

9233 Ward Parkway, Suite 355
Kansas City, MO 64114
800 944 3767
816 333 4545 (fax)
<http://www.FLPSOP.com>



Roland Thon
roland@FLPSOP.com
Steve York, CPA, MBA
steve@FLPSOP.com
Janet Lubart
janet@FLPSOP.com

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Advisory #106

To: ***Marketing Partners***

Re: ***Anti-Abuse Rules for "S" Corporation ESOPs***

Over the past several months, we have received several dozen inquiries from Marketing Partners regarding the new anti-abuse rules for "S" corporation ESOPs. I thought it would be a good idea to share some of the details with you.

It is important to note the legislation is only three months old and the IRS has not yet issued regulations. The information contained in this letter is our best interpretation of the legislation and must be considered subject to refinement when regulations are issued. We will be sure to keep you posted as the IRS issues more specific guidance.

One June 12th, you should have received an e-mail from us addressing the ESOP provisions that were contained in The Economic Growth and Tax Relief Reconciliation Act of 2001 that President Bush signed into law on June 7th. That e-mail contained a general overview of the new enhancements for "C" corporation ESOPs and the new anti-abuse rules for "S" corporation ESOPs. I encourage you to review our June 12th communication before continuing with this expanded information.

The Big Picture

The big picture is the rules for "C" corporation ESOPs **continue to be far more favorable** than the rules for "S" corporation ESOPs.

Without question, the biggest advantage to a "C" corporation ESOP continues to be the availability of the IRC Sec 1042 tax deferred rollover to selling shareholders of highly appreciated stock to the ESOP. This rollover **is not**

available to “S” corporation ESOPs. Simply put, the primary motivating factor in doing an ESOP with the vast majority of our clients is the 1042 rollover, which gives the business owner the ability to **ELIMINATE** capital gains taxes on his life’s work.

In addition to being more advantageous, the “C” corporation ESOP rules are **fully developed**. In stark contrast, the “S” corporation ESOP rules are still **under development**. In our view, delivering greater advantages on more solid ground makes far greater business sense than delivering far less benefit on undeveloped ground!!!!

The IRS has not yet issued needed written guidance on numerous technical issues regarding “S” corporation ESOPs. Until the IRS does issue the needed guidance, moving forward with the assumption the IRS will rule a certain way is a very dangerous gamble that very few clients can afford to take. While I could bore you with a long list of the undeveloped technical issues, one example is provided:

It is relatively common in “second stage” ESOP transactions for the sponsoring employer to provide a “floor guarantee” to ESOP participants with respect to the block of stock that was acquired in the “first stage” transaction. A “floor guarantee” is designed to prevent any declining value in “first stage” stock that may result from the leverage that may be associated with financing the “second stage” stock purchase. A “floor guarantee” is a very smart fail-safe feature for ESOPs, but at this point in time, the IRS has not yet issued any guidance regarding whether or not the “floor guarantee” attribute that is available to one block of stock, but not to the remaining shares of the corporation, creates a second class of stock. The danger is if the IRS does take the position that a second class of stock is created as a result of a “floor guarantee”, the “S” election of the sponsoring corporation will be busted.

It is our hope that as time moves on, the unsettled technical issues regarding “S” corporation ESOPs will be solidified by the IRS and it is also our hope that eventually, the more favorable rules for “C” corporation ESOPs will be extended by Congress to “S” corporation ESOPs. However, assuming the developing technical issues for “S” corporation ESOPs can be resolved relatively quickly, given the abusive “S” corporation structures that continue to proliferate, it is our view the liberalization of the “S” corporation ESOP rules is not a reasonable expectation in the foreseeable future.

If you have a client that is thinking about doing an ESOP, it is almost certain the primary motivation for your client is the 1042 tax deferred rollover which requires a “C” corporation structure. If your client is looking beyond the 1042 rollover and is interested in a more global wealth preservation strategy, such as is found in our *FLPSOP*[®], a “C” corporation structure is also required as limited partnerships are not permissible shareholders of “S” corporation stock.

The bottom line – **ESOPs simply work better in “C” corporations** – the financial advantages are far greater and the rules are well defined.

The Details

It should be noted the Conference Report that is attached to the new tax bill contains authority for the Treasury Department to issue regulations to address **any** abusive ESOP design. This is true regardless of when the ESOP was established, if the purpose of the ESOP is *“in substance, an avoidance or evasion of the prohibited allocation rule”*. This provision gives the Treasury Department the ability to shut down creative attempts to evade the law through the design of ESOP schemes that appear to be in technical compliance on the surface, only to be deemed a sham when the core structure is examined.

