

[4830-01-p]

Published December 17, 2004

DEPARTMENT OF THE TREASURY

Corrected March 8, 2005

Internal Revenue Service

26 CFR Part 1

TD 9164

RIN 1545-BC33

Prohibited Allocations of Securities in an S Corporation

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations concerning requirements for employee stock ownership plans (ESOPs) holding stock of Subchapter S corporations. The temporary regulations provide guidance on the definition and effects of a prohibited allocation under section 409(p), identification of disqualified persons and determination of a nonallocation year, calculation of synthetic equity under section 409(p)(5), and standards for determining whether a transaction is an avoidance or evasion of section 409(p). These temporary regulations generally affect plan sponsors of, and participants in, ESOPs holding stock of Subchapter S corporations. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section in this issue of the **Federal Register**.

DATES: Effective Date: These regulations are effective December 17, 2004.

Applicability Dates: These temporary regulations are applicable with respect to plan years beginning on or after January 1, 2005, but see §1.409-1T(i)(2) for specific exceptions.

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SUPPLEMENTARY INFORMATION:

### **Background**

Section 409(p) was enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) (115 Stat. 38) (2001) to address concerns about ownership structures involving S corporations and ESOPs that concentrate the benefits of the ESOP, directly or indirectly, in a small number of persons. Under the statute, an ESOP is generally permitted to hold S corporation stock, provided that the ESOP benefits a sufficiently broad-based group of employees.

Section 4975(e)(7) provides that an ESOP is a defined contribution plan that is designed to invest primarily in qualifying employer securities and that is either a stock bonus plan which is qualified, or a stock bonus plan and money purchase pension plan both of which are qualified, under section 401(a). A plan is not treated as an ESOP under the Internal Revenue Code (Code) unless it meets the following requirements, to the extent applicable: section 409(e) (relating to participants' voting rights if the employer has a registration-type class of securities); section 409(h) (relating to participants' right to receive employer securities; put options); section 409(o) (relating to participants' distribution rights and payment requirements); section 409(n) (relating to

securities received in transactions to which section 1042 applies); section 409(p) (relating to prohibited allocations of securities in an S corporation); and section 664(g) (relating to qualified gratuitous transfers of qualified employer securities). As authorized by section 4975(e)(7), additional requirements for ESOPs are imposed under §54.4975-11 of the Excise Tax Regulations.

Section 511 imposes an income tax on unrelated business taxable income (UBTI), as defined in section 512. Section 512(e)(1) generally provides that an interest in an S corporation held by an organization described in section 1361(c)(6), including a qualified plan, is treated as an interest in an unrelated trade or business. However, section 512(e)(3) has an exception for employer securities held by an ESOP, so that an ESOP of an S corporation generally does not have UBTI under section 512 with respect to the S corporation stock held by the ESOP.

Section 409(p)(1) requires an ESOP holding employer securities consisting of stock in an S corporation to 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, as defined in section 409(p). Section 409(p)(3)(A) provides that a "nonallocation year" includes any plan year during which the ownership of the S corporation is so concentrated among disqualified persons that they own or are deemed to own at least 50 percent of its shares. Section 409(p)(4) provides, in general, that whether someone is a "disqualified person" depends on a person's deemed-owned shares of S corporation stock held by

an ESOP (deemed-owned ESOP shares). Section 409(p)(4) provides, in general, that a "disqualified person" means any person whose deemed-owned ESOP shares are at least 10 percent of the number of deemed-owned ESOP shares or for whom the aggregate number of deemed-owned ESOP shares of such person and the members of such person's family is at least 20 percent of the number of deemed-owned ESOP shares.

The determination of whether someone is a disqualified person and whether a plan year is a nonallocation year is also made separately taking into account synthetic equity. 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 corporations, e.g., the circumstances in which options or similar interests are treated as creating a second class of stock. H.R. Conf. Rep. No. 107-84, at 102 n. 52. Under the rules for the treatment of synthetic equity at section 409(p)(5), if a person owns synthetic equity in an S corporation, then the shares of stock in such corporation on which such synthetic equity is based are treated as outstanding stock in such corporation, and as deemed-owned shares of such person, "if such treatment of synthetic equity of 1 or more such persons results in ... the treatment of any person as a disqualified person or ... the treatment of any year as a nonallocation year." [Emphasis added.]

