ECONOMIC POLICY BOARD
EXECUTIVE COMMITTEE MEETING

AGENDA

December 4, 1975
8:30 a.m.
Roosevelt Room

1.	Broadening Employee Stock Ownership	Gorog
2.	Status Report on Tax Reduction and Spending Restraint Initiative	Gorog

MINUTES OF THE ECONOMIC POLICY BOARD EXECUTIVE COMMITTEE MEETING
December 3, 1975

ATTENDEES: Messrs. Seidman, Gardner, Dunlop, Greenspan, Robinson, Cannon, Dent, Dunn, Zarb, Malkiel, Walker, Jones, Porter, Penner, Hinton, Harper, Hormats

1. Regulations on Tax Exempt Financing for Regional Municipal Power Systems

The Executive Committee reviewed a memorandum prepared by the Department of the Treasury outlining proposed regulations under Code Section 103(a)(1). Mr. Walker indicated the regulations took the most restrictive possible position consistent with the statute, court decisions, and past regulations. He also noted that they would not impact on industrial development bonds.

Decision

The Executive Committee approved the proposed regulations and the Treasury recommendation that they be noticed inthe Federal Register following compliance with OMB Circular A-85 pertaining to consultation with heads of State and local governments in the development of Federal regulations.

2. Public Debt Limitation

The Executive Committee reviewed a memorandum prepared by the Treasury on the public debt limitation proposal of the Republican Legislative Agenda. The discussion focused on whether there should be a change in the Second Liberty Bond Act to place responsibility for establishment of a statutory public debt limitation with the Budget Committees. There was general consensus that such a change would reduce the increasingly frequent reconsideration of the level of the public debt which currently exists.

Decision

The Executive Committee approved Treasury preparing appropriate legislation to amend the debt limit provisions of the Second Liberty Bond Act to place effective responsibility for establishment of the public debt limit with the Budget Committees.

3. Report of Task Force on Taxation of International Investment

Mr. Jones presented the report of the Task Force on Tax Policy and International Investment indicating that the Task Force had focused their attention on the inconsistency in the way U.S. multinational companies have handled their research and development expenses -- some have adopted cost sharing arrangements, some have allocated research and development expenses on a purely ad hoc basis, and some have not allocated research and development expenses abroad at all. Proposed new regulations were placed in the Federal Register on June 18, 1973, but have not become effective, creating considerable uncertainty in the business community. This issue will be considered by the Fiscal Committee of the OECD in mid-January.

Decision

The Executive Committee requested the Task Force to prepare an options paper on U.S. tax policy with respect to the allocation of R&D expenditures to foreign source income for consideration the week of December 22.

4. Prospective U.K. Import Controls

The Executive Committee discussed the series of recent statements by British officials to the effect that Britain may impose selective import controls. The discussion focused on communications between U.S. and British officials on this issue, any further action the U.S. should take, and press reports on the U.S. position. There was general agreement that the U.S. should make clear that we do not consider that existing conditions constitute "acute or emergency circumstances" and that therefore British protectionist measures at this time are inappropriate and could be detrimental to efforts for a liberalization of trade.

Decision

The Executive Committee agreed that the U.S. position should be clarified in any public statements on the issue by U.S. Government officials. Ambassador Dent will clarify the Administration's position in his meetings with the House Ways and Means Committee today.

5. Railroad Strike Situation

Secretary Dunlop reported that a nationwide railroad strike involving four shop craft unions is scheduled for tomorrow at 6:00 a.m. An emergency board was established and has reported, and efforts are currently underway by Mr. Usery to resolve the differences between the parties.

Secretary Dunlop indicated he has prepared legislation, testimony, and other necessary documents for a 60-day extension of the terms and conditions of employment while negotiations continue. He indicated that he was hopeful there would be a resolution of the matter by tomorrow morning.

Decision

The Executive Committee approved submission of a proposal for a 60-day extension of terms and conditions of employment in the event that there is a railroad strike tomorrow.

THE WHITE HOUSE

WASHINGTON

December 3, 1975

MEMORANDUM FOR THE ECONOMIC POLICY BOARD

SUBJECT: Broadened Stock Ownership Plans

On December 11, the Treasury Assistant Secretary Walker has been asked to testify on Expanded Stock Ownership Plans (ESOP) before the Joint Economic Committee. This Memorandum addresses three issues:

1. Should the Administration formally commit itself to the broadened stock ownership plan (BSOP) concept?
2. What is the best BSOP approach?
3. What is the best strategy vis-a-vis Congress?

