsors and the corporation which caused an explosion of companies introducing such plans. These corporations introduced ESOPs to preclude hostile takeovers and to take advantage of the tax benefits offered by them. One of the attractive tax features of ESOPs before 1989 was that the sponsor had the ability to deduct both the principal and the interest on an ESOP loan. Certain lenders were able to exclude 50% of the interest received on loans to ESOPs used to acquire employer securities from their income. The intended purpose of this provision was to make it possible for an ESOP to lower its effective rate of interest on loans to fund retirement benefits
with cash rather than stock contributions. These lower rates were possible since the lender could exclude 50% of the interest received. The lenders would usually pass a portion of the tax savings to the borrower. (Welytok 1990) Financing on favorable terms due to the 50% interest exclusion given to qualified lenders was a strong incentive for corporations considering an ESOP.

Another tax advantage that was offered to ESOPs was the corporation was allowed to deduct dividends paid on stock held by an ESOP under Section 404(k)(2)(c) to the extent such dividends were used to repay the ESOP loan. Where dividends were used to service debt on ESOP loans used to acquire ESOP stock, the dividends could be declared in amounts beyond the maximum allowable payroll-percentage-based contributions. (Welytok 1990)

Section 1042 exclusion was allowed for ESOPs which let shareholders in private corporations defer gains on certain sales of their stock to an ESOP if the taxpayers invested the proceeds from the sale of such "qualified securities" in the securities of a domestic corporation. (Groves 1990) This provision and the other previously mentioned made ESOPs before 1989 quite attractive and encouraged many corporations to implement such plans.

**ESOPs After the RRA of 1989**

ESOPs after the Revenue Reconciliation Act of 1989 were limited on the tax benefits offered to the corporations and qualified sponsors. This
legislation was enacted partly because of Congressional concerns that participants in ESOPs were not benefiting from some of the significant tax breaks available to such programs. Congress also felt that the revenue loss due to those tax breaks had increased more than was originally anticipated. Consequently, Congress reduced many of the tax benefits associated with ESOPs. (Lee 1990) Section 7301(a)(b) and (c) of the Revenue Reconciliation Act of 1989 amended Section 133(b) to make it more difficult for ESOPs to qualify for the benefits listed above.

Partial Interest Exclusion

Of the limitations imposed by Congress, one of the most detrimental was the one dealing with the 50% interest exclusion. A qualified lender may only use the 50% interest exclusion from income on interest received from loans to ESOPs if several conditions are met. First of all, immediately after the acquisition of the securities, the ESOP must own more than 50% of each class of outstanding stock. (Welytok 1990) Prior the the Revenue Reconciliation Act of 1989 there was no such rule. The new 50% ownership guarantees that the ESOP will hold a major percentage of the stock. Any period in which the ownership falls below 50%, the interest exclusion will be disallowed. Secondly, the term loan may not exceed fifteen years. Furthermore, participants must be allowed to direct how to vote the employer securities acquired with the loan which increases their right of ownership over the stock. (Welytok 1990)
Excise Tax for ESOP Loan

The Revenue Reconciliation Act of 1989 added Section 4978B(c) which imposes an excise tax on certain dispositions of securities acquired with the proceeds of a loan from a qualified lender. An ESOP will be taxed on any disposition made within three years of the acquisition of the securities if either the total number of employer securities it holds after the transfer is less than the number held after the acquisition, or the value of the stock it holds after the transfer is less than the number it held after the acquisition. (Zuckerman and Fife 1990) The excise tax will also be imposed when the employer securities are disposed of before being allocated to the participants’ accounts unless disposition is required to meet plan diversification requirements or is forced by state law. The excise tax is 10% of the realized amount on the disposition to the extent allocable to the subject transaction. If the amount realized cannot be determined, the tax base will be equal to the fair market value of the securities on the date they were sold. (Welytok 1990)

Deduction for Dividends Paid on ESOP-Held Securities

A limitation on the dividend deduction was imposed in 1989. The deduction of dividends used by ESOPs to repay acquisition loans by the corporation may only be used if the dividends that are used are those that were declared on the stock acquired by the loan. Then the dividends must meet further requirements. First, the dividends must be paid in cash to the plan’s participants or beneficiaries. The dividends can be paid no later
than 90 days after the close of the plan year in which the distribution occurred, or the dividends were used to make payments on loans used to acquire employer securities. The dividend deduction is usually allowable in the tax year of the corporation in which the dividend is distributed. If the dividends are used to repay the loan made to acquire employer securities, the deduction is allowable in the taxable year of the corporation in which the dividend is used to repay the loan. However, there is no requirement that a loan must qualify for the 50% interest exclusion in order for the dividend deduction to apply to dividends used to repay ESOP loans. (Welytok 1990)

Capital Gains Holding Period for ESOPs

Another limitation imposed was on the capital gains holding period for ESOPs. After the Tax Reform Act of 1986 was introduced, there were no differences between the capital gains rate and the ordinary income rate for individuals. To help eliminate the potential abuses, the 1989 Act limits the tax deferral on any capital gains realized from a taxpayer’s sale of securities to an ESOP only where the taxpayer has held stock for at least three years before selling the stock to an ESOP and after the sale, the ESOP must hold at least 30% of the employer stock. If the replacement securities are sold prior to the end of the holding period, a 10% excise tax will be imposed on the amount realized on the sale. The amount realized is limited to that portion of the cost of the replacement securities allocable to the underlying qualified securities. This limitation was enacted to
discourage companies from establishing an ESOP within three years of a key employee’s retirement in order to defer recognition of gain on the sale of qualified securities by the key employee. (Lee 1990)

