

## Part I

### Section 409.--Prohibited Allocations of Securities in an S Corporation

26 CFR 1.409(p)-1T: Prohibited allocation of securities in an S corporation.

(Also, §§ 1361, 4975, 4979A, 6011, 6111, and 6112; §§ 54.4975-11, 1.6011-4, 301.6111-2, and 301.6112-1.)

### **Rev. Rul. 2004-4**

## **ISSUES**

In the three situations described below, (1) are the individuals disqualified persons within the meaning of § 409(p)(4) of the Internal Revenue Code (the Code), (2) does the related employee stock ownership plan (ESOP) have a nonallocation year within the meaning of § 409(p)(3), and (3) are any disqualified persons treated as owning synthetic equity within the meaning of § 409(p)(5)?

## **FACTS**

### Situation 1

Before 2003, Individuals A and B own, either directly or indirectly, in whole or in part, a domestic professional services corporation. In addition, before 2003, individuals C, D, and E each owns, either directly or indirectly, in whole or in part, his or her own domestic professional services corporation. A, B, C, D, and E (Taxpayers) are employees of their respective domestic professional services corporations (Service Recipient Corporations).

In 2003, a new corporation (S Corp) is formed, and elects to be treated as a subchapter S corporation. S Corp forms a subsidiary corporation for each Taxpayer (QSubs A through E), and files a qualified subchapter S subsidiary (QSub) election for each subsidiary. S Corp contributes cash in exchange for 100 percent of the issued and outstanding stock of each QSub. Each Taxpayer is designated as an officer and investment manager for Taxpayer's respective QSub. In addition, each QSub grants its respective Taxpayer a nonqualified stock option to acquire substantially all or a majority of the shares of the QSub.

At the same time that S Corp is formed, it establishes a plan (ESOP) which is designed to be an employee stock ownership plan (within the meaning of § 4975(e)(7)) and which holds 100 percent of the stock of S Corp. All the employees of S Corp and the QSubs participate in the ESOP, with the exception of Taxpayers A through E.

Taxpayers A through E and their support staff terminate their existing employment relationship with their respective Service Recipient Corporations and become employees of the respective QSub. The customers of Taxpayers A through E stop doing business with the Service Recipient Corporations and begin doing business with the respective QSub of Taxpayers A through E.

Taxpayers A through E receive salary payments from their respective QSub, in an amount substantially less than the income to S Corp generated by the business activities of that Taxpayer after deduction for expenses. S Corp treats the subsidiaries as valid QSubs, and treats the income generated by each QSub each year, and earnings thereon, as earned by S Corp. The payments to the Taxpayers for current salary are deducted by S Corp as an ordinary and necessary business expense. However, since S Corp is wholly owned by an ESOP holding S corporation stock, S Corp's net earnings are not taxed currently.

Amounts of income to S Corp generated by the business activities of each Taxpayer (net of expenses) but not paid to Taxpayers within 2½ months after the end of the year accumulate in each Taxpayer's respective QSub, for example, in a brokerage account in each subsidiary, over which the respective Taxpayer has investment control as the investment manager of the subsidiary. A through E can access the amounts accumulated in their respective QSub by exercising their option to purchase shares in the QSub. If each Taxpayer's option to purchase shares of QSub stock were synthetic equity of S Corp (determined in accordance with § 1.409(p)-1T(f)(4)(ii)), then each Taxpayer would own at least 10 percent of the sum of the outstanding shares of S Corp plus the synthetic equity shares of S Corp.

## Situation 2

The facts are the same as in Situation 1, except that instead of 5 individuals, there are 11 individuals (Taxpayers A through K) each of whom is an employee of a Service Recipient Corporation owned either directly or indirectly, in whole or in part, by that Taxpayer. As in Situation 1, amounts of income to S Corp generated by the business activities of each Taxpayer (net of expenses) but not paid to the Taxpayer accumulate in each Taxpayer's respective QSub, and each Taxpayer has the right to acquire stock in that Taxpayer's QSub under the same terms as described in Situation

1. If each Taxpayer's option to purchase shares of QSub stock were synthetic equity of S Corp, then each Taxpayer would own less than 10 percent of the sum of the outstanding shares of S Corp plus the synthetic equity shares of S Corp.