I. SHOULD THE ADMINISTRATION FORMALLY ENDORSE THE BSOP CONCEPT?

Pro

Administration support for the BSOP concept would:

- o Be consistent with American traditions of dispersed property ownership as the foundation for republican self-government and individual liberty. (Even though about 1 in 6 American is a direct shareholder, families in the top one percent of total income own over half of the value of all individually owned stock).
- o Be consistent with the Administration's desire to broaden the political base of support for the free enterprise system.

- o Be consistent with the Administration's desire to provide increased savings and financing for needed capital formation.

- o Be consistent with the Administration's desire to improve employee motivation and productivity.

- o Give needed lift to equity markets.

- o Build on Congressional interest (including Senator Long) in expanded ownership and permit possible trade-off for support of Administration capital formation proposals.

<u>Con</u>

Formal Administration endorsement should be withheld because:

- o A considerable number of Americans are already direct beneficiaries of stock held by pension plans and insurance companies.

- o There is no firm evidence that employee stock ownership affects either productivity or political attitudes.

- o There is little evidence that BSOP incentives will significantly serve to broaden stock ownership. (Treasury estimates a three percent increase in ownership at a five-year cost of about $450 million)

- o Existing tax and market incentives have proved effective to induce adoption by a great many companies of employee plans, such as profit-sharing, stock bonus and thrift plans, that provide employees with a stake in the business.

- o Tax incentives for particular investments (savings bonds, saving accounts, or corporate stock) do not increase total savings, but simply redistribute savings. Strong political opposition from banking, insurance and thrift industries and labor unions to most BSOP stock purchase plans can be expected.

- o Exposes Administration to criticism of misguided priorities. In varying degrees, support for any BSOP proposal requires explanation of how Administration can oppose a $1000 exclusion from income for savings account interest and yet support special tax incentives to broaden stock ownership.

Recommendation

For Administration endorsement of BSOP concept ________

Against Administration endorsement of BSOP concept ________

II. WHAT IS THE BEST BSOP APPROACH?

Several key issues need to be resolved so that governing criteria can be established for development of a specific BSOP program acceptable to the Administration.

(a) Should BSOP eligibility be limited to low and middle income taxpayers?

Pro

- o Unlimited eligibility would reinforce the existing imbalance in stock ownership.
- o Unlimited eligibility would generate extensive political opposition and charges of expanding existing "tax loop-holes" for upper income taxpayer.
- o Unlimited eligibility would magnify revenue losses but not increase significantly new savings or stock ownership.

Con

- o Eligibility for BSOP incentives should be limited to the income classes currently having the least investment in stocks as a means of broadening the base of stock ownership.

- o Cut-off works inequities for income classes above the cut-off line.

Recommendation

For cut-off ___________

Against cut-off ___________

(b) Should BSOP sponsorship be limited to corporate employers?

Pro

- o Offers best approach to stimulate widespread acceptance and coverage as opposed to individual (IRA) sponsorship.
- o Directly furthers the objective of extending corporate ownership to employees.
- o Permits BSops to be a subject for collective bargaining; obviates union opposition to individual and non-corporate sponsorship as a by-pass of organized labor.

Con

- o Unfair to employees of government, not-for-profit, and non-corporate organizations.
- o Limits individual choice to the extent investments are pooled.

Recommendation

For limiting BSOP sponsorship to corporate employers _______

Against limiting BSop sponsorship to corporate employers _____

For dual program of corporate/individual plans ________

(c) Should BSOP be linked to employer's stock?

Pro

- o Provides employee with potential productivity incentive.
- o Gives employer an additional source of equity capital.

Con

- o Places too many investment "eggs" of low and middle income groups in one "basket", subjecting them to major downside risks which they can least afford.
- o Not needed in view of growing number of stock bonus and profit-sharing plans now being implemented by corporations.
- o May dilute ownership rights of existing holders.
- o Creates opportunity for self dealing and manipulation of stock in closely held corporations.

