Section 409(p).—Prohibited Allocations of Securities in an S Corporation

(Also, §§ 401, 4975, 4979A, 6011, 6111 and 6112; 1.401–1, 54.4975–11, 1.6011–4T, 301.6111–2T and 301.6112–1T.)

Employee stock ownership plans; delayed effective date, abuse. This ruling states that where the intent of section 409(p) of the Code to limit the establishment of ESOPs by S corporations to those that provide broad-based employee coverage and that benefit rank-and-file employees (as well as highly compensated employees and historical owners) is not present, the delayed effective date in section 656(d)(2) of the EGTRRA is not available and that such transactions are listed transactions.

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PURPOSE

The Internal Revenue Service and the Treasury Department understand that certain arrangements involving employee stock ownership plans (ESOPs) that hold employer securities in an S corporation are being used for the purpose of claiming eligibility for the delayed effective date of § 409(p) of the Internal Revenue Code, under section 656(d)(2) of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) (Pub. L. 107–16). This revenue ruling alerts taxpayers and their representatives that the tax benefits purportedly generated by these transactions are not allowable for federal income tax purposes. This revenue ruling also alerts taxpayers, their representatives, and organizers or sellers of these transactions to certain responsibilities that may arise from participating in these transactions.

ISSUE

Is an S corporation ESOP described below eligible for the delayed effective date under § 409(p) of the Code provided under section 656(d)(2) of EGTRRA?

FACTS

On or before March 14, 2001, A, a person in the business of providing advice to other companies or individuals, arranges for the establishment of a number of S corpo-

rations that have no substantial assets or business, and forms an ESOP for each of those corporations. A takes the position that some or all of the employees of A are eligible to participate under the terms of the ESOP sponsored by each S corporation, but there is no reasonable expectation that these individuals will accrue more than insubstantial benefits under the plans or more than an insubstantial share in the ownership of the S corporations. After March 14, 2001, A markets these S corporations and the associated ESOPs to other taxpayers, including individuals or companies.

After one of the S corporations (and its ESOP) are transferred to one or more taxpayers, the taxpayers restructure their businesses so that the S corporation receives income from those businesses. After the restructuring, the S corporation is wholly or substantially owned by the ESOP. In addition, there are one or more individual taxpayers who are disqualified persons, within the meaning of § 409(p) of the Code (relating to prohibited allocations under an ESOP that holds stock in an S corporation), who are deemed to own in the aggregate at least 50% of the number of shares of the S corporation.

LAW

Section 4975(e)(7) provides that an ESOP is a defined contribution plan which is (1) 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), and (2) designed to invest primarily in qualifying employer securities. A plan is not treated as an ESOP unless it meets the following requirements, to the extent applicable: § 409(h) (relating to participants' right to receive employer securities and 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 defined in § 409(e)(4)). As authorized by § 4975(e)(7), additional requirements are imposed under § 54.4975–11 of the Excise Tax Regulations.

The legislative history to the Tax Reform Act of 1976 (TRA '76) (Pub.L. 94–455) states that an ESOP "is a technique of corporate finance designed to build beneficial equity ownership of shares in the employer corporation into its employees . . . ." (See S. Rep. 94–938 at 180 and 1976–3 C.B. Vol. 3, 218.)

Section 1.401–1(a)(2)(ii) of the Income Tax Regulations provides that a qualified profit-sharing plan is established and maintained by an employer to enable employees or their beneficiaries to participate in the profits of the employer's trade or business. However, § 401(a)(27) permits contributions to be made without regard to profits if the plan is designated as a profit-sharing plan. Under § 1.401–1(a)(2)(iii), a stock bonus plan is a plan that provides employees or their beneficiaries benefits similar to those of a profit-sharing plan, except that benefits are distributable in stock of the employer.

Section 409(p) requires that an ESOP that holds employer securities consisting of stock in an S corporation provide that no portion of the assets of the plan attributable to 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. Indirect allocations include allocations of income on S corporation stock held in the account of a disqualified person. H.R. Conf. Rep. 107–84 at 276.

Any prohibited allocations in a nonallocation year are treated as distributions and are currently taxable to the disqualified person. Section 409(p)(3) provides that a "nonallocation year" means a plan year during which, at any time, disqualified persons own at least 50 percent of the number of shares of the S corporation. Section 409(p)(4) provides, in general, that a "disqualified person" means a person for whom (1) the aggregate number of deemed-owned shares of such person and the members of such person's family is at least 20 percent of the number of deemed-owned shares of stock in the S corporation or (2) the number of such deemed-owned shares is at least 10 percent of the number of deemed-owned shares of stock in the S corporation. If an ESOP fails § 409(p), prohibited allocations are treated as currently taxable to the disqualified person under § 409(p)(2), and an excise tax equal to 50 percent of the allocations is imposed on the S corporation under § 4979A.

