RELEASED RESTRICTED — Not to be released outside the General Accounting Office except on the basis of specific approval by the Office of Congressional Relations.

112668

BY THE COMPTROLLER GENERAL

Report To The Committee On Finance United States Senate

OF THE UNITED STATES

Released

Employer Stock Ownership Plans: Who Benefits Most In Closely Held Companies?

This report highlights problems in Employee Stock Ownership Plans of closely held companies which favor the company and adversely affect participants. These problems relate to the valuation, marketability, and voting of employer stock held by the Plans. The need for special scrutiny of certain Plan transactions is also discussed.

The Department of the Treasury was unable to provide data showing the total tax impact associated with Employee Stock Ownership Plans, but it conservatively estimated that the tax forgone during fiscal year 1979 was between $1.5 billion and $2.3 billion.

The Congress should amend the law, and the Secretaries of Labor and the Treasury should revise the regulations to assure that the Plans are established and operated primarily for the benefit of participants and their beneficiaries.

112668

UNITED STATES GENERAL ACCOUNTING OFFICE

511034

HRD-80-88
JUNE 20, 1980

Single copies of GAO reports are available free of charge. Requests (except by Members of Congress) for additional quantities should be accompanied by payment of $1.00 per copy. (Do not send cash).

Requests for free single copies should be sent to:

U.S. General Accounting Office
Distribution Section, Room 1518
441 G Street, NW
Washington, DC 20548

Requests for multiple copies should be sent with checks or money orders to.

U.S. General Accounting Office
Distribution Section
P.O. Box 1020
Washington, DC 20013

Checks or money orders should be made payable to the U.S. General Accounting Office.

To expedite placing your order, call (202) 275-6241. When ordering by phone or mail, use the report number and date in the lower right corner of the front cover.

GAO reports are now available on microfiche. If such copies will meet your needs, be sure to specify that you want microfiche copies.

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-199055

The Honorable Russell B. Long
Chairman, Committee on Finance
United States Senate

Dear Mr. Chairman:

As requested in your August 16, 1978, and July 3, 1979, letters, this report discusses problems we observed with Employee Stock Ownership Plans and actions we believe are necessary to bring about improvements.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of the report until 10 days after it is issued. At that time, we will send copies to interested parties and make copies available to others upon request.

Sincerely yours,

Comptroller General
of the United States

COMPTROLLER GENERAL'S
REPORT TO THE SENATE
COMMITTEE ON FINANCE

EMPLOYEE STOCK OWNERSHIP PLANS: WHO BENEFITS MOST IN CLOSELY HELD COMPANIES?

D I G E S T

The Employee Retirement Income Security Act of 1974 requires that Employee Stock Ownership Plans, as tax-qualified plans, be established and operated exclusively for the benefit of participants and their beneficiaries. (See p. 1.)

The Department of the Treasury was unable to give GAO data showing the total tax impact associated with the Plans, but conservatively estimated that the tax forgone during fiscal year 1979 was between $1.5 billion and $2.3 billion. (See p. 3.)

GAO reviewed selected operational aspects of Employee Stock Ownership Plans at 13 companies where the stock was closely held and at 3 companies where the stock was publicly traded. The companies, based in eight States, had Plan participants ranging from about 25 to 6,100. (See p. 4.)

PROBLEMS IDENTIFIED IN CLOSELY HELD COMPANIES

An analysis of Plan transactions showed that most were not being operated in the best interest of participants. Specifically, one or more of the following problems that could affect participants' benefits were present in each of the closely held company plans.

--The companies sold or contributed company stock to its Plan at questionable prices. These were based on appraisal valuations which lacked independence and/or did not properly consider relevant factors, such as earning capacity, book value, comparability with similar companies, and marketability. If the transactions in company stock were for more than fair market value, they (1) were prohibited transactions under the act of 1974 and subject to an excise tax, (2) could mislead participants about the value of their Plan account, and (3) could increase the amount on which participants would ultimately pay income tax. (See pp. 8 to 14.)

--Participants were not assured of a market for company stock distributed by the Plan. The act requires that Plans invest primarily in employer securities, but regulations do not generally require the employer to repurchase stock distributed to participants. (See pp. 22 to 24.)

--Participants generally were not permitted to vote or direct the voting of company stock allocated to their Plan accounts. Rather, a Plan committee, usually appointed by the employer, voted the Plan company stock without formal direction from the participants. (See pp. 24 to 26.)

EMPLOYEE STOCK OWNERSHIP PLANS OF PUBLICLY TRADED COMPANIES

The problems identified with stock valuations, marketability, and voting of stock in closely held companies were not observed in the publicly traded companies. (See pp. 6 and 7.)

OTHER MATTERS NEEDING ATTENTION

The lack of specific valuation regulations contemplated by the act of 1974 and the failure of some appraisers to use available guidance have contributed to the problem of determining fair market values of stock not regularly traded in a recognized market. (See pp. 14 to 17.)

To guard against potential abuses by parties-in-interest, the Congress intended that the Departments of Labor and the Treasury scrutinize such transactions to make sure that they primarily benefit participants and beneficiaries. Although Labor and Treasury have reviewed a number of plans, their approach for identifying and selecting them was not systematic and the number of cases reviewed was limited by available resources. (See pp. 29 to 31.)

IMPACT ON EMPLOYEE MOTIVATION AND PRODUCTIVITY

The companies reviewed established Plans primarily for reasons other than to improve employee motivation and productivity, and management had not tried to assess effect on its employees. (See pp. 37 to 39.)

Also, employees GAO interviewed generally did not perceive the Plans as influencing their work or the work of others. Further, available independent studies on motivation and productivity were inconclusive as to whether the Plans improved employee morale or increased productivity. (See pp. 39 to 42.)

RECOMMENDATIONS TO THE CONGRESS

In accordance with the Employee Retirement Income Security Act's policy of protecting employees' interests and to facilitate the passing of capital ownership to workers participating in Employee Stock Ownership Plans, the Congress should enact legislation to

--provide that full and unrestricted voting rights be passed to Plan participants for all employer stock allocated to their accounts and

--require plan provisions for redeeming, at fair market value, all company stock distributed by the Plan. (See p. 27.)

RECOMMENDATIONS TO THE SECRETARIES OF LABOR AND THE TREASURY

To correct the problems identified in Employee Stock Ownership Plans of closely held companies and to guard against potential abuses by parties-in-interest, the Secretaries should:

--Develop and promulgate, through regulations and implementing procedures, more specific criteria and guidelines for valuing the stock of closely held companies and require that such guidance be consistently applied. (See p. 19.)

--Develop and implement a program for providing special systematic scrutiny of Plan transactions. (See p. 32.)

AGENCY COMMENTS

Treasury pointed out that the problems described in the report are probably applicable to all defined contribution plans, such as stock bonus and profit sharing plans, that take advantage of the act's provisions to invest in closely held employer securities. GAO concurs. (See p. 7.)

Labor and Treasury agreed that more specific guidelines for valuing stock of closely held companies are needed but, because of the wide variety of valuation situations, question whether such guidelines can be developed. GAO recognizes that guidelines applicable to every conceivable stock valuation situation are not practical. However, GAO suggested several areas where more specific guidance could be provided. (See pp. 19 to 21.)

Treasury and Labor suggested that further legislative action is necessary to require that employers provide a market for stock distributed by an Employee Stock Ownership Plan which is not regularly traded in a recognized market. In view of the agencies' position, GAO redirected this recommendation to the Congress. (See pp. 27 and 28.)

Labor disagreed with GAO's recommendation on the need to implement a program to provide special scrutiny; it believed that such scrutiny had been provided within available resources. Treasury pointed out plans for expanding its efforts in this area. Although Labor and Treasury have examined a number of Employee Stock Ownership Plans since the act of 1974 was enacted, GAO believes that both agencies need to reassess their plans for future examinations to develop systematic programs for scrutinizing the Plans as the Congress intended within the constraints of limited resources. (See pp. 32 to 36.)

Contents

ABBREVIATIONS

ERISA	Employee Retirement Income Security Act of 1974
ESOP	Employee Stock Ownership Plan
GAO	General Accounting Office
IRS	Internal Revenue Service

CHAPTER 1

INTRODUCTION

The Chairman, Senate Committee on Finance, by letters dated August 16, 1978, and July 3, 1979, requested that we review Employee Stock Ownership Plans (ESOPs) of Federal contractors to determine if there are problems that require corrective legislation. He also asked that we attempt to ascertain whether ESOPs affect employee motivation or productivity.

ESOPs are tax-qualified employee benefit plans designed to give employees the chance to acquire stock in their company, while affording employers an innovative method of corporate capital financing. The Internal Revenue Code states that tax-qualified ESOPs are to be established and operated exclusively 1/ for the benefit of participants and their beneficiaries.

ESOP DEFINED

Until enactment of the Employee Retirement Income Security Act of 1974 (ERISA), no precise statutory definition of an ESOP existed. However, with the enactment of ERISA and the implementation of later Department of the Treasury and Department of Labor regulations, ESOPs received legal definition.

ERISA defines an ESOP as a stock bonus plan or a stock bonus and money purchase plan that meets the qualification requirements of the Internal Revenue Code. ERISA also provides that an ESOP (1) be designed to invest primarily in employer securities and (2) maintain individual accounts for each participant. Treasury and Labor implementing regulations provide that an ESOP must be formally designated as such in the plan document and must specifically state that it is designed to invest primarily in qualifying employer securities.

ERISA established minimum standards and requirements to govern employee pension plans and protect participants'

1/The Internal Revenue Service (IRS) has long interpreted the exclusive benefit requirement as meaning primarily for the benefit of employees. (For example, see Revenue Ruling 69-494.)

rights. However, in the acquisition, sale, or lease of qualifying employer securities and real property, ESOPs (as defined above) are not required to adhere to some of the ERISA safeguards imposed on some plan fiduciaries, 1/ including:

--The buying and holding of employer securities as the principal plan assets.

--The sale, exchange, or lease of any property between the plan and a party-in-interest. 2/

--Lending of money or other extension of credit between the plan and a party-in-interest.

--Furnishing of goods, services, or facilities between the plan and a party-in-interest.

To receive these exemptions, the transactions must be for adequate consideration and no commission charged with respect thereto. Additionally, because of the ESOP's status as a tax-qualified plan under the Internal Revenue Code, an employer's contributions to the plan are tax deductible, and employee benefits generally are not taxed until they are received.

