ESI ENTERPRISE SERVICES, INC.

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S Corporation Rules Reformed

By Sandy Paavola

The *American Jobs Creation Act of 2004*, signed into law October 22, 2004, provides changes to S corporations which impact companies with an ESOP.

Previously, a leveraged S-Corporation ESOP could use distributions from current earnings paid on unallocated ESOP stock to repay ESOP related debt. However, earnings distributed to shares already allocated to participants had to be paid to the participant accounts based on the proportional share of stock owned by each account. The law now permits distributions on both allocated and unallocated shares to be used to repay any outstanding ESOP loan first in order to acquire stock, provided the value of the shares returned to each participant is at least the value of the cash given up. This law is retroactive to January 1, 1998 and extends S corporations the same favorable treatment already accorded C corporations in the payment of dividends to ESOPs.

Another change increases the maximum number of shareholders in an S corp from 75 to 100. Additionally, family members can be considered as one shareholder. The ownership changes go into effect for tax years after December 31, 2004.

Prohibited Allocation of Securities in an S Corporation, Temporary Regulations 1.409(p)-1T issued by the IRS, addresses rules to prevent the abuse of ESOPs in S corporations. The new rules do not add major changes to existing regulations, but clarify existing regulations. For example, impermissible allocations and accruals to a 'disqualified person' are defined as a prohibited allocation. Disqualified persons are persons owning more than 10% or family members owning more than 20% of ESOP assets, who also collectively own more than 50% of total S corporation assets. Synthetic equity, such as phantom stock and stock appreciation rights, are included in the calculation of assets owned. The new rules close a potential loophole that allowed a company to issue stock options or similar rights to many employees under terms which made it extremely unlikely that the options could ever be exercised. This could increase the number of apparent outstanding shares, thereby reducing the percentage of ownership held by any one individual. Under the new rules, synthetic equity is looked at person-by-person, so the synthetic equity of others does not count toward the total share calculations in determining if an individual is a disqualified person. Generally, the rules are effective for plan years after January 1, 2005; there are special transition rules where the effective date is before July 1, 2005. These regulations are very complicated, and while few S corporation ESOPs may be affected by them, it is important to ensure that proper testing is done and that careful consultation and consideration are made in their implementation.

Q&A

This question and answer section is a new addition to Beyond the Number$. *Its purpose is to provide answers to some of your most frequently asked questions. Watch for it in each issue and let us know if you have anything you'd like to contribute.*

Q: In order to speed up the update process, can ESI determine a value based upon internal statements before our auditors or accountants have examined our financials?

A: Generally, no. Internal statements do not expedite the process because they lack the final adjustments, entries, and in some cases footnotes important to the valuation process. For accuracy and consistency, we need a draft copy of financial statements from your accounting firm. With draft statements we can determine a value for you; then, once final statements have been received we can update your report.

People You Have Met in a Meeting

Adapted from Employee Ownership Report

Meetings have become a defining feature of work in an employee-ownership company. That's because ESOP companies that succeed in getting employees to share their insights and suggestions make more money for themselves and their employees.

Hold meetings in unusual locations

Some employees associate regular meeting rooms with wasted time, boring speeches, and irrelevant information. So if you have an important topic to discuss, <u>try changing the location</u>.

For instance: Campbell Soup Chairman Gordon McGovern once held a board meeting in the back room of a supermarket. After the meeting, the participants roamed the aisles looking for comments about their products.

As you sit in on these meetings, chances are you've encountered a variety of participant types:

<u>The critic:</u> Many meetings have someone who finds things wrong with every idea. These people are valuable because they can make ideas better. However, one problem with this is that ideas get shot down too easily, destroying some good ones and discouraging people from submitting ideas in the future.

<u>The disengaged:</u> These people are there in body, but their minds are not. If the rest of the group is really making an effort, these people can be deflating. Instead of waiting for people to pipe up, ask them what they think, then give some positive reinforcement for contributing, even if their ideas aren't used.

<u>The on-and-onners:</u> No group is complete without someone who goes on and on. The group's leader should set up a meeting with the individual and gently explain the problem and how it bogs things down.

<u>The activist:</u> These people usually have opinions, and they often want to try to lead the discussion, the decision, or both. Every group needs these people or not much gets done, but if they become too dominant, the whole point of the meeting can be lost since other people stop expressing their views.

<u>The facilitator:</u> Many groups have a formal facilitator, but even in informal groups, there's often someone who tries to make sure things run smoothly. These people are valuable, but it can be detrimental because sometimes conflict in the group can bring things into sharper focus. What may seem like excessive rambling may just be a way to brainstorm until a good idea comes up.

<u>The know-it-all:</u> These people fall into two groups: those who think they know it all, and do; and those who think they know it all, but don't. The second group needs to be controlled, but even people who really do know a lot may be dangerous. People may defer to them, causing some good ideas to get lost. So while the experts' opinions deserve a lot of respect, they shouldn't be viewed as the final word.

<u>The contributor:</u> These people don't easily fit into any category, but they are the mainstays of a productive group. They contribute when they have an idea or information to share, and they respect other opinions. While it may seem the perfect group has only these people, having some of the other types involved is useful -- to keep people on their toes, to keep things moving, to do "reality checks," or just provide a challenge to make meetings better.

"The key to success is to get out and listen to what the associates have to say. It's terribly important for everyone to get involved."

- Sam Walton