Congress Giveth and Congress Taketh Away: The Slow Death of the SESOP

Beckett G. Cantley
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I. INTRODUCTION

In 1996, Congress passed the Small Business Job Protection Act ("SBJPA")\(^1\) that, in part, allowed an Employee Stock Ownership Plan ("ESOP")\(^2\) to own a Subchapter S\(^3\) corporation\(^4\). The SBJPA amended Section 1361\(^5\) of the Internal Revenue Code\(^6\) to permit an S Corp to be owned by an ESOP\(^7\) and thereafter be a shareholder in an S Corp.\(^8\) In 1997,\(^9\) Congress amended Section 512(e)\(^10\) to exempt ESOPs from the
Unrelated Business Income Tax ("UBIT"). The effect of the 1996 and 1997 actions was to allow ESOPs to hold S Corps in a tax advantaged manner and therefore allow the profits from the S Corp to build up tax-free inside of the ESOP. Given that many small family businesses are owned in an S Corp structure, this effectively gave “mom and pop” businesses the same benefits that big corporations have traditionally had by making use of an ESOP. In 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), which included a provision disqualifying SESOPs where one employee owns more than fifty percent (50%) of the SESOP. The new law mandated

(B) notwithstanding any other provision of this part—
(i) all items of income, loss, or deduction taken into account under section 1366(a), and
(ii) any gain or loss on the disposition of the stock in the S corporation, shall be taken into account in computing the unrelated business taxable income of such organization.

(2) Basis reduction. Except as provided in regulations, for purposes of paragraph (1), the basis of any stock acquired by purchase (as defined in section 1361(e)(1)(C)) shall be reduced by the amount of any dividends received by the organization with respect to the stock.

(3) Exception for ESOPs. This subsection shall not apply to employer securities (within the meaning of section 409(i)) held by an employee stock ownership plan described in section 4975(e)(7).

Id.  

12. See infra Parts III-VI (discussing the changes to the Internal Revenue Code of 1986 that allowed ESOPs to be owners of S Corps).

13. See infra Parts V-IX.


The Tax Reform Act of 1984, (1984 TRA) and the Tax Reform Act of 1986 (1986 TRA) enacted some of the most important legislative changes in the history of ESOPs. These laws created substantial tax incentives for employers maintaining ESOPs for the benefit of their employees and also created significant federal income tax planning opportunities.

Id.

15. See discussion infra Part V (discussing relevant changes to the Internal Revenue Code of 1986 regarding ownership requirements necessary for ESOPs).


(3) Nonallocation year.— For purposes of this subsection—
(A) In general.—The term ‘nonallocation year’ means any plan year of an employee stock ownership plan if, at any time during such plan year—
(i) such plan holds employer securities consisting of stock in an S corporation, and
(ii) disqualified persons own at least 50 percent of the number of shares of stock in the S corporation.

Id.
that the other owners\textsuperscript{18} must be totally unrelated\textsuperscript{19} to each other and each of the other owners must not own more than ten percent (10\%) of the shares of the S Corp.\textsuperscript{20} Any owner violating these rules is deemed a "disqualified person."\textsuperscript{21} This legislation had the effect of prohibiting many small family businesses from making use of the SESOP because these businesses rarely had enough non-family employees to qualify under these new strict ownership rules. The effective date of the EGTRRA ownership rules was applicable to SESOPs formed on or after March 14, 2001.\textsuperscript{22} In anticipation of the restrictions under EGTRRA,

\begin{itemize}
  \item \textsuperscript{18} See id. Other persons could be described as not being included as a disqualified person as defined as follows:
  \begin{itemize}
    \item \textsuperscript{(4) Disqualified person.— For purposes of this subsection—}
    \begin{itemize}
      \item \textsuperscript{(A) In general.—The term ‘disqualified person’ means any person if—}
      \begin{itemize}
        \item \textsuperscript{(i) the aggregate number of deemed-owned shares of such person and the members of such person’s family is at least 20 percent of the number of deemed-owned shares of stock in the S corporation, or}
        \item \textsuperscript{(ii) in the case of a person not described in clause (i), the number of deemed-owned shares of such person is at least 10 percent of the number of deemed-owned shares of stock in such corporation.}
      \end{itemize}
    \end{itemize}
    \item \textsuperscript{(B) Treatment of family members.—In the case of a disqualified person described in subparagraph (A)(i), any member of such person’s family with deemed-owned shares shall be treated as a disqualified person if not otherwise treated as a disqualified person under subparagraph (A).}
  \end{itemize}

\textit{Id.}

\begin{itemize}
  \item \textsuperscript{19} See id. (broadly defining family members which are also included as disqualified persons for purposes of the statute).
  \begin{itemize}
    \item \textsuperscript{(D) Member of family.—For purposes of this paragraph, the term ‘member of the family’ means, with respect to any individual—}
    \begin{itemize}
      \item \textsuperscript{(i) the spouse of the individual,}
      \item \textsuperscript{(ii) an ancestor or lineal descendant of the individual or the individual’s spouse,}
      \item \textsuperscript{(iii) a brother or sister of the individual or the individual’s spouse and any lineal descendant of the brother or sister, and}
      \item \textsuperscript{(iv) the spouse of any individual described in clause (ii) or (iii). A spouse of an individual who is legally separated from such individual under a decree of divorce or separate maintenance shall not be treated as such individual’s spouse for purposes of this subparagraph.}
    \end{itemize}
  \end{itemize}

\textit{Id.}

\begin{itemize}
  \item \textsuperscript{20} See id. (stating that “in the case of a person not described in clause (i), the number of deemed-owned shares of such person is at least 10 percent of the number of deemed-owned shares of stock in such corporation.”).
  \item \textsuperscript{21} Id. See definition of “disqualified person” supra note 18.
  \item \textsuperscript{22} See id., defining the effective date as follows:
    \begin{itemize}
      \item \textsuperscript{(1) In general.— The amendments made by this section shall apply to plan years beginning after December 31, 2004.}
      \item \textsuperscript{(2) Exception for certain plans.— In the case of any—}
      \begin{itemize}
        \item \textsuperscript{(A) employee stock ownership plan established after March 14, 2001, or}
        \item \textsuperscript{(B) employee stock ownership plan established on or before such date if employer securities held by the plan consist of stock in a corporation with respect to which an election under section 1362(a) of the I.R.C. (1986) is not in effect on such date, the}
      \end{itemize}
    \end{itemize}
\end{itemize}
some tax planners formed numerous SESOPs prior to the March 14, 2001 effective date,\textsuperscript{23} purportedly to grandfather the entities into the pre-EGTRRA laws. These SESOPs were then sold to taxpayers as tax shelters.\textsuperscript{24} The Internal Revenue Service issued a notice\textsuperscript{25} making this transaction a "listed transaction."\textsuperscript{26}

In an effort to get around the broad based ownership rules present in EGTRRA,\textsuperscript{27} SESOPs were formed using options to purchase shares of

amendments made by this section shall apply to plan years ending after March 14, 2001.

