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IRS ISSUES TEMPORARY REGULATIONS REGARDING S CORPORATION ESOP ANTI-ABUSE RULES

On December 16, 2004, the IRS issued a new set of temporary regulations to provide guidance regarding the anti-abuse rules that apply to S corporation ESOPs. S corporation ESOPs are ESOPs that own employer securities consisting of S corporation stock. These new regulations replace temporary regulations on this subject that were published in 2003 and include a number of important changes from the 2003 regulations. The new regulations generally are more stringent than the prior regulations, and they are part of an effort by the IRS to prevent the use of S corporation ESOPs as tax shelters for wealthy individuals. This article provides a brief overview of the anti-abuse rules and describes the most important changes in the new regulations from the prior regulations.

Background

In 1996 and 1997, Congress amended the Internal Revenue Code to allow S corporations to sponsor ESOPs. In response to business arrangements that concentrated the benefits of an ESOP in a small number of persons, Congress enacted anti-abuse rules for S corporation ESOPs as part of the Economic Growth and Tax Relief Reconciliation Act of 2001. Most of the anti-abuse rules are set forth in Section 409(p) of the Internal Revenue Code. The provisions of Section 409(p) eliminate the use of ESOPs by S corporations that have only one or a few participants. Section 409(p) also addresses abuses that can arise where an ESOP's ownership is subject to substantial dilution through the use of stock options, phantom stock, and other similar forms of equity interests ("synthetic equity") for management and outside investors.[1]

Under the anti-abuse law, an ESOP that holds shares of an S corporation is prohibited from accruing benefits for, or allocating benefits to, certain persons who are identified as "disqualified persons" during any "nonallocation year." The term "nonallocation year" means a plan year in which disqualified persons in the aggregate own or are deemed to own at least 50% of the outstanding

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[1] For a general description of the laws relating to S corporation ESOPs, including the anti-abuse provisions of Section 409(p), see Ackerman, "Legal Considerations for S Corporation ESOPs," *S Corporation ESOPs*, (National Center for Employee Ownership), ch. 2.

shares of the plan sponsor. A person is a "disqualified person" if either: (i) he or she is deemed to own 10% or more of the "deemed-owned shares" of the corporation; or (ii) together with family members, he or she is deemed to own 20% or more of the deemed-owned shares of the corporation. "Deemed-owned shares" are shares owned by a person through the ESOP, including stock allocated to his or her ESOP account as well as his or her proportionate share of any unallocated ESOP stock (such as stock in a suspense account). The determinations whether a person is a disqualified person and whether a plan year is a nonallocation year are made by reference to two calculations, one of which treats synthetic equity as deemed-owned shares and one of which does not. Synthetic equity will be treated as deemed-owned shares only if that treatment will result in a person being considered a disqualified person or will result in a plan year being considered a nonallocation year.

If the provisions of Section 409(p) are violated, and employer securities are allocated to the ESOP accounts of disqualified persons, then the company will be subject to an excise tax equal to 50% of the amount of the prohibited allocation. In addition, the shares allocated to the accounts of the disqualified persons will be treated as having been distributed to them, and they will be subject to tax on the value of those shares.

Temporary regulations under Section 409(p) were issued on July 21, 2003 (the "2003 Regulations"). The 2003 Regulations provided guidance on identifying disqualified persons, determining whether a plan year is a nonallocation year and the definition of the term "synthetic equity." During 2004, the IRS provided additional guidance in Revenue Ruling 2004-4, which provided three examples of schemes that it deems to constitute violations of the S-corporation anti-abuse rules. These examples have been incorporated into the 2004 Regulations.

Comments were received on the 2003 Regulations and a public hearing on the 2003 Regulations was held on November 17, 2003. After consideration of comments received and views expressed at the hearing, and taking into account Revenue Ruling 2004-4, as well as the fact that Section 409(p) applies to all ESOPs for plan years beginning on or after January 1, 2005, the IRS issued new temporary regulations on December 17, 2004 (the "2004 Regulations"). The new regulations are generally effective for plan years that begin on or after January 1, 2005, subject to a number of special effective date and transition rules.

The 2004 Regulations provide guidance on the following matters: (i) the definition and effects of a prohibited allocation under Section 409(p); (ii) how to determine whether an individual is a disqualified person and whether a plan year is a nonallocation year; (iii) the definition of synthetic equity; and (iv) standards for determining whether a transaction is an avoidance or evasion of Section 409(p).

Definition and Effects of a Prohibited Allocation

In order to satisfy Section 409(p), an S corporation ESOP must provide that, during a nonallocation year, no portion of the assets of the plan attributable to the S corporation shares may accrue under the ESOP, or be allocated under any qualified plan of the employer (including the ESOP), for the benefit of any disqualified person. The 2003 Regulations did not provide guidance regarding what constitutes a prohibited accrual or a prohibited allocation, but the 2004 Regulations now do.