1/A fiduciary is anyone who exercises discretionary authority and control in the management or disposition of pension plan assets, renders investment advice for a fee, or exercises any discretionary authority or responsibility for plan administration. ERISA requires a fiduciary to discharge his duties with respect to a plan solely in the interest of participants and beneficiaries and for the exclusive purpose of (1) providing benefits to participants and their beneficiaries and (2) defraying reasonable expenses of administering the plan. Additionally, the fiduciary is required to discharge these responsibilities with the care, skill, and diligence of a prudent man familiar with such matters.

2/A party-in-interest includes employers of plan participants; persons rendering services to the plan; unions whose members are plan participants, and their officers and agents; officers, fiduciaries, and employees of a plan; and relatives, agents, and joint venturers of any of the foregoing.

The most current data available from Labor records in August 1978 showed that, nationwide, about 2,500 companies had ESOPs. A more recent staff report by the Senate Select Committee on Small Business estimated the number of ESOPs as high as 3,000.

Treasury was unable to give us data showing the total tax impact associated with ESOPs, but conservatively estimated that the tax forgone during fiscal year 1979 was between $1.5 billion and $2.3 billion.

CONGRESSIONAL OBJECTIVE IN AUTHORIZING ESOPS

Through a series of laws dating back to 1973, the Congress has encouraged the use of ESOPs as a bold, innovative method of strengthening the free enterprise system to solve the problems of securing funds for necessary capital growth and bringing about stock ownership by all corporate employees.

March and November 1978 committee prints, prepared by the staff of the Senate Committee on Finance, explained that adopting an ESOP benefits:

--The employer because he receives favorable tax treatment for all payments made to the ESOP and because employees understand that their work performance directly affects the employer's financial success and the value of ESOP assets.

--Stockholders of small companies by giving them a buyer for their stock, which could also help the employer attract additional investors.

--Employees by permitting them to build stock ownership in the company--usually without employee contributions--and by giving them potential future financial benefits, although the value of this ownership is tied directly to the employer's success.

The committee prints also identified how the above benefits can be achieved through use of ESOPs. These documents explained that companies can use the ESOP as a vehicle for borrowing funds in exchange for company stock, repaying the indebtedness with tax deductible dollars--thus securing capital funds and transferring stock ownership to employees. The ESOP, when used this way, also provides a market for the shareholders' stock.

Stock appraisals by an individual or firm that also provides accounting or ESOP consulting services to the company does not constitute an arms-length environment and accordingly does not meet the independence requirement for a good faith determination. Also, relevant factors that affect stock values, outlined in Revenue Ruling 59-60, either were not considered in these evaluations or were inconsistently applied.

For example, a consulting firm that set up the ESOP at one company also computed the value of the company's stock for the first plan year. The consultant used Revenue Ruling 59-60 as the valuation criteria and concluded that a valuation approach which capitalized earnings was most appropriate. In using this approach, the consultant not only used an arbitrarily determined price/earnings ratio but also applied greater weight to projected future earnings than to current and past earnings. He discounted the computed value by 15 percent because the stock was not readily marketable.

In a subsequent tax audit, IRS questioned the consultant's appraisal on several relevant factors. Specifically, IRS faulted the valuation for

--applying greater weight to projected future earnings than to actual earnings,

--failing to use comparable companies to determine the price/earnings ratio,

--failing to account for the effect of actual Federal and State taxes in computing net earnings, and

--applying such a low discount for the lack of marketability.

Additionally, IRS faulted the company for not obtaining updated valuations for ESOP transactions in subsequent years. As a result, the company agreed to reductions in stock values and related tax deductions claimed for 3 consecutive plan years as follows: from $111,689 to $98,702 in 1975; from $90,079 to $82,082 in 1976; and from $53,441 to $41,467 in 1977. The reductions represented a 14.8-percent overvaluation of the stock during the 3-year period.

In another company, a consultant that the company retained as its ESOP advisor computed the value of company stock. The appraiser specifically cited Revenue Ruling 59-60

We also discussed the ESOP experiences of other Federal agencies with headquarters and selected regional officials. These agencies included the National Aeronautics and Space Administration, Office of Management and Budget, Small Business Administration, and Departments of Defense, Commerce, and Agriculture.

CHAPTER 2

PROBLEMS ASSOCIATED WITH ESOPS IN CLOSELY HELD COMPANIES NOT PRESENT IN PUBLICLY TRADED COMPANIES

We reviewed the operations of ESOPs in 3 publicly traded and 13 closely held companies. Our analysis of transactions in the 13 closely held companies showed that the plans generally were not being operated in the best interest of participants. Specifically, one or more of the following problems which could affect participants' benefits were present in each of the closely held company plans:

--Plan fiduciaries acquired employer stock without taking the steps necessary to assure that the transactions were not for more than fair market value.

--Plan documents did not contain provisions requiring the employer or the ESOP to repurchase employer stock when distributed to participants.

--Companies did not pass voting rights to participants for employer stock acquired by the ESOP.

In the absence of specific guidelines and ESOP regulations and in view of the pervasive nature of the problems with ESOPs at the 13 companies whose plans we reviewed, similar problems with ESOPs at other closely held companies are likely.

The problems identified with stock valuation, marketability, and voting in closely held companies were not observed in the publicly traded companies because their stock was:

--Traded in an established market at prices determined by willing buyers and sellers (this procedure overcame the valuation and marketability problems noted in closely held companies).

--Registered with the Securities and Exchange Commission, which made all transactions in the stock subject to the Commission's reporting and disclosure requirements. Additionally, these companies passed full voting rights directly to ESOP participants for shares of company stock allocated to their accounts.

Since these problems were not prevalent in ESOPs of the publicly traded companies, chapters 3 and 4 of this report deal exclusively with problems in ESOPs established by the closely held companies. Chapters 5 and 6 discuss the need for special scrutiny of certain ESOP transactions and the ESOP impact on employee motivation and productivity, both of which may apply to publicly traded and closely held companies.

In a March 19, 1980, letter commenting on a draft of the report (see app. II), Treasury said that, while the definition of ESOP in the report is accurate, it believes the issues raised and the problems described by the report are generally applicable to all defined contribution plans (e.g., stock bonus plans and profit sharing plans) that invest in closely held employer securities. Section 407 of ERISA imposes a limitation but does permit a portion of a plan's assets to be invested in employer securities. Treasury said that this applies to eligible individual account plans, which include profit sharing, stock bonus, thrift, and savings plans, ESOPs, and certain money purchase pension plans. Therefore, Treasury believes the problems of valuation and marketability we described are applicable to all eligible individual account plans that take advantage of the ability to invest in closely held employer securities.

Because the scope of our review encompassed only ESOPs as defined in ERISA, we cannot say with authority that the issues raised and problems described are applicable to all defined contribution plans. However, in our opinion, the Treasury conclusion is accurate. As emphasized in chapters 3 and 4, the primary issues and problems noted dealt with valuation and marketability of closely held company stock and fiduciary assurance that no more than fair market value is paid for such stock. Accordingly, the problem of assigning a proper value to closely held employer stock would apply to any plan acquiring or selling such stock.

CHAPTER 3

FAIR VALUES NOT ASSURED FOR TRANSACTIONS INVOLVING CLOSELY HELD EMPLOYER STOCK

Each of the 13 closely held companies whose ESOP we reviewed sold or contributed company common stock to its ESOP at questionable prices. The prices were based on appraisal valuations that lacked the independence required for good faith determinations and/or did not consider all relevant factors necessary in determining the fair market value. These circumstances resulted primarily because plan fiduciaries had not taken the steps required by ERISA and its implementing regulations to assure that ESOPs pay no more than fair market value for employer stock.

Additionally, Labor had not developed regulations, as contemplated by ERISA, for valuing company stock. The only guidelines Labor or IRS cited for valuing stock of closely held companies were very general and subject to broad interpretations. These conditions resulted in stock appraisers using significantly different approaches in considering the same appraisal factors. Contributing or selling overvalued stock to an ESOP is to the advantage of the company or individual making the contribution or sale because of the increased tax deduction or cash proceeds involved. Furthermore, transactions involving overvalued stock could be detrimental to the plan and its participants because such transactions

--are prohibited by ERISA and are subject to an excise tax,

--could mislead the participants about the value of their ESOP accounts, and

--could increase the amount on which participants would ultimately pay income tax.

REQUIREMENTS FOR VALUING STOCK

ERISA provides that plan transactions involving closely held employer stock must be based on fair market values determined in good faith. Regulations define a "good faith determination" as at least an annual appraisal independently arrived at by a person who customarily makes such appraisals and is independent of any party to a transaction involving a loan to the plan.

ESOP regulations state that, in addition to being determined in good faith, valuations must be based on all relevant factors. Labor has not promulgated regulations or guidelines on how stock not regularly traded in a recognized market is to be valued for ESOP purposes. Instead, it has effectively adopted Revenue Ruling 59-60 as guidance for stock valuations. (See p. 14 for further discussion of this ruling.) This ruling, therefore, is the primary guidance available for determining the fair market value of stock in closely held companies. However, guidance in the ruling is permissive and provides only very general directions for appraisers.

Some factors relevant to determining fair market values are outlined and discussed in Revenue Ruling 59-60. According to this ruling, the following factors, although not all inclusive, are fundamental and require careful analysis.

1. The nature of the business and the history of the enterprise from its inception.

2. The economic outlook in general and the condition and outlook of the industry in particular.

3. The book value of the stock and the financial condition of the business.

4. The earning capacity of the company.

5. The dividend-paying capacity.

6. Whether or not the enterprise has goodwill or other intangible value.

7. Sales of the stock and the size of the block of stock to be valued.

8. 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.

Other factors, according to industry valuation experts and/or IRS, that could affect the fair market value of stock that should be considered include:

1. Potential discounts for lack of marketability.

2. Potential discounts for minority interests.

3. Obligations to repurchase ESOP stock from terminating participants.

VALUATIONS NOT BASED ON ALL RELEVANT FACTORS

Companies and ESOP fiduciaries for each of the 13 plans of closely held companies we reviewed accepted and used prices during 1 or more years which lacked the independence required by regulations for good faith determinations and/or were computed without considering all relevant factors. The acquisition of employer stock for the ESOP without considering all relevant factors raises questions concerning the derived value and can result in transactions involving more than adequate consideration (fair market value), which are prohibited by ERISA. We observed several types of appraisal arrangements where independence was lacking and/or all relevant factors were not considered, including

--in-house appraisals by the company board of directors or other top company officials,

--appraisals by interested parties outside the company, and

--appraisals by independent appraisal firms.

Valuations by company officials

For 4 of the 13 ESOPs we reviewed, the board of directors or other top company officials valued common stock the company sold or contributed to the ESOPs. In addition to the lack of independence required for a good faith determination, these appraisals were not based on all relevant factors specified by ESOP regulations and Revenue Ruling 59-60.