Recommendation

For linking BSOP to employer's stock ______________________

Against linking BSOP to employer's stock ____________________

Against mandatory linkage but in favor of special incentives for BSOP purchase of employer's stock ______________________

(d) Should BSOP investments be long-term, retirement oriented?

Pro

- o Tax incentives for short-term investment in stock would simply redistribute savings from thrift and banking institutions to stocks. Restriction to long-term savings might reduce dissavings and increase net savings.
- o Opportunities for capital growth and appreciation are greatest over the longer-term.
- o Revenue losses per dollar of stocks held in qualified plans greater without restriction because of rollovers.

Con

- o Restriction would limit popularity of plan because many people save for reasons other than retirement.

- o Reasonably adequate retirement coverage and indirect capital ownership now exist through retirement plans and pension funds which hold equities.

Recommendation

For limiting BSOP investments to retirement-type plans ________

Against limitation on short-term investments and rollover ________

(e) Should we explore the use of a Federal insurance or guarantee program in place of tax incentives for increased stock ownership?

Pro

- o An actuarially sound insurance program would not increase the deficit in the long run.

- o A pension insurance mechanism is already in place and could be "tilted" in favor of stock ownership.

Con

- o Stocks are inherently a risky investment. Any insurance would encourage even greater risk taking, thus making it difficult to design an actuarially sound program. Consequently, the Government would be exposed to large risks.

- o Would require a large staff of examiners and very complicated regulations.

Recommendation

For exploration of a non-tax approach ________________

Against exploration of a non-tax approach ________________

The Treasury has developed and compared four specific BSOP options which highlight the eligibility, sponsorship, investment discretion and investment term issues presented above. The options are summarized in the Exhibit following this page. Tab A contains a full description of the options.

Note that the Kelso type ESOP plan previously advocated by Senator Long has been rejected as an option in the Treasury paper. It is included, for comparison purposes, in the Summary Exhibit.

It is recommended that the specific BSOP program options be reformulated pursuant to decisions and guidance flowing from this memorandum. As the Treasury options memorandum indicates, there are many possible combinations and modifications of the four basic options.

SUMMARY OF BASIC BSOP OPTIONS

OPTION	TAXPAYER ELIGIBILITY	PLAN SPONSORSHIP	PERMISSIBLE INVESTMENT	FINANCING MECHANISM	INVESTMENT TERM	TYPE OF TAX INCENTIVE	TAX COST
Sen. Long (ESOP): NEW STOCK ISSUANCE AND TRANSFER TO EMPLOYERS (excluded as an option)	Corporate employees	Corporate employer	Employer's stock	Corporate guaranteed bank loan to employee trust to purchase new stock issue	Specified period with progressive vesting	Corporate deduction for loan and/or dividend payments to employee trust Deferred taxation of gains and earnings	Not determined
1. INDIVIDUAL INCOME DEDUCTION	Any taxpayer with 10 to 25K income phase-out	Individual	Any stock	Individual's contribution, 15% of earnings up to $1500	Retirement except for death or disability	Deduction for contributions	$90 million after 5 years assuming 1.5% utilization
2. INDIVIDUAL EARNINGS EXCLUSION	Same as Option 1	Same as Option 1	Same as Option 1	Same as Option 1	Same as Option 1	Exemption of gains and earnings	25 million in 5th year assuming 1.5% utilization
3. INDIVIDUAL INCOME EXCLUSION (SALARY DEDUCTION)	Employees, with $10 to $25K income phase out	Employer	Any stock chosen by employee	Salary reduction of lower of $1500 or 15% of salary	Same as Option 1	Exclusion of salary deduction from income. Deferred taxation of gains and earnings	$90 million after 5 years assuming 1.5% utilization
4. INDIVIDUAL TAX CREDIT FOR STOCK PURCHASE	Any taxpayer with $20 to $25K phase-out	Individual	Any stock	Individual stock purchase	2 yrs or less results in credit recapture reduced by amount of any loss on sale	Tax Credit for 10% of stock purchase price up to $200 plus additional 5% for employer's stock with $300 maximum credit	$200 million after 5 years assuming 1.5% utilization

III. WHAT CONGRESSIONAL STRATEGY SHOULD BE ADOPTED?

The Administration could pursue four alternative strategies with respect to Congress:

(1) Present a specific Administration proposal.

