A Brief History of S Corporation ESOP Scams

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By NCEO Executive Director Corey Rosen

If you have or are thinking about an S corporation ESOP, you may wonder (or chafe) at the rules and regulations for preventing these plans from being abused to benefit just a few people. For some companies, especially very small ones (under 15 or so employees), these rules may effectively prohibit even the most well-intentioned and inclusive plans. Others question just what is wrong with using an ESOP to benefit just a few people.

Understanding the history of these rules can help understand why they ended up being written as they were. It also can alert you not proceed with anyone who tells you he or she has found a clever way around them.

Back around 2000 and 2001, you might have gone to a really intriguing meeting. A seemingly knowledgeable tax advisor told you that there was a way that a group of managers or other highly compensated employees could form a special kind of corporation called an S corporation ESOP. It sounded too good to be true, but it seemed that a small group of you could set yourselves up as a separate company and avoid most or all taxes! True, it involved some complex corporate restructuring, but your advisor assured you that for the right fee it can all be done quite legally.

"Here's the deal," the advisor told you. "Back in 1998, Congress made it possible for S corporations that were owned by an employee stock ownership plan (ESOP) to get a very special tax break. Specifically, the ESOP did not have to pay any tax on its share of the profits attributable to its ownership interest in an S corporation. As you know, in an S corporation, the corporation itself pays no tax. Instead, tax obligations are passed through to the owners pro rata to their ownership share. So if an ESOP owns 100% of the company, no federal income tax is due. In some, but not all, states, you still have to pay tax, but that's relatively small."

"But," you asked, "how does that help me and the other managers? I don't know a lot about ESOPs, but aren't they kind of like 401(k) plans and profit sharing plans in that they are supposed to be made available at least to most of your full-time employees? Frankly, I'm not that interested in sharing ownership with employees broadly—I just want to figure out a way to reduce taxes for myself and, if necessary other managers. Anyway, I can't believe Congress would pass a law that allows a group of managers or higher-income folks to avoid paying taxes. That's not the Congress I know."

You saw the twinkle in your tax advisor's eyes. It's the sparkling sign of dollars adding to his bank account, you suspected, but the potential tax break was too good not to consider. "Look," he said, "you're right about ESOPs technically. They are supposed to be made available on a nondiscriminatory basis at

least to all full-time employees who have worked for 1,000 hours. There are some limited exceptions for employees covered by unions, there's a rule that lets you cover 70% of the eligible employees, and another rule if you have a separate line of business. But all those exceptions are still far too broad for what you need. But I have come up with a way to get around all that."

"But," you stammered, still skeptical, "surely Congress or the IRS is watching out for these kinds of deals. Wouldn't they do something to prevent this?"

"You're right," he added, "Congress has tried to limit this law so that it can't be used by a small group of employees to avoid paying taxes, even when they are excluding a larger group of employees from being in the ESOP. But Congress only went so far—and we know how to walk right up to that line. So I'm just engaging in that great American pastime—finding loopholes in the law. It's downright patriotic! The tax law is very complicated, you see. That's why you're paying me larger fees than you might with just an ordinary advisor." (Much larger, you suspect.)

In the first go-round, your advisor just set up a management company for you and your partner. It charged an operating company, now a separate business you divided off from the main operation, all of the operating company's profits. Then as an S ESOP for just the two of you, you paid no tax. But then Congress passed this anti-abuse law in 2001. You looked on the NCEO web site and found these rules:

First, you define "disqualified persons." Under the law, a "disqualified person" is an individual who owns 10% or more of the "deemed-owned" shares or who, together with family members (spouses or other family members, including lineal ancestors or descendants, siblings and their children, or the spouses of any of these other family members) owns 20% or more of the "deemed-owned" shares. The "deemed-owned" shares include (1) shares allocated in the ESOP, (2) each ESOP participant's pro-rata portion of the unallocated shares, and (3) synthetic equity, broadly defined to include stock options, stock appreciation rights, and other equity equivalents (such as certain deferred compensation arrangements).

Second, determine whether disqualified individuals own at least 50% of all shares in the company. In making this determination, ownership is defined to include (a) shares held directly, (b) shares owned through synthetic equity, and (c) allocated or unallocated shares owned through the ESOP. If disqualifi e individuals own at least 50% of the stock of the company, then these individuals may not receive an allocation from the ESOP during that year without a substantial tax penalty, nor can they accrue more than 10% of the plan assets or 20% as a family group. If such an allocation or accrual does occur, it is taxed as a distribution to the recipient, and a 50% corporate excise tax would apply to the fair market value of the stock allocated or accrued. If synthetic equity is owned, a 50% excise tax would also apply to its value as well. In the first year in which this rule applies, there is a 50% tax on the fair market value of shares allocated to or accrued by disqualified individuals even if no additional allocations are made to those individuals that year (in other words, the tax applies simply if disqualified individuals own more than 50% of the company in the first year).