### Situation 3

Before 2003, Corporation M is an S corporation with 200 employees, wholly owned by an ESOP that was established after March 14, 2001, in which substantially all of its employees participate. Before 2003, Individual A (Taxpayer) operated a professional services corporation as a separate business. In 2003, Corporation M forms a QSub for A by contributing cash in exchange for 100 percent of the issued and outstanding stock of the QSub. As in Situation 1, A and A's support staff terminate their existing employment relationship with A's Service Recipient Corporation and become employees of the QSub; A's customers become customers of the QSub; amounts of income to S Corp generated by the business activities of A (net of expenses) but not paid to A accumulate in A's QSub; and A has the right to acquire stock in the QSub under the same terms as described in Situation 1. A does not participate in the Corporation M ESOP. If A's option to purchase shares of the QSub were synthetic equity of S Corp, then A would own less than 10 percent of the total of the outstanding shares stock of S Corp plus the synthetic equity shares of S Corp.

### **LAW**

Section 4975(e)(7) provides that an ESOP is a defined contribution plan that is designed to invest primarily in qualifying employer securities and that is either a stock bonus plan which is qualified, or a stock bonus plan and money purchase pension plan both of which are qualified, under § 401(a). A plan is not treated as an ESOP under the Code unless it meets the following requirements, to the extent applicable: § 409(h) (relating to participants' right to receive employer securities; put options); § 409(o) (relating to participants' distribution rights and payment requirements); § 409(n) (relating to securities received in transactions to which § 1042 applies); § 409(p) (relating to prohibited allocations of securities in an S corporation); § 664(g) (relating to qualified gratuitous transfers of qualified employer securities); and § 409(e) (relating to participants' voting rights if the employer has a registration-type class of securities). As authorized by § 4975(e)(7), additional requirements are imposed under § 54.4975-11 of the Excise Tax Regulations.

Section 1361(b)(1)(B) provides that an S corporation may not have as a shareholder a person that is not an estate, a trust described in § 1361(c)(2), an organization described in § 1361(c)(6), or an individual. In 1996, § 1361(c)(6) was amended to permit a qualified plan under § 401(a) to be a shareholder in an S corporation. Section 1316(a) of the Small Business Job Protection Act of 1996 (SBJPA) (110 Stat. 1755) (1996).

Section 1361(b)(3)(A) provides that, for purposes of title 26 of the U.S. Code, a corporation that is a qualified Subchapter S subsidiary will not be treated as a separate corporation and all assets, liabilities, and items of income, deduction and credit of the corporation are treated as assets, liabilities, and such items (as the case may be) of the S corporation.

Section 511(a)(1) imposes a tax on the unrelated business taxable income (as defined in § 512(a)) of organizations described in § 511(a)(2), which include plans that qualify under § 401(a). Section 512(e)(1) provides that if an organization described in § 1361(c)(6) holds stock in an S corporation, the interest is treated as an interest in an unrelated trade or business and, notwithstanding the organization's general tax-exempt status, all items of income, loss, or deduction taken into account under § 1366(a) and any gain or loss on the disposition of the stock in the S corporation are taken into account in computing the unrelated business taxable income of the organization. In 1997, § 512(e) was amended to provide that § 512(e) does not apply to employer securities (within the meaning of § 409(l)) held by an ESOP described in § 4975(e)(7). Section 1523 of the Taxpayer Relief Act of 1997 (TRA '97) (111 Stat. 788) (1997). Accordingly, S corporation income allocable to stock held by an ESOP is not subject to regular income or unrelated business income tax.