Section 409(p)(7)(A) authorizes the Secretary to prescribe such regulations as may be necessary to carry out the purposes of section 409(p). Section 409(p)(7)(B) provides that 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 section 409(p).

Section 4979A imposes a 50 percent excise tax on certain prohibited allocations in an ESOP, including any allocation of employer securities that violates section 409(p), and on any synthetic equity owned by a disqualified person during a nonallocation year under section 409(p). In addition, section 4979A includes special rules for the first nonallocation year of an ESOP under which the excise tax applies with respect to all deemed-owned ESOP shares and all synthetic equity of disqualified persons, even if there is no prohibited allocation in that year. Section 4979A(a)(3), (a)(4), and (e)(2)(C). Thus, for example, any unallocated shares in an ESOP loan suspense account that are treated as deemed-owned shares of a disqualified person pursuant to section 409(p)(4)(C) are taken into account in determining the amount involved under 4979A(e)(2)(C). In addition, under section 4979A(e)(3)(D), a special statute of limitations applies to the first year of an ESOP that is a nonallocation year.

Temporary regulations under section 409(p) were issued on July 21, 2003 (68 FR 42970). The text of those temporary regulations also served as the text of a notice of proposed rulemaking published at 68 FR 43058. The 2003 regulations provide guidance on identifying disqualified persons, determining whether an ESOP has a nonallocation year, and on the definition of synthetic equity under section 409(p)(5).

In January 2004, the IRS issued Rev. Rul. 2004-4 (2004-6 I.R.B. 414) which addresses three factual situations involving an S corporation with qualified subchapter S subsidiaries (QSUBs). Pursuant to the authority of section 409(p)(7)(B) and §1.409(p)-

1T(c)(3) of the 2003 regulations, Rev. Rul. 2004-4 states that a nonallocation year occurs and the individual is a disqualified person in any case in which (i) shares of an S corporation are employer securities held by an ESOP, (ii) the profits of the S corporation generated by the business activities of a specific individual are accumulated and held for the benefit of that individual in a QSUB or similar entity (such as a limited liability company), (iii) these profits are not paid to the individual as compensation within 2½ months after the end of the year in which earned, and (iv) the individual has rights to acquire shares of stock (or similar interests) of the QSUB or similar entity representing 50 percent or more of the fair market value of the stock of such QSUB or similar entity. Rev. Rul. 2004-4 also provides that such individual's right to acquire shares of stock (or similar interests) of the QSUB or similar entity is synthetic equity. Accordingly, Rev. Rul. 2004-4 holds in each of the three factual situations that, for purposes of sections 409(p) and 4979A, certain individuals are disqualified persons, the ESOP has a nonallocation year, and the disqualified persons are treated as owning synthetic equity in the form of their options to acquire shares of the corresponding QSUB.<sup>1</sup>

Rev. Rul. 2004-4 also stated that Treasury and the IRS intend to reflect the guidance in that revenue ruling in regulations under section 409(p), effective for plan

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<sup>1</sup> Rev. Rul. 2004-4 also states that arrangements that are the same as, or substantially similar to, the following transaction are identified as "listed transactions" for purposes of §§1.6011-4(b)(2), 301.6111-2(b)(2) and 301.6112-1(b)(2), effective January 23, 2004: any transaction in which (i) at least 50 percent of the outstanding shares of an S corporation are employer securities held by an ESOP, (ii) the profits of the S corporation generated by the business activities of a specific individual are accumulated and held for the benefit of that individual in a QSUB or similar entity (such as a limited liability company), (iii) these profits are not paid to the individual as compensation within 2½ months after the end of the year in which earned, and (iv) the individual has rights to acquire shares of stock (or similar interests) of the QSUB or similar entity representing 50 percent or more of the fair market value of the stock of such QSUB or similar entity.

years ending after October 20, 2003, and that it is expected that the regulations would apply to similar transactions that have the effect of reserving profits from an individual's business activities to provide similar tax benefits to the individual, either with the use of a QSUB or through the use of another method.

