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IRS IDENTIFIES ESOP-OWNED S CORPORATION ARRANGEMENTS AS LISTED TRANSACTIONS

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In their report, Carlisle and Lanning describe the rules under section 409(p) and the Treasury regulations that proscribe certain transactions by ESOP-owned S corporations and the ESOPs they sponsor. They then analyze Rev. Rul. 2004-4, in which the IRS describes three transactions that are used to avoid section 409(p) by issuing "synthetic equity" in an entity owned by an S corporation. The consequences to the S corporations and the persons receiving the synthetic equity are described and the possible application of Rev. Rul. 2004-4 to other transactions is discussed.

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On January 23, 2004, the Internal Revenue Service released Rev. Rul. 2004-4, 2004-6 IRB 414, *Doc 2004-1435, 2004 TNT 16-11*, identifying certain transactions involving S corporations owned by employee stock ownership plans as listed transactions for tax shelter disclosure purposes and subjecting the transactions to a 50-percent excise tax. The IRS and Treasury intend to reflect the guidance in Rev. Rul. 2004-4 in future regulations under section 409(p),[1] relating to prohibited allocations of S corporation stock to "disqualified persons" by an ESOP.

Rev. Rul. 2004-4 describes three situations in which ESOP-owned S corporations are structured to provide benefits to persons other than ESOP participants in a manner that avoids the provisions of section 409(p) and the temporary and proposed regulations promulgated thereunder. In each situation the persons who benefit from the structure (the Taxpayers) are treated as disqualified persons, the ESOP's plan year is treated as a nonallocation year, and the Taxpayers are treated as owning synthetic equity in the S corporation.

I. Background: Prohibited Allocations

ESOPs are qualified retirement plans that invest primarily in the stock of the sponsoring employer. S corporations are permitted to sponsor ESOPs. The profits of an S corporation owned by an ESOP are not subject to tax until the ESOP makes distributions to the ESOP participants when they retire. Thus, an S corporation owned by an ESOP can reinvest its profits on a tax-deferred basis. Congress enacted section 409(p) as part of the Economic Growth and Tax Relief Reconciliation Act of 2001[2] to ensure that ESOPs maintained by S corporations would benefit the rank-and-file employees of the S corporation as well as the highly compensated employees and historic owners of the S corporation.

Under section 409(p), an ESOP holding employer securities consisting of S corporation stock must provide that no allocation of S corporation stock is made to any "disqualified person" during a "nonallocation year." If allocations are made to disqualified persons in a nonallocation year in violation of section 409(p)(1), the consequences are myriad, affecting the ESOP, the S corporation, and the disqualified persons. First, the amounts of such prohibited allocations are included in income by the disqualified persons to whom the allocations are made. Second, because compliance with the provisions of section 409(p) is also one of the requirements under section 4975(e) for a qualified plan to be treated as an ESOP, an allocation of S corporation stock to a disqualified person in a nonallocation year results in the plan ceasing to be treated as an ESOP. Third, since the S corporation income of a qualified plan is treated as unrelated business income subject to tax under section 511 unless the plan is an ESOP, loss of

[1]All "section" references are to the Internal Revenue Code of 1986, as amended (the code), and all "reg. section" references are to the Treasury regulations promulgated thereunder.

[2]P.L. 107-16.

ESOP status will result in the plan being subject to tax on its income from the S corporation stock it owns. Finally, in any plan year of an S corporation ESOP that is a nonallocation year, the S corporation is subject to a 50 percent excise tax under 4979A on the amount of any allocations made to disqualified persons and any "synthetic equity" in the S corporation held by disqualified persons.

A nonallocation year is any plan year of the ESOP in which disqualified persons own, or are deemed to own, at least 50 percent of the stock of the S corporation. For this purpose, ESOP participants are treated as owning their share of the S corporation owned by the ESOP. A "disqualified person" generally is any individual who has more than a 10 percent interest in the S corporation stock owned by the ESOP (the deemed-owned shares).[3]

Section 409(p)(5) provides that for purposes of determining disqualified persons and nonallocation years, "synthetic equity" in the S corporation is treated as deemed-owned shares of the persons who own the synthetic equity if such treatment results in any person being treated as a disqualified person or any plan year being treated as a nonallocation year. Section 409(p)(6)(C) defines the term "synthetic equity" as any interest or right that gives the holder the right to acquire or receive stock in the S corporation in the future and, except to the extent provided in regulations, any right to receive a future cash payment based on the value of the stock of the S corporation or appreciation in such value.