Congress became aware that the tax exemption for earnings on S corporation stock held by an ESOP may lead to inappropriate tax deferral or avoidance in some cases. In order to address these concerns, Congress enacted § 409(p) as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) (115 Stat. 38) (2001). Section 409(p) is effective for plan years beginning after December 31, 2004. However, pursuant to section 656(d)(2) of EGTRRA, § 409(p) of the Code is effective for plan years ending after March 14, 2001, for an ESOP that is established after that date, or if the employer securities held by the plan consist of stock in an S corporation that did not have an S election in effect on that date. Notice 2002-2, Q&A-15, 2002-1 C.B. 285, provides that an S corporation does not have an election in effect on March 14, 2001, unless a valid election was actually filed on or before that date and is effective with respect to such corporation on or before that date. Temporary and proposed regulations under § 409(p) were issued on July 21, 2003 (2003-35 I.R.B. 420, 506, September 2, 2003), effective generally for plan years ending after October 20, 2003.

Section 409(p) is intended to limit the tax benefits of ESOPs maintained by S corporations unless the ESOP provides meaningful benefits to rank-and-file employees. As explained in the legislative history:

The Committee continues to believe that S corporations should be able to encourage employee ownership through an ESOP. The Committee does not believe, however, that ESOPs should be used by S corporation owners to obtain inappropriate tax deferral or avoidance.

Specifically, the Committee believes that the tax deferral opportunities provided by an S corporation ESOP should be limited to those situations in which there is broad-based employee coverage under the ESOP and the ESOP benefits rank-and-file employees as well as highly compensated employees and historical owners.

H.R. Rep. No. 107-51, part 1, at 100 (2001).

Sections 409(p) and 4979A apply if a nonallocation year occurs in an employee stock ownership plan, as defined in § 4975(e)(7), that holds shares of stock of an S corporation that are employer securities as defined in § 409(l). Section 409(p)(1) requires that an ESOP holding employer securities consisting of stock in an S corporation must provide that no portion of the assets of the plan attributable to (or allocable in lieu of) such employer securities may, during a nonallocation year, accrue (or be allocated directly or indirectly under any plan of the employer meeting the requirements of § 401(a)) for the benefit of any disqualified person, as defined in § 409(p).

Under § 409(p)(3), (4), and (5), a "nonallocation year" means a plan year of an ESOP during which, at any time, the ESOP holds any employer securities that are shares of an S corporation and either: 1) disqualified persons own at least 50 percent of the number of outstanding shares of stock in the S corporation (including deemed-owned ESOP shares), or 2) disqualified persons own at least 50 percent of the aggregate number of outstanding shares of stock (including deemed-owned ESOP shares) and synthetic equity in the S corporation. For these purposes, the rules of § 318(a) apply to determine ownership of shares in the S corporation (including deemed-owned ESOP shares) and synthetic equity. However, § 318(a)(4) (relating to options to acquire stock) is disregarded and, in applying § 318(a)(1), the members of an individual's family include members of the individual's family specified in § 409(p)(4)(D). In addition, an individual is treated as owning deemed-owned ESOP shares of that individual notwithstanding the employee trust exception in § 318(a)(2)(B)(i).

As indicated by the legislative history above, § 409(p) is intended to limit the tax benefits of ESOPs maintained by S corporations unless the ESOP provides broad based coverage for, and meaningful benefits to, rank-and-file employees. See H.R. Rep. No. 107-51, part 1, at 100 (2001). Accordingly, Congress added § 409(p)(7), recognizing that the structure of § 409(p) was not expected to be sufficient in all cases to ensure broad-based coverage for, and meaningful benefits to, rank-and-file employees. Section 409(p)(7)(A) thus authorizes the Secretary to prescribe such regulations as may be necessary to carry out the purposes of § 409(p). Section 409(p)(7)(B) provides that the Secretary may, by regulation or other guidance of general applicability, provide 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 § 409(p). The legislative history to § 409(p) includes the following with respect to exercise of this authority:

For example, this might apply if more than 10 independent businesses are combined in an S corporation owned by an ESOP in order to take advantage of the income tax treatment of S corporations owned by an ESOP. H.R. Conf. Rep. No. 107-84, at 277 (2001).

Pursuant to § 409(p)(7)(B), § 1.409(p)-1T(c)(3) of the Temporary Income Tax Regulations provides that the Commissioner, in revenue rulings, notices and other guidance published in the Internal Revenue Bulletin, may provide 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 § 409(p). For any year that is a nonallocation year, taking into account the legislative history cited above, § 1.409(p)-1T(c)(3) also provides that this exercise of authority includes the authority to treat any person as a disqualified person.