(2) Float a trial balloon or a suggestion that Congress consider specific plans for broadening stock ownership.

(3) Provide general background information and options to the Joint Economic Committee and work closely with Congressmen and Senators (Long, Fannin, Hansen, Schneebeli, Conable, Frenzel, etc.) who have expressed interest in promoting broader stock ownership.

(4) Cooperate directly with Senator Long to develop a mutually acceptable program for broader stock ownership.

Options

Option 1: Present a Specific Administration Proposal.

A specific proposal could be presented, for example, in Administration testimony before the Joint Economic Committee, scheduled for December 11, in testimony before the Senate Finance Committee on the Tax Reform Bill or the tax reduction portion of that bill, or in the State of the Union Address.

Pro

- o Facilitates full scale elaboration of rationale for the proposal, together with background and supporting material, and thus permits the best affirmative stance and defense of the proposal.

- o Shows Administration in leadership role on the issue.

Con

- o Continues the proliferation of Administration tax proposals (fall 1974 tax increase proposal, January 1975 tax reduction proposal, July 8, 1975, public utility proposals, July 31, 1975 capital formation proposals including ISA and IRA, and October 6, 1975 tax cut proposal) and may thus undermine credibility of Administration tax policy.

- o May be less effective than working with interested Congressmen and Senators to achieve the same objective.

Option 2: Float a trial balloon or call on Congress to consider stock investment incentives.

This option could be effected through a speech or through statements in the testimony referred to under Option 1.

Pro

- o Opens up possibilities for cooperative development of program with interested Congressmen, while maintaining public awareness of Administration interest and involvement.

- o Allows more time for preparing a specific program.

Con

- o Permits less full scale elaboration of rationale for special tax incentives and, thus, may provide less effective defense against partisan criticism.

- o May induce unfavorable partisan reaction and make more difficult working out a common approach with interested Congressmen and Senators.

Option 3: Provide background information and options to the Joint Economic Committee, and to groups such as the Labor Management Committee, interested Congressmen and Senators.

This approach can be implemented immediately, but will require that documentation be prepared for the Joint Economic Committee prior to December 11.

Pro

- Provides less visible Administration involvement or identity with the issue.

- Promotes positive relations with interested Congressmen, particularly minority members of Ways and Means who have requested staff assistance over the last several weeks on the issue.

Con

- By diffusing Administration effort, may be less effective (particularly if several options attract support).

- Risks losing the ball to others.

Option 4: Cooperate directly with Senator Long to develop a mutually acceptable position.

Pro

- Concentrates efforts to work out agreement with the Senator who has been most active and effective on this issue in the past and who will almost certainly raise the issue in the near future in connection with tax reductions and capital formation.

Con

- Special treatment of Senator Long may provoke adverse reaction from other Congressmen and Senators who have asked for ideas and assistance on this issue.

Recommendations

Option 1 _____

Option 2 _____

Option 3 _____

Option 4 _____

TAB A

TAB A

IV. Alternatives for Broadening Stock Ownership

Four basic options are examined below:

(1) individual income tax deduction for long-term savings,

(2) tax exemption of earnings on long-term savings,

(3) individual exclusion from income (salary reduction), and

(4) tax credit for stock purchases.

Certain features are generally common to all of the options: (1) a "cap," or annual limitation, on the maximum contribution, (2) an earned income phase-out limiting the tax incentives to low and middle income taxpayers, (3) a restriction of the plan to long-term savings (not true of Option Four), and (4) the requirement that all investments be in corporate stock (with an allowance for incidental holding of cash).

1. Option One--Individual income tax deduction. This option has the following characteristics (which are similar to the Individual Retirement Account (IRA) and Individual Savings Account (ISA) previously proposed):

-- Separate savings plan would be established by each participating individual.

-- Tax incentive would be allowance of an income tax deduction for contributions to the plan.

-- The maximum contribution would be specified, for example, the lower of $1,500 or 15% of salary.

  o Greater simplicity could be achieved with a dollar maximum, without any percentage of salary limitation.

  o The maximum contribution would be phased out for individuals with earned income between specified levels, such as $10,000 to $25,000. The phase-out would be based on preceding year's earnings, so as to facilitate stability of the savings program on a year-to-year basis.