For example, the board of directors for one company determined the value of its stock annually without using Revenue Ruling 59-60 or formal procedures. Rather, the board of directors, with advice from its attorney and accountant, selected a stock value it considered conservative and reasonable. Furthermore, the board, which was also the ESOP committee and the designated fiduciary, did not maintain documentation to support its stock valuations.

In another company, the board of directors also determined the value of stock each year, based on financial data determined by the controller. They computed the stock values by applying a price/earnings multiple of 12 to earnings per share for the year.

The board of directors adopted the price/earnings multiple of 12 based on a 1976 tender offer from an outside firm to acquire majority control of the company. The sale was not consummated, but the board considered the offer an accurate reflection of the company's value. The board, according to the controller, was unfamiliar with Revenue Ruling 59-60 and therefore had not considered it in determining stock values. Furthermore, the board had not updated or otherwise justified the use of the established multiple and had not accounted for the inherent difference between a tender offer to acquire majority control and contribution or sale of a minority interest to the ESOP.

In a third company, the board of directors (consisting of the president and two vice-presidents) computed the value of its stock each year using a formula approach. The formula included paid-in-equity, an arbitrary amount for goodwill, and 50 percent of contract backlog. The board in this company was also the ESOP committee and the designated fiduciary.

Another company also used a formula approach to determine the value of its stock for ESOP purposes. This company valued its stock based on book value plus 5 percent of book value for goodwill, computed as of the last day of its fiscal year.

Concerning valuing stock, Revenue Ruling 59-60 states that no formula can be devised that will be generally applicable to the multitude of valuation issues. A frequently encountered appraisal error, according to IRS, is the use of a formula to determine a question of fact which on a reasonable basis must be resolved in view of all pertinent circumstances. IRS also said that the courts have held that formulas may be used to appraise fair market values <u>only</u> in the absence of better evidence or as a check on other evidence.

<u>Valuations involving interested parties outside the company</u>

Individuals or firms that were providing other services to some companies we reviewed also calculated the value of stock the companies sold or contributed to their ESOP.

Stock appraisals by an individual or firm that also provides accounting or ESOP consulting services to the company does not constitute an arms-length environment and accordingly does not meet the independence requirement for a good faith determination. Also, relevant factors that affect stock values, outlined in Revenue Ruling 59-60, either were not considered in these evaluations or were inconsistently applied.

For example, a consulting firm that set up the ESOP at one company also computed the value of the company's stock for the first plan year. The consultant used Revenue Ruling 59-60 as the valuation criteria and concluded that a valuation approach which capitalized earnings was most appropriate. In using this approach, the consultant not only used an arbitrarily determined price/earnings ratio but also applied greater weight to projected future earnings than to current and past earnings. He discounted the computed value by 15 percent because the stock was not readily marketable.

In a subsequent tax audit, IRS questioned the consultant's appraisal on several relevant factors. Specifically, IRS faulted the valuation for

--applying greater weight to projected future earnings than to actual earnings,

--failing to use comparable companies to determine the price/earnings ratio,

--failing to account for the effect of actual Federal and State taxes in computing net earnings, and

--applying such a low discount for the lack of marketability.

Additionally, IRS faulted the company for not obtaining updated valuations for ESOP transactions in subsequent years. As a result, the company agreed to reductions in stock values and related tax deductions claimed for 3 consecutive plan years as follows: from \$111,689 to \$98,702 in 1975; from \$90,079 to \$82,082 in 1976; and from \$53,441 to \$41,467 in 1977. The reductions represented a 14.8-percent overvaluation of the stock during the 3-year period.

In another company, a consultant that the company retained as its ESOP advisor computed the value of company stock. The appraiser specifically cited Revenue Ruling 59-60 as valuation criteria, but his evaluation reports did not show that several relevant factors were considered. The appraisals, for example (1) did not compare the success of the company to that of its competitors, (2) arbitrarily considered only single year corporate earnings from the highest year available, although the revenue ruling states that considering earnings history is appropriate, and (3) derived a price/earnings ratio by comparison to publicly traded companies that did not meet the revenue ruling's standards of comparability.

The appraisals also relied heavily on the use of data that were not independently verified by the consultant/appraiser or other source, such as unaudited financial statements. The appraiser also failed to recognize that the company, which depended on Small Business Administration-supported contracts for 76 percent of its business, had lost this support. The consultant incorrectly stated that the Small Business Administration had reinstated the company in the program, even though he included an audited financial statement as an appraisal exhibit which stated that the company had lost this business.

Finally, in auditing the ESOP an independent public accounting firm stated that it would not express an opinion on the financial condition of the trust because of the lack of independently verifiable data used in determining stock values.

Valuations by independent appraisal firms

Independent appraisal firms (for one or more years) valued the company stock sold or contributed to the ESOPs for six companies. These appraisals seemed to satisfy the independence requirements for good faith determinations, but the appraisers did not properly consider all relevant factors that affect stock values. Even though the appraisers either directly made reference to Revenue Ruling 59-60 as criteria or prepared appraisal reports that indirectly referred to some of the fundamental factors contained in the ruling, their appraisal reports showed that they did not apply or they discounted factors that we believe were relevant for one or more appraisal periods.

For example, each of the appraisers either failed to address the lack of stock marketability or dismissed marketability as immaterial. Consequently, none of the appraisers applied any discount for the lack of a ready market--an omission that overstated the stock value by the amount of the applicable discount not applied. Additionally, most of these appraisers excluded one or more other relevant factors that may have affected the derived stock value. For example:

--One appraiser computed company earnings after deleting the effect of a subsidiary for which the parent company was guarantor to all debt and the subsidiary's entire line of credit.

--Another appraiser derived a price/earnings ratio by comparing his client, a small computer software firm, to several large conglomerates engaged in aerospace technology and justified the differences in industry and capital structure on the basis that both his client and the conglomerates were contractors for the same Government agency.

VALUATION GUIDELINES INADEQUATE TO ASSURE FAIR VALUATIONS OF CLOSELY HELD EMPLOYER STOCK

The absence of specific valuation regulations and guidelines and the failure of some valuators to use available guidance have contributed to significant differences in appraisal approaches and values derived for companies whose stock was not regularly traded in a recognized market. Although contemplated by section 3(18) of ERISA, Labor has not promulgated regulations or guidelines on how the stock of closely held companies is to be valued for ESOP purposes. Furthermore, Labor considers the language of this section to be permissive and contemplates no action thereon for at least 2 years. Consequently, Revenue Ruling 59-60 (discussed on pp. 8 to 10) is the primary guidance available for determining the fair market value of stock in closely held companies.

Some valuators, as discussed earlier in this chapter, did not use the general approach, methods, and factors suggested by Revenue Ruling 59-60--or any other approach that satisfied the requirement for a good faith determination based on all relevant factors. Instead, they used a formula or some other arbitrary approach which was not independent or which failed to recognize relevant factors that affect fair market value.

We noted that various appraisers used inconsistent approaches to consider relevant factors in calculating stock values, even though each used Revenue Ruling 59-60 as valuation criteria. These inconsistent approaches included

--using a discount for lack of marketability for some companies but not for others;

--capitalizing pretax earnings for some companies and posttax earnings for others;

--capitalizing earnings before ESOP contributions in some cases and after ESOP contributions in other cases; and

--capitalizing a single year's earnings, past years' average earnings, or various other combinations of earnings, including projections of future earnings (sometimes weighted).

None of these approaches appear to be precluded by existing valuation guidelines, but they can result in significantly different values. The following example further illustrates the different values that result from the lack of precise valuation guidelines.

One company whose ESOP we reviewed engaged the same independent public accounting firm to appraise its stock each year, beginning in 1975 when it established an ESOP. Each appraisal report cited Revenue Ruling 59-60 as criteria for the valuation. However, the appraiser--without adequate justification--weighted relevant appraisal factors differently each year, and used a different basis for stock values as follows:

--In 1975, the appraiser stated that a weighted average of the computation of adjusted book value ($2,768,520), capitalized earnings ($3,080,993), and years purchases method ($3,002,875) of valuation would produce a realistic value of $3 million for the company.

--In 1976, the appraiser concluded that a valuation based between the previous year's value of $3 million and an approximate adjusted book value of $3.5 million was most appropriate; therefore, the appraiser determined the fair value to be $3.3 million.

--In 1977, the appraiser selected an arbitrary value of $5 million--giving consideration to its computation of book value ($3,319,258), adjusted book value ($5,819,258), and capitalized earnings ($6,484,785).

--In 1978, the appraiser rejected values computed for book value ($4,825,072) and capitalized earnings ($9,334,325) and stated that the best representation of the company's value was $5,750,000, a value about midway between adjusted book value ($6,505,072) and the value computed using a price/earnings ratio times weighed average earnings for a 5-year period ($5,374,475).

During a corporate tax audit for tax years 1975 and 1976, IRS challenged the appraised value of the company's stock and reduced tax deductions for ESOP contributions in those 2 years because the stock was overvalued. In computing the amount of deduction disallowed, IRS commissioned another independent firm to appraise the company's stock for fair market value. The firm that IRS employed was a brokerage firm normally engaged in appraising stock of closely held businesses. Like the original appraiser, this firm also used Revenue Ruling 59-60 criteria for its appraisals.

The IRS-employed firm concluded that only two appraisal approaches were applicable to determining value for the company:

--Replacement cost of tangible and intangible assets.

--Capitalized earnings (rate of return on investment).

The appraiser computed stock values using both approaches for each year and accepted the highest computation in each instance. As a result of these appraisals, IRS concluded that

--company stock valued at $267,000 for 1975 was overstated by $230,543 (632 percent) and

--company stock valued at $447,075 for 1976 was overstated by $259,820 (139 percent).

The company appealed the IRS position, but later dropped the appeal and paid $239,437 in additional taxes.

Our analysis of the appraisals disclosed four substantive differences between the approaches the two firms used. First, the IRS appraiser used net after-tax earning figures. The company appraiser stated that ESOP expenses should not be charged against earnings. Therefore, he adjusted financial statement figures to add the ESOP contributions back into company earnings and deleted the tax effect of the ESOP contribution. Second, the IRS appraiser stated that a discount rate ranging between 10 and 50 percent is appropriate for nonvoting stock and applied a 30-percent discount; the company appraiser applied a 10-percent discount for this restriction. Third, the IRS appraiser used a computer model to project future earnings and growth trends; the company appraiser used an average of adjusted current and past earnings as a projection of future earning capacity. Fourth, the IRS appraiser derived a price/earnings multiple by considering industry trends reported in financial publications; the company appraiser, when computing the price/earnings multiple in a later year, selected publicly traded firms, which it cited as comparable, and selected a price/earnings multiple that fell midway between values described by two of the comparable companies.