\textit{Id.}

23. See discussion \textit{infra} Part VI.

24. See \textit{infra} notes 90-95 and accompanying text.


26. See \textit{infra} note 96 and accompanying text.

27. See I.R.C. § 409(p) (2005) providing: (p) Prohibited allocations of securities in an S corporation

(1) In general. An employee stock ownership plan holding employer securities consisting of stock in an S corporation shall 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.

(2) Failure to meet requirements.

(A) In general. If a plan fails to meet the requirements of paragraph (1), the plan shall be treated as having distributed to any disqualified person the amount allocated to the account of such person in violation of paragraph (1) at the time of such allocation.

(B) Cross reference. For excise tax relating to violations of paragraph (1) and ownership of synthetic equity, see section 4979A.

(3) Nonallocation year. For purposes of this subsection—

(A) In general. The term "nonallocation year" means any plan year of an employee stock ownership plan if, at any time during such plan year—

(i) such plan holds employer securities consisting of stock in an S corporation, and

(ii) disqualified persons own at least 50 percent of the number of shares of stock in the S corporation.

(B) Attribution rules. For purposes of subparagraph (A)—

(i) In general. The rules of section 318(a) shall apply for purposes of determining ownership, except that—

(I) in applying paragraph (1) thereof, the members of an individual's family shall include members of the family described in paragraph (4)(D), and

(II) paragraph (4) thereof shall not apply.

(ii) Deemed-owned shares. Notwithstanding the employee trust exception in section 318(a)(2)(B)(i), an individual shall be treated as owning deemed-owned shares of the individual. Solely for purposes of applying paragraph (5), this subparagraph shall be applied after the attribution rules of paragraph (5) have been applied.

(4) Disqualified person. For purposes of this subsection—

(A) In general. The term "disqualified person" means any person if—

(i) the aggregate number of deemed-owned shares of such person and the members of such person's family is at least 20 percent of the number of deemed-owned shares of stock in the S corporation, or

(ii) in the case of a person not described in clause (i), the number of deemed-owned shares of such person is at least 10 percent of the number of deemed-owned shares of

https://ideaexchange.uakron.edu/akrontaxjournal/vol20/iss1/3
stock in such corporation.
(B) Treatment of family members. In the case of a disqualified person described in subparagraph (A)(i), any member of such person's family with deemed-owned shares shall be treated as a disqualified person if not otherwise treated as a disqualified person under subparagraph (A).
(C) Deemed-owned shares.
(i) In general. The term "deemed-owned shares" means, with respect to any person—
(I) the stock in the S corporation constituting employer securities of an employee stock ownership plan which is allocated to such person under the plan, and
(II) such person's share of the stock in such corporation which is held by such plan but which is not allocated under the plan to participants.
(ii) Person's share of unallocated stock. For purposes of clause (i)(II), a person's share of unallocated S corporation stock held by such plan is the amount of the unallocated stock which would be allocated to such person if the unallocated stock were allocated to all participants in the same proportions as the most recent stock allocation under the plan.
(D) Member of family. For purposes of this paragraph, the term "member of the family" means, with respect to any individual—
(i) the spouse of the individual,
(ii) an ancestor or lineal descendant of the individual or the individual's spouse,
(iii) a brother or sister of the individual or the individual's spouse and any lineal descendant of the brother or sister, and
(iv) the spouse of any individual described in clause (ii) or (iii). A spouse of an individual who is legally separated from such individual under a decree of divorce or separate maintenance shall not be treated as such individual's spouse for purposes of this subparagraph.
(5) Treatment of synthetic equity. For purposes of paragraphs (3) and (4), in the case of a person who owns synthetic equity in the S corporation, except to the extent provided in regulations, the shares of stock in such corporation on which such synthetic equity is based shall be treated as outstanding stock in such corporation and deemed-owned shares of such person if such treatment of synthetic equity of 1 or more such persons results in—
(A) the treatment of any person as a disqualified person, or
(B) the treatment of any year as a nonallocation year. For purposes of this paragraph, synthetic equity shall be treated as owned by a person in the same manner as stock is treated as owned by a person under the rules of paragraphs (2) and (3) of section 318(a).
If, without regard to this paragraph, a person is treated as a disqualified person or a year is treated as a nonallocation year, this paragraph shall not be construed to result in the person or year not being so treated.
(6) Definitions. For purposes of this subsection—
(A) Employee stock ownership plan. The term "employee stock ownership plan" has the meaning given such term by section 4975(e)(7).
(B) Employer securities. The term "employer security" has the meaning given such term by section 409(1).
(C) Synthetic equity. The term "synthetic equity" means 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.
(7) Regulations and guidance.
(A) In general. The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection.
the SESOP instead of direct ownership of the shares of stock. In response to this activity, the Service issued Regulations that inhibited the use of options as an end run around the broad based ownership rules of Section 409(p) by treating the options as synthetic equity. Lastly, in one final attempt to thwart the broad based ownership restrictions set forth in Section 409(p), S Corps and qualified subsidiaries were set up in a manner that, while consistent with the plain language of the broad based ownership rules, were in fact a method of getting around these rules. In response to this activity, the Service issued a pronouncement which described three factual situations that were to be challenged by the Service. These three factual situations essentially undercut the use of qualified subsidiaries in this manner.

As each of the above taxpayer actions indicates, the SESOP has been a very rich source of tax gamesmanship since its inception. However, while Congress and the Service have been very effective at closing all the perceived loopholes, they have equally been extremely adept at dismantling the SESOP as a viable planning vehicle for the average small family business. This article discusses in detail each of the SESOP skirmishes mentioned above and outlines the practical effect of the outcome of each of them.

II. WHAT IS AN SESOP?

An Employee Stock Ownership Plan is a qualified pension plan that invests primarily in employer stock, and consequently, allows

(B) Avoidance or evasion. 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 this subsection.