The 2004 Regulations point out that the Section 409(p) prohibition has two elements: (i) a prohibition on "accruals;" and (ii) a prohibition on "allocations." In explaining how these two

prohibitions work, the new Regulations create two new terms: "impermissible accrual" and "impermissible allocation." If there is either an impermissible accrual or an impermissible allocation, then there is a prohibited allocation within the meaning of Section 409(p).

Under the new definitions, an impermissible *accrual* occurs if any S corporation stock owned by the ESOP, or any assets attributable to that stock, are *held* for the benefit of a disqualified person during a nonallocation year. For example, any S corporation stock *held* in a disqualified person's account would be counted as an impermissible accrual, even if the stock had already been allocated in a prior year. In addition, any distributions made on, and any proceeds from the sale of, S corporation stock would constitute impermissible accruals. An impermissible *allocation* is any allocation for a disqualified person under any tax-qualified plan of the employer that occurs during a nonallocation year to the extent that an allocation is made that, but for a provision in the ESOP to comply with Section 409(p), would have been added to the account of the disqualified person under the ESOP and invested in S corporation securities owned by the ESOP.

These provisions of the Regulations expand Section 409(p) substantially beyond what previously was thought to be the scope of its coverage. Although the statute provides that an ESOP sponsored by an S corporation must prohibit both "accruals" and "allocations," the monetary penalty for a violation was imposed only on "allocations" and not on "accruals" (except in the first nonallocation year). Therefore, it was thought that the taxes on prohibited allocations (but not the taxes on synthetic equity) could be avoided in nonallocation years as long as no allocations were made for the benefit of any disqualified persons. Many S corporation ESOPs adopted "savings clauses" to prohibit allocations to disqualified persons during nonallocation years. The expansive definition of the term "prohibited allocations" in the new Regulations renders most of these savings clauses ineffective.

> **Planning Note:** The new Regulations will now render ineffective most of the Section 409(p) "savings clauses" in existing plans. In addition, it appears that under the new Regulations, during a nonallocation year, it will not be enough merely to avoid making new allocations to disqualified persons' accounts, but that amounts previously allocated to their accounts must be reduced or eliminated as well. *There are a number of techniques that can be applied to comply with the new Regulations, described below under "Prevention of Prohibited Allocations." However, certain of these steps must be taken by July 1, 2005 to avoid a violation in 2005 for a plan year beginning on or after January 1, 2005. ESOP practitioners and sponsors of S corporation ESOPs should therefore be reviewing their plans on an expedited basis.*

The amount of any prohibited allocation is treated as distributed to the disqualified person at the time of the prohibited allocation. As a result, the fair market value of the stock allocated to the disqualified person's account must be included in his or her gross income. Also, the excise tax on premature distributions will apply if the disqualified person is under age 59 ½. Moreover, if there is a prohibited allocation in a nonallocation year, the plan will fail to satisfy the requirements for qualification as an ESOP. Although it would remain a qualified plan, it would lose both the prohibited-transaction exemption for any loans made to the ESOP and the exemption for ESOPs from the unrelated business income tax.

Determination of Disqualified Persons on a Person-by-Person Basis

Attribution of Ownership. The 2004 Regulations make a significant change in the rules that are to be applied in determining whether (a) an individual is deemed to own at least 10% of the total number of deemed-owned shares of an S corporation, or (b) an individual and his or her family members in the aggregate are deemed to own at least 20% of the total deemed-owned shares. It was previously thought that attribution of ownership rules from other parts of the Code would not be applied for purposes of the 10% and 20% tests. However, the new Regulations would now incorporate the attribution rules from Section 318(a) of the Code into the 10% and 20% tests.

> **Planning Note:** Use of attribution-of-ownership rules in applying the 10% test, as provided for in the new Regulations, does not appear to be authorized by the language of Section 409(p) itself, and is believed to be inconsistent with the intent of Section 409(p). A public hearing on the Regulations is scheduled for April 20, 2005. We anticipate that objections will be raised to this provision of the new Regulations.

Determination on a Person-by-Person Basis. Another change in the 2004 Regulations from the 2003 Regulations is that, in determining whether a person is a disqualified person, only the synthetic equity of that person will be counted. In addition, in determining whether a particular year is a nonallocation year, only the synthetic equity held by disqualified persons is counted. The purpose of this change is to prevent evasion of the new rules by means of the issuance to lower-paid employees of stock options or stock appreciation rights that are not likely to be exercised. These options or rights might be exercisable only at a strike price far exceeding the likely future value of the shares, or the strike price might be reset periodically to exceed the expected value of the shares during the term of option or right. If all of these options or rights are counted as synthetic equity for purposes of applying the Section 409(p) test, they could artificially dilute the calculation of whether another shareholder is a disqualified person. Under the person-by-person approach adopted by the 2004 Regulations, these types of options or rights would be ignored in determining whether someone is a disqualified person.