-- An individual's saving in the plan could be invested only in stock, but each individual could determine the stocks to be purchased by his savings plan.

-- The plan would be a retirement plan, with the individual being allowed to withdraw his account only upon retirement, disability, or the attainment of a specified age (under IRA, specified age is 59-1/2).

The revenue cost of this option is estimated to be approximately the same as that for Option Three (see section (IV)(6)(c) below), which ranges from about $ 90 to $380 million after five years.

2. <u>Option Two--Tax exemption for earnings on long-term savings.</u> This option would be identical to option one, except that tax incentive would be a tax exemption for both the dividends and capital gains earnings on investments in the savings plan, rather than an income tax deduction for amounts contributed to the plan. The earnings of the plan would be tax exempt even when later distributed to the individual maintaining the plan. This option is estimated to cost approximately $3 million in the first full year and $25 million by the fifth full year, with a phase out from $10,000 to $25,000 of earned income.

3. <u>Option Three--Exclusion from income for amounts contributed to savings plans.</u> This option is the Individual Stock Ownership Plan (ISOP) option previously discussed in the memorandum of November 11, 1975, and has the following characteristics:

-- It would (like an ESOP) be a qualified employer-established plan meeting the participation, non-discrimination and other relevant qualification requirements.

-- The tax incentive (not available under ESOP) would be allowance of an exclusion from an employee's income for amounts contributed to the plan.

- o That is, the ISOP would be a salary reduction plan such as that currently available to employees of certain exempt organizations. Employees would elect individually whether to participate by taking a reduced salary.

-- The maximum reduction in salary would be specified, for example, the lower of $1,500 or 15% of salary.

- o Greater simplicity could be achieved with a dollar maximum, without any percentage of salary limitation.
- o The maximum reduction in salary would be phased out for individuals with earned income between specified levels, such as $10,000 to $25,000. The phase-out would be based on preceding year's earnings, so as to facilitate stability of the salary reduction program on a year-to-year basis.

-- An individual's account in an ISOP could be invested only in stocks, but each employee could elect (which he cannot do in an ESOP) how to allocate his account between an investment in the employer's stock and an investment in a pool of representative listed stocks.

-- The ISOP (like an ESOP) would be a retirement plan, with an employee being allowed to withdraw his account only upon retirement, disability, or attainment of a specified age (under IRA, the specified age is 59-1/2).

-- The ISOP would be prohibited from borrowing in order to purchase employer's stock or other stock, the leveraged financing aspect of ESOP.

This option would cost from about $90 to $380 million after five years (see section (IV)(6)(c) below).

4. Option Four--Tax credit for stock purchases. Under this option, individuals who purchase stock would be allowed a tax credit equal to a specified percentage of the purchase price of stock held for at least one year.

-- Basic credit would be 10% of purchase price of stock up to $2,000 ($200 credit).

-- Investment in employer stock would qualify for additional 5% credit (bringing maximum credit to $300).

-- The maximum purchase qualifying for the credit would be phased out for individuals with earned income between specified levels, such as $10,000 to $30,000. The phase out would be based on preceding year's earnings, so as to facilitate stability of the savings program on a year-to-year basis.

-- Credit would be allowed in the year when the one year required holding period ends.

-- If the stock were sold within two years of purchase, the credit would be recaptured, but the amount recaptured would be reduced by the amount of any loss on the sale.

This option is estimated to cost $50 million in the first full year and about $200 million by the fifth year.

5. Comparison of options. An assessment of the four options should include consideration of the following points:

-- Use of an individual account plan (options 1, 2 and 4) as opposed to an employer-sponsored plan (option 3) tends to identify the proposal with IRA and ISA, previously proposed by the Administration, and thus may invite partisan criticism.

-- Use of individual account plan tends to duplicate coverage of IRA; that is, the same individuals who have become aware of IRA and have established an IRA are those most likely to respond to the new incentive.

-- Use of employer-sponsored plan (ISOP option 3) identifies with and builds on ESOP, which has already captured substantial Congressional support.

-- Use of employer plan increases likelihood of utilization, particularly utilization by persons not reached by IRA.

  o Employees more likely to be responsive to employer-sponsored plan than bank or other solicitation for individual accounts.

  o Employer information and solicitation should reach additional individuals, not reached by IRA solicitation.