The divergent valuation approaches and significant differences in resulting stock values in this example--even though both firms said they used the same criteria--illustrate the imprecise nature of the only guidelines cited by Labor and IRS for use in valuing stock of closely held companies.

CONCLUSIONS

Because ESOPs are required to invest primarily in employer securities (generally company stock), the value of these securities is critical to the tax break a company will realize and to the benefits that participants and beneficiaries will receive.

Stock valuations made in good faith and based on all relevant factors are essential to assure that no more than fair market value is paid for the stock acquired by the ESOP. Transactions in employer stock involving more than fair market value not only are prohibited by ERISA and subject to an excise tax, but can adversely affect ESOP participants and their beneficiaries. In addition to being a prohibited transaction, ESOP assets may be drained off if employer stock is acquired by the plan at more than fair market value. Also, improperly valued stock can mislead participants about the ultimate value of their ESOP benefits.

Further, overvalued stock could increase the amount on which participants will be taxed when the stock is distributed or made available to them. This potential impact exists because the price paid by the ESOP for employer stock becomes the cost basis of such stock to ESOP participants for income tax purposes. The ESOP participants will be required to include the employer stock in their income at cost (price paid by the ESOP) for the year or years in which it is received or made available to them.

We believe that fiduciaries did not act in the best interest of participants when they directed or effected ESOP purchases of employer stock without taking the necessary steps to assure that the stock values were determined in good faith by independent appraisers and/or based on all relevant factors as required by ERISA and its implementing ESOP regulations. This is clearly a fiduciary responsibility that must be fulfilled to protect the interests of participants and their beneficiaries. Our recommendations to correct this problem are included in chapter 5, where we report the need for closer scrutiny of ESOP operations.

Valuation guidance contained in Revenue Ruling 59-60 is inadequate because it recognizes various approaches to stock valuation with no restrictions against annually selecting the approach that will yield the highest value. The valuation guidance also does not specify whether:

--Pretax or posttax earnings are to be used when the capitalization of earnings approach is used to value stock.

--Pre-ESOP contribution or post-ESOP contribution earnings should be used in capitalizing earnings.

--ESOP loan obligations guaranteed by the company should be recognized as a company liability (which results in a corresponding reduction of book value) when stock values are based on book value.

--Calculated stock values should be discounted because of lack of marketability and, if so, by how much.

--Calculated stock values should be discounted for minority interest or failure to pass voting rights.

The guidance also does not emphasize the requirement for independent stock appraisals. This list of problems, although not all inclusive, shows the need for more precise guidance to help fiduciaries obtain fair market values for company stock.

Labor considers the language of ERISA, which contemplates the issuance of regulations for valuing stock (adequate consideration), as permissive. Furthermore, Labor does not contemplate action on these regulations for at least 2 years. In view of the magnitude and frequency of valuation problems and their potential impact on participants, we believe Labor should issue these regulations as soon as possible.

RECOMMENDATIONS TO THE SECRETARIES OF LABOR AND THE TREASURY

To bring about needed improvements in fiduciary actions related to the valuation of company stock sold or contributed to ESOPs and to ensure that ESOPs are established and operated primarily for the benefit of participants, we recommend that the Secretaries of Labor and the Treasury develop, and promulgate through regulations and implementing procedures, more specific criteria and guidelines for valuing the stock of closely held companies for ESOP purposes, and require that such guidance be consistently applied.

AGENCY COMMENTS AND OUR EVALUATION

Labor agreed that more specific criteria and guidance are needed for valuing stock of closely held companies, but said that the myriad of factual situations involved in such valuations preclude the development of a precise method of determining adequate consideration in ESOP purchases of employer securities. (See app. I.) Labor said, however, that it remains committed to the development of standards for plan fiduciaries making valuation determinations, and it hopes to develop more specific guidelines for valuing the stock in closely held companies as its experience in the ESOP area grows.

According to Labor, it provided some valuation guidance in a speech before the ESOP Council of America in May 1979, by reiterating the Department's position that a fiduciary should use recognized methods of valuing stock in closely held corporations when making a good faith determination of the fair market value of such stock.

Labor added that it is considering whether to formally adopt the guidelines contained in Revenue Ruling 59-60 for the valuation of qualifying employer securities for which there is no generally recognized market.

Treasury agreed that current valuation practices are subject to abuse (see app. II), but expressed concern about how valuation regulations would be designed. Treasury said that, since there will be a wide variety of situations to which such regulations must apply, it does not believe a system can be designed that will indicate clearly to the public which factors are appropriate in valuing stock in a particular situation. Treasury also believes that, even if it were able to develop specific guidelines, an appraiser would still have to exercise good faith in determining which portion or portions of the guidelines to apply.

We agree that, even with specific stock valuation guidelines, appraisers would need to exercise good faith in applying the guidelines to a given situation. We also recognize that developing specific stock valuation guidelines applicable to every conceivable situation is not practical. However, we believe that the imprecise and permissive existing guidelines in Revenue Ruling 59-60 are inadequate to assure fair valuations for closely held employee stock sold or acquired by plan fiduciaries.

The various approaches we described that appraisers used in calculating stock values show that significantly different stock values can be calculated depending on the approach used. Under existing guidelines, for example, nothing precludes an appraiser from changing the stock valuation approach or technique from one year to the next to achieve more desirable results. Under such a situation, valuation techniques and approaches could be selected to achieve the desired results--higher prices when stock is being sold/contributed to the plan and lower prices in later years when stock is to be redeemed from retiring ESOP participants. Other specific valuation issues not addressed in existing guidelines are discussed on pages 15 and 16.

We are not recommending that Labor and Treasury develop a universal formula approach to stock valuations, nor are we advocating a single, all-inclusive, mechanical approach for determining adequate consideration. Rather, we have pointed out several areas where specific guidance can be developed to guard against potential abuses and to help protect the interest of plan participants and their beneficiaries.

Further, we believe that an action which only further endorses existing guidelines will not correct the problems identified. ERISA section 3(18), passed in 1974, contemplates the promulgation of regulations for determining adequate consideration. To date no regulations have been developed or issued, and comments from Labor and Treasury provided no assurance that such regulations will be issued soon.

CHAPTER 4

OTHER ASPECTS OF ESOPS THAT ADVERSELY

AFFECT EMPLOYEE INTERESTS

Although ERISA's fundamental policy is to protect employees' pension plan interests, and a major congressional intent behind ESOPs is diffusion of ownership of the company to employees, the plans of the closely held companies we reviewed

--invested ESOP assets in employer stock that may be unmarketable when distributed to participants and

--with one exception, had not passed voting rights to ESOP participants for stock conveyed to the plan.

Companies have used ESOPs largely for their own advantage, such as for tax benefits and to give the company a market for its stock, rather than for the primary benefit of participants and beneficiaries.

ASSETS INVESTED IN EMPLOYER STOCK MAY BE UNMARKETABLE

Since ESOPs are required to invest primarily in employer securities (usually employer stock), the marketability of such stock is of primary importance to participants and their beneficiaries. The final measure of an ESOP's benefit to participants is their ability to convert, at fair market value, distributed assets to cash or cash equivalent.

ESOP regulations provide that employer stock that an ESOP acquires after September 30, 1976, with the proceeds of an exempt loan 1/ must be subject to a put option 2/ if it is not publicly traded at the time of distribution. However, only 2 of the 13 ESOPs of closely held companies we reviewed had acquired stock with loan proceeds for which a put option would be required, and these two companies acquired only

---

1/An exempt loan refers to a loan to an ESOP made or guaranteed by a party-in-interest. An ESOP with an exempt loan is referred to as a leveraged ESOP.

2/A put option gives the participant or beneficiary the right to demand that the employer buy his shares of company stock at their fair market value.

part of the ESOP stock with loan proceeds. Any other assurances that participants would have a market for employer stock otherwise acquired by the ESOP were discretionary on the part of the employer and/or an employer-appointed ESOP committee. Further, these companies generally had not identified or provided for financial resources necessary to repurchase stock distributed to participants. The ESOP holdings consisted primarily of employer stock with little or no liquid assets available to repurchase employer stock distributed to participants.

Officials at several companies said that, although their plans did not assure a market for participants' stock, they intend to repurchase distributed shares from participants at fair market value. However, there was no evidence that these employers had made provision to carry out this intent.

Although not required, some of the closely held companies whose ESOPs we reviewed had redeemed distributed company stock at the recognized fair market value. These repurchases represent present voluntary practice. However, the following example illustrates the potential adverse impact on participants when the repurchase is voluntary and there is no assurance of a market. A stockholder of one closely held company whose ESOP we reviewed needed to sell 350 shares of employer stock. The ESOP committee decided that it was unable to purchase the shares because the trust did not have sufficient funds. The company's highest offer was $90 per share, although the appraised fair market value was $116.08 per share. The company repurchased the shares as Treasury Stock at $90 per share and, later in the same accounting period, contributed 350 shares of Treasury Stock to the ESOP at a new appraised fair market value of $147 per share. Thus, the company had an excessive tax deduction of at least $9,128 ($116.08 - $90 = $26.08 X 350 shares).

While this example does not involve company stock distributed by the ESOP, it does illustrate (1) what can happen to ESOP participants or anyone holding company stock when the stock's marketability is at the discretion of the company and (2) how a company can profit from a tax standpoint.

Employers are not identifying and providing for their financial obligations to ESOP participants

The assets held by ESOPs of closely held companies we reviewed consisted primarily of employer stock, with little or no cash or other assets with which to acquire the employer stock to be distributed to participants. Further, the company and ESOP financial statements did not indicate that provisions have been made to assure the availability of funds necessary to repurchase the stock distributed by the ESOP. (Three companies, however, had prepared a forecast of future cash needs for repurchase of company stock distributed by the ESOP.)

The ESOP trusts we reviewed held only employer stock and maintained little cash. Generally, the amount, form, and timing of contributions to the trust were entirely at the employer's discretion. Thus, the responsibility and capacity for redeeming participant stock, from year to year, rests solely with the employer. Officials at two companies believed their company had adequate potential for growth to "go public," thereby creating a market for distributed stock. One company had not made a contribution of any type to the ESOP for over 2 years. Furthermore, the president of one company said that he would terminate the ESOP if required to guarantee a market for stock distributed to participants.

We observed no specific instances where ESOP participants actually experienced a loss of pension benefits due to employers' inability or refusal to repurchase company stock, because ESOPs had not been in operation long enough to require that companies meet substantial financial obligations to participants.

