

Section 1367.—Adjustments to Basis of Stock of Shareholders, etc.

26 CFR 1.1367-1: Adjustments to basis of shareholder's stock in an S corporation.
(Also §§ 402, 409, 511, 512, 1361, 1366, 4975; 1.402(a)-1.)

Employee stock ownership plan (ESOP). This ruling concerns basis adjustments of S corporation stock held by an employee stock ownership plan (ESOP).

Rev. Rul. 2003-27

ISSUES

(1) Is an employee stock ownership plan (ESOP) required to adjust its basis in S corporation stock under § 1367(a) of the Internal Revenue Code for the ESOP's *pro rata* share of the corporation's items?

(2) Upon the distribution of S corporation stock by an ESOP to a participant, is the stock's net unrealized appreciation under § 402(e)(4) determined using the ESOP's adjusted basis in the stock?

FACTS

Corporation *X*, a calendar year S corporation, maintains plan *Y*, an ESOP, as defined in section 4975(e)(7) of the Internal Revenue Code (Code). *Y* holds 100 shares of *X* stock that it purchased on January 1, 2001, for \$10,000 with employer contributions. *Y*'s *pro rata* share of *X*'s income for *X*'s 2001 taxable year is \$1,000 (comprised entirely of nonseparately computed income of \$10 per share), which *Y* properly reports on Form 5500, *Annual Return/Report of Employee Benefit Plan*. *X* makes no distributions to its shareholders during 2001.

A, an individual who is a U.S. citizen, is an employee of *X* and a participant in *Y*. *Y* holds five shares of *X* stock for the benefit of *A* from January 1 to December 31, 2001. On December 31, 2001, *Y* distributes the five shares of *X* stock to *A*, subject to *A*'s right to require *X* to repurchase the shares under a fair valuation formula in accordance with § 409(h). On that date, the fair market value of the five shares is \$580.

LAW

Section 501(a) provides that an organization described in § 401(a) is exempt from tax under subtitle A of the Code. Section 401(a) provides that a trust created or organized in the United States and forming a part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of its employees or their beneficiaries constitutes a qualified trust if the requirements of that section are satisfied.

Section 4975(e)(7) provides that an ESOP is a defined contribution plan (i) which is either a stock bonus plan which is qualified or a stock bonus and money purchase plan both of which are qualified under § 401(a), and which are designed to invest primarily in employer securities and (ii) which is otherwise defined in regulations prescribed by the Secretary. A plan is not treated as an ESOP unless it meets the requirements of § 409(h), § 409(o), and if applicable, § 409(n), § 409(p), and § 664(g), and, if the employer has a registration-type class of securities (as defined in § 409(e)(4)), it meets the requirements of section 409(e).

Section 511(a)(1) imposes a tax on the unrelated business taxable income (as defined in § 512(a)) of organizations described in § 511(a)(2), which includes organizations described in § 401(a). Section 512(e)(1) provides that if an organization described in § 1361(c)(6) holds stock in an S corporation, the interest is treated as an interest in an unrelated trade or business and, notwithstanding any other provisions of Part III of Subchapter F, all items of income, loss, or deduction taken into account under § 1366(a) and any gain or loss on the disposition of the stock in the S corporation are taken into account in computing the unrelated business taxable income of the organization. Section 512(e)(3) provides that § 512(e) does not apply to employer securities (within the meaning of § 409(l)) held by an ESOP described in § 4975(e)(7).

Section 1366(a)(1) provides that, in determining the tax of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends, there is taken into account the shareholder's *pro rata* share of the corporation's (i) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment

of which could affect the liability for tax of any shareholder and (ii) nonseparately computed income or loss.

Under § 1367(a)(1), the basis of each shareholder's stock in an S corporation is increased for any period by the sum of the following items determined with respect to that shareholder for such period: (i) items of income described in § 1366(a)(1)(A), (ii) any nonseparately computed income determined under § 1366(a)(1)(B), and (iii) the excess of the deductions for depletion over the basis of the property subject to depletion.

