S CORPORATION ESOP ABUSES

Background

Effective for years beginning after December 31, 1997, the Internal Revenue Code was amended to allow ESOPs to be shareholders in S corporations and to exempt the flow-through earnings to the ESOP from the unrelated business income tax. Accordingly, beginning in 1998, the income of an S corporation could pass through to an ESOP, and, because an ESOP is tax-exempt, no tax is paid on the income until it is distributed to the ESOP participant.

Congress intended that S corporations, like C corporations, be able to encourage employee ownership through an ESOP, but the new laws immediately led to abusive arrangements where an S corporation was used to pass corporate income to a tax-exempt ESOP where the only participants in the ESOP were the owner/employees of the business. Congress became aware that the law was subject to abuse and in 2001 amended the Code to add section 409(p) which limits the tax benefits of S corporation ESOPs unless the ESOP provides meaningful benefits to rank-and-file employees.

Change in Law

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 when there are prohibited allocations under 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 percent of S corporation stock held by the ESOP (or 20 percent 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).

Temporary regulations providing guidance under section 409(p) were issued in July 2003 (2003 regulations). The IRS and Treasury have recently issued Temporary regulations providing additional guidance concerning the application of section 409(p) to S corporation ESOPs (2004 regulations). The text of both of these regulations can be found through links on the IRS web site.

The preamble to the 2004 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.

Abusive Transactions Involving ESOPs

In addition to section 409(p), 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. Many of the existing arrangements designed to take advantage of the S corporation ESOP rules would not only violate section 409(p) when it becomes effective for these plans, but also violate other 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, an S corporation is created, with the owner of the operating business as the only employee of the S corporation. The owner of the operating business 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 purports to adopt an ESOP that is treated as 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 purported ESOP. They further contend that because the purported 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 purported ESOP fails to satisfy the requirements of the Code for a valid ESOP.

The following is an example of a typical abusive arrangement:

> Individual A is an employee and the sole shareholder of Corporation X, a C corporation. Corporation X is an operating business with a small number of nonexcludable employees, some of who are not highly compensated employees. Corporation X does not maintain a qualified retirement plan. In 1998, Corporation X has taxable income of \$500,000 and Individual A receives compensation of \$200,000. The compensation is deducted by Corporation X in calculating its taxable income and is included in income by Individual A.

In 1999, Corporation Y, an S corporation, is created, and a trust purported to be an ESOP is established by Corporation Y. All of the stock of Corporation Y stock is contributed to the purported ESOP. Individual A is the sole employee of Corporation Y and the sole participant in the purported ESOP. All the stock of Corporation Y is allocated to the account of A. The purported ESOP provides for full and immediate vesting of all benefits. Although the trust is purported to be an ESOP, it is not operated in accordance with the requirements for tax qualification under section 401(a) of the Code.

Also in 1999, Corporation Y enters into an agreement with Corporation X for fees to be paid in exchange for management services provided by Individual A to Corporation X. The principal business of Corporation Y is performing management functions for Corporation X on a regular and continuing basis. In 1999, the fees paid by Corporation X to Corporation Y equal $700,000. Corporation X deducts the full amount of the fees on its corporate tax return as a business expense and reports no taxable income. The $700,000 is reported by Corporation Y as income of the tax-exempt ESOP. Similar fees are paid in the years 2000-2003 and are reported as in 1999.

ESOP Requirements

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. For example, an ESOP must satisfy the nondiscrimination rules of section 401(a)(4) and the coverage rules of section 410(b). The nondiscrimination rules of section 401(a)(4) provide that the contributions or benefits provided under a plan may not discriminate in favor of highly compensated employees. An employee is a highly compensated employee either by being a 5-percent owner of the employer or by having compensation above a certain level.

Under the coverage rules of section 410(b), an ESOP must benefit either a certain percentage of the employer's nonhighly compensated employees or a classification of employees that does not discriminate in favor of highly compensated employees. For example, an ESOP that provides benefits to an employer's highly compensated employees, but does not provide benefits to the employer's nonhighly compensated employees, will fail these coverage rules and fail to be a qualified ESOP. The plan will therefore lose any tax benefits associated with being an ESOP.

Also, in determining whether these nondiscrimination and coverage rules are satisfied, section 414(m) of the Code provides that all employees of the members of an "affiliated service group" shall be treated as employed by a single employer. In that case, an employee who is a 5-percent owner of any member of the group is a highly compensated employee for the group. The term “affiliated service group” includes a group of two or more service organizations (e.g. corporations or partnerships whose principal business is the performance of services) where one of these organizations provides services to the other organization(s) in the group and there is a certain level of common ownership between the organizations. See Rev. Rul. 81-105, 1981-1 C.B. 256. In addition, the term also includes a group consisting of (1) an organization whose principal business is performing, on a regular and continuing basis, management functions for another organization (the recipient organization) and (2) the recipient organization (the organization for which such management functions are performed).

