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S Corporation ESOPs: Curbing Abuses and Clarifications

The Internal Revenue Service (IRS) has issued new guidance to resolve technical questions concerning the administration of employee stock ownership plans (ESOPs) sponsored by Subchapter S corporations (S-corps). In addition, the IRS released an official pronouncement intended to prevent tax practitioners from marketing “grandfathered” S-corp ESOPs to small businesses to take advantage of tax savings associated with ESOPs.

Curbing S-Corp Abuses

In 1998, Congress enacted legislation to allow ESOPs as eligible shareholders of S-corps. This created significant tax savings for small businesses because of the pass-through attributes of S-corps and the tax-exempt status of ESOPs. For example, an S-corp that is wholly owned by an ESOP is not subject to federal income tax. Instead, the income tax is deferred until the ESOP participants receive their benefits from the ESOP (and may be deferred even further if the participants rollover their benefits into IRAs).

Concerned by the potential for abuse, Congress amended the Internal Revenue Code to add new Code Section 409(p) in 2001, which prevents S-corps having ten or fewer employees from sponsoring ESOPs by imposing severe adverse tax consequences for both the employer and employees. The law also authorized the IRS to issue regulations or other guidance to address situations “in which the principal purpose of the ownership structure of an S corporation constitutes an avoidance or evasion” of the tax laws. The law was effective immediately for ESOPs established after March 14, 2001, but deferred for existing ESOPs until the first plan year beginning after December 31, 2004.

Revenue Ruling 2003-6 describes a situation where, before March 14, 2001, a consultant established a number of S-corps with no substantial assets or business, and the consultant formed an ESOP for each corporation. Although some or all of the employees of the S-corps were eligible to participate in the ESOPs, there was no reasonable expecta-

tion of employee entitlement to more than an insubstantial ESOP benefit or an insubstantial share in the ownership of the S-corp. After March 14, 2001, the consultant marketed the S-corps and the associated ESOPs to other taxpayers to take advantage of the “grandfathered” tax benefits.

This strategy came to an end with the recent issuance of Revenue Ruling 2003-6. The IRS held that the ESOPs adopted by the S-corps described above will not be treated as established on or before March 14, 2001 and, therefore, will not be entitled to the delayed 2005 effective date.

In addition, the IRS announced that it is developing further guidance to address other abusive arrangements involving S-corp ESOPs. We expect that the IRS will issue other guidance to address a scheme sold by aggressive tax-shelter promoters that involves the use of management companies.

Clarification of Rollover Rules

An S-corp’s ESOP may provide that benefits will be distributed either in the form of cash or in the form of employer stock, subject to the requirement that the stock must be sold back to the company or to the ESOP. Some companies prefer the latter approach so that plan participants can take advantage of favorable tax treatment available to lump sum distributions of employer stock. However, an IRA is not an eligible S-corp shareholder, and there was a concern that a distribution made directly to an IRA might result in the employer’s loss of its S-corp election. Under qualified retirement plan rules, applicable to ESOPs, plans must allow participants to elect to roll over distributions from the plan directly into an IRA.

In Revenue Procedure 2003-23, the IRS ruled that a momentary ownership of S-corp stock by an IRA will not terminate the company’s status as an S-corp if certain requirements are satisfied. These requirements are easily met. First, the ESOP document must require that the S-corp repurchase its stock immediately upon the ESOP’s distri-

bution to an IRA. Second, the S-corp must actually repurchase the stock contemporaneously with, and effective on the same day as, the distribution. Third, no income (including tax-exempt income), loss, deduction, or credit attributable to the distributed S-corp stock may be allocated to the IRA. To do this, the company is not required to file with the IRS for any ruling.

To take advantage of the protection afforded by Revenue Procedure 2003-23, the S-corp, not the ESOP, must repurchase the distributed stock. However, if the company wants a deduction or otherwise desires that the repurchased stock end up in the ESOP, the company may make a contribution to the ESOP in the form of the repurchased shares.

If the conditions in Revenue Procedure 2003-23 are not met, the S-corp may request a ruling from the IRS to preserve the S-corp election in accordance with Code Section 1362(f) which allows the IRS to waive the effect of the terminating event if the S-corp timely corrects the event and the S-corp and shareholders agree to be treated as if the termination had not occurred. Before Revenue Procedure 2003-23, the IRS issued several private letter rulings allowing a corporation to continue to be treated as an S-corp following transfers of stock from an ESOP to an IRA.

Calculation of Basis

If a plan participant receives a lump sum distribution of employer stock and the fair market value of the stock is greater than the cost basis, the participant may elect to be taxed at ordinary income rates on the cost basis of the shares at the time of the distribution and at capital gains rates on the net unrealized appreciation (NUA) at the time the stock is sold. In Revenue Ruling 2003-27, the IRS issued guidance for calculating basis in S-corp stock held by an ESOP.

Under the general tax rules, a shareholder's basis in stock of an S-corp is increased by his or her share of the S-corp's income and is decreased by losses, deductions and distributions paid to the shareholder. Thus, in an S-corp a shareholder's basis in his or her stock is adjusted annually to take into account items of income, loss, deduction, or credit for the year as well as distributions made during the year. In Revenue Ruling 2003-27, the IRS held that an ESOP is required to adjust its basis in S-corp stock under the general tax rules and that upon the ESOP's distribution of S-corp stock to a participant, the NUA is determined using the ESOP's adjusted basis in the stock. The effect of this ruling is likely to decrease the tax advantage to plan participants.

If you have any questions about the application of these new IRS rulings to ESOPs, please contact the Seyfarth Shaw employee benefits group attorney with whom you work or any employee benefits group attorney listed on the website at www.seyfarth.com.

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