

inappropriate tax deferral or avoidance in some cases. In order to address these concerns, Congress enacted section 409(p) as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) (115 Stat. 38) (2001). Section 409(p) is intended to limit the tax benefits of ESOPs maintained by S corporations unless the ESOP provides meaningful benefits to rank-and-file employees. As explained in the legislative history:

The Committee continues to believe that S corporations should be able to encourage employee ownership through an ESOP. The Committee does not believe, however, that ESOPs should be used by S corporation owners to obtain inappropriate tax deferral or avoidance.

Specifically, the Committee believes that the tax deferral opportunities provided by an S corporation ESOP should be limited to those situations in which there is broad-based employee coverage under the ESOP and the ESOP benefits rank-and-file employees as well as highly compensated employees and historical owners.

H.R. Rep. No. 107–51, part 1, at 100 (2001).

Section 409(p)(1) requires an ESOP holding employer securities consisting of stock in an S corporation to provide that no portion of the assets of the plan attributable to (or allocable in lieu of) 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 section 401(a)) for the benefit of any disqualified person, as defined in section 409(p).¹

Section 409(p)(3)(A) provides that a “nonallocation year” includes any plan year during which the ownership of the S corporation is so concentrated among disqualified persons that they own at least 50 percent of its shares. Section 409(p)(3)(B) provides that, in determining the shares owned by an individual for purposes of section 409(p)(3)(A), the attribution rules of section 318(a) apply, with certain exceptions, and the individual is treated as owning his or her deemed-owned ESOP shares.

Under section 409(p)(4)(C)(i), the term *deemed-owned shares* includes, with respect to any person, the stock in the S corporation constituting employer securities of an ESOP which is allocated to that person under the ESOP, and that person’s share of the stock in the S corporation which is held by the ESOP but which is not allocated to participants under the ESOP. Suspense account stock is deemed to be allocated

to participants in the same proportion as the most recent plan allocation.

Section 409(p)(4) provides, in general, that whether someone is a “disqualified person” depends on a person’s ownership of deemed-owned shares of S corporation stock held by an ESOP (deemed-owned ESOP shares). Section 409(p)(4) provides, in general, that a “disqualified person” means any person whose deemed-owned ESOP shares are at least 10 percent of the number of deemed-owned ESOP or for whom the aggregate number of deemed-owned ESOP shares of such person and the members of such person’s family is at least 20 percent of the number of deemed-owned ESOP shares.

The determination of whether someone is a disqualified person and whether a plan year is a nonallocation year is made without regard to “synthetic equity” attributable to that person and is also made separately taking into account synthetic equity. Synthetic equity is a general classification unique to section 409(p). The provisions relating to synthetic equity do not modify the rules relating to S corporations, *e.g.*, the circumstances in which options or similar interests are treated as creating a second class of stock. H.R. Conf. Rep. No. 107–84, at 102 n.52. Under section 409(p)(6)(C), synthetic equity is defined as:

any stock option, warrant, restricted stock, deferred issuance stock right, or similar interest or right that gives the holder the right to acquire or receive stock of the S corporation in the future. Except to the extent provided in regulations, synthetic equity also includes a stock appreciation right, phantom stock unit, or similar right to a future cash payment based on the value of such stock or appreciation in such value.

Under the rules for the treatment of synthetic equity at section 409(p)(5), if a person owns synthetic equity in an S corporation, then the shares of stock in such corporation on which such synthetic equity is based are generally treated as outstanding stock in such corporation, and as deemed-owned shares of such person, if such treatment of synthetic equity results either in the treatment of any person as a disqualified person or the treatment of any year as a nonallocation year. Accordingly, if a person is treated as a disqualified person or a year is treated as a nonallocation year without regard to synthetic equity, then the inclusion of synthetic equity as outstanding stock does not cause the person to fail to be treated as a disqualified person or the year to fail to be treated as a nonallocation year.

Section 409(p)(7)(A) authorizes the Secretary to prescribe such regulations as may be necessary to carry out the purposes of section 409(p). As indicated by the legislative history above, section 409(p) is intended to limit the tax benefits of ESOPs maintained by S corporations unless the ESOP provides meaningful benefits to rank-and-file employees. See H.R. Rep. No. 107–51, part 1, at 100 (2001). Section 409(p)(7)(B) 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 section 409(p). “For example, this might apply if more than 10 independent businesses are combined in an S corporation owned by an ESOP in order to take advantage of the income tax treatment of S corporations owned by an ESOP.” H.R. Conf. Rep. No. 107–84, at 277 (2001).

Under section 656 of EGTRRA, section 409(p) is effective for plan years ending after March 14, 2001, except for those ESOPs eligible for a delayed effective date applicable to certain ESOPs that were established on or before March 14, 2001. See Rev. Rul. 2003–6, 2003–3 I.R.B. 286.

Section 4979A imposes a 50 percent excise tax in certain cases, including an allocation of employer securities that is prohibited by section 409(p), the ownership of any synthetic equity by a disqualified person during a nonallocation year, and the occurrence of the first nonallocation year of an ESOP, as described in section 4979A(e)(2)(C).

Explanation of Provisions

Overview

Section 409(p) was enacted to address concerns about ownership structures involving S corporations and ESOPs that concentrate the benefits of the ESOP in a small number of persons. Under the statute as amended, an ESOP is still permitted to hold S corporation stock, provided that the ESOP benefits a sufficiently broad-based group of employees.

These temporary regulations reflect the statutory language under section 409(p)(1) prohibiting an accrual or allocation in a nonallocation year, but do not provide additional guidance on what constitutes a prohibited accrual or allocation. It is expected that this issue will be addressed in additional regulations.

An ESOP has a nonallocation year for any plan year during which, at any time,

¹ This definition is different from the definition of disqualified person for purposes of section 4975.