

## Private Request for Analysis: Budgetary Effects of Expansion of Employee Stock Ownership Plans

October 29<sup>th</sup>, 2025

Contact: Richard Prisinzano ([richard.prisinzano@yale.edu](mailto:richard.prisinzano@yale.edu))

**Disclaimer:** Please inform The Budget Lab before sharing this private analysis. If findings from the score below are used publicly, The Budget Lab will make the report available on its website.

### Proposal

This analysis examines the budgetary impacts of this proposal that creates a new structure under the Employee Stock Ownership Plan moniker.

This structure requires the business to be organized as a c-corporation, shares must be allocated pro rata and within 15 years. It also requires institutional investors in an arms-length transactions funded with 10% common equity and 90% below-market subordinated debt.

### Estimated Budgetary Effects

Table 1 below presents estimated budgetary effects over the budget window starting in fiscal year 2026. The analysis assumes a Date of Enactment (DOE) of 1/1/26. We estimate the policy would cost \$98.6 billion over the 2026-2036 time-period. The current ESOP structure costs the federal government roughly \$300 per individual participant. This proposal would raise that per participant cost by roughly \$600 to almost \$1,000 per participant. Over the decade 2037-2047, the proposal costs an additional \$524.8 billion as the proposal is fully adopted and incorporated in business decisions. These numbers are “conventional” estimates, meaning that they account for tax avoidance behavior (e.g., changes in how much taxable income is reported to the IRS) but not macroeconomic feedback (e.g., changes in labor supply). The Budget Lab expects that there would be two main sources of behavioral feedback in response to these policies:

- **Business entity type shifting.** Research shows that owners of businesses are responsive to changes in the relative tax treatment of C corporations versus pass-through entities, reorganizing from one form to another if the tax benefits outweigh nontax costs. In the case of this policy, C-corporate form would become relatively more attractive as compared to pass-through businesses. The Budget Lab expects that the share of business activity would rebalance away from pass-through businesses and towards C corporations.
- **Preference by Private Equity Firms in acquiring businesses.** Evidence shows that investors respond to higher capital gains rates. By structuring their acquisitions through this framework, investors could access expanded 1042 tax benefits (allowing tax-deferred reinvestment of gains), utilize 90% of their capital through below-market subordinated debt at a 5% return cap (significantly reducing their cost of capital). This vehicle would be particularly attractive for investors targeting larger, established companies where employee ownership could drive

performance improvements, companies in competitive labor markets where employee retention is crucial, or situations where sellers prefer transactions that benefit workers.

TABLE 1. Creation of 'Electing C-Corp ESOP'

	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035	2036	26-36	37-47
Revenue (billions)	0.0	-3.0	-3.1	-3.2	-3.6	-4.0	-4.4	-11.6	-13.1	-14.9	-16.9	-20.6	-98.6	-524.8

## Background

Under existing law, Employee Stock Ownership Plans operate within a patchwork of regulations primarily governed by ERISA (Employee Retirement Income Security Act of 1974) and the Internal Revenue Code. Current law provides modest support for ESOPs through tax incentives: selling shareholders can defer capital gains taxes under Section 1042 if they reinvest proceeds in qualified securities, and companies receive tax deductions for contributions to their ESOPs. The Small Business Administration offers some financing programs that can be used for ESOP transactions, but there is no dedicated federal program specifically designed to promote worker ownership. Current law requires annual independent appraisals and establishes basic fiduciary duties for trustees but provides limited specific guidance on independence requirements or transaction oversight.

## Discussion of Proposal

The proposal significantly expands the tax benefit of ESOPs, specifically to larger companies through the creation of a new "Electing C-Corp ESOP" structure. The proposal essentially creates a parallel ESOP system designed for larger companies and institutional capital markets, while preserving existing ESOP mechanisms for traditional transactions. Under this proposed structure, an ESOP trust would receive a 10% equity stake at no cost when transactions involve institutional investors making arms-length acquisitions. The share value would be allocated pro-rata based upon accrued payroll tax deductions for which the company would become eligible, with compensation capped at approximately \$150,000 for purposes of calculating that additional payroll tax deduction. This cap is an effort to direct benefits at lower-paid workers. Additionally, all shares must be allocated within 15 years.

The proposal requires institutional investors to fund 90% of their investment through below-market subordinated debt with a 5% return cap and 10% through common equity. The proposal argues this structure allows ESOP shares to generate "super-charged" returns. The super charge comes from the liquidation preference given to this equity. However, the return is still based on returns of the underlying company, not the specific structure. In any investment scenario, investors share a common goal of increasing stock value. In this way, all investors benefit. However, there are significant tax incentives that may decrease the incentive of the equity investor since they need less of a return to make the same money. The Electing C-Corp ESOP structure adds a tax benefit in the calculation of whether to take on an investment. Under this proposal, the decision calculus includes a considerably lower tax rate since a significant portion is tax free. The proposal includes a 5-year incremental tax deduction equal to eligible US payroll that can be carried forward if unused. In considering a new investment, investors require a lower return. As such, this proposal may increase investment in companies just to exploit this tax benefit as well as section 1042 deferral benefits that would apply to institutional investors. The proposal allows employees to liquidate up to 20% of their vested share while also requiring 401K plans with employer matching to ensure this isn't their sole retirement benefit. It also allows for the employee to direct cash proceeds at sale into either Roth or Traditional IRAs.

The proposal also includes a payroll tax deduction that functions as a federal subsidy for employee compensation, effectively allowing companies to deduct 200% of eligible payroll (the normal deduction

plus the incremental one) for five years. This creates an incentive for companies to increase wages for workers earning under \$150,000, as every dollar of additional compensation to these employees generates an extra tax savings. The five-year time limit encourages businesses to retain employees within that the time-period while also potentially creating cliff effects when the deduction expires, as companies might reduce employment or wages after five years.

## **Methodology**

We estimated the effects of this proposal using economic assumptions from the Congressional Budget Office (CBO) long-term budget projections. We utilized the forecasts of GDP, labor force growth rate, level projection of the civilian population, wage and salary disbursements, and proprietor's income. We estimated equations relating these variables to the historic number of ESOPs, value of assets held ESOPs, and participants within ESOPs. We used historical data provided by the ESOP association as the basis of these equations. That data was supplemented by publicly available data. We use the data to establish a relationship between the macro variables and the total number and value of mergers and acquisitions. We also calculate the tax rate on forecasted earnings under current law and the proposals. We then apply an elasticity to the difference in tax rates to estimate the benefit of the proposals. In the calculation of the tax rate, we consider the usage of the additional labor deduction outlined in the proposal. Given the ability of businesses to carry these deductions forward if they have no tax liability, we apply the historical proportion of use of Net Operating Losses.

We estimate that private equity firms will be the majority of investors taking advantage of this tax benefit. As such, we consider the trajectory of the value of private equity mergers and acquisitions. We use data from Pitchbook's 2024 annual breakdown of private equity activity. We take the value in 2024 (\$838.5 billion) and grow it by the average growth rate over the last decade (approximately 10 percent). We then estimate a return to those investments of almost 12 percent. This calculation yields our forecast of gains that would be able to defer capital gains taxation.