VOTING RESTRICTIONS DENY PARTICIPANTS FULL CAPITAL OWNERSHIP

The Congress created ESOPs partly as a mechanism for transferring capital ownership to employees. However, some companies have established and operated ESOPs with no apparent intention of transferring full ownership rights to employees. This is evidenced by the failure of employers to pass voting rights to participants for company stock they sold or contributed to ESOPs. For example, before establishing an ESOP, the president of one company expressed concern to his attorney that such a plan would significantly dilute his interest in the company and lessen his control. His attorney, in response to this concern, advised that:

"It would appear to me that given the fact that you now own approximately 80% of the stock of the corporation, and that you will be entitled to the greatest share of the stock which is contributed to the trust, that there is little real problem in this area. Further, the Board of Directors will control the amount of cash available to the trust to purchase stock; the plan could be drafted so that the Administrative Committee controls all of the voting rights of stock while in the trust; and the trust will have the right to repurchase all stock distributed out of the trust."

Further, the president of another company said that he would terminate the ESOP if required to pass voting rights to ESOP participants.

Twelve of the 13 closely held company ESOPs we reviewed held voting stock. A committee--usually appointed by the employer--voted the ESOP's company stock. One company issued a separate nonvoting class of common stock to the ESOP; in this case, the principal owners retained all voting stock. Only one of the plans with voting stock had established a formal mechanism for ESOP participants to communicate their desires, as stockholders, to company management or to the voting committee. This company's plan provided that the ESOP committee would vote stock allocated to participants' accounts in accordance with instructions from each individual. The mechanism for implementing this provision was a written ballot outlining the voting issues.

The Congress recognized the importance of stock voting rights for tax-credit employee stock ownership plans authorized by the Tax Reduction Act of 1975, by requiring that (1) employer securities acquired with investment tax-credit funds have voting rights no less favorable than any other company stock of the same class and (2) participants be permitted to direct the voting of such stock allocated to their accounts. However, these statutory provisions do not extend to ESOPs.

For company stock acquired after December 31, 1979, the Internal Revenue Code, as amended, requires that voting rights be passed to ESOP participants on corporate matters which (by law or charter) must be decided by more than a majority vote of outstanding common shares voted, if

--the employer's stock is not publicly traded and

--the employer has an ESOP with more than 10 percent of its assets in securities of the employer. 1/

CONCLUSIONS

Because plan documents obligate neither the company nor the ESOP to repurchase distributed stock (unless the stock was acquired with an exempt loan), plan participants have no guaranteed market for stock distributed by the ESOP. The repurchase of distributed stock that was not acquired with loan funds is at the discretion of the company and/or the ESOP committee, which is generally made up of company officials. These circumstances may prevent participants from converting their distribution of stock to cash when needed upon retirement.

Even though companies may have a moral obligation to repurchase ESOP shares from terminated participants and say that they intend to do so, they had not made financial provisions for these obligations (even for shares involving put options). Since ESOPs are relatively new, the repurchase obligations to date have been relatively small and cash demands to meet such obligations have not been a problem. As these plans mature, however, the terminations of key employees who are fully vested will become increasingly significant and may require large repurchases. Such requirements, even if paid in installments, could severely strain the company finances.

Companies have established and operated ESOPs to gain tax advantages, to provide the company a market for its stock, or for other reasons without transferring full stock ownership rights to employees. Full capital ownership is not passed to ESOP participants when company stock sold or contributed to the plan is nonvoting or when voting rights are withheld. Stock held by the ESOP is voted by a committee, which is usually appointed by the company, and companies generally had not established formal means for allowing participants to communicate their desires, as stockholders, to management or to provide input to the voting decisions of the ESOP committee. Therefore, employees had to rely on the

---

1/A full pass-through of voting rights is required if the employer stock is publicly traded.

company-appointed committee to vote the ESOP stock in their best interest.

RECOMMENDATIONS TO THE CONGRESS

In line with ERISA policy of protecting employees' interests and to facilitate the passing of full capital ownership to workers participating in ESOPs, we recommend that the Congress enact legislation to provide that full and unrestricted voting rights be passed to ESOP participants for all employer stock allocated to their accounts which is not publicly traded.

Moreover, to ensure that ESOPs are established and operated primarily for the benefit of participants, we recommend that the Congress pass legislation to require plan provisions for redeeming, at fair market value, all nonpublicly traded company stock distributed by the ESOP, regardless of whether it was contributed or acquired with the proceeds of a loan.

AGENCY COMMENTS AND OUR EVALUATION

Labor and Treasury said that they do not believe they have the authority to promulgate regulations to require plans to redeem, at fair market value, all company stock distributed by an ESOP--as we initially proposed in the draft of this report.

More specifically, Labor said that regulations it issued under the definition of an ESOP contained in section 407(d)(6) of ERISA require that employer stock acquired by an ESOP with the proceeds of an exempt loan must be subject to a put option if it is not publicly traded at the time of distribution. (See app. I.) It is Labor's view that ERISA does not confer similar authority to require put options under all circumstances involving the distribution of closely held employer stock by an individual account plan designated an ESOP. Labor said that the Congress, in enacting the Revenue Act of 1978, amended the Internal Revenue Code to require that participants receiving a distribution of employer stock from a Tax Credit Stock Ownership Plan or a leveraged ESOP must generally be given a put option in the case of an employer whose stock is not publicly traded at the time of distribution. Labor, therefore, concluded that further legislative action would probably be necessary to impose additional plan provisions pertaining to the redemption of all closely held employer stock distributed from an ESOP.

Treasury said that a "put" back to the employer on distribution of closely held stock is appropriate in the case of all defined contribution plans which distributed such securities. (See app. II.) Treasury also said that distribution of securities that have no market seems to be contrary to the intent and purpose of providing special treatment for ESOPs and other eligible individual account plans. However, Treasury does not believe that current law gives the Secretary authority to impose such a requirement through regulations.

Treasury said that it would support legislation requiring an employer to provide a market for closely held securities distributed from a plan maintained by the employer.

Our original proposal to the Secretaries of Labor and the Treasury was founded in the belief that the authority to promulgate regulations for redeeming company stock distributed by ESOPs flowed from ERISA section 505, as did the authority for previous regulations--the requirement for granting put options on qualifying employer securities which an ESOP acquires with the proceeds of an exempt loan, if it is not publicly traded at the time of distribution. In view of the agencies' position that further legislative action may be necessary to clarify congressional intent in this area, we are addressing our recommendation to the Congress.

CHAPTER 5

ESOP OPERATIONS NEED

CLOSER SCRUTINY

Employee stock ownership plans are authorized by ERISA to engage in certain party-in-interest transactions in which the potential for self-dealing by fiduciaries exists and in which the interests of plan fiduciaries may conflict with the interests of participants. To guard against this potential abuse, the Congress intended that all aspects of these ESOP transactions would be subject to special scrutiny by the Departments of Labor and the Treasury to ensure that they are primarily for the benefit of plan participants and beneficiaries.

Although Labor and the Treasury have examined a number of ESOPs since the enactment of ERISA, their approach to selecting and reviewing these plans has not been systematic. We believe that there is a continuing need to provide special scrutiny of transactions that the Congress identified as being subject to abuse. Accordingly, we believe that Labor and the Treasury need to reassess their plans for future examinations to develop systematic programs for scrutinizing ESOPs and to assure maximum coverage within the constraints of limited resources.

SPECIAL SCRUTINY OF ESOP TRANSACTIONS INTENDED BY THE CONGRESS

When the Congress enacted ERISA in 1974, it gave Labor and the Treasury joint responsibility for administering the act. One provision of the act prohibits plan fiduciaries from engaging in certain transactions with a party-in-interest. However, as individual account plans, ESOPs were exempted from some of the prohibited rules. Specifically, ERISA exempted loans from a party-in-interest to an ESOP if such loans are primarily for the benefit of participants and beneficiaries of the plan, and the interest is not in excess of a reasonable rate. Concerning this matter, House Conference Report No. 93-1280 states that the exemption from prohibited transaction rules with respect to loans to ESOPs is to apply only in the case of loans (and guarantees) used to leverage the purchase of qualifying employer securities and related business interests.

However, the Congress recognized that allowing these exemptions might present problems. Specifically, plan assets might be drained off because of unreasonable interest rates and high purchase prices of stock from parties-in-interest. The Congress was also concerned that undue financial strain might be placed on the plan if a party-in-interest is allowed to call a note at his convenience. We found that the congressional concerns pertaining to stock prices were justified because fair market values were not assured in ESOP transactions involving employer stock of closely held companies. (See ch. 3.)

Because of these potential problems, the Congress intended that all aspects of such transactions would be subject to special scrutiny. Although Labor and the Treasury have promulgated regulations that recognize the potential for abuse and the need for close scrutiny of party-in-interest transactions, they have not developed formal programs or guidelines on how the special scrutiny is to be accomplished. Further, they did not have a systematic method for identifying and selecting ESOPs for special scrutiny.

The Treasury/IRS has concentrated on the tax qualification of plans

IRS enforcement of ERISA is discussed in our report to the Joint Committee on Taxation, "Internal Revenue Service Efforts and Plans To Enforce the Employee Retirement Income Security Act" (HRD-79-55, Mar. 28, 1979).

After the enactment of ERISA, IRS dedicated most of its available field staff resources to reviewing pension plan documents submitted by employers to assure that the plans comply with the minimum requirements of the Internal Revenue Code and to issuing determination letters for tax qualification to employers. However, IRS officials advised us that, since early 1979, IRS has been actively examining employee benefit plans, including ESOPs.

Officials of the IRS Employee Plans Division said that IRS is implementing a special program starting in 1980 which will help them to identify ESOPs and to increase the number of pension plan examinations. ESOPs are to be included in this examination effort along with all other employee benefit plans. In addition to this program, IRS and Labor have a joint referral program for problems noted during examination of employee plans, including ESOPs.

Labor's ESOP review efforts 1/

Labor's enforcement of ERISA is discussed in our report to the Senate Committee on Governmental Affairs, Permanent Subcommittee on Investigations, "Laws Protecting Union Members and Their Pension and Welfare Benefits Should Be Better Enforced" (HRD-78-154, Sept. 28, 1978).

Labor's enforcement activities related to ESOPs have been limited because of a continuing shortage of field examiners. Since the enactment of ERISA, Labor has selected ESOPs for examination through desk audits of annual reports (Form 5500 series), participant complaints, and referrals from other agencies.