-- All of the options create potential that individuals will simply shift existing savings into the new savings plan and, thereby, reduce tax on current income.

- However, in practice the tax shelter--tax planning potential is greatest under the Option One savings deduction plan, since an end-of-the-year deduction generates a full deduction. The ISOP salary reduction is more likely, partly because of employer administrative concerns, to follow a pattern of monthly contributions; the tax exemption benefits under Option Two will generally be proportionate to the period savings are held within the plan; and a stock purchase under Option Four will generally generate a tax credit only in the following year.

-- All four options would tend to fuel further the tendency towards the proliferation of special categorical tax provisions that substitute for direct grant programs and undermine the viability of the tax system as a system for measuring income and collecting taxes on that income.

-- The tax credit option contains the weakest requirements respecting the limitation of the tax incentives to long-term savings and, thus, incurs the highest tax cost in relation to the amount of new stock ownership or new savings generated.

- Two years recapture permits rollover of stock investment every two years, with full tax credit.

- o Offset of losses against credit recapture encourages realization of losses and acceleration of rollover.

-- Under tax exemption option (option two) taxpayer could not reduce tax on current income; only future earnings from the savings plan would be exempt from tax.

-- If an individual's marginal tax rate remains constant over time, the tax incentive afforded by a current deduction for contributions to the savings plan would be identical to the tax incentive afforded by an exemption from tax for earnings of the plan.

- o For example, assume an individual contributes $1,000 to the plan, that the rate of return on invested funds is 8 percent, and individual has a marginal tax rate of 20 percent. The annual tax benefit from the deductibility of contributions to the plan would be the value of deferring, for one year, the tax on the amount contributed. The amount of tax deferred equals the amount of the deduction times the rate of tax; and the value of deferral is equal to the annual rate of return times the amount of tax deferred. Thus, the tax benefit would be equal to $1,000 times 20% times 8%. Similarly, the value of tax exemption of savings plan earnings is equal to the earnings of the plan ($1,000 times 8%) times the individual's marginal tax rate (20%), or $1,000 times 8% times 20%.

-- The tax exemption option costs substantially less revenue in early years, and is likely to be perceived as affording less tax incentives, than other options.

  o The lower revenue cost estimate arises because the immediate revenue reduction is taken as the revenue cost to the government, rather than the true economic (i.e., financial) cost of deferring tax receipts. However, the actual tax incentives are a function of the true economic cost to the government.

-- Because many individuals expect their marginal tax rates to be lower after retirement, they will prefer Option One (contributions deduction) and Option Three (salary reduction) to the tax-exemption option. That is, Options One and Three permit the shifting of income from high tax to low tax years, which provides additional benefits beyond tax deferral or tax exemption.

6. Possible Modification of Options. There are a number of possible modifications that could be made in these options.

a. Requirement of initial minimum or additional savings. Options One (contributions deduction) and Three (ISOP) could be modified to require that an individual make a minimum stock purchase (or contribution to the plan) before further purchases (or contributions) would qualify for the tax incentives. For example, the threshhold savings requirement could be stated as a percentage (perhaps 5 percent) of earned income.

Alternatively, the options could be modified to provide that only a portion (perhaps 50%) of contributions (or stock purchases) would qualify.

Considerations

--Increases likelihood that tax benefits will be provided only to new savings additional to savings that would otherwise occur.

--Introduces substantial complexity by requiring basis adjustment.

- For example, under Option One and Option Three, all amounts in the plan are pre-tax amounts; and all withdrawals are fully taxable. Under Option Two (tax exemption), all amounts in plan are either post-tax contributions or exempt plan earnings; and all withdrawals are fully exempt from tax. Threshhold requirement or less than 50 percent deductibility under Option One and Three would mix post-tax and pre-tax amounts and require basis rules for determining those amounts.

b. Limitation of investment discretion. Rather than giving participating individuals full authority under Options One, Two, and Three to determine the stocks in which their account would be invested, these options could provide that a minimum portion of the account (say, 50%) would have to be invested in employer stock. The individual's authority to direct investments would then extend only to the remaining portion of the account.

Alternatively, could provide the tax incentives for an additional amount, over and above the base amount, for investments in employer stock. For example, if maximum contribution is $1,500 could allow an additional $750 contribution for investment in employer stock.

