



# Client Alert

## Changes in S Corporation ESOP Regulations

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On July 21, 2003, the IRS published temporary and proposed regulations under Internal Revenue Code Section 409(p) intended to eliminate certain kinds of abusive arrangements involving ESOP-owned S corporations. The new regulations treat nonqualified deferred compensation plans, and the right to acquire interests in certain entities owned by an S corporation, as “synthetic equity” in the S corporation for testing purposes.

The new regulations expand the reach of Section 409(p) of the Internal Revenue Code beyond the language of the statute and its legislative history, neither of which supports the treatment of traditional cash deferred compensation plans as synthetic equity.

## Summary of Code Section 409 (p)

### New Regulations will:

- Be used to eliminate abusive arrangements involving ESOP-owned S corporations
- Create a set of tests for ESOP-owned companies to pass under a penalty of a 50% excise tax
- Mandate that deferred compensation be treated as synthetic equity

Code Section 409 (p) creates a complex set of tests that ESOP-owned S corporations must pass under penalty of a draconian 50% excise tax. The purpose of the Section 409(p) rules is to ensure that ESOP-owned S corporations provide broad-based coverage and benefits to their employees.

The 50% excise tax is imposed on ESOP-owned S corporations in the first “nonallocation year,” which is defined as any year in which more than 50% of the corporation is owned

(or deemed to be owned) by “disqualified persons.”

The excise tax is also triggered if plan assets are allocated to disqualified persons, or if a disqualified person owns any synthetic equity in a non-allocation year. A disqualified person is someone whose “deemed-owned” ESOP shares are 10% or more of the total number of deemed-owned ESOP shares, or someone who, together with his or her family, has deemed-owned ESOP shares equal to 20% or more of the total number.

Deemed-owned shares for any person include allocated shares of company stock held by the ESOP, a pro rata share of unallocated company stock held by the ESOP, and any “synthetic equity” owned by the person. Synthetic equity is defined in the Code as an option, warrant, or similar interest or right to acquire stock of the S corporation in the future, and includes phantom stock, stock appreciation and other similar rights.

# Summary of the New Regulations



**Regulations are effective now for ESOPs established after March 14, 2001!**

The new regulations provide that deferred compensation must be counted as synthetic equity, even if the compensation is for a fixed dollar amount completely unrelated to the company's stock value. To determine the number of shares of synthetic equity represented by the right to receive deferred compensation, the present value of the deferred compensation must be calculated and then divided by the fair market value of a share of S corporation stock. The right to receive as deferred compensation property other than cash, or a transfer of restricted property which is not substantially vested under Code Section 83, is also treated as synthetic equity.

Some S corporations own interests in entities (such as certain trusts, partnerships qualified subchapter S subsidiaries or limited liability companies) that are disregarded for

tax purposes. The regulations define as synthetic equity the right to acquire an equity interest in any such related entity, if the interest in the entity is the only significant asset of the S corporation, and the S corporation is its only significant owner. In addition, an option or right to acquire assets of the S corporation or a related entity is treated as synthetic equity if it is part of a structure that provides rights to the holder comparable to the rights provided by other arrangements classified as synthetic equity, and the purpose of the structure is to avoid or evade Section 409(p).

There is some good news in the regulations for ESOP-owned S corporations. The regulations confirm that synthetic equity does not include the right to acquire shares in an S corporation that are issued and outstanding and held

by a person other than the ESOP, the S corporation or a related entity, at all times when such rights are effective. The regulation protects bona fide shareholder buy-sell agreements and rights of first refusal outside the ESOP structure from being characterized as synthetic equity.

The new temporary and proposed regulations apply to plan years beginning on or after January 1, 2005 for ESOPs established by March 14, 2001, and to plan years ending after October 20, 2003 for all other ESOPs. The temporary and proposed regulations permit S corporations to avoid having nonqualified deferred compensation treated as synthetic equity if the deferred compensation is distributed by July 21, 2004. Additional regulations on Section 409(p) issues are expected in the future.



**STEIKER, FISCHER, EDWARDS & GREENAPPLE, P.C.**

7318 Germantown Avenue  
Philadelphia, PA 19111  
215.242.5100 *phone*  
215.248.2288 *fax*

6 South Street, Suite 2  
Morristown, NJ 07960  
973.540.9292 *phone*  
973.540.9295 *fax*

The Foundry Corporate Office Center  
235 Promenade Street, Suite 497  
Providence, RI 02908  
401.632.0480 *phone*  
401.632.0483 *fax*

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Steiker, Fischer, Edwards and Greenapple, P.C., in conjunction with Shared Equity Strategies, is pleased to announce that you will begin to receive regular "Client Updates." These Updates will inform you about changes in legislation that may affect your company's ESOP, as well as other information that you may find useful. As always, we're here to answer your ESOP-related questions at any time.

## Steiker, Fischer, Edwards & Greenapple

James Steiker	215.242.5100
Steven R. Fischer	215.242.5100
Robert W. Edwards	401.632.0480
Steven B. Greenapple	973.540.9292
Rita J. Linguiti	215.242.5100
Susan Cole Halevi	401.632.0480

## Shared Equity Strategies

Robert E. Massengill	973.540.9200
James F. Higgins, Jr.	973.540.9200
Michael Golden	215.242.5200
Brian Wurpts	215.242.5200