Between the enactment of ERISA and March 1980, Labor opened about 160 ESOP cases, many of which resulted from a special project by one regional office. Labor said that about 115 of these cases were closed by the regional offices because of voluntary compliance by the company or the absence of any apparent violation, and 42 cases were still pending. Of the cases opened, 17 were referred to Labor's Solicitor, and 4 of these resulted in litigation. One additional lawsuit is contemplated in the near future, and others are being considered by the Office of the Solicitor. The four lawsuits involving ESOPs represent about 10 percent of all suits filed by Labor alleging violations of ERISA.

Labor officials said that their total enforcement staff, consisting of about 190 compliance officers, is dedicated to all aspects of ERISA enforcement. They said future enforcement strategy will be to selectively target available staff time to areas where they feel the Department can have the most impact. Specifically, this strategy calls for Labor to devote a high percentage of available enforcement staff to pursuing fiduciary problems. Most of the effort will be targeted at what Labor officials term "significant" cases--those involving legal precedent, a large dollar value, or a large number of participants.

1/As a result of additional data that Labor provided on its review efforts after we submitted the draft report for comments, we revised this section of the report and related conclusions and recommendations. Additional comments on these revisions are on pages 32 to 35.

CONCLUSIONS

Despite past examination efforts by Labor and the Treasury, closer scrutiny is needed to protect the rights of ESOP participants. This need is illustrated by employers' lack of compliance with ERISA and its implementing regulations which require that stock valuations be made in good faith and based on all relevant factors. The result of this apparent noncompliance, as discussed in chapter 3, is the potential overvaluation of company stock to the detriment of plan participants. The number of ESOP cases Labor has referred to its Solicitor and lawsuits resulting therefrom represent further evidence that a formal program for providing special systematic scrutiny is needed to assure that the interests of plan participants are protected.

RECOMMENDATIONS TO THE SECRETARIES OF LABOR AND THE TREASURY

To assure that the potential abuse of ESOPs by parties-in-interest is effectively scrutinized as the Congress intended, we recommend that the Secretaries of Labor and the Treasury reassess their plans for future examinations and develop programs for systematically scrutinizing ESOPs and maximizing coverage within the constraints of limited resources.

AGENCY COMMENTS AND OUR EVALUATION

Department of Labor

During the review, Labor officials told us that, because of a general lack of trained enforcement people in field offices, they had not specifically targeted ESOPs for special scrutiny--with the exception of a one-time self-initiated effort by one region. These officials said, however, that they had opened cases on other ESOPs in response to referrals by other agencies, participant complaints, and desk audits of annual reports. They also said that about 10 cases had been referred to the Office of the Solicitor for possible action. In commenting on our draft report, however, Labor disagreed with the accuracy of this data and conclusions drawn therefrom. (See app. I.)

We met with Labor officials to ascertain the basis for their disagreement. Labor provided additional data and acknowledged that we had not been provided complete information on its ESOP enforcement and special scrutiny efforts. Based on the additional data Labor provided, which we did not verify, we revised our findings and conclusions to more completely show Labor's efforts and position regarding this matter.

Labor said that, within the constraints imposed by available resources, it has fully complied with the congressional mandate to provide special scrutiny of ESOPs. This special scrutiny, according to Labor, has taken the form of a special project devoted solely to the investigation of ESOPs, the opening of cases on over 150 such plans, and the filing of four lawsuits. Labor said this special scrutiny will continue in the form of additional lawsuits, increased training of enforcement personnel with regard to stock valuation, and special emphasis on targeting potential abuses of ESOPs through new reporting requirements incorporated in the Annual Return/Report of Employee Benefit Plan (Form 5500 series) for 1979.

Labor said that its opening of over 150 cases on ESOPs--which generally are small plans that would not normally fit into the scope and strategy of its enforcement program--plus the fact that it had taken litigative action on four of these cases, is evidence of emphasis in this area. We agree that some of the scrutiny the Congress intended has been provided for some of the cases opened. However, the mere opening of a case does not assure that applicable party-in-interest transactions, which the Congress was afraid might be abused, were properly scrutinized and dealt with.

In fact, Labor officials could not say with certainty that the specific transactions of concern to the Congress (see pp. 29 and 30) were subjected to the special scrutiny mandated for all of the cases opened. In this regard, Labor officials told us that the Department had not developed and issued a formal policy or program describing how special scrutiny of ESOPs is to be conducted. Labor officials also said that records had not been maintained to show national office direction to field offices concerning ESOPs. These officials said that such direction is made through

--bimonthly meetings with area regional administrators,

--interoffice memorandums, and

--telephone calls.

Nevertheless, Labor maintained that most of the cases opened received the scrutiny the Congress mandated.

As stated earlier, we did not review in detail any of the ESOP cases Labor opened to verify the extent of work performed. However, based on our perusal of selected files and related correspondence from Labor's enforcement and solicitor offices, we question whether Labor adequately evaluated party-in-interest transactions involving the fair market value of stock sold or contributed to several plans.

For example, one issue raised concerned whether plan fiduciaries' consistent use of book value to value employer securities is compatible with the prudence and adequate consideration requirements of ERISA sections 404(a)(1)(B) and 408(e). A memorandum from Labor's Office of the Solicitor stated that, although book value cannot generally be relied on as an adequate approximation of fair market value, it is relatively consistent, inexpensive to compute, and readily available. It also said that the cost of recurring appraisals, which might be necessary if Labor took the position that only an appraisal adequately measures value, could be very high in many instances. The memorandum stated further that, for many corporations, book value could, even though by chance, turn out to be close to fair market value.

Labor's counsel for this case concluded that:

> "In the absence of regulations or of some independent evidence of a discrepancy between book value and some other means of valuation, we are reluctant at this time to recommend challenging the use of book value by this ESOP or profit-sharing plan to purchase employer securities--especially when book value has been used by the plan sponsor for other purposes, e.g., to sell and repurchase stock. We base this view in large part upon our concern that in plans of this kind, book value may be as favorable or even more favorable to the plan than any other valuation method. Even if that were not the case, a court in reviewing this type of issue without the benefit of regulations might draw a conclusion that in the long term would be adverse to the development of the law on the methods to be applied by plan fiduciaries in determining the value to be paid for employer stock.

"We therefore recommend that no further action be taken and that the file in this matter be closed."

As a result of this reasoning, Labor closed at least three of the ESOP cases without, in our opinion, adequately assuring that fair market value was used in ESOP transactions involving employer securities--one of the specific areas that the Congress was concerned about because of potential abuses by parties-in-interest.

Department of the Treasury

Treasury said that its current program indicates an ongoing and expanding effort to fulfill the congressional mandate for special scrutiny of ESOP activities. (See app. II.)

In summarizing these activities, Treasury said that the first ERISA annual report forms developed did not provide for sufficient data to identify all ESOPs, because of the necessity for a short-form report for corporate plans with fewer than 100 participants. However, Treasury said it has taken steps to implement an ESOP examination program of the type the Congress envisioned. For example, implementing instructions for selecting returns for examination in fiscal years 1979 and 1980 specifically identify ESOPs as a type of plan to be selected for examination in order to ensure a balanced compliance program.

Beginning with the 1979 returns, Treasury said all ESOPs must answer a specific three-part question designed to help IRS select the appropriate ones for examination. The first part of the question asks whether the plan contains an ESOP feature and, if so, whether a current appraisal of the value of the stock was made immediately before the contribution of the stock or the purchase of the stock by the plan. The second part asks whether the appraisal was made by an unrelated third party, and if not, the third part asks whether the appraisal was made in accordance with the provisions of Revenue Ruling 59-60. Treasury said that 1979 returns warranting examination will be examined in fiscal year 1981 to the extent examination resources are available.

Treasury also noted the following actions, which it believes will improve the ESOP examination program:

--A taxpayer compliance measurement program, started in January 1980, which provides for gathering data on ESOPs with 100 or more participants.

--Implementation of a computer selection program beginning with 1980 returns, which Treasury said will (1) be the foundation for IRS's examination program starting in fiscal year 1982, and (2) will allow IRS to ensure that retirement plans are operated for the benefit of all participants and beneficiaries.

--Revised procedures requiring mandatory referral of ESOPs to Employee Plan Specialists, who must determine whether the plan is a qualified plan operated for the exclusive benefit of employees; these procedures require special scrutiny of any transactions involving the employer's stock.

--Valuation training classes for Employee Plan Specialists to help them recognize and deal with stock valuation problems.

--Procedures for referral of appropriate cases to IRS Examination Division engineers when special assistance is needed.

We believe that Treasury's ongoing and planned efforts will help identify ESOPs for special scrutiny.

CHAPTER 6

SUBSTANTIVE EVIDENCE BEHIND ESOP MOTIVATION AND PRODUCTIVITY THEORY IS LACKING

One widely discussed theory underlying ESOPs is that employee participation results in improved worker motivation and increased productivity. However, available published research data on this theory are largely inconclusive, and we were unable to develop substantive evidence in our review of 16 ESOPs to support this theory. Our review showed, however, that some companies may have precluded any potential for positively motivating employees because they had not involved employees in the ESOP or effectively communicated details about the plan--factors that we believe are essential if such plans are to motivate employees and improve productivity.

Discussions with company officials and review of plan documents disclosed that companies established the ESOPs for such purposes as providing an employee pension plan, generating cash flow for the company, giving the company a market for its stock, and providing tax advantages to the company. Officials at only 4 of the 16 companies cited improved employee motivation and productivity as a reason for establishing the ESOP, and only 2 cited this as the primary reason for establishing the ESOP. None of the companies whose plans we reviewed had assessed the effects of their ESOP on employees.

Although there has been some research addressing ESOP effects on motivation and productivity, the published studies we reviewed were tentative in their conclusions. These studies cite a lack of industry experience with ESOPs and a limited number of plans available for analysis as their basis for qualifying their conclusions on ESOPs and suggesting a need for further study.

As discussed in previous chapters, several aspects of ESOP operations in closely held companies we reviewed adversely affect workers' interests. These adverse effects, coupled with the fact that the operational details of ESOPs have not been effectively communicated to employees, would tend to lessen the potential for favorable morale and productivity effects at companies where such conditions exist.

ESOP OPERATION AND COMMUNICATION REDUCE POTENTIAL FOR POSITIVE EFFECTS

Employee involvement in ESOPs, plus timely and informative communication of related matters, seems essential to maximize the impact of an ESOP on employee motivation and productivity. However, several of the companies whose ESOPs we reviewed had not involved employees in ESOP matters or effectively communicated plan details. Consequently, the companies did not fully realize the potential for motivating employees and improving their productivity.