28. See Treas. Reg. § 1.409(p)-1T. Synthetic equity includes a right to acquire stock or other similar interests in a related entity to the extent of the S corporation's ownership. Synthetic equity also includes a right to acquire assets of an S corporation or a related entity other than either rights to acquire goods, services, or property at fair market value in the ordinary course of business or fringe benefits excluded from gross income under section 132.

29. Supra note 27 and accompanying text.


31. Defined and codified in scattered sections of I.R.C. [hereinafter ESOP].


(7) Employee stock ownership plan. The term "employee stock ownership plan" means a defined contribution plan—
participants who own the employer stock to gain an ownership interest in the sponsoring company. An ESOP, as defined under Section 4975(e)(7), is a defined contribution plan that:

1. is a stock bonus plan qualified under Section 401(a) or a stock bonus plan and money purchase plan qualified under Section 401(a); 2. that invests in qualified employer securities; and 3. meets the requirements of Section 409(h) and is afforded special

(A) which is a stock bonus plan which is qualified, or a stock bonus and a money purchase plan both of which are qualified under section 401(a), and which are designed to invest primarily in qualifying employer securities; and
(B) which is otherwise defined in regulations prescribed by the Secretary. A plan shall not be treated as an employee stock ownership plan unless it meets the requirements of section 409(h), section 409(o), and, if applicable, section 409(n), 409(p), and section 664(g) and, if the employer has a registration-type class of securities (as defined in section 409(e)(4)), it meets the requirements of section 409(e).

Id.

34. See THE NATIONAL CENTER FOR EMPLOYMENT OWNERSHIP, supra note 4.
36. Id.
37. See Kaplan, supra note 14 at A-2 for a discussion of the § 401(a) requirements for an ESOP.
38. Id.
40. See Kaplan, supra note 14 at A-2.
41. Id.
(h) Right to demand employer securities; put option.
(1) In general. A plan meets the requirements of this subsection if a participant who is entitled to a distribution from the plan—
(A) has a right to demand that his benefits be distributed in the form of employer securities, and
(B) if the employer securities are not readily tradable on an established market, has a right to require that the employer repurchase employer securities under a fair valuation formula.
(2) Plan may distribute cash in certain cases.
(A) In general. A plan which otherwise meets the requirements of this subsection or of section 4975(e)(7) shall not be considered to have failed to meet the requirements of section 401(a) merely because under the plan the benefits may be distributed in cash or in the form of employer securities.
(B) Exception for certain plans restricted from distributing securities.
(i) In general. A plan to which this subparagraph applies shall not be treated as failing to meet the requirements of this subsection or section 401(a) merely because it does not permit a participant to exercise the right described in paragraph (1)(A) if such plan provides that the participant entitled to a distribution has a right to receive the distribution in cash, except that such plan may distribute employer securities subject to a requirement that such securities may be resold to the employer under terms which meet the requirements of paragraph (1)(B).
(ii) Applicable plans. This subparagraph shall apply to a plan which otherwise meets the requirements of this subsection or section 4975(e)(7) and which is established and maintained by—
treatment under the Internal Revenue Code.\textsuperscript{43}

In their most basic form, ESOPs allow a participating employee to grow tax deferred monetary benefits\textsuperscript{44} in anticipation of retirement.\textsuperscript{45}

(1) an employer whose charter or bylaws restrict the ownership of substantially all outstanding employer securities to employees or to a trust described in section 401(a), or
(II) an S corporation.

(3) Special rule for banks. In the case of a plan established and maintained by a bank (as defined in section 581) which is prohibited by law from redeeming or purchasing its own securities, the requirements of paragraph (1)(B) shall not apply if the plan provides that participants entitled to a distribution from the plan shall have a right to receive a distribution in cash.

(4) Put option period. An employer shall be deemed to satisfy the requirements of paragraph (1)(B) if it provides a put option for a period of at least 60 days following the date of distribution of stock of the employer and, if the put option is not exercised within such 60-day period, for an additional period of at least 60 days in the following plan year (as provided in regulations promulgated by the Secretary).

(5) Payment requirement for total distribution. If an employer is required to repurchase employer securities which are distributed to the employee as part of a total distribution, the requirements of paragraph (1)(B) shall be treated as met if—

(A) the amount to be paid for the employer securities is paid in substantially equal periodic payments (not less frequently than annually) over a period beginning not later than 30 days after the exercise of the put option described in paragraph (4) and not exceeding 5 years, and

(B) there is adequate security provided and reasonable interest paid on the unpaid amounts referred to in subparagraph (A). For purposes of this paragraph, the term ‘total distribution’ means the distribution within 1 taxable year to the recipient of the balance to the credit of the recipient’s account.

(6) Payment requirement for installment distributions. If an employer is required to repurchase employer securities as part of an installment distribution, the requirements of paragraph (1)(B) shall be treated as met if the amount to be paid for the employer securities is paid not later than 30 days after the exercise of the put option described in paragraph (4).

(7) Exception where employee elected diversification. Paragraph (1)(A) shall not apply with respect to the portion of the participant’s account which the employee elected to have reinvested under section 401(a)(28)(B).

\textit{Id.}\textsuperscript{43} \textit{See Kaplan, supra note 14 at A-2.}

\textit{Id.} \textit{See I.R.C. § 83(h) (2005).}

In the case of a transfer of property to which this section applies or a cancellation of a restriction described in subsection (d), there shall be allowed as a deduction under section 162, to the person for whom were performed the services in connection with which such property was transferred, an amount equal to the amount included under subsection (a), (b), or (d)(2) in the gross income of the person who performed such services. Such deduction shall be allowed for the taxable year of such person in which or with which ends the taxable year in which such amount is included in the gross income of the person who performed such services.

\textit{Id.}\textsuperscript{45} \textit{I.R.C. § 4975(e)(7) (2005).}

(7) Employee stock ownership plan. The term "employee stock ownership plan" means a defined contribution plan—
However, ESOPs have also been used to form capital,\textsuperscript{46} refinance debt,\textsuperscript{47} invest or divest financing\textsuperscript{48} or provide estate-planning alternatives\textsuperscript{49} for closely held businesses in the context of business ownership succession.