Comments were received on the 2003 regulations. A public hearing on the 2003 regulations was held on November 17, 2003. After consideration of comments received and views expressed at the hearing, and taking into account Rev. Rul. 2004-4 and that section 409(p) applies to all ESOPs for plan years beginning on or after January 1, 2005, these new temporary regulations are being issued effective generally for plan years that begin on or after January 1, 2005, subject to a number of special effective date and transition rules that are described in this preamble under the heading Effective date.

## **Explanation of Provisions**

### Definition of Prohibited Allocation

In order to satisfy section 409(p), an ESOP holding employer securities consisting of stock in an S corporation must 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 under the ESOP, or be allocated directly or indirectly under any plan of the employer (including the ESOP) meeting the requirements of section 401(a), for the benefit of any disqualified person. This requirement has two elements; it prohibits accruals and allocations. These regulations provide two new terms, impermissible accrual and impermissible allocation, to reflect these two elements.

Under the regulations, if there is an impermissible accrual or an impermissible allocation, then there is a prohibited allocation in violation of this requirement.

Under the definition of impermissible accrual in these regulations, there is a prohibited allocation to the extent (and only to the extent) that employer securities consisting of stock in an S corporation owned by the ESOP and any assets attributable thereto are held under the ESOP for the benefit of a disqualified person during a nonallocation year. This rule was recommended by a commentator. For this purpose, assets attributable to S corporation securities include not only S corporation stock held in a disqualified person's account in the ESOP, but also any distributions, within the meaning of section 1368, made on S corporation stock held in a disqualified person's account in the ESOP (including earnings thereon), plus any proceeds from the sale of S corporation securities held for a disqualified person's account in the ESOP (including any earnings thereon).

Under the definition of impermissible allocation, prohibited allocations include any allocation for a disqualified person directly or indirectly under any plan of the employer qualified under section 401(a) that occurs during a nonallocation year to the extent that a contribution or other annual addition is made, or the disqualified person otherwise accrues additional benefits, under the ESOP or any other plan of the employer qualified under section 401(a) (including a release and allocation of assets from a suspense account, as described at §54.4975-11(c) and (d)) that, for the nonallocation year, would otherwise have been added to the account of the disqualified person under the ESOP



and invested in employer securities consisting of stock in an S corporation owned by the ESOP but for a provision in the ESOP to comply with section 409(p).

#### Effect of a Prohibited Allocation

Under section 409(p)(2) and these regulations, if there is a prohibited allocation, then the amount of the prohibited allocation is treated as distributed to the disqualified person at the time of the prohibited allocation. Accordingly, the fair market value of the disqualified person's account under the ESOP would generally be included in his or her gross income (to the extent in excess of his or her allocable investment in the contract, if any, under section 72). The additional income tax imposed by section 72(t) would also apply if the disqualified person is less than age 59 ½ (and no other exception applies).

Like a deemed distribution under section 72(p),<sup>2</sup> a deemed distribution under section 409(p) is not an actual distribution from the ESOP. Thus, the amount of the prohibited allocation is not an eligible rollover distribution and, for purposes of applying sections 72 and 402 with respect to any subsequent distribution from the ESOP, the amount previously taken into account by the disqualified person as income as a result of the deemed distribution is treated as an investment in the contract.

Under these regulations, if there is a nonallocation year and there are prohibited allocations in that year, the plan would fail to satisfy the requirements of section 4975(e)(7) and would cease to be an ESOP. As a result, not only would the plan lose the prohibited transaction exemption for loans to an ESOP under section 4975(d)(3) of the Code and section 408(b)(3) of Title I of the Employee Retirement Income Security

Act of 1974, as amended (ERISA), but also the exception in section 512(e)(3) would cease to apply to the plan, so that the plan would owe income tax as a result of unrelated business taxable income under section 512 with respect to S corporation stock held by the plan from and after the date of the prohibited allocation.<sup>3</sup> Other consequences include imposition of an excise tax under section 4979A and, assuming that the plan's provisions do not permit a prohibited allocation under section 409(p), loss of tax qualification for failure to operate the plan in accordance with its terms.