Accordingly, where an affiliated service group exists, an ESOP maintained by one of the organizations in that group may violate the coverage and nondiscrimination rules of the Code even if that organization’s only employee is covered by the plan. In the example provided above, Corporations X and Y form an affiliated service group because the principal business of Corporation Y is performing, on a regular and continuing basis, management functions for Corporation X. The purported ESOP of Corporation Y violates the coverage rules under section 410(b) because only Individual A is covered by the purported ESOP, and there are other nonexcludible employees of Corporations X and Y who are nonhighly compensated employees. As a 5-percent owner of Corporation Y, A is a highly compensated employee with respect to the affiliated service group of Corporations X and Y.

Tax Consequences of Abusive ESOPs

If an abuse is found to exist that is similar to the one described above, there are tax consequences for the management corporation (Corporation Y, in the above example) and for the ESOP participant (Individual A).

With respect to the management corporation, because the trust of the purported ESOP is nonqualified, it may not be a shareholder of an S corporation. Accordingly, the income will not pass through to the trust, but will instead be taxable to the management corporation as a C corporation. As a result, the management corporation will be taxed at the corporate level on all of its taxable income for all open years.

With respect to the ESOP participant, the tax liability will vary depending on whether or not a violation of the coverage rules is found. Section 402(b) provides generally that contributions to an employees’ trust under a nonqualified plan are includible in the employee’s income to the extent the employee is vested in those amounts. Section 402(b) further provides that any amount (other than an employee’s investment in the contract if any) actually distributed or made available to an employee from an employees’ trust under a nonqualified plan is includible in income when distributed or made available. However, section

402(b)(4) includes a special rule for an employees' trust where one of the reasons for disqualification of a plan is a coverage violation under section 410(b). In that case, under section 402(b)(4) of the Code, any highly compensated employee covered by the nonqualified plan is taxable on the value of his or her vested accrued benefit under the trust (other than his or her investment in the contract, if any). Thus, in the above example, because the purported ESOP fails to satisfy the coverage rules, the amount includible in A's income for each open year would be the value of A's account balance in the trust of the purported ESOP for that year (other than A's investment in the contract if any). The value of A's account balance would include the fair market value of the shares of Corporation Y stock allocated to the account.

<u>What you should do if you are involved with an abusive ESOP</u>

If you believe your arrangement may be considered an abusive transaction, you should immediately consult your tax advisor. If your tax adviser determines that your arrangement is, in fact, abusive, you should immediately file an amended return for all open years affected by the arrangement. This issue may not be resolved under the Employee Plans Resolution Compliance System (EPCRS). Employee Plans anticipates initiating a compliance program to review a large number of S corporation ESOPs with a small number of participants.

<u>Qualified Amended Returns</u>

Internal Revenue Code § 6662(a) imposes a penalty equal to 20 percent of any underpayment of tax required to be shown on a return if it is the result of negligence or a substantial understatement of income tax.

An individual substantially understates his or her income tax when the reported tax is understated by the greater of 10 percent of the tax required to be shown on the return or $5,000. For corporations, other than an S corporation or a personal holding company, the understatement is measured by 10 percent of the tax required to be shown or $10,000.

In determining the amount of "underpayment" that exists for purposes of the application of the penalty, the "amount shown as the tax by the taxpayer upon the return" includes or is adjusted by the amount which is shown as additional tax on a later "qualified amended return".

Thus, in some instances, a taxpayer may be able to avoid or mitigate the application of the penalty if the taxpayer files a qualified amended return *before* the IRS takes certain actions.

Under the provisions found in Treasury Regulation §1.6664-2(c)(3), a qualifying amended return is an amended return, or a timely request for an administrative adjustment under I.R.C. § 6227, which is filed after the due date of the return but before the earliest of:

(1) The date on which the taxpayer is first contacted by the IRS concerning an examination of the return;

(2) The date on which a person described in Section 6700(a) is first contacted by the Service about an examination of an activity described in Section 6700(a), if the taxpayer claimed any tax benefit on the return either directly or indirectly related to the Section 6700 activity; or

(3) For certain pass-through items, the date on which the pass-through entity, such as a partnership or S Corporation, is first contacted by the Service in connection with an examination to which the pass-through item relates.

By means of a Notice issued on April 30, 2004, the IRS announced that it intended to issue temporary and proposed regulations which would modify and narrow the definition of a qualified amended return by the identification of additional periods of time after which a taxpayer would not be permitted to file a qualified amended return. Notice 2004-38 may be found at 2004-21 I.R.B. 949.

Prior to filing any document which you intend to serve as a Qualified Amended Return, you should consult with your tax advisor.

Additional guidance on qualified amended returns can be found in Notice 2004-38 and Treasury Regulation section 1.6664-2(c)(3).