Under § 409(p)(4), a disqualified person is any person for whom: 1) the number of such person's deemed-owned ESOP shares is at least 10 percent of the number of deemed-owned ESOP shares of the S corporation; 2) the aggregate number of such person's deemed-owned ESOP shares and synthetic equity shares is at least 10 percent of the aggregate number of deemed-owned ESOP and synthetic equity shares of the S corporation; 3) the aggregate number of deemed-owned ESOP shares of such person and of the members of such person's family is at least 20 percent of the number of deemed-owned ESOP shares of the S corporation; or 4) the aggregate number of deemed-owned ESOP shares and synthetic equity shares of such person and of the members of such person's family is at least 20 percent of the aggregate number of deemed-owned ESOP and synthetic equity shares of the S corporation.

Section 409(p)(4)(C) defines "deemed-owned ESOP shares" to mean, with respect to any person: 1) any shares of stock in the S corporation constituting employer securities that are allocated to such person's account under the ESOP; and 2) such person's share of the stock in the S corporation that is held by the ESOP but is not allocated to the account of any participant or beneficiary (with such person's share to be determined in the same proportion as the most recent stock allocation under the ESOP).

Section 1.409(p)-1T(f)(1), interpreting § 409(p)(5), provides that the determination of whether someone is a disqualified person and whether a plan year is a nonallocation year is made without regard to "synthetic equity" attributable to that person and is also made separately taking into account synthetic equity. For purposes of § 409(p) and § 1.409(p)-1T, synthetic equity is treated as owned by a person in the same manner as stock is treated as owned by a person, directly or under the rules of § 318(a)(2) and (3).

Section 409(p)(6)(C) defines "synthetic equity" to include any stock option, warrant, restricted stock, deferred issuance stock right, stock appreciation right payable in stock, or similar interest or right that gives the holder the right to acquire or receive stock of the S corporation in the future. Synthetic equity also includes a right to a future payment (payable in cash or any other form other than stock of the S corporation) from an S corporation that is based on the value of the stock of the S corporation or appreciation in such value, such as a stock appreciation right with respect to stock of an S corporation that is payable in cash or a phantom stock unit with respect to stock of an S corporation that is payable in cash.

Section 1.409(p)-1T(f)(2)(iv) provides a rule treating nonqualified deferred compensation as synthetic equity. Specifically, that section of the temporary regulations provides that synthetic equity also includes any remuneration for services rendered to the S corporation, or a related entity, to which § 404(a)(5) applies (including remuneration for which a deduction would be permitted under § 404(a)(5) if separate accounts were maintained), any right to receive property (to which § 83 applies) in a future year for the performance of services to an S corporation, or related entity, and any transfer of property (to which § 83 applies) in connection with the performance of services to an S corporation, or a related entity, to the extent that the property is not substantially vested within the meaning of § 1.83-3(i) of the Income Tax Regulations by the end of the plan year in which transferred. Section 1.409(p)-1T(f)(2)(iv) also provides that synthetic equity includes any other remuneration for services rendered to the S corporation, or a related entity, under a plan, method or arrangement, deferring the receipt of compensation to a date that is after the 15th day of the 3d calendar month after the end of entity's taxable year in which the related services are rendered, other than a plan that is an eligible retirement plan within the meaning of § 402(c)(7)(B).

Pursuant to the authority in § 409(p)(7), § 1.409(p)-1T(f)(2)(iii)(A) provides that synthetic equity also includes a right to acquire stock or other similar interests in a related entity if such interests in the related entity are the only significant asset of the S corporation and the S corporation is the only significant owner of the related entity. Whether an asset is the only significant asset of the S corporation or the S corporation is the only significant owner of the related entity depends on the relevant facts and circumstances. Section 1.409(p)-1T(f)(2)(iii)(A)(4) provides that a related entity means any entity in which the S corporation holds an interest and which is a partnership, a trust, an eligible entity that is disregarded as an entity that is separate from its owner under § 301.7701-3 of the Procedure and Administration Regulations or a Qualified Subchapter S Subsidiary under § 1361(b)(3).