For ESOPs in existence before March 14, 2001, the rules become effective for plan years beginning after December 31, 2004. For plans established after March 14, 2001, or for preexisting C Corporation ESOPs that switched to S status after this date, the effective date is for plan years ending after March 14, 2001. " That seemed enough to dissuade you, but your advisor persisted. "No, wait!" the advisor says, clutching

his wallet fiercely. "We can get around this. Here's what we do:

1. "We spin off a separate management company. We'll call it AvoidTaxCorp (ATC) for now. It has 11 employees. You see, with 11, we can easily get around the math problem the new law creates because no one will own more than 10% of the allocations.
2. "ATC gets a contract to manage the operating company, now an independent corporation. Its fees are high enough to take most of the operating company's profit.
3. "We put shares in every ATC employee's account, making sure we stay within the rules for S corporation ESOPs. 100% of the company is owned by the ESOP.
4. "The profits are paid out to the employees' accounts every year, building bigger and bigger nest eggs. But because they stay in the ESOP, they are not taxable. Then, when someone leaves, the ESOP buys their shares and reallocates them to those who remain. You can take your distribution and put it into an IRA.

Another variation on this theme involved setting up an ESOP in which all the employees, including those of the operating company, participate in an ESOP in the management company. Typically, there was not much value on the operating company, so the employees never own much of anything. But the point of this particular scam was not to put value in the ESOP. Instead, it gave managers a large deferred compensation benefit, which is tax-sheltered because the S corporation, being 100% owned by the ESOP, is not taxable.

Yet another variation had the operating company setting up the ESOP. It will then set up a management corporation it will own. As a 100% ESOP company, it can still have the managers participate in a large deferred compensation plan. It won't be taxable because the company pays no federal income tax. The management company can then siphon off a large share of the profits by charging a high fee to the operating company.

The IRS Responds

The IRS was having none of it. ESOPs were created to benefit employees broadly, not provide exceptional tax benefits to a very few usually highly paid people. So new regulations were created.

In Revenue Ruling 2003-6, the IRS struck decisively at companies that want to use S corporations ESOPs to benefit a small number of people while providing insubstantial benefits to employees. This ruling specifically addresses S ESOPs established before March 14, 2001, the "grandfathering" date provided by EGTRRA for the new rules to discourage abuses of the S corporation ESOP model. Some advisors set up what were in effect shell ESOP companies, companies with no or few assets. The advisors then set up ESOPs for these companies that provided nominal benefits to employees. The shell companies were then sold to one or more taxpayers who would restructure their own businesses so that the shell S ESOP now owned most or all of their companies. These individuals would be precluded from participating in an S ESOP because they do not meet the "disqualified person" test of EGTRRA—except for the fact that ESOPs set up before March 14, 2001, were grandfathered under the old rules. These advisors believed that these structures would qualify as ESOPs for the March 14 test.

The IRS decisively disagreed, saying that an ESOP cannot be considered established if "the initial employees of the entity forming the ESOP do not receive more than insubstantial benefits or more than insubstantial ownership." So these pre-March 14 ESOPs do not qualify as ESOPs, meaning the

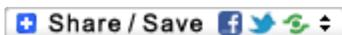
individuals setting them up till now face extraordinarily punitive tax costs of EGTRRA. In addition, the IRS was very clear that transactions that are the same as, or substantially similar to, these transactions will have to register as tax shelters.

The ruling's language makes it clear that the IRS intends to follow the spirit and the letter of the law on this topic. In particular, its attack on ESOPs providing insubstantial benefits to employees should signal that other arrangements than the one described here, but with the same effect, will not work. The IRS has not yet ruled on the issue of S ESOP corporations in which the tax trick is to exclude management from the ESOP, but pay them large deferred (and, because the company pays no federal income tax if 100% ESOP owned, tax sheltered) benefits. But this ruling should provide cold comfort to promoters of these schemes as well.

What Makes a Legitimate S Corporation ESOP

After reading this article, some readers may think it may be best to stay away from this area altogether. Nothing could be farther from our intention. S corporation ESOPs are extraordinary opportunities. Congress explicitly wrote the law to encourage companies to set up and expand their ESOPs, even to the point that they become 100% owned by their ESOP and free from federal income tax. The provisions were not loopholes; they were the result of a deliberate and considered discussion. What Congress did want to encourage is the ESOP that covers at least most or all full-time people who have worked for the company for one year or more. That means the ESOP includes the receptionist and the CFO; the sales clerk and the vice-president for marketing; the machine operator and the COO. The plans are intended to own the operating assets of the company; management sees the plans as a way to provide meaningful benefits to everyone, not primarily a way to siphon them off to a few. Fortunately, the vast majority of S corporation ESOPs meet these criteria, and many go much further, creating a real culture of ownership as well. If that is the kind of company you plan with an S corporation ESOP, the law supports you all the way.

For more information on S corporation ESOPs, see our book on the subject.



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