Considerations

--Permits substantial diversification reducing employee risk while retaining ESOP objective of providing employee stake in success of employer's business.

o Where employer has a declining business, retains ESOP disadvantage of forcing unwise investment.

--Reintroduces unfairness for government employees and others to whom employer stock would not be available.

o Could have exceptions for such cases allowing employees to exercise full investment control, but would introduce complexity and possible complaints from employees denied full investment control.

--Under Option Three, increases employer incentive to establish an ISOP by increasing assurance that ISOP accounts will be source of employer financing.

c. Changes in contribution limit and phase-out. The various options can be designed with any desired combination of contribution limit and phase-out of the contribution limit. The following table shows the revenue loss for various such combinations under Option Three (ISOP).

Rough Estimates of "ISOP" Plan Revenue Losses
(Salary Reduction Only)
1976 Levels After 5 Years

Phase-out range: (by earned income):	Maximum Contribution $1,000	$1,500	$2,000	$2,500
	Revenue Loss ($ millions) 1/			
10-25	88	89	90	91
15-30	120	142	165	187
20-35	152	196	239	282
25-40	184	249	314	378

Office of the Secretary of the Treasury
Office of Tax Analysis

November 10, 1975

1/ The total annual stock investment varies with the phase-out range and the maximum contribution limit from about 4-1/2 times the revenue loss ($10-$25,000 phase-out rate and $1,000 maximum contribution limit) to about 3 times the revenue loss ($25-$40,000 phase-out range and $2,500 maximum contribution limit).

d. Employer deduction rather than salary reduction. Option Three (ISOP) could be modified to provide for an employer deduction for contributions to an ISOP rather than an exclusion from the employee's income for a reduction in salary. The employer would be required to contribute on behalf of all eligible employees.

To the extent that employers are not already contributing to pension plans the maximum amount deductible under present law, the allowance of an employer deduction would not provide any additional tax incentive beyond that in existing law. Thus, if an employer deduction is to provide an effective incentive, it would be necessary to allow the employer to deduct more than 100 percent of the amount contributed. For example, employers might be allowed to deduct 150% of contributions. (Kelso proposes a similar deduction for ESOPs.)

Considerations:

--Direct employer tax benefits increase likelihood employer will establish an ISOP plan.

- o However, if employer increases total compensation payments, he will have increased cost; and this will tend to dissuade employer from establishing plans.

--Employer deduction more likely than salary reduction approach, to be viewed as a business tax benefit, which could attract business support and labor opposition.

- o However, tends to induce larger compensation payments which would affect strength of business support and soften labor opposition.

--Because of higher corporate than individual average marginal tax rates, corporate deduction causes higher revenue loss per dollar of investment and 150% corporate deduction causes much higher revenue loss.

--Employer deduction is meaningless to tax-exempt employers (governments, charities, labor unions, etc.), so participation effectively limited to non-exempt sector.

--Employees may identify less with their stock ownership if they have less choice in the matter.

o Such lack of identification partially explains the lack of awareness of employees' stake in business through their pension plans.

o The employees would have reduced choice regarding both whether to participate and how their account should be invested. While in theory the law could mandate that employees have investment choice, they are less likely to assert their rights with respect to "employer contributions" than with respect to "their income" which they have elected not to receive.

e. Combination of salary reduction and employer contribution features. Option Three (ISOP) could be modified to require, or permit, employer contributions matching all, or part, or the employee's contribution.

Example: Employees could elect to reduce their salary by a maximum of $1,000 (or, if less, 10 percent of salary). Employers would be required to contribute 25 percent of the amount contributed by each employee and would be allowed a deduction of 150 percent of the amount contributed.

Considerations:

--Increase employee incentive to participate.

--Unlike pure employer deduction plan, does not exclude tax-exempt sector.

--May increase employer interest in establishing plan, except to extent causes increased compensation costs.

--Revenue loss per dollar of investment is greater than pure salary reduction plan but much less than pure employer deduction plan.

--May introduce complexities (e.g., rules for vesting employee's interest in employer contributions).

- o Vesting questions also arise under pure employer deduction plan but could be resolved under new 1974 pension reform act rules applicable to all qualified plans. Special rules providing faster vesting may be required where there is direct linkage between employee and employer contributions.