**ESOP Contribution Limitation**

Additional changes were made to the maximum annual additions to an ESOP by the Revenue Reconciliation Act of 1989. Before RRA of 1989, the addition was limited to the lesser of $30,000 or 25% of the employee’s compensations. However, a higher annual addition dollar limit of up to $60,000 was permitted by ESOPs meeting a special nondiscrimination test by Section 415. RRA of 1989 repealed the upper limit which became effective after July 12, 1989 and added no grandfather clause. ESOPs that had been funded with loans designed for the Section 415 $60,000 upper limit had to be modified in some way. Four alternatives are available to the plan sponsors. First of all, the plan may use dividends to repay the loan because loan payments attributable to dividends are usually not included in annual additions. Another alternative is to renegotiate the loan to lengthen the repayment period. A company might also modify the plan formula so that the special nondiscrimination rule is met. This would permit the loan interest payments and the allocation of certain forfeitures to be disregarded for annual addition purposes. A last alternative is to create a Section 415 suspense account. (Sherman 1990) Congress feels that other incentives for the development of ESOPs override the barriers perceived to exist fifteen years ago and that this provision is no longer
necessary to encourage corporations to develop ESOPs.

**ESOP Net Operating Loss Rule**

Further alterations have been made in the ESOP Net Operating Loss Rule. The RRA of 1989 eliminated the special provision which allowed certain employer securities not to be taken into account for purposes of built-in gains when determining whether an ownership change had occurred, or the limitations on use of prechange losses and credits are triggered for purposes of the net operating loss rules. (Welytok 1990)

**Estate Tax Changes**

RRA of 1989 repealed the provision which allowed for an election by a decedent’s estate to discharge estate tax liability under certain conditions by transferring the decedent’s stock to the company’s ESOP in exchange for the ESOP’s assuming the estate’s tax liability up to the fair market value of the stock. This election had allowed the ESOP to pay the liability in installments which provided extremely favorable financing for the stock purchase, and it allowed the tax to be paid entirely with pretax corporate funds. (Welytok 1990)

**Reporting Requirements**

Before the RRA of 1989, there were no reporting requirements for ESOPs which acquired employer securities using a securities’ acquisition loan to file any reports with the Internal Revenue Service. The 1989 Act enacted reporting requirements applicable to employers implementing an ESOP and any person making or holding a loan. These returns and reports
must be made in the form, contain the information and be made at the
time designated by the IRS. (Welytok 1990)

**Effects of the 1989 Changes**

The changes in the treatment of ESOPs due to the Revenue
Reconciliation Act of 1989 could have several effects. With the new
limitations, ESOP plans will be difficult to implement for smaller, private
firms. Smaller companies will have a difficult time finding qualified
lenders to finance the plan because of the restricted 50% interest exclusion.
This restriction raises the effective rate of interest which most smaller
firms will not be able to afford. The interest exclusion is still available for
firms using these loans if they contribute at least 30% of their stock to the
employees. The problem with this is the high costs of collecting 30% of the
company stock. Most smaller firms could not afford this enormous cost.
There are efforts underway to lower the hurdle rate to 20%, but even then,
the small, private firms will find this a hard obstacle to overcome. (Parham
1991)

Many companies have used the ESOPs as an antitakeover tool. The
inability to put ESOPs into action will open up the door for outsiders to
come in and take over the company. Instead of companies taking care of
themselves, they will be forced to sell out to foreigners and "fat cats".
ESOPs also were able to take care of themselves without the government so
directly involved in business. However, corporate history has proven
companies cannot use ESOPs in the middle of a takeover attempt. With the limitations on ESOPs now, many companies' corporate protection strategy against hostile takeovers have been damaged and will have to be altered or changed. (Parham 1991)

The new constraints on the interest exclusion will drive interest rates up. Not only does this raise the effective interest rates of interest, but it will also require close scrutiny between loan payments and employee benefit allocations. A company's earnings and dividend growth rates and the profit sharing allocation requirements all interact to determine the financial benefit to be gained from establishing an ESOP. Employers must carefully consider these interactions to determine whether implementing an ESOP would be profitable. (Groves 1990)

**Conclusion**

Congress has been able to repeal several benefits associated with ESOPs, but ESOPs still offer favorable treatment over other types of retirement plans. These previous repeals open the door for Congress in search for new tax revenues to further limit the tax advantages of ESOPs. The Congressional Budget Office is assessing the potential revenue generated by repealing certain ESOP provisions, and it is certain that ESOPs are a prime target area for more revisions. If this happens, ESOPs may soon become obsolete because of the enormous costs that will be required from the corporations. (Lee 1990)

Even though many of the tax benefits associated with ESOPs have
been repealed, ESOPs still receive more favorable treatment than other qualified plans. These plans are still the best approach for countering hostile takeovers. These plans, also, still allow some firms a dividend deduction, and some firms can benefit from the tax-subsidized borrowing rate on loans to buy ESOP shares. (Scholes 1992) ESOPs serve as an excellent employee incentive, too. The increased limitations, however, may limit the attractiveness of ESOPs for some firms. The larger firms may soon become the only companies that may be able to afford the benefits of ESOPs. Congressional efforts to raise tax revenues through limitations on ESOPs has hurt the smaller businesses. To be equitable, Congress should alter some of the limitations to make ESOPs more easily implemented by the average size business. In these recessionary times, ESOPs could offer the needed incentives that most companies do not have available to them in their cash reserves and should be made implementable by the smaller companies.
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