IRS Issue Snapshot: S Corporation ESOPs and IRC section 409(p)

By: Nona K. Massengill

04.25.2019

In one of its Issue Snapshots, the IRS recently focused on methods for preventing the occurrence of an ESOP ?nonallocation year? under IRC section 409(p). Issue Shapshots are not precedential IRS guidance, but are research summaries issued periodically by the Tax Exempt and Government Entities (TE/GE) Knowledge Management team.

IRC Section 409(p) was enacted to prevent concentrated ownership, or deemed ownership, of ESOP-owned S Corporations. Because of the substantial tax benefits accruing to S Corporations owned by ESOPs, Congress added rules ? through 409(p) ? to ensure that the tax advantage benefits a broad group of rank-and-file employees.

In general, 409(p) bars an ESOP allocation to certain owners or deemed owners of an S Corporation (?disqualified persons?) for any year in which those disqualified persons collectively own at least 50% of the S Corporation (a ?nonallocation year?). In determining whether an individual is a disqualified person, both ?synthetic equity? and indirect ownership of shares through an ESOP account are considered. Synthetic equity includes options and other equity-based rights, *and also* certain nonqualified deferred compensation arrangements even if not share-value-based.

There are no prescribed correction methods for a violation of 409(p). Loss of S Corporation status and excise taxes are some of the consequences of a violation. Thus, *preventing* a nonallocation year is key.

S Corporation ESOP sponsors:

- *should understand how their plan document and administrative practices address 409(p);*
- *should incorporate regular monitoring and testing procedures; and*
- *should evaluate, in advance, any synthetic equity arrangements, grants, and allocations for 409(p) effects.*

The Issue Snapshot is a reminder that the only prescribed method for preventing a nonallocation year is the ?transfer method,? which directs the plan administrator to transfer a formulated number of shares, for any participant who would otherwise become a disqualified person, to a non-ESOP account. Transfer method language must appear in the plan *prior to* the occurrence of a nonallocation year, and it must be spelled out in the plan, rather than incorporated by reference. In addition, if the transfer method must be used in a given year, the securities moved to a non-ESOP account are subject to UBIT in the year of transfer. In the event of an audit, the Issue Snapshot directs examiners to request a copy of Form 990T to evidence payment of these taxes.

The Issue Snapshot also explains that several alternative compliance methods, described in Chief Counsel Advice Memorandum 201747007 (dealing largely with plan allocation methods that may have a preventative effect), have limitations. They may not capture every situation that could result in a 409(p) violation, and thus should not be considered a substitute for transfer method language. These alternative methods must be evaluated under general qualified plan principles such as non-discrimination, anti-cutback restrictions, written plan document requirements, and a definite predetermined allocation formula.

For questions about the Issue Snapshot, or 409(p) generally, please contact Nona K. Massengill or any member of the Williams Mullen Employee Benefits & Executive Compensation Practice.

Related People

- Nona K. Massengill ? 804.420.6569 ? nmassengill@williamsmullen.com

Related Services

- Employee Stock Ownership Plans (ESOPs)
- Employee Benefits & Executive Compensation