Until the Economic Growth and Tax Relief Reconciliation Act of 2001,\textsuperscript{50} an ESOP could own stock in a Subchapter S\textsuperscript{51} Corporation,\textsuperscript{52} and consequently, allow tax deferred growth resulting from the treatment afforded such Subchapter S Corporations\textsuperscript{53} under the Code.\textsuperscript{54} The

\begin{itemize}
  \item[(A)] which is a stock bonus plan which is qualified, or a stock bonus and a money purchase plan both of which are qualified under section 401(a), and which are designed to invest primarily in qualifying employer securities; and
  \item[(B)] which is otherwise defined in regulations prescribed by the Secretary. A plan shall not be treated as an employee stock ownership plan unless it meets the requirements of section 409(h), section 409(o), and, if applicable, section 409(n), 409(p), and section 664(g) and, if the employer has a registration-type class of securities (as defined in section 409(e)(4)), it meets the requirements of section 409(e).
\end{itemize}

\textit{Id.}


A loan to an employee stock ownership plan (as defined in section 407(d)(6) [29 USCS § 1107(d)(6)]), if—

\begin{itemize}
  \item[(A)] such loan is primarily for the benefit of participants and beneficiaries of the plan, and
  \item[(B)] such loan is at an interest rate which is not in excess of a reasonable rate. If the plan gives collateral to a party in interest for such loan, such collateral may consist only of qualifying employer securities (as defined in section 407(d)(5) [29 USCS § 1107(d)(5)]).
\end{itemize}

\textsuperscript{47} The investment of all or part of a plan’s assets in deposits which bear a reasonable interest rate in a bank or similar financial institution supervised by the United States or a State, if such bank or other institution is a fiduciary of such plan and if—

\begin{itemize}
  \item[(A)] the plan covers only employees of such bank or other institution and employees of affiliates of such bank or other institution, or
  \item[(B)] such investment is expressly authorized by a provision of the plan or by a fiduciary (other than such bank or institution or affiliate thereof) who is expressly empowered by the plan to so instruct the trustee with respect to such investment.
\end{itemize}

\textit{Id.}

\textsuperscript{48} See \textit{id.}

\textsuperscript{49} See generally I.R.C. § 2057 (2005) (providing requirements for certain family owned business as related to Subtitle B).


\textsuperscript{51} See generally I.R.C. § 1361 (2005) (defining an S Corp as “a small business corporation for which an election under section 1362(a) is in effect for such year.”).

\textsuperscript{52} See discussion \textit{infra} Parts III-IV (discussing pre-Economic Growth and Tax Relief Reconciliation Act of 2001 planning available for SESOPs).

\textsuperscript{53} See generally I.R.C. § 1361 (2005) (defining an S Corp as “a small business corporation for which an election under section 1362(a) is in effect for such year.”).

\textsuperscript{54} I.R.C. § 1363 (2005).

\begin{itemize}
  \item[(a)] General rule. Except as otherwise provided in this subchapter, an S corporation shall not be subject to the taxes imposed by this chapter.
  \item[(b)] Computation of corporation’s taxable income. The taxable income of an S corporation shall be computed in the same manner as in the case of an individual, except
practical result of this plan, commonly referred to as an SESOP, was to allow the profits of the ESOP-owned S Corp to grow inside the ESOP on a tax-deferred basis, and thus forego taxation until the ESOP distributed the built-up capital to the beneficiaries. Generally, the distributions from the ESOP occurred when the company employee participant retired or left the business. As the following history and examples will illustrate, the Internal Revenue Service has effectively whittled away any benefit an SESOP could provide for the closely held business through a series of Internal Revenue Rulings, Internal Revenue Bulletins and Treasury Regulations. In all practicality, the state of the SESOP today is past its golden years and half a step away from the celestial world of the tax-planning graveyard.

III. THE BIRTH OF THE SESOP – SMALL BUSINESS JOB PROTECTION ACT OF 1996

In 1996, Congress passed the Small Business Job Protection Act (SBJPA) that, in part, allowed S Corps to be owned by an ESOP. The SBJPA amended Section 1361 of the Code to permit an S Corp to be owned by an ESOP and thereafter be a shareholder in an S Corp. The tax significance of this type of ownership structure was great. Because an S Corp’s income is not taxed at the corporate level, like a Subchapter C Corporation, the income flows through to the

that—

(1) the items described in section 1366(a)(1)(A) shall be separately stated,
(2) the deductions referred to in section 703(a)(2) shall not be allowed to the corporation,
(3) section 248 shall apply, and
(4) section 291 shall apply if the S corporation (or any predecessor) was a C corporation for any of the 3 immediately preceding taxable years.

Id.

55. See discussion infra Parts III-VIII.
57. See Treas. Reg. § 1.409(p)-1T (as amended in 2004).
59. See THE NATIONAL CENTER FOR EMPLOYEE OWNERSHIP, supra note 2.
60. See generally I.R.C. § 1361 (2005) (defining and regulating the usage of an S Corp).
62. I.R.C. § 1316(a)(2); see supra note 8.
63. For a comprehensive overview of the taxation and treatment of Subchapter C Corporations, see Accumulated Earnings Tax, 796-2nd Tax Mgmt. (BNA) A-1 (2002). Sections 531 and 532 impose a tax on the accumulated taxable income of each corporation formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting
shareholder/owner. Since the ESOP owned all of the shares of the S Corp, already a tax preferred investment vehicle, the profits from the S Corp flowed through to the ESOP and grew over time, absent taxation until a distribution was made from the ESOP.

However, when Congress amended Section 1361, the ESOP income from the S Corp was still subject to taxation as Unrelated Business Taxable Income (UBIT) under Section 512. Thus, the intent to create a favorable tax treatment vehicle was thwarted on account of Congressional oversight to exempt the SESOP from the UBIT. In an effort to finalize what Congress initially intended, Congress examined the SESOP vehicle again in 1997 and provided the proper UBIT exemption for the SESOP via the Taxpayer Relief Act of 1997.


In response to their 1996 oversight, Congress amended Section 512(e) to exempt ESOPs from the UBIT. The effect of this exemption was to allow ESOPs to hold S Corps in a tax advantaged

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earnings and profits to accumulate instead of being divided or distributed. For purposes of § 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business is determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by a preponderance of the evidence shall prove to the contrary.

Id.


Subchapter S treats the S corporation as a pass-through entity similar to the partnership. Thus, the S corporation must pass through income and loss items separately to its shareholders, and generally, the corporation is not subject to any corporate level tax on those items. If a valid S corporation election is in effect for the entire year, § 1363 provides that the S corporation normally will not be subject to any taxes imposed under Chapter I of the Internal Revenue Code. This means the S corporation is not subject to the corporate income tax (§ 11), the environmental tax (§ 59A), the accumulated earnings tax (§ 531), or the personal holding company tax (§ 541).

