Statement for the Record for Senate Finance Committee September 15, 2011 Hearing on "Tax Reform Options: Promoting Retirement Security"

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The tax treatment of S-ESOP firms reduces the bias against saving in the U.S. tax system and provides a structure under which worker-participants at S-ESOPs build savings for a more secure retirement. In addition to helping families prepare for retirement, the S-ESOP organizational form contributes to increased national saving and, as a result, to stronger investment, economic growth, and job creation. S-ESOPs thus work to meet two key U.S. economic challenges: inadequate retirement security for our workers and families, and insufficient national saving for the economy as a whole. Moreover, employee-ownership at S-ESOPs gives workers a direct stake in the success of the company and better incentives for firm growth. A 2010 study I co-authored for the Employee-owned S-Corporations of America (ESCA) found that S-ESOP firms were more resilient in the face of the recent recession, with better employment performance than non-ESOP firms.[1] Expanded opportunities for S-ESOPs would provide the benefits of this structure to more working Americans.

Firms organized as S-ESOPs enhance the retirement security of their workers, as contributions by the employer together with growth in the value of the stock over time can provide a powerful boost to employees' retirement savings. An S-ESOP is a business that provides flow-through tax treatment to its shareholders, and in which the shares are owned by the employees' qualified defined contribution retirement plan. Taxes on the appreciated value of the stock in the retirement plan are deferred until the employee eventually sells his or her shares while in retirement. This tax treatment is similar to that of a traditional defined benefit or defined contribution retirement plan.

S-ESOPs make substantial contributions to workers' retirement security. They do this by giving employees ownership of the company and building their retirement security with set-aside funds in ESOP accounts. This stands in stark contrast with the fact that, according to the Employee Benefit Research Institute, only half of Americans in 2008 worked for an employer that provided employees with any kind of retirement savings plan, and not much more than 40 percent of workers participated in such plans. A 2008 University of Pennsylvania study found that S-ESOPs contribute substantially in new savings to their workers beyond the income of what these workers would have otherwise earned.[2]

When nearly 60 percent of working Americans have no work-related retirement plan, S-ESOP firms play a vital role in contributing to their employee-owners' retirement security—an ownership stake in their employer is a form of diversification compared to workers who otherwise rely on government retirement plans such as Social Security. Further diversification is achieved for workers as they near retirement, as ESOP retirement plans are mandated to provide asset diversification for workers aged 55

[1] Philip Swagel and Robert Carroll, March 2010. "Resilience and Retirement Security: Performance of S-ESOP Firms in the Recession."
[2] Steven F. Freeman and Michael Knoll, July 2008. "S Corp ESOP Legislation Benefits and Costs: Public Policy and Tax Analysis," University of Pennsylvania, Center for Organizational Dynamics, Working Paper #08-07.

and older.   In addition, studies have found that 80 percent of S-ESOP firms offer workers retirement savings plans beyond the ESOP—and many of these firms make employer contributions to workers' retirement savings in these plans.

Employees of S-ESOP firms have employer-provided retirement contributions that are superior to those received by employees of firms in the overall economy. This is particularly the case for ESOP participants, demonstrating and reflecting the benefits of ownership. Moreover, S-ESOP employee-owners have substantially more resources accumulated for their retirement than typical workers at other firms. Among the findings of my recent study are:

- Employer contributions to retirement benefits rose by 18.6 percent for all employees in the S-ESOP firms surveyed.   This compares to 2.8 percent growth of contributions by all employers to employee retirement plans.

- The employee-owners of S-ESOP firms accumulate substantial amounts for retirement. The value of S-ESOP assets per active participant was $100,000 in 2008, compared to only $45,500 for the average 401(k) account for the overall economy.

The pass-through nature of the S-ESOP structure enables the company to avoid the double-tax on saving inherent in the corporate tax system, while using those funds to the direct benefit of employees. In the S-ESOP structure, business income is taxed at retirement, close to when these savings are consumed, and at ordinary income rates that are higher than the capital gains rates applied to distributions from other qualified retirement savings accounts. The S-ESOP organizational form results in a lower cost of capital for S-ESOP firms and thus greater investment, growth, and job creation.   This helps to address the key U.S. economic challenge of inadequate national saving that manifests as the trade deficit and as the U.S. fiscal imbalance.

Tax policies for retirement saving can be viewed through both the "micro" lens of how to improve retirement security for individual families and through the "macro" lens of how to boost overall national saving and thereby improve U.S. growth and job creation.   On the individual level, the looming fiscal challenges facing the United States likely imply that families must anticipate having greater responsibility for preparing for retirement, because the U.S. government will be less able to participate directly in providing for retirees. The S-ESOP works to boost retirement preparedness while contributing to increase saving and U.S. economic vitality. This is good for workers, business and American taxpayers as a whole.

About the Author:

Phillip L. Swagel was Assistant Secretary for Economic Policy at the Treasury Department from December 2006 to January 2009. He was previously chief of staff and a senior economist at the White House Council of Economic Advisers from 2000-2005. Mr. Swagel is currently a professor at the University of Maryland's School of Public Policy, where he teaches classes on international economics and is a faculty fellow at the Center for Financial Policy at the Robert H. Smith School of Business. He is also a non-resident scholar at the American Enterprise Institute and an advisor to the Employee-owned S Corporations of America.