Pursuant to the authority in § 409(p)(7), § 1.409(p)-1T(f)(2)(iii)(C) provides that the Commissioner may, if necessary to carry out the purposes of § 409(p), through revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin, provide that synthetic equity includes a right to acquire stock or other similar interests in a related entity in cases in which such interests in the related entity are not the only significant asset of the S corporation or the S corporation is not the only significant owner of the related entity.

Section 1.409(p)-1T(f)(4)(ii) provides that, in the case of synthetic equity that is determined by reference to shares of stock (or other similar interests) in a related entity, the person who is entitled to the synthetic equity is treated as owning shares of stock in the S corporation with the same aggregate value as the number of shares of stock (or similar interests) of the related entity (with such value determined without regard to any lapse restriction as defined at § 1.83-3(i)).

Section 4979A imposes a 50 percent excise tax in certain cases, including an allocation of employer securities that is prohibited by § 409(p), the ownership of any synthetic equity by a disqualified person during a nonallocation year, and the occurrence of the first nonallocation year of an ESOP, as described in § 4979A(e)(2)(C). Section 4979(A)(c)(1)(A) provides for this excise tax to be paid by the employer sponsoring the ESOP.

## **ANALYSIS**

In each situation described above, the ownership structure of the S corporation is designed to allow one or more Taxpayers, each operating a business for that Taxpayer's own benefit, to take advantage of the tax-exempt status of the S corporation that results from the ownership of its outstanding stock by the ESOP. The ownership structure thereby avoids current taxation of the profits of each Taxpayer's separate business, while each Taxpayer retains the right to at least 50 percent of the business



through the right to acquire shares in the QSub. Because the profits of each business are being segregated and accumulated in each Taxpayer's QSub, the ESOP is owner of the business only in form, not in substance, to the extent that the Taxpayer has a right to the profits by exercising the Taxpayer's option to acquire the shares of the QSub. Thus, the ESOP is not providing benefits to rank-and-file employees that reflect its ownership share in the S corporation.

In Situation 1, each Taxpayer is using options on QSub stock to retain ownership of his or her separate business, with the profits of that business being segregated from the profits of the businesses of the other QSubs. In this way, the structure is designed to divert the profits of each business away from the ESOP. If each QSub were an S corporation directly owned by an ESOP, each Taxpayer's right to acquire shares of that corporation would be synthetic equity pursuant to § 409(p)(6)(C). Accordingly, the structure described in Situation 1 is similar to other forms of synthetic equity, such as the right to acquire stock in a related entity that is the only significant asset of an S Corporation (owned by an ESOP). Further, the economic effect is similar to nonqualified deferred compensation for services rendered to the QSub which is declared to be synthetic equity in § 1.409(p)-1T(f)(2)(iv).

Consequently, the options granted to each Taxpayer in Situation 1 to acquire shares in the QSub for that Taxpayer's business should be treated as synthetic equity in S Corp. Accordingly, pursuant to the authority in § 1.409(p)-1T(f)(2)(iii)(C), the Commissioner in this revenue ruling provides that the options are synthetic equity. Because these options are synthetic equity in Situation 1, each Taxpayer is a 10 percent owner of the number of deemed-owned shares of S Corp, Taxpayers A through E are thus disqualified persons, and, because disqualified persons A through E own an aggregate of at least 50 percent of the shares, 2003 is a nonallocation year for the ESOP.

A group of individuals with the same right to acquire the accumulated profits of their businesses as described in Situation 1 should not avoid the application of § 409(p) merely because each individual's right to acquire the accumulated profits of that individual's business does not have a value equal to at least 10 percent of the value of S Corp because more than 10 separate businesses are combined (as described in Situation 2). In fact, Congress anticipated the combining of more than 10 businesses as a means of avoiding the application of § 409(p) and gave this ownership structure as an example of the type of situation where exercise of the authority granted in § 409(p)(7)(B) would be appropriate.