Id.


66. See I.R.C. § 512(a)(1) (defining unrelated business taxable income as “the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business . . . .”).

67. Id.


69. Id.

70. I.R.C. § 512(e); see supra note 10.

71. I.R.C. § 512(a)(1); see supra note 66.
manner and therefore accomplish the objectives set forth above. The profits from the S Corp could build up tax-free inside of the ESOP and the beneficiaries of the ESOP could get money out, for living and other expenses, via salaries and loans. This arrangement was especially advantageous to small family owned businesses, where all of the tax deferred income was retained in an SESOP and all of the SESOP beneficiaries were family members.

For example, ABC Corp., an S Corp owned solely by Taxpayer A, could establish an ESOP for the benefit of himself, and contribute one hundred percent (100%) of the ABC stock to the ESOP. In order to meet the needs of Taxpayer A's living and other expenses, the S Corp could borrow heavily and grant incentive stock options to himself. During the early years, ABC Corp. could earn profits, without tax, and pay down the debt without any need to distribute dividends to cover shareholder tax obligations. After the debt was paid off, Taxpayer A could exercise his stock options and purchase his stock interests. Under this plan, Taxpayer A would only pay tax on the distribution of the income from the SESOP.

Congress clearly endorsed this type of arrangement with their passage of the SBIPA and further with the 1997 TRA amendment to Section 512(e). However, with the passage of four years and a shifting climate at the Service, the days of beneficial SESOPs for small family businesses were slowly suffocated.

72. I.R.C. § 512(e); see supra note 10 (amending § 512(e), the UBIT statute, by providing an exception for ESOPs).
73. See supra notes 31-65 and accompanying text.
74. See Kaplan, supra note 14 at A-1.
75. See id. at A-1 to A-2.
76. See id. at A-2 to A-3 for discussion and examples of ESOP options.
77. See infra Section VII regarding options and examples illustrating the ability to purchase options.
78. See supra notes 10-11 and accompanying text.
V. BROAD BASED OWNERSHIP REQUIREMENTS — ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001

The Congressionally created single-member SESOPs were effectively dissolved in 2001 with the passage of EGTRRA. Congress implemented legislation requiring that one employee may own no more than fifty percent (50%) of an SESOP. The new law mandated that the other owners must be totally unrelated to each other and each of the

81. The changes to I.R.C. § 409(p) and associated Treasury Regulations dismantled the single-member SESOPs on account of broad based ownership rules. See discussion infra notes 82-88 and accompanying text.
83. See id. Other persons could be described as not being included as a disqualified person as defined as follows:
84. See id., broadly defining family members, also included as disqualified persons for purposes of the statute.
85. See id., for purposes of this subsection—
(A) the aggregate number of deemed-owned shares of such person and the members of such person’s family is at least 20 percent of the number of deemed-owned shares of stock in the S corporation, or
(B) any member of such person’s family with deemed-owned shares shall be treated as a disqualified person if not otherwise treated as a disqualified person under subparagraph (A).
86. See id., for purposes of this section—
(D) Member of family.—For purposes of this paragraph, the term ‘member of the family’ means, with respect to any individual—
(i) the spouse of the individual,
(ii) an ancestor or lineal descendant of the individual or the individual’s spouse,
(iii) a brother or sister of the individual or the individual’s spouse and any lineal descendant of the brother or sister, and
(iv) the spouse of any individual described in clause (ii) or (iii).
other owners must not own more than ten percent (10%) of the shares of the S Corp. 85 Any owner violating these rules is deemed a "disqualified person." 86 The effective date for compliance with the new law was applicable to SESOPs formed on or after March 14, 2001. 87

Clearly the policy of broad-based ownership is to benefit the rank and file members of a company. However, if there are no rank and file employees, as is the case in a small family owned business, the post-EGTRRA law changes preclude the small family business operation from partaking in the benefits otherwise afforded small, closely held businesses. 88 The restrictions set forth in EGTRRA threw the proverbial baby, that is, the small family business, out with the bath water.


In anticipation of the restrictions under EGTRRA, a "person in the business of providing advice to other companies or individuals" 90 formed numerous SESOPs prior to the March 14, 2001 effective date, 91 purportedly to grandfather the entities into the pre-EGTRRA laws. The S Corps that were owned by the ESOPs had no substantial assets or

purposes of this subparagraph.

Id.

85. See id. (stating that "in the case of a person not described in clause (i), the number of deemed-owned shares of such person is at least 10 percent of the number of deemed-owned shares of stock in such corporation").

86. Id.

87. See Economic Growth and Tax Relief Reconciliation Act of 2001 Pub. L. 107-16, 115 Stat. 38 § 656(d), stating the effective date for the amendments to I.R.C. § 409 as follows:

(1) In general.— The amendments made by this section shall apply to plan years beginning after December 31, 2004.

(2) Exception for certain plans.— In the case of any—

(A) employee stock ownership plan established after March 14, 2001, or

(B) employee stock ownership plan established on or before such date if employer securities held by the plan consist of stock in a corporation with respect to which an election under section 1362(a) of the I.R.C. (1986) is not in effect on such date, the amendments made by this section shall apply to plan years ending after March 14, 2001.

Id.

88. See id. Because of the broad based ownership rules and disqualification of family members as owners, a small, closely held business is likely to be disqualified under the 2001 law, whereas a business with multiple employees or owners is at the very least, given the opportunity to participate in an SESOP plan. See supra notes 79-87 and accompanying text.


90. Id.

business. According to the Service, this person then sold the existing entities, formed prior to March 14, 2001, after the effective date of implementation for Section 409(p). After the S Corp and its ESOP were sold, the buyer/taxpayer would restructure his/her business so that the new S Corp would receive all of the income from their existing business. Further, the Service noted that some of the buyers/taxpayers were “disqualified persons” as defined under Section 409(p) of the Code. In addition, the Service designated these transactions as “listed transactions.” The Service took the position that because the ESOPs were not set up to “provide substantial benefits, or substantial participation in the ownership of the S Corporations,” the entities would not be treated as having been formed prior to the effective date.