Plan provisions and management implementation of the ESOPs we reviewed in most cases precluded rank-and-file participants from being involved in several functions. Specifically:

- --Eleven plans did not give participants the right to vote or to direct the voting of their stock.
- --One company contributed only nonvoting stock to the ESOP.
- --Eleven companies had provided no formal mechanism for ESOP stockholders to have any input to management decision processes.
- --Only one company had a rank-and-file ESOP participant on the board of directors.
- --Only five companies had rank-and-file representation on the ESOP committee (generally appointed by the board of directors).

Additionally, the 13 closely held companies whose ESOPs we reviewed had provided only minimal formal communication to their employees regarding the ESOP; consequently, employees were not provided the information normally associated with being an owner of capital stock. Further, in the area of communication to participants,

- --none of the plans at closely held companies had complied with ERISA minimum standards by providing all the prescribed minimum information to participants and
- --six plans did not inform participants, as required by ERISA, of the current market value of their stock.

Interviews with selected employees clearly showed the lack of employee involvement in ESOP operations and the absence of substantive communication from employers to participants.

We interviewed 98 participants at various companies concerning the operation of their company's ESOP. Several of the participants at closely held companies were unfamiliar with the basic elements of the ESOP, such as how allocations were made to their accounts and how benefits were to be vested and paid. Some participants at one company were totally unaware of their ESOP. Several participants at five companies said that management had not provided them details on how the ESOP works.

Most employers felt that their ESOPs were a positive influence on employees; however, none could provide evidence to support these opinions. Employers had not attempted to determine what impact the ESOP was having on employees and could not provide any measure of increased productivity resulting from the plans.

Unlike their employers, most employees interviewed did not perceive the ESOP as influencing their work or the work of others. Employees at five companies expressed the opinion that the ESOP had a negative effect on employee morale. At another firm where individual employees were not interviewed, the company observed strong employee dissatisfaction with the ESOP because of the declining value of company stock.

INDEPENDENT RESEARCH DOES NOT SUPPORT SUBSTANTIVE CONCLUSIONS ON MOTIVATION AND PRODUCTIVITY THEORY

Although many articles have been written on various aspects of ESOPs, as of July 1979 little had been published on the results of research concerning the relationship between ESOPs and employee motivation and productivity. The studies that had been published presented only tentative conclusions and developed little substantive evidence that would support contentions that ESOPs result in increased productivity or improved morale.

We identified only three studies, completed since the enactment of ERISA, that addressed ESOP motivation and productivity. The two most recent (both published in 1977) were performed at the University of Michigan, under a technical assistance grant from the U.S. Economic Development Administration, and at the University of California, Los Angeles, under sponsorship of the ESOP Council of America. 1/ The third study was prepared by an independent consultant, under contract to the United States Railway Association, in 1975. Although there was other research in progress that may address motivation and productivity in companies with ESOPs, the results were either unpublished or otherwise unavailable for our review.

University of Michigan, Survey Research Center, study on employee ownership

The University of Michigan, Survey Research Center, Institute for Social Research, studied ESOPs using a sample of 98 companies that reported having a plan of employee ownership, 30 of which provided profit data sufficient to evaluate profitability as a correlate of productivity. The report, however, clearly states that conclusions were "tentative" because the sample was not extensive enough to obtain statistically valid results. Nevertheless, the report shows that some of the trends identified were considered statistically significant.

In analyzing the 30 firms providing profit data, the researchers noted a relationship between profitability and employee ownership. These firms showed a higher profit level than similar conventional firms; however, the researchers state that it is not possible on the basis of this comparison to assert that employee-owned firms are more profitable than conventional firms.

The researchers further reported that the profitable firms in which workers held a high proportion of the equity (1) tended to be directly owned, as opposed to "beneficial ownership" through a trust, (2) had worker representatives on the board of directors, and (3) passed voting rights to employee owners.

Graduate school survey of ESOPs

The University of California, Los Angeles, Graduate School of Management, studied ESOPs and published its results

---

1/A nonprofit trade association founded in 1976 to provide, in part, a united front for companies and individuals involved in ESOPs.

in December 1977, under the title "Survey of Employee Stock Ownership Plans."

This study analyzed questionnaire responses from management officials of 180 companies with ESOPs to ascertain whether ESOPs in operation had met the companies' intended objectives. The field study team prefaced its findings and conclusions on employee motivation with the observation that most of its respondents were unsure of the ESOP's effect on employee motivation because most plans had been in existence only a short time--the average plan age in the sample was 3 years.

The report stated that 80 percent of the responding companies noted that the ESOP had produced no effect on employee turnover. It also noted that many companies perceived confusion or indifference to the ESOP on the part of their employees and reported that 71 percent of the respondents rated employees' understanding of the ESOP as "fair" or "poor." The study team reported most companies felt that this apparent employee indifference or confusion was due to plan complexity and the difficulty of making an intangible benefit, such as an ESOP, appear real to employees.

The study team concluded that an ESOP by itself did not appear to measurably improve employee morale or motivation unless the work atmosphere and employer/employee communications were already good. They stated that, where no esprit de corps exists, an ESOP cannot be expected to create it.

Report to the United States Railway Association on probable motivational effects of ESOPs

The third study was published in April 1975, by an employee motivation consultant under the title "Analysis of Probable Motivational Effects of Employee Stock Ownership Plans in Railways in Reorganization." He submitted the report to the United States Railway Association as part of a contract to evaluate the possible applications an ESOP might have to ConRail (Consolidated Rail Corporation).

This report focused on the specific question of ESOP motivation as it might apply to ConRail. It presented general conclusions based on a review of 15 companies with operating ESOPs, an analysis of published ESOP motivational theory, and an analysis of published research on motivation and behavior changes.

In comparing ESOP motivational theory to the motivating elements identified in published behavioral research, the consultant reported three general conclusions: (1) the "free gift" aspect of ESOPs, supported entirely by company contributions, may have some motivation-enhancing effect, although not as much as other forms of financial motivation, such as stock purchase, (2) the fact of ownership in itself may cause small but appreciable changes in employee motivation to protect company property, and (3) the trustee-beneficiary relationship in ESOPs dilutes the positive motivational effects of employee ownership.

In analyzing the experiences of the 15 companies, the report noted that most ESOPs were installed in small, motivationally healthy companies, usually for purposes unrelated to motivation. The report also observed that evidence to support contentions of positive motivational change at these companies was tentative, and concluded that evidence of motivational results from ESOPs was, at best, tenuous and premature.

CONCLUSIONS

Our review showed that most employers were not primarily concerned with ESOPs as a tool for enhancing employee morale or increasing productivity. Furthermore, the way closely held companies designed and operated their ESOPs tended to mitigate any positive impact in these areas. Research to date is inconclusive about the impact of ESOPs on employee motivation and productivity. On the basis of our review, discussions with employees and company officials, and a review of the literature, we could not determine whether ESOPs improved employee motivation and productivity.

U. S. Department of Labor

Inspector General
Washington, D.C. 20210

MAR 1 8 1980

Mr. Gregory J. Ahart
Director
Human Resources Division
U. S. General Accounting Office
Washington, D. C. 20548

Dear Mr. Ahart:

This is in reply to your letter to Ray Marshall, Secretary of the United States Department of Labor, requesting comments on the draft GAO report entitled, "Employee Stock Ownership Plans: Who benefits most in closely held companies--employers or employees?"

The Department's responses are enclosed.

The Department appreciates the opportunity to comment on this report.

Sincerely,

Marjorie Fine Knowles

MARJORIE FINE KNOWLES
Inspector General

Enclosures

APPENDIX I

U. S. Department of Labor's Response To
The Draft General Accounting Office Report
Entitled, "Employee Stock Ownership Plans:
Who benefits most in closely held companies--
employers or employees?"

Recommendation: The Secretary of Labor should develop and promulgate through regulations and implementing procedures, more specific criteria and guidelines for valuing stock of closely-held companies.

Response: The Department concurs.

Comments: The Department of Labor has previously provided guidance on the valuation of stock for which there is no generally recognized market. In a speech before the ESOP Council of America on May 7, 1979, Ian D. Lanoff, Administrator, Pension and Welfare Benefit Programs, reiterated the Department's position that a fiduciary should make a good faith determination with respect to the fair market value of stock by utilizing recognized methods of valuing stock in closely-held corporations. Mr. Lanoff further noted that the factors outlined in Revenue Ruling 59-60 should assist the plan fiduciary in making valuation determinations.

Although the myriad of factual situations precludes the development of a precise method of determining adequate consideration in the case of ESOP purchases of employer securities, the Department remains committed to the development of standards for plan fiduciaries making valuation determinations. The Department hopes to develop more specific guidelines for valuing the stock in closely-held companies as our experience in the ESOP area grows.

The Department wishes to note that it is currently in the process of considering whether to formally adopt the guidelines contained in Revenue Ruling 59-60 for the valuation of qualifying employer securities for which there is no generally recognized market under section 3(18) of ERISA.

U. S. Department of Labor's Response To
The Draft General Accounting Office Report
Entitled, "Employee Stock Ownership Plans:
Who benefits most in closely held companies--
employers or employees?"

Recommendation: That the Secretary of Labor promulgate regulations to require plan provisions for redeeming, at fair market value, all company stock distributed by an ESOP.

Response: The Department does not concur.

Comments: Regulations issued by the Department under the definition of an ESOP contained in section 407(d)(6) of ERISA require that employer stock acquired by an ESOP with the proceeds of an exempt loan must be subject to a put option if it is not publicly traded at the time of distribution. It is the Department's view that ERISA does not confer similar authority to require put options under all circumstances involving the distribution of closely-held employer stock by an individual account plan designated an ESOP. Congress, in enacting the Revenue Act of 1978, amended the Internal Revenue Code to require that participants receiving a distribution of employer stock from a TRASOP or a leveraged ESOP must generally be given a put option in the case of an employer whose stock is not publicly traded at the time of distribution. It would appear that further legislative action would be necessary in order to impose additional plan provisions pertaining to the redemption of all closely-held employer stock distributed from an ESOP.

U. S. Department of Labor's Response To
The Draft General Accounting Office Report
Entitled, "Employee Stock Ownership Plans:
Who benefits most in closely held companies--
employers or employees?"

Recommendation: To carry out the Congress' intent to guard against potential abuse of ESOPs by parties-in-interest, we recommend that the Secretaries of Labor and Treasury develop and implement a program for providing special scrutiny of ESOP transactions.

Response: The Department does not concur.

Comments: The Department is of the view that its past programs have provided the special scrutiny mandated by Congress and that present programs continue to assure that such scrutiny will be provided in the future. Within the constraints of its limited resources, the Department's activities in this area, since the passage of ERISA on September 2, 1974, have included the following:

* The Department has opened over 150 cases on ESOPs, 42 of which are presently pending.

