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ESOP Update: Deduction Disallowance Under Section 267; Section 409(p) Letter Ruling; and *King & Prince Seafood* Decision

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IRS Emerging Issue: S Corporation Accrued Expenses to ESOP Participants a Potential Pitfall for the Less Than 100% S Corporation ESOP

The director for prefiling and technical guidance at the Internal Revenue Service (IRS) issued a memorandum on September 28, 2007 (LMSB-04-0907-064) providing notification of an emerging issue related to S corporation ESOPs and deductions for certain accrued expenses in respect of related parties, including accrued compensation for ESOP participants. At issue in the memorandum is Section 267 of the Internal Revenue Code (the Code). The memorandum was circulated to all executives and managers of the IRS's Large and Mid-Size Business (LMSB) division, and to the chief of the Appeals Division Counsel. The memorandum advised any IRS representative who identifies a taxpayer who may be impacted by the memorandum to refer the matter to the S corporation technical advisor.

Section 267 of the Code generally disallows loss recognition on a sale or exchange of property between related persons. It also states that deductions for amounts paid to a related party can only be taken in the year in which the related party includes such amounts in its income. Section 267(e) of the Code provides that any person who directly or indirectly owns stock in an S corporation is considered a related party to that S corporation. Section 267(c)(1) of the Code states that stock owned either directly or indirectly by a trust shall be considered as being owned proportionately by its beneficiaries. Accordingly, participants in an ESOP are treated as indirect shareholders of the S corporation and therefore are related parties to the S corporation.

Deductions for accrued expenses to a related party (i.e., any participant in an S corporation ESOP) are only allowed in the taxable year in which the individual includes that amount in his or her income. For companies that are accrual-basis taxpayers, in order to avoid an inadvertent violation of Section 267 of the Code, it is recommended that accrued expenses be examined. Accrued expenses that are impacted could include, but are not limited to, accrued wages, accrued bonuses, and accrued vacation pay. Although the issue is equally applicable to a 100% S corporation ESOP, since the S corporation income is allocated to the ESOP that is exempt from tax, any audit adjustment required by Section 267 of the Code would have no current-year impact, and therefore has the practical effect of only impacting partially owned S corporation ESOPs. Companies that are cash-basis taxpayers are not likely to be significantly affected by this interpretation, since for such companies, compensation deductions usually coincide with the recipients' income inclusion.

IRS Issues First Private Letter Ruling on Section 409(p) of the Code

On January 25, 2008, the IRS published the first ruling on the S corporation ESOP anti-abuse rules codified in Section 409(p) of the Code since the rules became law in 2001. Because the rules were complicated and left many questions unanswered, in 2003 the Treasury Department issued temporary and proposed regulations to provide guidance on the application of the provisions of Section 409(p) of the Code. On December 17, 2004, a new set of temporary and proposed regulations were issued to clarify, expand, and modify the 2003 regulations; these regulations were ultimately finalized in December 2006. Despite these actions by the Treasury Department, it has taken the IRS more than seven years to first interpret these complicated and draconian rules.

Section 409(p) of the Code generally provides that if a person is deemed to own 10% or more of an S corporation's equity, the individual is a disqualified person. If disqualified persons, in the aggregate, are deemed to own 50% or more of the S corporation's equity, a nonallocation year has occurred and confiscatory tax penalties are assessed. Under the tests of Section 409(p) of the Code, if several members of a family own equity in an S corporation, the IRS aggregates the family members' deemed ownership to determine whether the family group is a disqualified person under Section 409(p) of the Code.

At issue in Private Letter Ruling (PLR) 200804023 was a family-owned S corporation owned in part by an ESOP, with a cousin and the cousin's child involved in the business. Although the PLR did not contain the actual percentages of the individuals' deemed ownership in question, it was represented that no individuals were deemed to own 10% or more of the company and that the family group's deemed ownership, in the aggregate, was less than 20% of the company. It was further represented that there was no outstanding synthetic equity involved. The primary request in the PLR was a determination of whether a nonallocation year had occurred under Section 409(p) of the Code.

In testing whether the cousin and the cousin's child were disqualified persons for purposes of Section 409(p) of the Code, the IRS appropriately applied the family deemed-ownership aggregation rules of Section 409(p)(4)(D) of the Code. Under the facts in the PLR, the only family members who were aggregated under the rules of Section 409(p) of the Code were the cousin and that individual's child. Since the aggregate number of shares in the ESOP accounts of these two individuals is less than 20% of the number of deemed-owned shares of stock of the company, neither of these two individuals constitutes a disqualified person. In addition, the IRS found that no other individuals in the company had deemed-owned shares which were at least 10% of the deemed-owned shares. Most significantly, the PLR makes it clear that the corporate family attribution rules set forth in Section 318 of the Code are not used in determining whether an individual is a disqualified person. The Section 318 attribution rules are only applied in the determination of whether a nonallocation year has occurred once the disqualified persons have been identified (using only the aggregation rules under Section 409(p)(4)(D) of the Code). Consequently, in this PLR, the IRS appropriately ruled that a nonallocation year had not occurred because there were no disqualified persons involved with the S corporation.