Section 409(p)(7)(A) authorizes the IRS to prescribe such regulations as may be necessary to carry out the purposes of section 409(p). In particular, section 409(p)(7)(B) authorizes the IRS and Treasury to issue regulations or other guidance of general applicability that treats an ESOP plan year as a nonallocation year in any case in which the principal purpose of the ownership structure of an S corporation constitutes an avoidance or evasion of section 409(p).

Temporary and proposed regulations under section 409(p) that were issued on July 21, 2003 (the Temporary and Proposed Regulations), provide that nonqualified deferred compensation paid by an S corporation is treated as synthetic equity in the S corporation. Also, synthetic equity in an entity other than the S corporation is treated as synthetic equity in the S corporation if the entity is the only significant asset of the S corporation and the S corporation is the only significant owner of the entity. The Temporary and Proposed Regulations provide that the IRS may, if necessary to carry out the purposes of section 409(p), issue guidance of general applicability that treats a right to acquire stock or similar interests in an entity as synthetic equity in the S corporation without regard to whether the entity is the only significant asset of the S corporation or whether the S corporation is the only significant owner of the entity.

II. Rev. Rul. 2004-4: Use of QSub Structure

A. Facts

1. Situation 1. In Situation 1, five individuals (the Taxpayers) who directly or indirectly own interests in domestic professional services corporations cause an S corporation to be formed, which in turn forms five qualified subchapter S subsidiaries (QSubs).[4] The S corporation establishes an ESOP that holds 100 percent of the stock of the S corporation. All employees of the S corporation and the QSubs (other than the Taxpayers) are participants in the ESOP.

Each QSub employs a Taxpayer to conduct the professional services business he or she previously conducted. Each Taxpayer is designated as an officer and investment manager of his or her respective QSub and each QSub grants its respective Taxpayer a nonqualified stock option to acquire substantially all or a majority of the shares of the QSub. The strike price of the option is not mentioned. The Taxpayers are paid salaries by their respective QSubs that are substantially less than the profits they generate. Such excess profits are retained by the QSubs in brokerage accounts over which the Taxpayer has investment control as the investment manager of the QSub. The Taxpayers can access the amounts accumulated in such brokerage accounts by exercising their options to acquire QSub stock.

If the options to acquire QSub stock were treated as synthetic equity in the S corporation, each of the five Taxpayers would be treated as having more than a 10 percent interest in deemed-owned shares and would be treated as disqualified persons. Also, the ESOP's plan year would be treated as a nonallocation year because the five disqualified persons would be treated as owning more than 50 percent of the S corporation stock.

2. Situation 2. In Situation 2, the facts are the same as in Situation 1, except that there are 11 Taxpayers and 11 QSubs, rather than five. If the options to acquire the stock of the QSubs were treated as synthetic equity in the S corporation, none of the 11 taxpayers would be treated as a disqualified person because their respective interests in deemed-owned shares would be less than 10 percent. Accordingly, treatment of the options to acquire the stock of the QSubs as synthetic equity in the S corporation would not cause the ESOP's plan year to be treated as a nonallocation year.

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[3]Also, a person is treated as a disqualified person if (1) such person and members of his or her family in the aggregate have more than a 20 percent interest in the deemed-owned shares; or (2) such person has any interest in the deemed-owned shares and is a family member of a person who has more than a 10 percent interest in the deemed-owned shares.

[4]Under section 1361(b)(3)(A), a QSub is not treated as a separate corporation and all of the assets, liabilities, and items of income, deduction, and credit of the QSub are treated as the assets, liabilities, and tax items of the S corporation. Accordingly, the income and deductions of the QSubs formed by the S corporations are treated as the income and deductions of the S corporations and, since the S corporations are owned by ESOPs, the profits of the QSubs are exempt from tax.

