

S CORPORATION ESOPs – WHAT IS CODE SECTION 409(p) ALL ABOUT?

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Both C corporations and S corporations are permitted to sponsor Employee Stock Ownership Plans (ESOPs). However, Congress has created additional “anti-abuse” rules (in Section 409(p) of the Internal Revenue Code) that apply only to S corporations. Since, with S corporations, the taxes are paid by the shareholders instead of the corporation itself, the Internal Revenue Service felt there was a need to preclude certain abuses – e.g., one-man S corporations wholly owned by a tax-exempt ESOP. The main idea behind the regulations is that certain allocations will be prohibited, in order to keep from having too much of the company value and the ESOP’s tax advantages concentrated for the benefit of just a few individuals. The rules are very complex, but include the following:

A) **“Deemed-owned” shares** are ESOP shares which are

- 1) Shares allocated to an individual in the ESOP, plus
- 2) That individual’s pro rata share of any unallocated ESOP shares. (This pro-rata portion is assumed to be allocated in the same way as the most recent stock allocation under the plan.)

Note this sum does NOT include stock directly owned by the individual or family *outside* of the ESOP.

B) **“Synthetic Equity”**

- 1) Synthetic equity is defined as stock options, warrants, restricted stock, deferred issuance stock rights, stock appreciation, phantom stock units, a right to a future cash payment based on the value of such stock or appreciation in such value, split dollar and other deferred compensation arrangements, rights to acquire interests in certain related entities, rights of first refusal, etc.
- 2) Synthetic equity is treated as outstanding and as *deemed-owned stock*, if such treatment of such synthetic equity of one or more persons, results in either:
 - a) Anyone being treated as a disqualified person (defined below), or
 - b) The plan year being treated as a nonallocation year (defined below).

C) A **“Disqualified Person”** is any person for whom:

- 1) His deemed-owned shares plus synthetic equity are at least 10% of all deemed-owned shares plus his synthetic equity, *or*
- 2) His *and* his *family’s* deemed-owned shares plus synthetic equity are at least 20% of all deemed-owned shares plus his and his family’s synthetic equity, *or*
- 3) He is *both*:
 - a) A member of a family of any person who is a disqualified person; *and*

- b) A participant with deemed-owned ESOP shares.
- D) A “**Nonallocation Year**” is any plan year if, on any date during such year, the S corporation ownership is so concentrated among disqualified persons that all disqualified persons combined own either:
- 1) At least 50% of the outstanding shares in the S corporation, or
 - 2) At least 50% of the outstanding shares and synthetic equity in the S corporation.

Outstanding shares include all “deemed owned” ESOP shares and directly owned shares.

- E) **Prohibited Allocation** --- The S Corp ESOP must not accrue or allocate shares (or other assets in lieu of shares) to a disqualified person during a nonallocation year.

F) **Penalties and Other Side Effects**

- 1) In general:
 - a) There are severe penalties for having a nonallocation year.
 - b) The penalties are worse if there is a prohibited allocation during such a year.
- 2) The disqualified person pays income tax on, and the corporation pays a 50% excise tax on, the following deemed distributions:
 - a) The prohibited allocation of employer securities,
 - b) The fair market value of any synthetic equity held by a disqualified person during a nonallocation year (including shares and investment gains on shares allocated in prior years), and
 - c) By this regulation’s reference to Code Sec. 4979A(e)(2)(C) --- for the occurrence of the *first* nonallocation year of the ESOP --- all deemed-owned shares of all disqualified persons.
- 3) A deemed distribution is not eligible for rollover into another plan or an IRA.
- 4) The corporation can lose its S corporation status due to ownership by an ineligible entity.
- 5) The disqualified person can owe an excise tax on distributions occurring prior to age 59 ½.
- 6) The plan can lose its status as qualified under Code Section 401.
- 7) A leveraged ESOP can lose its exemption from the excise tax on prohibited transactions for loans to a leveraged ESOP.

As noted in D above, since the tests have to be passed *each* day of the plan year, it is imperative to consult with your advisors *prior* to making any stock or synthetic equity transactions.