This PLR confirms practitioners' understanding as to how deemed ownership is calculated for purposes of the Section 409(p) tests and the determination as to whether a nonallocation year has occurred. More importantly, the PLR confirms the IRS's position that the Section 318 stock ownership attribution rules only apply in determining whether a nonallocation year has occurred and are not used in connection with the determination as to whether an individual is a disqualified person.

U.S. District Court Opinion Rendered in King & Prince Seafood Corporation ESOP Litigation

In a lengthy opinion, the U.S. District Court for the Southern District of Georgia recently rendered its decision on defendants' motions for summary judgment in *DelRosario and Taylor v. King & Prince Seafood Corporation*. The court's opinion encompasses a number of areas; this discussion focuses on the main claim—the claim for benefits.

In 2004 and 2005, two separate groups of former employees of the King & Prince Seafood Corporation filed putative class action lawsuits against the company, its ESOP, and the ESOP trustees, claiming benefits under ERISA, statutory penalties under ERISA, damages for breach of fiduciary duty and breach of contract under ERISA, equitable estoppel under ERISA, and attorneys' fees under ERISA and Georgia state law.

The claims revolved around the distribution features of the ESOP and the distribution policy followed by the trustees. The ESOP provided that distributions would be paid no later than the anniversary date of the sixth plan year following termination. The 1991 payment policy provided that terminated participants would be eligible to receive distributions as soon as possible during the sixth plan year following termination. The 1999 payment policy moved up the distribution date to the third plan year following termination. In 2003, the payment policy was again amended to begin distributions by the end of the second plan year following termination. In practice, participants were not required to wait the full six, three, or two years, and distributions were paid shortly before the plan's next annual valuation, with the result that terminated participants were often paid out at nearly year-old stock values. Prior to the end of each plan year, the ESOP sent distribution notices and consent forms to participants eligible to receive distributions. The timing of the notices and the form of the notices varied from 1998 through 2003 and participants were not always allowed a full 30-day period to elect distributions. The plaintiffs argued that some of the consent forms did not include all of the benefit features, including the put option, the right to elect to receive and roll over stock, and the right to defer distribution.

In 2006, the court dismissed the breach of fiduciary duty and breach of contract claims. The recent opinion focuses on the remaining claims. The plaintiffs' claims for benefits under ERISA were focused upon three issues: (1) the defendants' decision to make distributions near the end of the plan year using year-old valuations and shortening the waiting period violated the plan and ERISA; (2) the adoption of the 1999 and 2003 payment policies shortening the waiting period violated the anti-cutback rules of ERISA; and (3) the notices given to plaintiffs violated the consent and significant detriment rules of ERISA.

The court reviewed the benefits decision *de novo*, applying the Eleventh Circuit's opinion in *Williams v. BellSouth Telecomm., Inc.*, 373 F.3d 1132 (11th Cir. 2004). The court found that (1) the practice of making distributions late in the plan year according to the valuation of the prior plan year, and (2) the shortening of the waiting period did not violate ERISA or the terms of the plan. Because the plan document provided only an outer limit as to when distributions must commence, nothing prohibited the trustees from shortening the waiting period. The court also found that the payment policies were in compliance with IRS regulations regarding valuations. The court could have concluded its benefits analysis here, but chose to review the benefits claim under the more liberal standards of review encompassed in Eleventh Circuit case law. However, even under those standards, the court found that the trustees provided a legitimate basis for the timing of distributions (based upon the company's

business cycles), and that the different sources of funding for ESOP cashouts versus stock buybacks from nonparticipants were matters of business judgment that the court would not second-guess.

The court also addressed the plaintiffs' claim that management of the company's repurchase liability should not be a consideration in setting forth the payment policy. The court held that the attempt to manage repurchase obligations constituted reasonable grounds to shorten the waiting period. The court rejected the plaintiffs' argument that trustees should not concern themselves with managing repurchase obligations unless and until the company gets into financial straits.

Because the plaintiffs' anti-cutback rule claim was based on a changed policy, rather than an amendment to the plan, the court found that there was no violation of the anti-cutback rule. However, the court did find that the trustees violated the consent rule that requires ERISA plans to provide participants with sufficient information to make informed decisions. The court explained that while the trustees may have implemented the distribution rules in accordance with the ESOP and ERISA, it could not find that rank-and-file terminated participants were apprised of the material rules of the distribution policy. The court found that participants were not provided consent forms more than 30 days prior to distribution, in violation of the rule. The court further found that the failure of the notices to apprise participants of their right to defer distribution until age 65, of their option to roll stock into an IRA, of the availability of the put option periods, and of the tax consequences of their decision violated the consent rule, as did the failure of the notices to inform participants that they would receive a year-old valuation.

In summary, the court declined to find that plaintiffs had a valid claim to benefits based upon the plan's distribution policies, and found that the trustees had not violated the terms of the plan in fashioning distribution policies. The court left open the possibility of some form of remedy for violation of the consent rule, underscoring the importance of plan administrators' responsibility to provide timely and proper notice to participants. The court also recognized the validity of considering repurchase obligations in connection with distribution policies and declined to second-guess the business judgment of trustees in crafting distribution policies.

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