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3. Situation 3. In Situation 3, an S corporation that is owned by an ESOP has conducted substantial business activities for several years. The S corporation has 200 employees who are participants in the ESOP. As in Situations 1 and 2, the S corporation forms a QSub that employs a Taxpayer to conduct a professional service business that the Taxpayer previously conducted through a professional service corporation. As in Situations 1 and 2, the Taxpayer is granted options to acquire substantially all or a majority of the shares of the QSub and the salary paid to the Taxpayer is substantially less than the profits the Taxpayer generates and accumulates in the QSub. If the options to acquire the stock of the QSub were treated as synthetic equity in the S corporation, the Taxpayer's interest in deemed-owned shares would be less than 10 percent. Accordingly, treatment of the options to acquire the stock of the QSub as synthetic equity in the S corporation would not cause the ESOP's plan year to be treated as a nonallocation year.

B. Analysis

In Rev. Rul. 2004-4, the IRS concludes that in each situation, each QSub operates, in effect, as a separate S corporation owned by the ESOP and is treated as such for purposes of section 409(p). Thus, as shown in Situations 2 and 3, the fact that a Taxpayer's interest in his or her respective QSub represents less than a 10 percent interest in the overall S corporation is disregarded. What is determinative is that each Taxpayer has at least a 50 percent synthetic interest in his or her respective QSub. Moreover, as shown in Situation 3, having the ESOP also benefit the rank-and-file employees of the parent S corporation does not save the structure. We assume that in Situation 3 the ESOP was compensated for the use of its tax exemption by the Taxpayer to defer tax on the Taxpayer's business profits. Also, each Taxpayer (who owns options to acquire at least 10 percent of the stock of his or her respective QSub) is treated as a disqualified person and the ESOP's plan year is treated as a nonallocation year if such Taxpayers have at least a 50 percent synthetic interest in his or her respective QSub.

Rev. Rul. 2004-4 broadens the scope of section 409(p) to apply separately to QSubs and similar entities such as limited liability companies owned by an S corporation when synthetic equity in the QSub or similar entity has been issued. Rev. Rul. 2004-4 does not fully explain what an entity "similar" to a QSub is. However, both a QSub and a limited liability company with a single owner have the common characteristic of being disregarded as an entity separate from their owner for federal income tax purposes and being treated as, in effect, a branch or division of their owner. Such entities also have the common characteristics of being legal entities under state law. Although Rev. Rul. 2004-4 refers to similar "entities" and a branch or division of an S corporation may not be a separate legal "entity" under state law, it would be ludicrous if the rules of Rev. Rul. 2004-4 could be avoided by using a branch or division rather than a legal entity such as a QSub or limited liability company. Thus, if a person is given the right to acquire an ownership interest in a branch or division that is not a legal entity under state law, Rev. Rul. 2004-4 should apply if the other conditions set forth in Rev. Rul. 2004-4 are present.

If Rev. Rul. 2004-4 applies to branches or divisions that are not legal entities, query whether the rationale of Rev. Rul. 2004-4 also would apply to treat the deferred compensation account of an employee of an S corporation as an "entity" similar to a QSub. Under the Temporary and Proposed Regulations, deferred compensation provided by an S corporation is treated as synthetic equity in the S corporation, but does not automatically result in the employee being treated as a disqualified person or the ESOP's plan year being treated as a nonallocation year. Treating the employee's rights regarding the deferred compensation account as an interest in an "entity" similar to a QSub would mean that any amount of deferred compensation would cause the employees entitled to deferred compensation to be treated as disqualified persons and cause the ESOP plan year to be treated as a nonallocation year. Such a draconian result for all deferred compensation, in even the smallest amount, appears to be inconsistent with the treatment of deferred compensation under the Temporary and Proposed Regulations.

> ***It would be ludicrous if the rules of Rev. Rul. 2004-4 could be avoided by using a branch or division rather than a legal entity such as a QSub or limited liability company.***

Rev. Rul. 2004-4 does not discuss the consequences of treating the Taxpayers as disqualified persons, treating the ESOPs' plan years as nonallocation years, and treating the options to acquire QSub stock as synthetic equity in the S corporations. However, the press release issued by the Treasury to announce the issuance of Rev. Rul. 2004-4[5] indicates that the result is to impose on the S corporations the 50 percent excise tax under section 4979A on the value of the options on QSub stock.