Further, an individual with the same right to acquire the accumulated profits of that individual's business, similar to the rights described in Situation 1, should not avoid the application of § 409(p) merely because the business is combined, as in Situation 3, with the business of an S corporation owned by an ESOP that otherwise fulfills Congressional intent by providing broad-based coverage and benefits to rank-and-file employees. The rank-and-file employees in Situation 3 are not sharing in the profits of the Taxpayer's separate business through the ESOP's ownership share to the extent that the profits of that business are being accumulated for the benefit of that Taxpayer. With respect to that Taxpayer's separate business, the ownership structure of the S corporation is designed to avoid or evade the application of § 409(p).

In all three situations, the accumulation of profits for the benefit of a specific individual is comparable to the operation of an S corporation owned by an ESOP. Moreover, as in Situation 1, if any one of these businesses were the only business activity of S Corp, the option held by the taxpayers would be synthetic equity which would result in a nonallocation year and each taxpayer being a disqualified person if those shares of synthetic equity were at least 50 percent of the shares of stock of S Corp plus the total synthetic equity shares.

Accordingly, pursuant to the authority of § 409(p)(7)(B) and § 1.409(p)-1T(c)(3), the Commissioner provides in this revenue ruling that a nonallocation year occurs and the individual is a disqualified person in any case in which (i) shares of an S corporation are employer securities held by an ESOP, (ii) the profits of the S corporation generated by the business activities of a specific individual are accumulated and held for the benefit of that individual in a QSub or similar entity (such as a limited liability company), (iii) these profits are not paid to the individual as compensation within 2½ months after the end of the year in which earned, and (iv) the individual has rights to acquire shares of stock (or similar interests) of the QSub or similar entity representing 50 percent or more of the fair market value of the stock of such QSub or similar entity. In addition, pursuant to the authority in § 1.409(p)-1T(f)(2)(iii)(C), the Commissioner in this revenue ruling provides that such individual's right to acquire shares of stock (or similar interests) of the QSub or similar entity is synthetic equity. For purposes of this paragraph, the rights of the individual are determined after taking into account the attribution rules of § 409(p).

As a result, in Situations 2 and 3, the Taxpayer's right to acquire the shares of the QSub is synthetic equity, each individual Taxpayer (A through K in Situation 2, and A in Situation 3) is a disqualified person, and a nonallocation year occurs. The respective Taxpayers in Situations 2 and 3 are disqualified persons regardless of whether, at any time, a particular Taxpayer owns synthetic equity shares of S Corp equal to at least 10 percent of the sum of the outstanding shares of S Corp plus the synthetic equity shares of S Corp.

The same conclusions would apply with respect to Situations 1, 2, and 3 even if the support staff of the Taxpayers were to continue to be employed by their respective Service Recipient Corporations, the Service Recipient Corporations were to continue to provide substantially the same services for their customers, any of the Taxpayers or their support staff were to be employees of S Corp (instead of employees of a QSub), or any of the Taxpayers were to participate in the ESOP.

Treasury and the Service intend to reflect the guidance in this revenue ruling in regulations under § 409(p), effective for plan years ending after October 20, 2003. It is expected that the regulations would apply to similar transactions that have the effect of reserving profits from an individual's business activities to provide similar tax benefits to the individual, either with the use of a QSub or through the use of another method.

In appropriate cases, the Service may challenge other tax benefits claimed by any taxpayer involved in this type of business structure. For example, in the appropriate case, the Service may take the position for income tax purposes that, even though the Taxpayer purported to transfer his or her business (including the employment of his or her support staff) to the QSub, the Taxpayer never relinquished ownership of his or her business and, therefore, the Taxpayer should still be taxed on the profits. The Service might also take the position that the subsidiary is not a QSub. Alternatively, if the support staff of the Taxpayers were to continue to be employed by their respective Service Recipient Corporations, and the Service Recipient Corporations were to continue to provide substantially the same services for their customers, the Service might assert that each Taxpayer continues to be employed by their respective Service Recipient Corporation, with the related tax consequences.