Synthetic Equity

The 2004 Regulations take an approach regarding the definition of synthetic equity that is similar to the approach that was followed in the 2003 Regulations. One difference is that the 2004 Regulations expand the definition of synthetic equity to include the right to acquire stock or assets of a related entity. A second difference is that the 2004 Regulations exclude from the definition of synthetic equity nonqualified deferred compensation that was taken into account before January 1, 2005 for FICA purposes, and that was provided for before the first date on which the ESOP acquired any employer securities.

Other important differences between the 2004 Regulations and the 2003 Regulations relate to the treatment of synthetic equity the value of which is not determined by reference to shares of the plan sponsor's stock. The 2003 Regulations provided that a person who is entitled to this kind of synthetic equity is treated as owning a number of shares equal to the present value of the synthetic equity divided by the fair market value of one share of the plan sponsor's stock. The 2004 Regulations maintain this rule, but add three supplementary rules. First, the new regulations include a special rule with respect to voting rights. If a synthetic equity right includes a right to purchase or receive shares of S corporation stock that have greater voting rights on a per-share basis than the shares held by the

ESOP, the number of deemed-owned shares attributable to the synthetic equity then will be at least equal to the number of shares that would have the same voting rights if those shares had the same per-share voting rights as the voting rights of the shares held by the ESOP.

> **Example:** If shares of S corporation stock held by an ESOP are entitled to one vote per share, then an individual who holds an option to purchase one share with 100 votes is treated as owning 100 shares of synthetic equity.

A second new rule in the 2004 Regulations provides a helpful way to avoid an inadvertent violation of Section 409(p). The Regulations permit an ESOP to provide that the number of shares of synthetic equity treated as owned as of a specified determination date by reason of participation in a deferred compensation plan shall remain constant for a period of up to three years. This rule addresses the risk that a legitimate deferred compensation plan might trigger a violation of the Section 409(p) rules if the value of the plan sponsor's stock declines dramatically over the term of the plan.

> **Planning Note:** In order to take advantage of this rule, the ESOP plan document must be amended to specifically provide for the use of tri-annual recalculations. ESOP practitioners and their clients should review their plans and consider whether it is advantageous to adopt this type of provision.

Another new rule contained in the 2004 Regulations relating to synthetic equity is that the number of shares deemed to be owned by a holder of synthetic equity is to be determined on a proportionate basis where the ESOP does not own all of the stock of the S corporation.

> **Example:** Assume that an S corporation has 200 shares outstanding and that individual A owns 50 shares and the ESOP owns the remaining 150 shares. Assume also that individual B would be treated as owning 200 synthetic equity shares but for the special rule provided for situations where the ESOP does not own all the stock of the S corporation. The number of synthetic equity shares treated as owned by B is decreased from 200 to 150, because the ESOP owns only 75% of the outstanding stock of the corporation.

<u>Prevention of Prohibited Allocations</u>

The preamble to the 2004 Regulations describes several steps that might be taken by an S corporation that sponsors an ESOP to prevent an individual from becoming a disqualified person and thereby avoid a nonallocation year. The measures described in the preamble are the following:

- reducing the amount of synthetic equity (for example, by canceling or distributing some or all of it);
- selling the S corporation stock held in the participant's ESOP account, so that the account is not invested in S corporation stock;
- distributing the S corporation stock held in the participant's account from the ESOP to the participant; or

- transferring the S corporation stock held for the participant under the ESOP into a separate portion of the plan that is not an ESOP or to another qualified plan sponsored by the employer.

A transfer of S corporation stock allocated to one participant's account to another plan might be deemed to violate the general nondiscrimination requirements applicable to all tax-qualified employee benefit plans. This is because the transfer would not be made generally available to all participants in the plan. The 2004 Regulations provide relief from the nondiscrimination requirements for a transfer made for the purpose of assuring compliance with Section 409(p). However, it should be noted that the other plan would be subject to unrelated business income tax on its share of the plan sponsor's income. ESOPs are the only type of employee benefit plans that are exempt from this tax.