93. Id.
94. Id.
95. Id.
96. Id. In the Ruling, the Service describes a listed transaction as follows:

Transactions that are the same as, or substantially similar to, the transaction described in this revenue ruling are identified as “listed transactions” for purposes of § 1.6011-4T(b)(2) of the temporary Income Tax Regulations and § 301.6111-2T(b)(2) of the temporary Procedure and Administration Regulations with respect to each disqualified person for plan years beginning prior to January 1, 2005. See also § 301.6112-1T, A-4. Further, it should be noted that, independent of their classification as “listed transactions” for purposes of §§ 1.6011-4T(b)(2) and 301.6111-2T(b)(2), transactions that are the same as, or substantially similar to, the transaction described in this revenue ruling may already be subject to the disclosure requirements of § 6011, the tax shelter registration requirements of § 6111 or the list maintenance requirements of § 6112 (§§ 1.6011-4T, 301.6111-1T, 301.6111-2T, and 301.6112-1T, A-3 and A-4). Persons who are required to satisfy the registration requirement of § 6111 with respect to the transaction described in this revenue ruling and who fail to do so may be subject to the penalty under § 6707(a). Persons who are required to satisfy the list-keeping requirement of § 6112 with respect to the transaction and who fail to do so may be subject to the penalty under § 6708(a). In addition, the Service may impose penalties on participants in this transaction or substantially similar transactions, or, as applicable, on persons who participate in the reporting of this transaction or substantially similar transactions, including the accuracy-related penalty under § 6662, and the return preparer penalty under § 6694.


In these transactions, A has not formed the ESOPs to provide substantial benefits, or substantial participation in the ownership of the S corporations, to the initial purported participants in the ESOPs. The initial employees of the entity forming the ESOP do not receive more than insubstantial benefits or more than insubstantial ownership interests through the ESOP. For purposes of the effective date of § 409(p), an ESOP is not established until it is adopted by an employer for the purpose of enabling its employees to participate in a more than insubstantial manner in the ownership of the employer’s business and to provide its employees with more than insubstantial benefits under the ESOP.
Further, the Service treated the transaction as having a nonallocation year\(^9\) and thus, disqualified persons were deemed to have received distributions under Section 409(p)(2)(A).\(^9\)

The effective date loophole is a clear example of the cat and mouse game that the IRS and tax planners have been undertaking of recent. Unfortunately, this skirmish only served to move the focus of the SESOP debate away from a discussion about how to best allow SESOPs to continue. Instead of focusing on the best method to allow small family businesses to continue to reap the benefits of ESOPs, the IRS began a long battle to close down ever increasing inventions on the part of tax planners to keep the SESOP alive. Thus, instead of seeking a positive broad based solution to the SESOP dilemma, the IRS began to use a "band-aid" approach. Each time tax planners opened up a new loophole, the IRS sought to shut it down quickly with a new administrative pronouncement. However, each time the IRS took such action, it also added layers of administrative rulings to the law that any prospective small family owned business needed to navigate in order to take advantage of the SESOP.


(3) Nonallocation year. For purposes of this subsection—

(A) In general. The term 'nonallocation year' means any plan year of an employee stock ownership plan if, at any time during such plan year—

(i) such plan holds employer securities consisting of stock in an S corporation, and

(ii) disqualified persons own at least 50 percent of the number of shares of stock in the S corporation.

(B) Attribution rules. For purposes of subparagraph (A)—

(i) In general. The rules of section 318(a) shall apply for purposes of determining ownership, except that—

(I) in applying paragraph (1) thereof, the members of an individual's family shall include members of the family described in paragraph (4)(D), and

(II) paragraph (4) thereof shall not apply.

(ii) Deemed-owned shares. Notwithstanding the employee trust exception in section 318(a)(2)(B)(i), an individual shall be treated as owning deemed-owned shares of the individual. Solely for purposes of applying paragraph (5), this subparagraph shall be applied after the attribution rules of paragraph (5) have been applied.

\[^9\] Id.

(2) Failure to meet requirements.

(A) In general. If a plan fails to meet the requirements of paragraph (1), the plan shall be treated as having distributed to any disqualified person the amount allocated to the account of such person in violation of paragraph (1) at the time of such allocation.

\[^9\] Id.
VII. SYNTHETIC EQUITY RULES - TREAS. REG. § 1.409(p)-1T (2003)

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 Corps. Accordingly, if a person is treated as a "disqualified person, or a year is treated as a nonallocation year," notwithstanding 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."

In an effort to make an end run around the broad based ownership rules present in EGTRRA, SESOPs were formed using options to purchase shares of the SESOP instead of direct ownership of the shares of stock. The Service issued Regulations that inhibited the use of options as an end run around the broad based ownership rules of Section 409(p) by treating the options as synthetic equity.

The Service issued Reg. § 1.409(p)-1T in response to what it perceived as a dilution of rank and file employees' stock in an ESOP with outstanding options. The Service was concerned that although...
the technical requirements of broad based ownership existed, the policy
to benefit the rank and file employees was impeded by the options
structure which in practice allowed the option holders to be the primary
beneficiaries of the SESOP.\textsuperscript{109}

Thus, the application of Section 409(p),\textsuperscript{110} after Reg. § 1.409(p)-1T,\textsuperscript{111} applies to synthetic equity owned directly through ownership of
shares of stock in the sponsoring S Corp\textsuperscript{112} as well as indirectly through
an option to purchase shares of the S Corp stock.\textsuperscript{113} Even if actual
ownership of the SESOP was in fact broad based and in compliance with
the requirements of Section 409(p),\textsuperscript{114} the inclusion of options to
purchase shares of stock in the S Corp foreclosed one of the last
possibilities to side step Section 409(p)\textsuperscript{115} limitations on SESOP
ownership. As such, if a business were to have an option structure as
described above, they would be considered disqualified persons\textsuperscript{116} and a

the management corporation. The management corporation in turn retains these fees to
satisfy its obligations to pay future compensation. Although the stock of the management
corporation is owned by the ESOP, the ownership interest held for rank-and-file
employees through the ESOP has a substantially reduced value. Rather than being a
mechanism for the transfer of not only ownership, but also the rights associated with
ownership, to the employees of the S corporation, the ESOP is used as part of a structure
designed to shelter profits that will be paid as future compensation for a small group of
executives or management employees.

\textit{Id.}

\textsuperscript{109} Id.

\textsuperscript{110} I.R.C. § 409(p) (2005).

\textsuperscript{111} Treas. Reg. § 1.409(p)-1T (as amended in 2004).