I would like to emphasize the following anti-abuse rules apply **ONLY** to “S” corporation ESOPs, “C” corporation ESOPs are not subject to these anti-abuse rules, at least not yet.

The effective dates of the new anti-abuse rules for “S” corporation ESOPs are:

- 1) For “S” corporation ESOPs that were in existence prior to March 14th, 2001, the rules become effective for plan years beginning after December 31, 2004.
- 2) For “S” corporation ESOPs that are established after March 14th, 2001 or for “C” corporation ESOPs in which the sponsoring employer elected “S” status after March 14th, 2001, the rules become effective for plan years ending after March 14th, 2001.

The anti-abuse rules provide that an “S” corporation is not permitted to allocate employer securities to participants that are deemed to be *“disqualified individuals”* during a *“non-allocation year”*. These rules are very encompassing, they are very well conceived, leaving no wiggle room for creative promoters to engineer designs that circumvent these anti-abuse provisions. These anti-abuse

rules were championed by Senator John Breaux (D-La) with significant technical input from the ESOP Association and the National Center for Employee Ownership. Senator Breaux commands a very good technical knowledge of ESOPs and is recognized to be one of the strongest and most influential ESOP supporters in Congress.

A participant is a “*disqualified individual*” if:

- 1) The participant is deemed to own 10% or more of the shares of the corporation that sponsors the ESOP, or:
- 2) The shares that are deemed to be owned by the participant, together with the shares that are deemed to be owned by members of the participant’s family, amounts to more than 20% of the “*deemed owned*” shares of the corporation that sponsors the ESOP. “*Deemed owned*” shares are defined to be:
 - a) ESOP shares that have been allocated to the participant’s “*stock account*” as well as a portion of the ESOP shares that are held in the ESOP’s “*suspense account*”, which have not yet been allocated to participant’s “*stock accounts*.” (Determining how much of the “*suspense account*” stock to apportion to a “*disqualified individual*” is another very important unsettled technical issue that requires IRS guidance).
 - b) Shares that are considered to be “*synthetic equity*” such as stock options, warrants, stock appreciation rights, restricted stock, phantom stock or other feature that gives the individual the right to acquire or receive stock of the sponsoring employer at some point in the future or gives the individual the right to receive cash payments based on either the current value or future growth in the value of the sponsoring employer’s capital stock.

It is important to note the “*attribution of ownership*” rules apply to “*deemed owned*” shares. Under the “*attribution of ownership*” rules, an individual is considered owning stock that his held by his/her spouse, children, grandchildren and parents. The “S” corporation anti-abuse rules further extend the “*attribution of ownership*” rules to **also include** brothers, sisters, brothers-in-law, sisters-in-law as well as shares that are owned by partnerships, estates, trusts and corporations that are controlled by these family members.

A “*non-allocation*” year is an ESOP plan year in which at any time during the plan year “*disqualified individuals*” are deemed to own 50% or more of the company’s outstanding shares. If the 50% threshold is crossed, the ESOP may not allocate employer securities to the ESOP “*stock account*” of “*disqualified individuals*” and **no other assets** may be allocated to the “other investments account” or any other tax-qualified retirement plan that your client’s “S” corporation may sponsor. Therefore, this non-allocation rule **also affects** your client’s 401(k) savings plan, profit sharing plan and pension plan arrangements.

The penalties for prohibited allocations during a “*non-allocation*” year are extremely severe:

- 1) Your client’s company will be subject to a non-deductible excise tax equal to 50% of the amount of the prohibited allocation.
- 2) Your client’s company will also be subject to a non-deductible excise tax equal to 50% of any “*synthetic equity*” that is owned by “*disqualified individuals*” in any “*non-allocation*” year.
- 3) The amount of the prohibited allocation will be taxed as ordinary income to the “*disqualified individuals*”.

Epilogue

In the simplest of terms, significantly greater client value can be delivered with a “C” corporation ESOP and all the devastating financial penalties of these anti-abuse rules can be completely avoided.

ESOPs just work better in “C” corporations, plain and simple.

If you have any client situations that you would like to discuss, please feel free to contact Steve York, Janet Lubart or me and we will be happy to respond.

Sincerely,

Roland Thon