> **Planning Note:** In light of the definition of prohibited allocations to include accruals as well as allocations, measures of the kind described above must be implemented *before* the beginning of a plan year in order to prevent that year from becoming a nonallocation year. It will be of critical importance for S corporations that sponsor ESOPs to review both current and projected compliance with the rules of Section 409(p), so as to assure themselves an opportunity to make necessary adjustments before the beginning of a year in which there might be a violation. *As noted above, in some cases changes must be made by July 1, 2005, in order to avoid a violation in 2005 for a plan year commencing on or after January 1, 2005.*

Avoidance or Evasion of Section 409(p)

Section 409(p) authorizes the Treasury Department to issue regulations providing that a nonallocation year occurs in any case in which "the principal purpose of the ownership structure of an S corporation constitutes an avoidance or evasion of Section 409(p)." The new Regulations include a standard for determining whether the principal purpose of the ownership structure of an S corporation involving synthetic equity constitutes an avoidance or evasion of Section 409(p). The applicable standard is "whether, to the extent of the ESOP's stock ownership, the ESOP receives the economic benefits of ownership in the S corporation that occur during the period that stock of the S corporation is owned by the ESOP." Among the factors identified in the Regulations to be considered in determining whether the ESOP receives these economic benefits are shareholder voting rights, the right to receive distributions made to shareholders and the right to benefit from the profits earned by the S corporation. In evaluating these factors, the Regulations provide that there shall be taken into account the extent to which actual distributions of profits are made from the S corporation to the ESOP and the extent to which the ESOP's ownership interest in undistributed profits and future profits is subject to dilution as a result of synthetic equity.

The 2004 Regulations go on to identify certain specific transactions that will be deemed to constitute an avoidance or evasion of Section 409(p). These transactions are the ones described in Revenue Ruling 2004-4, which was issued in January 2004, and involve specific fact patterns relating to use of subchapter S subsidiaries and other pass-through entities to enable certain individuals to benefit from the plan sponsor's S corporation status, while limiting the ESOPs ability to benefit from the sponsor's profits.

Effective Dates

The 2004 Regulations generally are applicable for plan years of an ESOP beginning on or after January 1, 2005. However, there are a number of special effective dates and transition rules. For example, under the transition rules, ESOP shares that are held for a disqualified person before the first plan year beginning on or after January 1, 2005 will not be treated as an impermissible accrual in 2005 if the shares of disposed of before July 1, 2005, and no amount is contributed for the benefit of the disqualified person under any related plan prior to June 30, 2005. However, the excise taxes on impermissible accruals and on synthetic equity still will apply. In addition, subject to certain exceptions, the person-by-person rules regarding the identification of disqualified persons do not go into effect until July 1, 2005. Under another transition rule, the new rules relating to rights to receive shares with disproportionate voting rights also do not go into effect until July 1, 2005.

Conclusion

The new Regulations provide important guidance for all S corporations which sponsor ESOPs. As described above, some important changes in the interpretation of the S corporation ESOP anti-abuse laws are provided in these new Regulations. Therefore, all S corporations which sponsor ESOPs should promptly consult with their ESOP advisors regarding the application of the new Regulations to their plans, in order to make sure they are in compliance and to avoid the drastic penalties that are imposed for violations. As discussed above, if a plan would otherwise be in violation of the new Regulations for a plan year beginning on or after January 1, 2005, certain remedial steps may be available if taken before July 1, 2005. A public hearing on the new Regulations is scheduled for April 20, 2005. There may be further revisions to the Regulations or other additional guidance provided by the IRS regarding the S corporation ESOP anti-abuse rules. We will inform you promptly if there are any revisions to the Regulations or if any other guidance is provided.

What We Are Doing, Where We Are Going

The Morgan Lewis ESOP Team congratulates John Kober on his reelection to the Board of Directors of the National Center for Employee Ownership.

David Ackerman, Betsy Perdue, Brian Hector, Renee Lewis, and Michael Peipert will be attending the meeting of the Illinois chapter of The ESOP Association on January 26, 2005, and David will be giving an update on ESOP legal issues.

At The ESOP Association's S Corporation Seminar on February 24-25, 2005, Riva Johnson and John Kober will be speaking about corporate governance for ESOP companies. David will be speaking about fiduciary issues in S corporation ESOPs, and Brian will be speaking about Section 409(p).

John Kober will be attending the ESCA conference on January 27th and 28th, and will be participating in the meeting of the Technical Advisory Board.

Mark Your Calendars

January 26, 2005
The ESOP Association
Illinois Chapter Annual Conference
Radisson Hotel
Chicago, IL

February 24-25, 2005
The ESOP Association
7th Annual S Corporation ESOP Seminar
Hyatt Regency
Orlando, FL

April 12, 2005
The ESOP Association
Michigan Chapter Annual Spring Conference
Clarion Hotel and Conference Center
Lansing, MI

April 15, 2005
Ohio Employee Ownership Conference
Annual Meeting
Akron Hilton West
Fairlawn, OH

April 20-22, 2005
National Center for Employee Ownership
2005 Annual Conference
Grand Hyatt Hotel
San Francisco, CA

May 11-13, 2005
The ESOP Association
28th Annual ESOP Conference Clarion
Grand Hyatt Hotel Washington
Washington, D.C.

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