\textsuperscript{112} See id.

\textsuperscript{113} See id.

\textsuperscript{114} I.R.C. § 409(p) (2005).

\textsuperscript{115} Prohibited Allocations of Securities in an S Corporation, 68 Fed. Reg. 42,972 (Jul. 21,

\textsuperscript{116} See Treas. Reg. § 1.409(p)-1T(g)(1)(ii) (as amended in 2004).
nonallocation year would accrue, resulting in a large tax burden for the option holders on account of the disqualification of the application of the beneficial tax treatment afforded SESOPs.

The synthetic equity rules are another example of the IRS' "band-aid" approach to policing the use of SESOPs. It is probably true that several tax planners were using synthetic equity as a means to allow an owner of a business to make use of an SESOP without covering his rank and file employees. However, by adding this additional layer of Treasury Regulations to the laws governing SESOPs, the IRS had also served to continue the focus of the SESOP discussions onto its war with tax planners over aggressive tax planning. While this may serve to make life more difficult for tax planners, it does nothing to attempt to find a way for small family businesses to make use of SESOPs. The IRS has just layered in additional administrative rules for potential small family owned businesses to pay a tax lawyer to try to negotiate.


In the final attempt to thwart the broad based ownership restrictions set forth in Section 409(p), S Corps and qualified subsidiaries were set up in a manner consistent with the plain language of the broad based ownership rules. However, in a pronouncement, the Service still looked through the entity structure and deemed each of the following three factual situations within the gambit of the rules and regulations governing SESOPs.

The first factual situation discussed in the pronouncement involved a situation where, prior to 2003, five individuals each owned, in whole or in part, their own domestic professional services corporation. In 2003, a new corporation was formed and elected Subchapter S status. Further, the

117. See Treas. Reg. § 1.409(p)-1T(g)(1)(iii) (as amended in 2004).
121. Id.
122. Id.
123. Id.
S Corp filed a "qualified subchapter S . . . election"124 for each of the five domestic services corporations.125 In exchange for one hundred percent (100%) of the outstanding stock of the qualified subsidiaries, the S Corp exchanged cash.126 Each of the qualified subsidiaries granted its owner, an officer and investment manager for their qualified entity, a nonqualified stock option to acquire most if not all of the shares of the qualified subsidiary.127

The S Corp, at the time of formation, created an ESOP to hold one hundred percent (100%) of the S Corp stock.128 All of the employees of the S Corp and qualified subsidiaries, with the exception of the five officers/investment managers, participated in the ESOP.129 Moreover, the five officers/investment managers and their support staff became employees of their respective qualified subsidiaries.130 The five officers/investment managers received salaries from their qualified subsidiaries.131 The income to the S Corp from the qualified subsidiaries, less expenses, was not taxed at the time of earning because

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124. *Id.* A taxpayer elects qualified subchapter S status under I.R.C. § 1362(a) providing:
   (a) Election.
   (1) In general. Except as provided in subsection (g), a small business corporation may elect, in accordance with the provisions of this section, to be an S corporation.
   (2) All shareholders must consent to election. An election under this subsection shall be valid only if all persons who are shareholders in such corporation on the day on which such election is made consent to such election.

126. *Id.*
127. *Id.*
128. *Id.*
129. *Id.*
130. *Id.*

Taxpayers A through E and their support staff terminate their existing employment relationship with their respective Service Recipient Corporations and become employees of the respective QSub. The customers of Taxpayers A through E stop doing business with the Service Recipient Corporations and begin doing business with the respective QSub of Taxpayers A through E.

*Id.*

Taxpayers A through E receive salary payments from their respective QSub, in an amount substantially less than the income to S Corp generated by the business activities of that Taxpayer after deduction for expenses. S Corp treats the subsidiaries as valid QSubs, and treats the income generated by each QSub each year, and earnings thereon, as earned by S Corp. The payments to the Taxpayers for current salary are deducted by S Corp as an ordinary and necessary business expense. However, since S Corp is wholly owned by an ESOP holding S corporation stock, S Corp’s net earnings are not taxed currently.

*Id.*
the S Corp was one hundred percent (100%) owned by the ESOP. If the income generated by the subsidiaries was not paid two and one half months after year’s end, the surplus accumulated in each of the subsidiaries accounts, over which the five officers/investment managers had complete control to exercise their options or the like. If each of the five officers/investment managers’ options to purchase were treated as synthetic equity, each of the five individuals would own at least ten percent (10%) of the shares of stock of the S Corp.  

The second factual situation is the same as the first, except that instead of five officers/investment managers, eleven officers/investment managers participated in the S Corp’s ESOP. However, if each of the eleven officers/investment managers’ options to purchase were treated as synthetic equity, each of the eleven individuals would own less than ten percent (10%) of the shares of stock of the S Corp.

132. Id. Taxpayers A through E receive salary payments from their respective QSub, in an amount substantially less than the income to S Corp generated by the business activities of that Taxpayer after deduction for expenses. S Corp treats the subsidiaries as valid QSubs, and treats the income generated by each QSub each year, and earnings thereon, as earned by S Corp. The payments to the Taxpayers for current salary are deducted by S Corp as an ordinary and necessary business expense. However, since S Corp is wholly owned by an ESOP holding S corporation stock, S Corp’s net earnings are not taxed currently.

133. Id. Amounts of income to S Corp generated by the business activities of each Taxpayer (net of expenses) but not paid to Taxpayers within 2 1/2 months after the end of the year accumulate in each Taxpayer’s respective QSub, for example, in a brokerage account in each subsidiary, over which the respective Taxpayer has investment control as the investment manager of the subsidiary. A through E can access the amounts accumulated in their respective QSub by exercising their option to purchase shares in the QSub. If each Taxpayer’s option to purchase shares of QSub stock were synthetic equity of S Corp (determined in accordance with § 1.409(p)-1T(f)(4)(ii)), then each Taxpayer would own at least 10 percent of the sum of the outstanding shares of S Corp plus the synthetic equity shares of S Corp.


135. Id. The facts are the same as in Situation 1, except that instead of 5 individuals, there are 11 individuals (Taxpayers A through K) each of whom is an employee of a Service Recipient Corporation owned either directly or indirectly, in whole or in part, by that Taxpayer. As in Situation 1, amounts of income to S Corp generated by the business activities of each Taxpayer (net of expenses) but not paid to the Taxpayer accumulate in each Taxpayer’s respective QSub, and each Taxpayer has the right to acquire stock in that Taxpayer’s QSub under the same terms as described in Situation 1.

