TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Sample

John Doe, Inc.
1234 Main Street
Anywhere, USA

Re: Employee Stock Ownership Plan
EIN: 12-34567
Plan Number: 001

Dear Sir or Madam:

Our records indicate that you sponsor an Employee Stock Ownership Plan (ESOP) with 10 or fewer participants which is maintained by an S corporation. Accordingly, we believe you should be aware:

> (1) the plan may be affected by a change made to the Internal Revenue Code applicable to S corporation ESOPs that is generally effective on January 1, 2005, and
>
> (2) that a number of S corporation ESOPs have entered into abusive transactions unrelated to the change in the law.

<u>CHANGE IN LAW</u>

In 2001, Congress added section 409(p) to the Code. Section 409(p) was enacted to address concerns about ownership structures involving S corporations and ESOPs that concentrate the benefits of the ESOP in a small number of persons. In general, this section imposes income and excise taxes on prohibited allocations made by an S corporation ESOP in a nonallocation year. A nonallocation year occurs when the ownership of the S corporation is so concentrated that disqualified persons own or are deemed to own at least 50 percent of the S corporation shares. Disqualified persons are persons who own at least 10% of S corporation stock held by the ESOP (or 20% with family members).

For S corporation ESOPs in existence on March 14, 2001, section 409(p) is effective for plan years beginning after December 31, 2004. This delayed effective date has allowed existing S corporations that maintain ESOPs the time to restructure the stock ownership in order to avoid the tax effects of section 409(p).

The IRS recently issued Temporary regulations providing additional guidance concerning the application of section 409(p) to S corporation ESOPs. Temporary regulations under section 409(p) were also issued in July 2003. The text of these regulations can be found through links to the IRS web site discussed below.

The preamble to the Temporary regulations discusses ways an ESOP can prevent a nonallocation year from occurring. These methods include sale of employer securities in a participant's ESOP account, distribution of S corporation securities (if the plan allows) or transfer of S corporation securities to a non-ESOP portion of the plan or to another plan. You may want to discuss these options with your tax adviser.

Additional information regarding section 409(p) and the temporary regulations, as well as other issues pertaining to ESOPs adopted by S corporations, may be found on our Internet site. You can access the information at www.irs.gov/ep by clicking on S Corporation ESOP Guidance.

ABUSIVE TRANSACTIONS

As you are aware, ESOPS are subject to various requirements under the Code which must be met in order for the ESOP to be tax-exempt and to qualify for other tax benefits. We have determined that many of the existing arrangements designed to take advantage of the S corporation ESOP rules would not only violate section 409(p), but also violate other qualification requirements of the Code.

In these arrangements, taxpayers attempt to exclude the income of an operating business through the use of a combination of an S corporation and ESOP. In a typical case, the owner of an operating business creates an S corporation and causes the two entities to enter into an agreement under which the operating business pays a fee to the S corporation in exchange for management or other services. In addition, the S management corporation adopts an ESOP that becomes the sole shareholder of the S management corporation and in which the owner is the sole participant.

Taxpayers have argued that under this arrangement the operating company may deduct its payments to the S management corporation and the income of the S corporation is passed through to the ESOP. They further contend that because the ESOP is a tax-exempt entity, the income is not subject to tax until distributed from the plan. The Service has determined, however, that in many of these arrangements the ESOP fails to satisfy the qualification requirements of the Code for a valid ESOP, including the coverage rules of Code section 410(b). When an ESOP is not qualified under these circumstances, the subchapter S management corporation may be taxable as a C corporation and any highly compensated ESOP participant may be taxable on the value of his account balance.

As indicated above, additional information regarding issues pertaining to ESOPs adopted by S corporations may be found on our Internet site. If you believe that you or your company may have participated in a transaction similar to the one above, you

may want to access the web site to review this additional information. Please be aware that the abusive transactions described in this letter and explained further on the Internet site may not be resolved under the Employee Plans Compliance Resolution System (EPCRS).

There is no need to reply to this letter. If you have any questions regarding this letter, you may contact TE/GE Customer Account Services at 877-829-5500 (a toll-free number) between the hours of 8:30 a.m. and 5:30 p.m., Eastern Time.

Sincerely,

Carol D. Gold
Director, Employee Plans