Rev. Rul. 2004-4 does not state whether the S corporations' issuance of synthetic equity to the Taxpayers would be treated as a violation of section 409(p), which prohibits the allocation of S corporation stock by the ESOP to a disqualified person in a nonallocation year. If the Taxpayers were treated as receiving a prohibited allocation, they would be required to include the amount of the allocation in income and the ESOP would cease to qualify as an ESOP.

III. Future Regulations Under Section 409(p)

The IRS and Treasury intend to reflect the guidance in Rev. Rul. 2004-4 in future regulations under section 409(p), effective for plan years ending after October 20, 2003. Rev. Rul. 2004-4 says those future regulations are expected to apply to transactions similar to those described in Rev. Rul. 2004-4, whether through the use

[5] Treasury Department Office of Public Affairs, press release JS-1114, Jan. 23, 2004, *Doc 2004-1543, 2004 TNT 16-82.*

of options on QSub stock or rights to acquire interests in "similar entities, such as limited liability companies."

IV. Listed Transaction Status

Effective January 23, 2004, Rev. Rul. 2004-4 identifies arrangements that are the same as, or "substantially similar to," Situations 1, 2, or 3 as "listed transactions" for purposes of the tax shelter disclosure requirements of reg. section 1.6011-4, the tax shelter registration requirements of reg. sections 301.6111-1T and 301.6111-2, and the tax shelter list maintenance requirements of reg. section 301.6112-1. Rev. Rul. 2004-4 says the transactions are identified as "listed transactions" with respect to the S corporation and each individual who is treated as a disqualified person under the ruling. Accordingly, the S corporation and each individual treated as a disqualified person under the ruling would be subject to the tax shelter disclosure requirements, which apply to any taxpayer (including an S corporation) that participates in a listed transaction. The ESOP apparently is not treated as a participant in the listed transaction and is not subject to the tax shelter disclosure requirements.

Rev. Rul. 2004-4 states that the defining characteristics of Situations 1, 2, and 3 are (1) at least 50 percent of the outstanding shares of the S corporation are owned by an ESOP; (2) the profits of the S corporation generated by the business activities of a specific individual are accumulated and held for the benefit of that individual in a QSub or similar entity such as a limited liability company; (3) the profits are not paid currently to the individual, but are deferred; and (4) the individual has rights to acquire 50 percent or more of the fair market value of the stock of such QSub or similar entity. Although rights to deferred compensation payable by an S corporation are already treated as synthetic equity in the S corporation under the Temporary and Proposed Regulations, the rationale of Rev. Rul. 2004-4 could extend to an executive's claims as a creditor to receive deferred compensation. Profits of the S corporation generated by the executive's business activities are accumulated and held for the benefit of the executive, the executive's receipt of such profits is deferred, and the executive has the right to 100 percent of the amount so deferred. Although the profits are not accumulated in a QSub or limited liability company, they may be accumulated in a rabbi trust or in a separate bookkeeping account. In many respects, these arrangements are "similar" to the arrangements described as listed transactions in Rev. Rul. 2004-4.

Persons who fail to comply with the tax shelter disclosure requirements, the tax shelter registration requirements, or the tax shelter list maintenance requirements may be subject to penalties.

V. Effective Dates

Rev. Rul. 2004-4 applies to ESOP plan years ending after October 20, 2003. However, Rev. Rul. 2004-4 is not effective before March 15, 2004, if (1) all interests in a QSub (or similar entity) held by individuals treated as disqualified persons under Rev. Rul. 2004-4 are distributed to such individuals as compensation on or before March 15, 2004; and (2) no such individual has been a participant in the ESOP at any time after October 20, 2003, and before March 15, 2004. An individual's interest in a QSub (or similar entity) that is treated as synthetic equity under Rev. Rul. 2004-4 will be disregarded for purposes of the 50 percent excise tax under section 4979A to the extent that interest is distributed to the individual as compensation on or before March 15, 2004.

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