136. Id. "If each Taxpayer’s option to purchase shares of QSub stock were synthetic equity of S Corp, then each Taxpayer would own less than 10 percent of the sum of the outstanding shares of
Finally, the third factual situation giving rise to the Service’s inquiry involved a 200 employee S Corp that was wholly owned by an ESOP formed prior to March 14, 2001. In 2003, the 200 employee corporation formed a qualified subsidiary for a single professional services corporation and structured the transaction in a manner similar to the facts present in situation one, supra. The single officer/investment manager for the single qualified subsidiary did not participate in the 200 employee corporation. Further, if the manager’s option to purchase his shares of the qualified subsidiary was considered synthetic equity, he would own less than ten percent (10%) of the stock of the 200 employee S Corp.

The Service held that each of the five individuals in the first factual situation, the eleven individuals in the second situation and the single individual in the third situation were disqualified persons with

S Corp plus the synthetic equity shares of S Corp.” Id.

137. Id.

Before 2003, Corporation M is an S corporation with 200 employees, wholly owned by an ESOP that was established after March 14, 2001, in which substantially all of its employees participate. Before 2003, Individual A (Taxpayer) operated a professional services corporation as a separate business. In 2003, Corporation M forms a QSub for A by contributing cash in exchange for 100 percent of the issued and outstanding stock of the QSub. As in Situation 1, A and A’s support staff terminate their existing employment relationship with A’s Service Recipient Corporation and become employees of the QSub; A’s customers become customers of the QSub; amounts of income to S Corp generated by the business activities of A (net of expenses) but not paid to A accumulate in A’s QSub; and A has the right to acquire stock in the QSub under the same terms as described in Situation 1. A does not participate in the Corporation M ESOP. If A’s option to purchase shares of the QSub were synthetic equity of S Corp, then A would own less than 10 percent of the total of the outstanding shares stock of S Corp plus the synthetic equity shares of S Corp.


139. Id.

140. Id., holding:

With respect to Situation 1, for purposes of §§ 409(p) and 4979A, (1) A through E are disqualified persons with respect to the ESOP, (2) the ESOP has a nonallocation year, and (3) the options to acquire stock in QSubs A through E are synthetic equity to which the § 4979A excise tax applies.

141. Id., holding:

With respect to Situation 2, for purposes of §§ 409(p) and 4979A, (1) A through K are disqualified persons with respect to the ESOP, (2) the ESOP has a nonallocation year, and (3) A through K are each treated as owning synthetic equity in the form of each individual’s option to acquire shares of the corresponding QSub.

142. Id., holding:

With respect to Situation 3, for purposes of §§ 409(p) and 4979A, (1) A is a disqualified person with respect to the ESOP, (2) the ESOP has a nonallocation year, and (3) A is
nonallocation years and synthetic equity in each of their qualified subsidiaries. The Service found that the ESOP owners were businesses only in form, not in substance, and the ownership share structure did not provide any benefit to rank and file employees.\(^{143}\)

Further, the Service found that the owners/investment managers were using their options as a means to retain ownership of his or her separate business and divert the profits from their respective subsidiaries away from the ESOP.\(^{144}\) The Service treated this ownership structure as falling within the purview of synthetic equity, as defined in Treas. Reg. § 1.409-1T.\(^ {145}\) Moreover, the Service concluded that an aggregation of business interests in an effort to prevent the application of Section 409(p)\(^ {146}\) was an improper entity structure and inconsistent with the policy inherent in the EGTRRA changes\(^ {147}\) to benefit rank and file employees.\(^ {148}\) As with Rev. Rul. 2003-6,\(^ {149}\) the Service designated these transactions as "listed transactions."\(^ {150}\)

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\(^{143}\) Id.


\(^{145}\) Id.

\(^{146}\) Id.

\(^{147}\) Id.

\(^{148}\) Id.


\(^{150}\) See description of listed transactions, supra note 96.
Quite clearly, Rev. Rul. 2004-4\(^{151}\) was the death knell to any and all attempts by practitioners and planners to plan around the 2001 EGTRRA changes regarding SESOPs.

**IX. CONCLUSION**

Ever since its inception, the SESOP has been a fertile battleground in the ongoing war between the Service and taxpayers over aggressive tax planning. The skirmishes in this battle include those fought over the effective date,\(^{152}\) the use of synthetic equity,\(^{153}\) and the use of multiple employer plans.\(^{154}\) However, while the Service's fixes to these problems may have reduced the number of businesses that may make use of the SESOP, the changes made by EGTRRA were the real killer. Section 409(p)\(^{155}\) of the Code was more than just a loophole closing law: it was a noose. From 2001 until today, the Service has ensured that the rank and file employee would be protected when participating in an SESOP.\(^{156}\) However, the small family businesses suffered as a result of this draconian measure.\(^{157}\) For their effort and due to its cat and mouse game with taxpayers, Congress and the Service have administratively eliminated the ability of small family owned S Corp businesses to form an SESOP. Thus, what Congress giveth, Congress taketh away. The benefits created for small businesses by the laws it passed in 1996\(^{158}\) and

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153. As defined in I.R.C. § 409(p) (2005), and further modified by Treas. Reg. § 1.409(p)-1T (as amended in 2004), *supra* notes 58-69 and accompanying text.
154. *See discussion supra* Part VIII.
155. *See discussion supra* note 27 and accompanying text.
156. *See discussion supra* Parts V-VIII.

In appropriate cases, the Service may challenge other tax benefits claimed by any taxpayer involved in this type of business structure. For example, in the appropriate case, the Service may take the position for income tax purposes that, even though the Taxpayer purported to transfer his or her business (including the employment of his or her support staff) to the QSub, the Taxpayer never relinquished ownership of his or her business and, therefore, the Taxpayer should still be taxed on the profits. The Service might also take the position that the subsidiary is not a QSub. Alternatively, if the support staff of the Taxpayers were to continue to be employed by their respective Service Recipient Corporations, and the Service Recipient Corporations were to continue to provide substantially the same services for their customers, the Service might assert that each Taxpayer continues to be employed by their respective Service Recipient Corporation, with the related tax consequences.

*Id.*

1997\textsuperscript{159} have clearly been eliminated for small family owned companies.

\textsuperscript{159} Taxpayer Relief Act of 1997, Pub. L. 105-34, 111 Stat. 788.