* Of these cases, four have resulted in litigation. Since, in total, the Department has brought approximately 40 lawsuits alleging violations of ERISA, the number of lawsuits involving ESOPs represents approximately 10% of all suits filed. One additional lawsuit is contemplated in the near future and others are under active consideration by the Office of the Solicitor.

* The Kansas City Region of LMSA, the Region containing the most LMSA area offices, instituted a special targeting effort concentrating solely on ESOPs. ESOPs are the only type of employee benefit plan which has ever been singled out for such special targeting. As a result of this project, 27 ESOPs were investigated in depth.

* Investigative and auditing guidelines designed specifically for examining ESOPs have been developed. These guidelines have been distributed throughout the program for use in investigations of ESOPs.

With regard to ESOP investigations, the main issue usually confronting DOL auditors is the proper valuation of employer securities. This issue, therefore, has been the primary focus of all Departmental activity with regard to such investigations. As stated by Ian Lanoff, Administrator of the Pension and Welfare Benefit Programs, in a speech on May 7, 1979 to the ESOP Council of America:

> We place great importance on the process of determining the value of securities in the ESOP context because the purchase or sale of employer securities by the Plan may directly benefit those persons responsible for the investment decision and because adequate consideration is more difficult to determine because the stock may not be publicly traded or may not have a generally recognized market.
>
> A problem common to several ESOPs which has come to the attention of the Department is the failure of plan fiduciaries to take sufficient steps to determine the value of the securities prior to the purchase.

This emphasis has also been reflected in the activities of the ERISA Advisory Council of the Department of Labor. The investment and fiduciary responsibility work group of that Council, recognizing the importance of ESOPs, undertook a detailed study of the Department's activities in this area. In its report to the full Advisory Council, on November 7, 1979, the committee recommended that: "The Department be commended for its enforcement focus in the ESOP context on 'adequate consideration' for, and proper valuation of, employer securities...."

The Department's emphasis in this area is continuing. With regard to staff training, internally, LMSA is developing a two week long course in investments one of the main focuses of which is valuation of employer securities. Externally, the Department has recently had three of its supervisory personnel attend a pilot valuation training program developed by the IRS. The Department contemplates that additional employees will attend future sessions of this course as it is offered.

As indicated by the Kansas City Pilot Program, it is possible to successfully target ESOPs for investigation. However, to increase the Department's ability to select plans for such investigations, changes have been made in the Form 5500 series for the year 1979. For the first time, this form includes specific questions relating to ESOPs. Question 19(c) is as follows:

(c) Is this a plan with Employee Stock Ownership Plan (ESOP) features?

(i) If "yes," was a current appraisal of the value of the stock made immediately prior to the contribution of the stock or the purchase of the stock by the trust?

(ii) If (i) is "yes," was the appraisal made by an unrelated third party?

(iii) If (ii) is "no," was the appraisal made in accordance with provisions of a Revenue Ruling 59-60?

It is anticipated, when responses to the 1979 Form 5500 series are received that this item (as well as other items) will be computer scrutinized as part of the Department's ongoing program of targeting plans for future investigations.

In the past, it has been through such analysis of reports filed with the Department that most investigaitons have been instituted. For example, of the 20 investigations listed in our memorandum to you of July 11, 1979, only five were generated by a participant complaint. Two were referred to us by other Governmental agencies and the other 13 were generated internally based on reviews of reports filed by the plans.

In conclusion, it is the Department's view that it has, within the constraints imposed by its available resources, fully complied with its congressional mandate to provide special scrutiny to ESOPs. In the past, this special scrutiny has taken the form of a major special project devoted solely to the investigation of ESOPs, the opening of cases on over 150 such plans, and the filing of four lawsuits. In the future, this special scrutiny will continue to exist in the form of additional lawsuits, increased training of LMSA personnel with regard to stock valuation, and special emphasis on targeting potential abuses through new reporting requirements in the 1979 Form 5500 series.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

MAR 19 1980

Dear Mr. Voss:

Thank you for the opportunity to review the General Accounting Office draft report to the Chairman of the Senate Finance Committee entitled "Employee Stock Ownership Plans: Who Benefits Most in Closely Held Companies--Employers or Employees?"

We would like to make four comments with respect to the draft report. These comments reflect the views of both the Treasury Department and the Internal Revenue Service.

First, while the definition of employee stock ownership plan in the draft is accurate, we believe the issues raised and the problems described by the report are generally applicable to all defined contribution plans (e.g., stock bonus plans and profit sharing plans) which invest in closely-held employer securities. Section 407 of the Employee Retirement Income Security Act of 1974 (ERISA) imposes a limitation on the portion of a plan's assets which may be invested in employer securities. An exception from this rule is provided for eligible individual account plans which include profit sharing, stock bonus, thrift and savings plans, employee stock ownership plans and certain money purchase pension plans. We believe the problems of valuation and marketability which you describe in the draft report are applicable to all eligible individual account plans which take advantage of the ability to invest in closely-held employer securities.

Second, you recommend that the Treasury Department work with the Department of Labor to develop regulations and procedures with more specific criteria and guidelines for valuing the stock of closely-held companies and that we require that such guidance be consistently applied. While we agree with your conclusion that current valuation practices are subject to abuse, we are concerned with the manner in which valuation regulations would be designed. It seems clear that there will be a wide variety of situations to which such regulations must apply and we do not believe it is possible to design a system which will indicate clearly to the public which factors are appropriate in valuing stock in a particular situation. We also believe that even if we were able to develop specific guidelines, it still would be necessary for an appraiser to exercise good faith in determining which portion or portions of the guidelines would be applicable. We would appreciate any comments or suggestions you or your staff may have regarding the standards you believe should be applied based on your study and your experience in this area.

Third, you recommend that the Secretaries of Treasury and Labor develop and implement a program for providing special scrutiny of ESOP transactions as mandated by the Congress in 1974. We would appreciate any specific recommendations you may have in this regard. We also wish to point out that our current program indicates an ongoing and expanding effort to fulfill the Congressional mandate.

When the first ERISA annual report forms for employers (Form 5500 Series) were developed for tax year 1975, an item was included on Form 5500 to identify an ESOP which was not part of a qualified plan and an additional item was added to identify an ESOP forming a part of a qualified plan. Approximately 30,000 large corporate plans (100 or more participants) file Form 5500 and we have been able to determine which of them have been maintaining ESOPs. However, because of the necessity to develop a short form (Form 5500-C) for small corporate plans (with fewer than 100 participants) we have not been able to obtain identifying information for all types of plans. Thus, we have not had the capability to identify how many ESOPs there are among some 430,000 small corporate plans reported on 1975 through 1978 return filings.

Despite the problems arising because of the need to avoid burdensome paperwork for small employers, we believe the Internal Revenue Service has taken steps to implement an ESOP examination program of the type Congress envisioned. For example, in implementing instructions for selecting Form 5500 series returns for examination in fiscal year 1979 and fiscal year 1980, the Internal Revenue Service specifically identified ESOPs as a type of plan to be selected for examination in order to ensure a balanced compliance program. Also, beginning in January 1980, a Taxpayer Compliance Measurement Program (TCMP) is being conducted of approximately 18,500 retirement plans to determine, by in-depth examination, precisely where violations of ERISA are occurring. Sampling instructions for the TCMP call for inclusion of all ESOPs which cover 100 or more participants. It is anticipated that this program, which concludes in November, 1981, will provide the Internal Revenue Service with detailed compliance information on all types of retirement plans, including ESOPs. The information obtained from the TCMP program will enable the Internal Revenue Service to redesign its returns and examination program to close identified compliance gaps.

The Internal Revenue Service recently changed its procedures for referrals from the Examination Division covering corporate returns examined (Forms 1120, 1120-S, etc.) for which a tax deduction is taken for a contribution to a retirement plan. Under the revised procedures, ESOPs are mandatory referrals to Employee Plan Specialists in the Internal Revenue Service who must determine whether the plan is a qualified plan operated for the exclusive benefit of employees. In connection with this determination, any transactions involving the employer's stock are given special scrutiny.

In order to increase awareness of Employee Plan Specialists, the Internal Revenue Service is currently conducting valuation training classes so the Specialists will be better able to recognize and deal with stock valuation problems that arise in the examination of ESOPs. Further, the Internal Revenue Service has provided procedures to refer appropriate cases to Examination Division engineers when specialized assistance is needed.

Beginning with the 1979 return forms, a specific three-part question was developed for ESOPs and included on both the Form 5500 and Form 5500-C returns. The first part asks whether the plan contains an ESOP feature, and, if so, whether a current appraisal of the value of the stock was made immediately prior to the contribution of the stock or the purchase of the stock by the plan. The second part asks whether the appraisal was made by an unrelated third party, and if not, the third part also asks whether the appraisal was made in accordance with the provisions of Revenue Ruling 59-60. Answers to these questions will enable the Internal Revenue Service to identify all ESOPs and schedule for examination those which are warranted. The examination of 1979 returns warranting examination will be conducted in fiscal year 1981 to the extent examination resources are available in light of our commitment to the TCMP examinations.

Similar ESOP questions will be part of 1980 and subsequent year returns and will be a criteria for a computer selection program currently under development. The 1980 returns are already under development. This computer selection system will be the foundation for the Service's examination program for fiscal year 1982 and later years and will allow the Service to ensure that retirement plans are operated for the benefit of all participants and beneficiaries.

Finally, your report recommends that the Secretaries of Treasury and Labor require an employer to provide, at a participant's election, for a fair market value redemption of all closely-held company stock distributed by an ESOP regardless of how it was acquired. We believe that a "put" back to the employer on distribution of closely-held stock is appropriate in the case of all defined contribution plans which distribute such securities. Distribtuion of securities which have no market seems to be contrary to the intent and purpose of providing special treatment for employee stock ownership plans and other eligible individual account plans. However, we do not believe that current law gives us the authority to impose such a requirement through regulations and we suggest that your recommendation regarding marketability be addressed to the Congress. We would support legislation which would require an employer to provide a market for closely-held securities distributed from a plan maintained by the employer.

In the event our comments raise issues which you believe are beyond the scope of the report, we would have no objection if you separately included our comments as an Appendix with an indication that they raise issues outside of the report.

Sincerely yours,

Emil M. Sunley

Emil M. Sunley
Acting Assistant Secretary
(Tax Policy)

Allen R. Voss
Director
General Government Divsion
United States General Accounting Office
Washington, D.C. 20548

cc: The Honorable
Jerome Kurtz
Commissioner of Internal Revenue

(207320)