#### Prevention of a Nonallocation Year

As part of the regulations that were proposed in 2003, comments were requested with respect to issues raised by S corporation ESOPs established by March 14, 2001, that will need to comply with the requirements of section 409(p) beginning in 2005, including transition approaches for ESOPs that become subject to section 409(p) in 2005. One commentator requested a transition rule under which nonqualified deferred compensation would be disregarded if it was granted at a time when it was not synthetic equity and was distributed within 12 months after it became synthetic equity.

These issues are particularly important because compliance with the requirements of section 409(p) is required on a current operational basis, as well as a plan document basis. Thus, for example, if S corporation shares are held in a

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<sup>2</sup> See §1.72(p)-1, Q&A-11 and 12.

<sup>3</sup> It should be noted that transactions that give rise to loss of the prohibited transaction exemptions under section 4975(d)(3) of the Internal Revenue Code and section 408(b)(3) of Title I of ERISA for loans to an ESOP could also give rise to other prohibited transactions under section 4975 of the Internal Revenue Code, as well as violations of Title I of ERISA, including prohibited transactions under section 406 of Title I of ERISA, resulting in, among other things, the assessment of additional excise taxes under section 4975(a) and (b) of the Internal Revenue Code, as well as civil penalties under section 502(i) of ERISA.

disqualified person's account during a nonallocation year, then there is a failure to satisfy section 409(p), without regard to whether the terms of the ESOP prohibit such actions or require preventative action to be taken. Factors that might be considered in determining whether there has been a failure to comply with the requirements of section 409(p) on a current operational basis include, for example, the exercise of voting rights of shares in the disqualified person's account, distributions from the S corporation to the disqualified person's account, and plan account statements showing allocations to the disqualified person's account.

A plan might choose to take a number of steps before the beginning of a year in order to ensure that the year is not a nonallocation year, such as steps to prevent an individual from becoming a disqualified person. These include:

- Reduction of synthetic equity, e.g., by cancellation or distribution of the synthetic equity.
- A sale of the S corporation securities held in the participant's ESOP account so that the account is not invested in S corporation stock.
- A distribution of the S corporation securities held in the participant's account from the ESOP to the participant. Such a distribution is only permissible to the extent the amount is otherwise permitted to be distributed (e.g., for amounts that are subject to section 401(k), the distribution does not violate the distribution restrictions of section 401(k)(2)(B)(i)).
- A transfer of the S corporation securities held for the participant under the ESOP into a separate portion of the plan that is not an ESOP (as permitted under

§54.4975-11(a)(5) of the Excise Tax Regulations) or to another qualified plan of the employer that is not an ESOP.

Any of these steps must satisfy applicable legal and qualification requirements, including the nondiscrimination requirements of section 401(a)(4).<sup>4</sup> These regulations provide that, if a transfer is made from an ESOP to a separate portion of the plan or to another qualified plan of the employer that is not an ESOP in order to prevent a nonallocation year, then both the ESOP and the plan that is not an ESOP will not fail to satisfy the requirements of §1.401(a)(4)-4 merely because of the transfer. Further, subsequent to the transfer, the plan that is not an ESOP will not fail to satisfy the requirements of §1.401(a)(4)-4 merely because of the benefits, rights, or features with respect to the transferred benefits if those benefits, rights, or features would satisfy the requirements of §1.401(a)(4)-4 if the mandatory disaggregation rule for ESOPs at §1.410(b)-7(c)(2) did not apply.

In the event of such a transfer, the transferee plan would be subject to tax on unrelated business taxable income with respect to its pro rata share of income from the S corporation securities, with that expense to be charged to the account holding the transferred amount. However, the ESOP would be able to continue to satisfy the requirements of section 4975(e)(7) and the allocations could be made for the participant for the year.