Under § 1367(a)(2), the basis of each shareholder's stock in an S corporation is decreased for any period (but not below zero) by the sum of the following items determined with respect to that shareholder for the period: (i) distributions by the corporation which were not includible in the income of the shareholder by reason of § 1368, (ii) the items of loss and deduction described in § 1366(a)(1)(A), (iii) any nonseparately computed loss determined under § 1366(a)(1)(B), (iv) any expense of the corporation not deductible in computing its taxable income and not properly chargeable to capital account, and (v) the amount of the shareholder's deduction for depletion for any oil and gas property held by the S corporation to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such shareholder under § 613A(c)(11)(B).

Section 402(a) provides that any amount distributed by an employees' trust described in § 401(a) that is exempt from tax under § 501(a) is taxable to the distributee in the taxable year of the distributee in which distributed, under § 72 (relating to annuities).

Section 402(e)(4)(B) provides that, for purposes of § 402(a) and § 72, in the case of any lump-sum distribution that includes securities of the employer corporation, there is excluded from gross income the net unrealized appreciation (NUA) attributable to that part of the distribution that consists of securities of the employer corporation.

Section 402(e)(4)(C) provides that NUA and the resulting adjustments to basis are determined in accordance with regulations prescribed by the Secretary.

Section 1.402(a)-1(b)(2) of the Income Tax Regulations provides that the amount of NUA in securities of the employer corporation that are distributed by the trust is

the excess of the market value of the securities at the time of distribution over the cost or other basis of the securities to the trust.

ANALYSIS

Stock of an S corporation held by an ESOP is subject to the same basis adjustments under § 1367(a) as stock held by any other S corporation shareholder. Accordingly, *Y* must increase its basis in *X* stock under § 1367(a)(1) for the items of income described in § 1366(a)(1). Specifically, *Y*'s *pro rata* share of *X*'s nonseparately computed income for *X*'s 2001 taxable year increases the basis of each share of *X* stock held by *Y* by \$10. Therefore, the basis of each of the five shares of *X* stock held by *Y* for the benefit of *A* is increased by \$10 from \$100 to \$110.

Under § 402(e)(4) and § 1.402(a)-1(b)(2), the amount of NUA in the *X* stock is \$30, the excess of the market value of the stock at the time of distribution (\$580) over *Y*'s adjusted basis in the stock (\$550). Unless *A* rolls the distributed stock over into an eligible retirement plan in accordance

with the rules of § 402(c), *A* will have \$550 of ordinary income as a result of the distribution.

HOLDINGS

(1) An employee stock ownership plan (ESOP) is required to adjust its basis in S corporation stock under § 1367(a) for the ESOP's *pro rata* share of the corporation's items.

(2) Upon the distribution of S corporation stock by an ESOP to a participant, the stock's net unrealized appreciation under § 402(e)(4) is determined using the ESOP's adjusted basis in the stock.

DRAFTING INFORMATION

The principal authors of this revenue ruling are Craig Gerson of the Office of Associate Chief Counsel (Passthroughs and Special Industries), John Ricotta of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) and Steven Linder of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding the S corporation aspects of the rev-

enue ruling, contact Mr. Gerson at (202) 622-3050 (not a toll-free call). For further information regarding the employee plans aspects of the revenue ruling, contact the Employee Plans' taxpayer assistance telephone service at 1-877-829-5500 (a toll-free call) between the hours of 8:00 a.m. and 6:30 p.m. Eastern Time, Monday through Friday or contact Mr. Linder at (202) 283-9888 (not a toll-free call).

Section 4975.—Tax on Prohibited Transactions

26 CFR 54.4975-7: Other statutory exemptions.

Is an employee stock ownership plan (ESOP) required to adjust its basis in S corporation stock under § 1367(a) of the Internal Revenue Code for the ESOP's *pro rata* share of the corporation's items? Upon the distribution of S corporation stock by an ESOP to a participant, is the stock's net unrealized appreciation under § 402(e)(4) determined using the ESOP's adjusted basis in the stock? See Rev. Rul. 2003-27, page 597.