## **HOLDINGS**

With respect to Situation 1, for purposes of §§ 409(p) and 4979A, (1) A through E are disqualified persons with respect to the ESOP, (2) the ESOP has a nonallocation year, and (3) the options to acquire stock in QSubs A through E are synthetic equity to which the § 4979A excise tax applies.

With respect to Situation 2, for purposes of §§ 409(p) and 4979A, (1) A through K are disqualified persons with respect to the ESOP, (2) the ESOP has a nonallocation year, and (3) A through K are each treated as owning synthetic equity in the form of each individual's option to acquire shares of the corresponding QSub.

With respect to Situation 3, for purposes of §§ 409(p) and 4979A, (1) A is a disqualified person with respect to the ESOP, (2) the ESOP has a nonallocation year, and (3) A is treated as owning synthetic equity in the form of A's option to acquire shares of the corresponding QSub.

## **EFFECTIVE DATE AND TRANSITION RULE**

This revenue ruling applies for plan years ending after October 20, 2003, but this revenue ruling (including the listing in the Listed Transactions section below) is not effective before March 15, 2004 if (i) all interests in a QSub held by individuals who would be disqualified persons under this revenue ruling are distributed to those individuals as compensation on or before March 15, 2004 and (ii) no such individual has been a participant in the ESOP at any time after October 20, 2003 and before March 15, 2004. In addition, for purposes of the excise tax under § 4979A, an individual's interest in a QSub that constitutes synthetic equity under this revenue ruling will be disregarded to the extent such interest is distributed to the individual as compensation on or before March 15, 2004.

## **LISTED TRANSACTIONS**

Arrangements that are the same as, or substantially similar to, the following transaction are identified as "listed transactions" for purposes of §§ 1.6011-4(b)(2), 301.6111-2(b)(2) and 301.6112-1(b)(2) effective January 23, 2004, the date this document was released to the public: Any transaction in which (i) at least 50 percent of the outstanding shares of an S corporation are employer securities held by an ESOP, (ii) the profits of the S corporation generated by the business activities of a specific individual are accumulated and held for the benefit of that individual in a QSub or similar entity (such as a limited liability company), (iii) these profits are not paid to the individual as compensation within 2½ months after the end of the year in which earned, and (iv) the individual has rights to acquire shares of stock (or similar interests) of the QSub or similar entity representing 50 percent or more of the fair market value of the stock of such QSub or similar entity. For purposes of the preceding sentence, the rights of an individual are determined after taking into account the attribution rules of § 409(p). These arrangements are identified as "listed transactions" with respect to the S corporation and each individual who is a disqualified person under this revenue ruling.

Independent of their classification as "listed transactions," transactions that are the same as, or substantially similar to, the transactions described in the preceding paragraph may already be subject to the disclosure requirements of § 6011 (§ 1.6011-4), the tax shelter registration requirements of § 6111 (§§ 301.6111-1T, 301.6111-2), or the list maintenance requirements of § 6112 (§ 301.6112-1).

Persons required to register these tax shelters under § 6111 who have failed to do so may be subject to the penalty under § 6707(a). Persons required to maintain lists of investors under § 6112 who have failed to do so (or who fail to provide such lists when requested by the IRS) may be subject to the penalty under § 6708(a). In addition, the IRS may impose penalties on parties involved in this transaction or substantially similar transactions, including the accuracy-related penalty under § 6662.

The Service and the Treasury recognize that some taxpayers may have filed tax returns taking the position that they were entitled to the purported tax benefits of the type of transaction described in this revenue ruling. These taxpayers should consult with a tax advisor to ensure that their transactions are disclosed properly and to take appropriate corrective action.

#### **DRAFTING INFORMATION**

The principal authors of this revenue ruling are Robert Gertner of the Employee Plans, Tax Exempt and Government Entities Division and John Ricotta of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information Employee Plans' taxpayer assistance telephone service at 1-877-829-5500 (a toll-free call) between the hours of 8:00 a.m. and 6:30 p.m. Eastern Time, Monday through Friday or contact Mr. Gertner at (202) 283-9888 (not a toll-free call).