#### Determination of Nonallocation Year

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<sup>4</sup> Further, any sale or transfer of plan assets must comply with the requirements of Part 4 of Subtitle B of Title I of ERISA.

Under section 409(p), a nonallocation year generally means a plan year during which on any date disqualified persons own 50 percent or more of the stock in the S corporation, separately applied by taking into account all outstanding shares of stock in the S corporation (including shares held by the ESOP) and by taking into account all outstanding shares of stock in the S corporation and synthetic equity. These regulations include some changes from the rules in the 2003 regulations for purposes of determining whether there is a nonallocation year.

The 2003 regulations generally treat a person as owning outstanding non-ESOP stock that the person has the right to acquire, but only in very limited cases. These regulations treat a person as owning outstanding non-ESOP stock that the person has the right to acquire unless the actual owner is a person who is subject to federal income tax, the right is one that would not be taken into account in determining whether an S corporation has a second class of stock under §1.1361-1(l)(2)(iii) or (l)(4)(iii)(C), and a principal purpose of the right is not to avoid or evade a nonallocation year under section 409(p).

Other differences from the 2003 regulations include a change relating to synthetic equity (discussed in this preamble under the heading Determination of disqualified persons on person-by-person basis) and, in response to comments, clarification that, if any share is treated as owned by more than one person, then that share is counted as a single share and that share is treated as owned by disqualified persons if any of the owners is a disqualified person.

Determination of Disqualified Persons on Person-by-person Basis

Under the 2003 regulations, a person's synthetic equity shares are added to his or her deemed-owned ESOP shares to determine whether he or she is a disqualified person. This total number of shares is then compared with the total outstanding synthetic equity shares in determining whether that person is a disqualified person. The 2003 regulations were criticized for this approach in the case of options because it allowed options held by other shareholders to dilute the interests of the person being tested and prevent them from being treated as a disqualified person.

These regulations change this approach by looking only at the synthetic equity of the person being tested to determine if he or she is a disqualified person. In addition, a nonallocation year occurs as a result of synthetic equity if the total share ownership of disqualified persons (actual ownership, deemed-owned ESOP shares, plus synthetic equity) is at least 50 percent of the total shares outstanding plus the synthetic equity of disqualified persons. This 'person-by-person approach' is more consistent with the statutory rule that synthetic equity is counted for one person if it results in any person being treated as a disqualified person.

The person-by-person approach applies to synthetic equity in the form of nonqualified deferred compensation, as well as in the form of options or other rights related to stock. This approach prevents dilution of the disqualified person's ownership and also addresses a known abuse identified by several commentators involving stock options or stock appreciation rights that are unlikely to be exercised. In this abuse, the S corporation issues a large number of stock options or stock appreciation rights to lower paid employees which are only exercisable at a strike price far exceeding even

the likely future value of the shares or the strike price is periodically reset to exceed the expected value during the term of the option or right. These options or rights would never be exercised by the employees, but are designed to count as synthetic equity shares in order to prevent shareholders who actually have the right to own 10 percent or more of the S corporation from being treated as disqualified persons. Several commentators urged Treasury and the IRS to prevent this abuse. Under the person-by-person approach adopted in these regulations, these options or rights would be ignored in determining whether other shareholders were disqualified persons and would not prevent persons who have actual rights to become 10 percent shareholders from being treated as disqualified persons.

#### Synthetic Equity

These regulations are generally similar to the 2003 regulations regarding what constitutes synthetic equity. Differences include the expansion of the definition of synthetic equity to include the right to acquire stock or assets of a related entity and an exclusion for nonqualified deferred compensation that was taken into account before January 1, 2005, for purposes of the Federal Insurance Contributions Act (FICA) and that was outstanding before the first date on which the ESOP acquired any employer securities.