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, 2002–2 I.R.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.

The legislative history to section 656 of EGTRRA, which added § 409(p) to the Code, states that § 409(p) is intended to limit the establishment of ESOPs by S corporations to those that provide broad-based employee coverage and that benefit rank-and-file employees as well as highly compensated employees and historical owners. (See H.R. Rep. 107–51, pt. 1, at 100, and H.R. Conf. Rep. 107–84, at 274 (2001).) In addition, Congress has expressed concern regarding techniques to avoid or evade the requirements of § 409(p). (See § 409(p)(7)(B), which 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 the nonallocation requirements of § 409(p).)

ANALYSIS

In these transactions, A has not formed the ESOPs to provide substantial benefits, or substantial participation in the ownership of the S corporations, to the initial purported participants in the ESOPs. The initial employees of the entity forming the ESOP do not receive more than insubstantial benefits or more than insubstantial ownership interests through the ESOP. For purposes of the effective date of § 409(p), an ESOP is not established until it is adopted by an employer for the purpose of enabling its employees to participate in a more than insubstantial manner in the ownership of the employer's business and to

provide its employees with more than insubstantial benefits under the ESOP.

For the foregoing reasons, an ESOP adopted by an S corporation under the facts provided above will not be treated as having been established on or before March 14, 2001, and is not entitled to the delayed 2005 effective date for purposes of the nonallocation rules of § 409(p).

Accordingly, because there is a nonallocation year under § 409(p), the disqualified persons under § 409(p)(4) are treated as receiving deemed distributions to the extent of any allocation to their account, pursuant to § 409(p)(2)(A). In addition, excise taxes under § 4979A apply to any nonallocation year.

HOLDING

An S corporation ESOP described in this ruling is not eligible for the delayed effective date under § 409(p) of the Code provided under section 656(d)(2) of EGTRRA, and thus is subject to the nonallocation rules of § 409(p) of the Code effective for plan years ending after March 14, 2001. Any taxpayer who is a disqualified person with respect to the S corporation ESOP is treated as receiving a deemed distribution of stock allocated to the taxpayer's account and income with respect to that account. In addition, excise taxes under § 4979A apply to any nonallocation year.

LISTED TRANSACTIONS

Transactions that are the same as, or substantially similar to, the transaction described in this revenue ruling are identified as "listed transactions" for purposes of § 1.6011–4T(b)(2) of the temporary Income Tax Regulations and § 301.6111–2T(b)(2) of the temporary Procedure and Administration Regulations with respect to each disqualified person for plan years beginning prior to January 1, 2005. See also § 301.6112–1T, A–4. Further, it should be noted that, independent of their classification as "listed transactions" for purposes of §§ 1.6011–4T(b)(2) and 301.6111–2T(b)(2), transactions that are the same as, or substantially similar to, the transaction described in this revenue ruling may already be subject to the disclosure requirements of § 6011, the tax shelter registration requirements of § 6111 or the list maintenance requirements of § 6112 (§§ 1.6011–4T, 301.6111–1T, 301.6111–2T, and 301.6112–1T, A-3 and A–4).

Persons who are required to satisfy the registration requirement of § 6111 with respect to the transaction described in this revenue ruling and who fail to do so may be subject to the penalty under § 6707(a). Persons who are required to satisfy the list-keeping requirement of § 6112 with respect to the transaction and who fail to do so may be subject to the penalty under § 6708(a). In addition, the Service may impose penalties on participants in this transaction or substantially similar transactions, or, as applicable, on persons who participate in the reporting of this transaction or substantially similar transactions, including the accuracy-related penalty under § 6662, and the return preparer penalty under § 6694.

FURTHER GUIDANCE

The Service is developing further guidance to address other abusive arrangements involving S corporation ESOPs.

DRAFTING INFORMATION

The principal drafters of this revenue ruling are Steven Linder of the Employee Plans, Tax Exempt and Government Entities Division and John Ricotta of the Office of the Associate Chief Counsel/ Division Counsel (TEGE). For further information regarding this revenue ruling, please contact the Employee Plans' taxpayer assistance telephone service at 1–877–829–5500 (a toll-free number) between the hours of 8:00 a.m. and 6.30 p.m. Eastern Time, Monday through Friday. Mr. Linder may be reached at (202) 283–9888; Mr. Ricotta may be reached at (202) 622–6060. The telephone numbers in the preceding sentence are not toll-free.