AMERICAN BENEFITS COUNCIL

Statement of Joseph E. Marx
On Behalf of the American Benefits Council
at the
U.S. Treasury Department/Internal Revenue Service Hearing
On Proposed Rule on Dividends Paid Deduction for Stock Held in ESOP
January 18, 2006

Good morning. I am Joe Marx, a senior consultant with Principal Financial Group working out of our New York office. Principal is a member of the Board of Directors of the American Benefits Council. The Council is a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. I am testifying today on behalf of the Council, whose members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans.

Principal is testifying on the Council's behalf because we provide administrative services for more than 570 Employee Stock Ownership Plans, otherwise known as ESOPs and consult with 100 additional ESOPs. The ESOPs we administer have more than $15 billion in assets and cover more than 475,000 participants. Principal administers all types of retirement plans including 401(k)s, stand-alone ESOPs and 401(k) plans that contain employer securities with and without ESOP components.

Like the Council's comment letter, our testimony today will focus on the portion of the proposed regulation that provides guidance concerning which corporation is entitled to the deduction for applicable dividends under Internal Revenue Code Section 404(k).

The Council appreciates this opportunity to testify about the effects the proposed regulations would have on corporations that have foreign parents, and that have or are considering establishing an ESOP. A number of Council members are either directly affected by the proposal or have clients affected by it.

The Council believes that by denying the tax deduction to American employers with a foreign parent, the regulations, as proposed, would strongly discourage these companies from establishing or maintaining an ESOP. Not only would this harm American employees, it contradicts the expressed intent of Congress: to encourage employers to establish ESOPs.

The Council strongly urges you to instead direct that the employer, not the parent company, is entitled to the ESOP dividend deduction. This treatment would be consistent with fundamental principals of tax law and other interpretations of the Internal Revenue Code that treat the employer as the party entitled to a deduction for payments made by a related third party.

We believe that Treasury and the Service have the authority to reverse the proposed regulations and allow the employer to take the deduction. We understand that some do not share this belief and that they have based their opinion on the following statutory language contained in Code Section 404(k):

> "…there shall be allowed as a deduction for a taxable year the amount of any applicable dividend paid in cash by such corporation with respect to applicable employer securities."

Some have narrowly interpreted "dividends paid in cash by such corporation" as meaning "dividends paid in cash DIRECTLY by such corporation", implying that only the issuer corporation can take the deduction. However, such a reading makes the phrase "applicable employer securities" and its subsequent definition confusing and superfluous. If the corporation that directly pays the dividend is the only corporation allowed to take the deduction, why does the statute reference applicable employer securities instead of simply the corporation's securities? If a defined term is necessary to incorporate the idea that the stock is held in an ESOP, why does the definition of "applicable employer securities" include employer securities from a corporation that is a member of a controlled group of corporations? Such an extended definition would not be necessary if only the corporation that issues the stock and pays the dividend is entitled to the deduction. This supports the Council's interpretation that the employer should be allowed to take the deduction.

In addition, as noted in the Council's comment letter, the Service clearly believed it previously had the authority to allow the employing corporation to take the deduction. The proposed rule directly reverses a position taken by the Service in a private letter ruling that held a domestic subsidiary of a foreign parent was entitled to the dividend deduction even though the dividends were paid by the foreign parent. The Council understands and appreciates that private letter rulings are only intended for use by the company that receives them and cannot be cited as precedent. However, it is reasonable for other companies to look to the Service's stated position in a letter ruling in the absence of any other guidance since 404(k) was first enacted 21 years ago.

The Council's comment letter also notes that extensive legislative history clearly supports this interpretation. On numerous occasions, the legislative history has specifically stated that the employer is entitled to the deduction. Specific legislative history is cited in the Council's letter and the Council would be happy to follow up with you on this or any other issue.

Allowing the employer to deduct the dividend payments also aligns with fundamental principles of tax law as reflected in regulatory interpretations of other statutes in the Internal Revenue Code. This guidance treats the service recipient (the employer) as the entity entitled to the deduction for compensation. That parent stock is used to provide the compensation is irrelevant. For example, regulations under Code Section 1032 explicitly reconstruct transactions of this type as a transfer of stock from the parent to the subsidiary, followed by a compensatory payment to the subsidiary's employee. Numerous interpretations under Code Section 83 indicate that the person for whom services were performed (the subsidiary-employer) is entitled to a deduction with respect to the transfer of property by a shareholder or parent company to an employee of the employer. Treating the dividend payment as a "deemed capital contribution" to the subsidiary which becomes deductible by the subsidiary would be consistent with these rulings.

The Council is also concerned that the proposed rule is inequitable. It treats domestic companies that have a foreign parent less favorably than domestic companies that have a domestic parent. Companies with a domestic parent generally can file consolidated returns to benefit from the deduction.

For these reasons, the Council respectfully requests that Treasury and the Service revise these proposed regulations to allow the sponsoring employer to take the deduction under Internal Revenue Code Section 404(k). In the alternative, the Council recommends this portion of the regulations be withdrawn and that Treasury respond favorably to future private letter ruling requests that domestic companies with foreign parents may benefit from the deduction.

Finally, we understand that a stock issuer parent, in some situations, might argue they should be entitled to the deduction, causing a problem for Treasury and the Service if it reversed the proposed regulation. The Council informally polled its members and none reported any concerns with limiting the deduction to the employer corporation.

Again, we want to thank you for allowing the Council to share our comments on the proposed regulations. The Council would be happy to provide any additional feedback or assistance that might be helpful. I would be happy to answer any questions you may have at this point.