#### Determination of Number of Shares of Synthetic Equity

The 2003 regulations include rules under which the number of synthetic equity shares attributed for a stock option is based on the number of shares that are subject to that option. The same rule also applies to any other synthetic equity that is determined

by reference to shares of stock of the S corporation but for which payment is made in cash or other property. These regulations provide that in the case of synthetic equity determined by reference to shares of stock in the S corporation, the number of shares of synthetic equity depends on the gross number of shares deliverable pursuant to the synthetic equity. In the case of synthetic equity determined by reference to S corporation shares but payable in cash or other property (other than S corporation shares), the number of synthetic equity shares treated as owned is equal to the number of shares of stock having a fair market value equal to the cash or other property paid (disregarding lapse restrictions as described in §1.83-3(i)). Accordingly, the number of shares of synthetic equity attributed for a stock appreciation right (payable in stock or in cash) equals the number of shares having a value equal to the appreciation at the time of measurement (determined without regard to lapse restrictions).

In addition, the 2003 regulations provide that rights to acquire stock or interests in an entity related to the S corporation are treated as synthetic equity if the interests in the related entity are the only significant assets of the S corporation and the S corporation is the only significant owner of the related entity. These regulations broaden that rule by providing that synthetic equity includes all rights to acquire stock or similar interests in a related entity to the extent of the S corporation's ownership. The regulations provide that 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.



In the case of synthetic equity that is not determined by reference to shares of stock of the S corporation (or shares of stock or similar interests in a related entity), the 2003 regulations provided that the person who is entitled to the synthetic equity is treated as owning a number of shares of stock in the S corporation equal to the present value of the synthetic equity (with such value determined without regard to any lapse restriction as defined under the section 83 regulations) divided by the fair market value of a share of the S corporation's stock as of the same date. These regulations include a similar rule, but include three rules that were not in the 2003 regulations.

First, these regulations include a special rule with respect to voting rights. While sections 409(l) and 4975(e)(7) generally require that the employer securities of an ESOP have voting rights at least equal to the voting rights of that class of common stock having the greatest voting rights (assuming the employer has no stock readily traded on an established securities market), there might be rights to acquire a class of shares that are not currently outstanding and that have greater voting rights. Under these regulations, if a synthetic equity right includes (directly or indirectly) a right to purchase or receive shares of S corporation stock that have per-share voting rights greater than the per-share voting rights of one or more shares of S corporation stock held by the ESOP, then the number of shares of deemed owned synthetic equity attributable to such right is at least equal to the number of shares that would have the same voting rights if such shares had the same per-share voting rights as shares held by the ESOP.

Second, like the 2003 regulations, these regulations permit the number of synthetic equity shares for nonqualified deferred compensation (that is not determined by reference to shares of stock of the S corporation or shares of stock or similar interests in a related entity) to be determined as of the first day of the ESOP's plan year, or any other reasonable determination date or dates during a plan year that is consistently used by the ESOP for this purpose for all persons. These regulations require that the date used be reasonably representative of the share value of the S corporation's stock. The number of shares of synthetic equity treated as owned for any period from a determination date through the date immediately preceding the next following determination date is the number of shares treated as owned on the first day of that period. In addition, these regulations include a new rule intended to address concerns expressed in the comments regarding administrative and planning difficulties that arise from a daily, or even annual, determination of synthetic equity shares where the number is affected both by the potential volatility of the S corporation stock value and separately by the potential volatility of the nonqualified deferred compensation. Under these regulations, the ESOP may provide, on a reasonable and consistent basis used by the ESOP for this purpose for all persons, that the number of shares of synthetic equity treated as owned on an identified determination date remain constant for the period from that determination date until the date that is immediately preceding the third anniversary of the identified determination date. As new grants are made during this three-year period, the appropriate number of shares of synthetic equity resulting from the new grant would be determined at the next determination date, which

would likewise remain constant during the remainder of the same three-year period. However, the ESOP must recalculate the number of shares of this type of synthetic equity at least every three years, based on the S corporation share value on the applicable determination date and the aggregate present value of nonqualified deferred compensation on that determination date. The regulations include an example illustrating this rule.

