Written Statement of J. Michael Keeling, President of The ESOP Association, to the Senate Committee on Small Business and Entrepreneurship's July 17, 2013, Roundtable on *Small Business Tax Reform: Making the Tax Code Work for Entrepreneurs and Startups*.*

Thank you, my comments focus on employee ownership through the ESOP model.

ESOPs are often referred to as ERISA plans. The record should show that an ESOP is a tax qualified deferred compensation plan that by law is required to be primarily invested in employer securities and may use borrowed funds to acquire the assets of the plan.

I comment primarily on the inquiry: "What should a reformed tax code retain to help America's employee-owned businesses?" While my comments are directed to employee-owned businesses, as this Committee knows, the overwhelming majority of economic units in our nation are small businesses, not publicly owned and traded on stock markets. Thus, nearly all ESOP companies, and we have approximately 1500 ESOP company members, and in my career I have personally visited in over 500 ESOP companies are small businesses. The dominant number of employees of our members is in the 100 to 250 employee range. Let me be clear, however, successful ESOP companies often grow pass the formal 500 employee level that defines what is a small business.

Key for the ESOP community is to maintain the three tax law provisions that encourage the creation and operation of employee ownership through the ESOP model.

One, ensures that S corporations that sponsor ESOPs are not disadvantaged compared to conventionally owned S corporations. The 1997 law that permitted S ESOPs made clear that an S with an ESOP is not to pay a corporate level tax just like as other S corporations do not pay a corporate level tax. ESOP participants pay income tax on distributions from their S corp ESOPs. (Specific Code Section 512(c)(3))

Another important tax deferral benefit for ESOPs added to the code in 1984, and it is the key provision encouraging the continuation of private ownership, when the original owner/ founder with no heirs wanting to take over the private company exits the company. This law provides that the exiting shareholder may defer capital gains tax on the sale of shares to an ESOP if the ESOP owns 30% or more of the highest class of shares after the transaction, and the seller reinvests proceeds in the securities of operating U.S. businesses. When the seller sells securities acquired with the proceeds of the sale to the ESOP, he or she pays capital gains taxes on the basis of the shares sold to the ESOP. (Code Section 1042)

The last unique tax law for ESOPs, again added in 1984, permits a C corporation to deduct the value of dividends paid on stock in an ESOP if the dividends are passed through to the employees in cash, or if the employee directs the dividends be reinvested in his or her account for more stock, or if the employer uses the dividends to pay the debt incurred to acquire the shares of the ESOPs, with more shares being released to the ESOP participates. (Code Section 404 (k))

*Attachments is a summary on performance of private ESOP companies evidenced in recent research.

In terms of what is needed to expand the opportunity for more Americans to be owners in the places where they work, topping the list is a provision of S. 742, introduced by your Committee colleague Senator Cardin, and which both this Committee's chair and ranking member have co-sponsored. Section 3 of S. 742 would expand the tax gains deferral provisions of current law to sell S shares to an ESOP.

In terms of others provisions that our community believe should be seriously considered, here are a few we desire: 1. An S corporation like a C corporation should be able to pay "dividends" in cash to employees in the ESOP, and the employees of course would pay tax at that time to Uncle Sam on the dividends, 2. Congress basically repealed in 1989, a law adopted in 1984 that encouraged lenders to make loans to create ESOPs, by permitting the lender to exclude 50% of its interest income from its income, 3. There was for a time a variety of tax laws that encouraged estate planning of owners of private businesses to pass along in their wills ownership to the ESOP, and the ESOP would take on the responsibility for paying the estate tax.

I will stop here, but other ideas have surfaced over the years.

I conclude with two comments.

One, the General Social Survey of 2010 evidenced that during the Great Recession, employee stock owned companies laid off employees at a rate of 2.6%, whereas conventionally owned companies laid off employees at a rate of 12.1%!

Why if the focus of national policy is jobs, jobs, jobs, is there not more national push for the best jobs policy in America today, which has a proven record that it leads to people keeping their jobs that are locally controlled – our modest policy encouraging employee ownership?

Finally, I go to the roots of why Louisiana and Senate icon, the late Senator Long became such an advocate of broad based ownership – income inequality in America. The roots of his dedication to broad based ownership was to enhance the wealth of working men and women in comparison to those whose wealth is primarily through ownership in the most successful economic model ever known to humans, the free enterprise system. Please keep in mind, income inequality creates an us versus them feeling among the people. Us versus them is not good in our homes; in our schools; in our companies; and not good in a democracy based, republican form of government.

Surely our tax laws need to have reasonable policies to encourage less us versus them that can lead to government ownership of property, or massive government redistribution of wealth schemes.

I thank the Committee for this roundtable invitation, and look forward to discussion.

Employee Owner Impact Corporate Performance Positively

Overwhelming Evidence ESOP Companies More Productive, More Profitable, and More Sustainable, Providing Locally Controlled Jobs

- During the Great Recession, employee stock owned companies laid off employees at a rate of less than 3%, whereas conventionally owned companies laid off at a rate greater than 12%. (Data source: 2010 General Social Survey.)

- Because employees of ESOP companies were four times more likely to retain jobs during the Great Recession, Federal government recognized savings of over $14 billion in 2010 compared to tax payments foregone by laid off employees of conventionally owned companies; in other words for every $1 in tax expenditures to promote employee stock ownership, the Federal government collected $13 in taxes. (Data Source: 2010 General Social Survey analyzed by National Center for Employee Ownership.)

- A survey of 1400 ESOP companies in 2010 evidenced the average age of the companies' ESOPs were 15 years, and the average account balances for employees were nearly $200,000, much higher than data reported for average 401(k) account balances. (The ESOP Company Survey, 2010, of The ESOP Association's Corporate members.)

- According to 2012 General Social Survey, 13% of employees of employee stock-owned companies were thinking of seeking employment elsewhere, whereas 24% of the employees of conventionally-owned companies were considering leaving their current job.

- S corporations with employee-ownership grew employment at a rate of 60% during the Great Recession. Analysis by former staff member Bowles-Simpson Tax Commission and staff member of President Bush's Council of Economic Advisors.

- Research done by visiting Professor at Georgetown University's McDonough School of Business, and former Assistant Secretary for Economic Policy U.S. Treasury, Philip Swagel, and Executive in residence at American University School of Public Affairs and former Deputy Assistant for Tax Analysis, U.S. Treasury, Robert Carroll, evidenced S corporations with employee-ownership through ESOPs performed better than conventionally owned firms in providing retirement security.

- More than half of the ESOP companies have two retirement savings plan (primarily a 401(k)), whereas more than half of all companies have <u>no</u> retirement income savings plan. (Analysis of forms 5500, and Bureau of Labor Statistics by the National Center for Employee Ownership, funded by the Employee Ownership Foundation.)

- The average ESOP company (less than 200 employees) has sales $9 million more per year than its non-employee owned comparable competition. (June 2008 Dissertation, Dr. Brent Kramer, CUNY.)

- A study of 1100 ESOP companies over eleven years compared to 1100 comparable conventional owned companies evidenced the 1100 ESOP companies had better sales, more employment, and were more likely over the period to remain independent businesses by 16%. (Most detailed study of ESOP companies by Dr. Joseph Blasi, and Dr. Douglas Kruse, tenured professors, Rutgers University School of Labor and Management, 1999.)