Third, these regulations include a new rule for cases in which the ESOP does not own all of the stock of the S corporation. This rule reflects the view that the dilutive effect of synthetic equity only affects an ESOP to the extent of the ESOP's ownership interest in the S corporation. Under this rule, the number of synthetic shares otherwise determined is reduced ratably to the extent that shares of the S corporation are owned by a person who is not an ESOP (and who is subject to federal income taxes). For example, if an S corporation has 200 outstanding shares, of which individual A owns 50 shares and the ESOP owns the other 150 shares, and individual B would be treated as owning 200 synthetic equity shares of the S corporation but for the special rule for cases in which the ESOP does not own all of the stock of the S corporation, then the number of synthetic shares treated as owned by B is decreased from 200 to 150 (because the ESOP only owns 75% of the outstanding stock of the S corporation, rather than 100%).

#### Avoidance or Evasion of Section 409(p)

These regulations include a standard for determining whether the principal purpose of the ownership structure of an S corporation involving synthetic equity

constitutes an avoidance or evasion of section 409(p). Under this standard, whether the principal purpose of the ownership structure of an S corporation involving synthetic equity constitutes an avoidance or evasion of section 409(p) is determined by taking into account all the surrounding facts and circumstances. An avoidance or evasion of section 409(p) does not occur where the ESOP receives the economic benefits of ownership in the S corporation, taking into account all features of the ownership of the S corporation's outstanding stock and related obligations (including synthetic equity), any shareholders who are taxable entities, and the rights of the ESOP, to determine whether, to the extent of the ESOP's stock ownership, the ESOP receives the economic benefits of ownership in the S corporation that occur during the period that stock of the S corporation is owned by the ESOP. Among the factors indicating that the ESOP receives these economic benefits include shareholder voting rights, the right to receive distributions made to shareholders, and the right to benefit from the profits earned by the S corporation, including the extent to which actual distributions of profits are made from the S corporation to the ESOP and the extent to which the ESOP's ownership interest in undistributed profits and future profits is subject to dilution as a result of synthetic equity, for example, the ESOP's ownership interest is not subject to dilution if the total amount of synthetic equity is a relatively small portion of the total number of shares and deemed-owned shares of the S corporation.

This standard is promulgated pursuant to the authority of Treasury and the IRS to act promptly to issue guidance to prevent ownership structures that deny an ESOP the

economic benefits of ownership and, in addition, these regulations identify certain specific ownership structures that constitute an avoidance or evasion of section 409(p). Specifically, the regulations identify the transactions described in Rev. Rul. 2004-4 as being an avoidance or evasion of section 409(p) and provide that there is a nonallocation year not only in the situations described in the revenue ruling but also in situations in which profits are segregated using a method other than QSUBs. Under the regulations, the principal purpose of the ownership structure of an S corporation constitutes an avoidance or evasion of section 409(p), and a nonallocation year results, in any case in which (i) the profits of the S corporation generated by the business activities of a specific individual or individuals are substantially accumulated and held for the benefit of that individual or individuals on a tax-deferred basis within an entity related to the S corporation, such as a partnership, trust, or corporation (such as in a subsidiary that is a disregarded entity), or through any other method that has the same effect of segregating profits for the benefit of such individual or individuals (such as nonqualified deferred compensation), (ii) the individual or individuals for whom profits are segregated have rights to acquire 50 percent or more of those profits directly or indirectly (for example, by purchase of the subsidiary), and (iii) a nonallocation year would occur if this section were separately applied with respect to either the separate entity or whatever method has the effect of segregating profits of the individual or individuals, treating such entity as a separate S corporation owned by an ESOP (or in the case of any other method of segregation of profits by treating those profits as the only assets of a separate S corporation owned by an ESOP). This conclusion both

reflects the holding in Rev. Rul. 2004-4 (discussed in this preamble under the heading Background) and treats similar transactions as resulting in a nonallocation year, as Rev. Rul. 2004-4 indicated would be reflected in these regulations.

#### Effective Dates

These temporary regulations are applicable for plan years beginning on or after January 1, 2005. However, there are a number of special effective date and transition rules.

These regulations preserve the rules of the 2003 temporary regulations with respect to plan years beginning before January 1, 2005, with the new rules in these regulations to apply thereafter. However, as described in this section, the rules in these regulations dealing with ownership structures that constitute an avoidance or evasion of section 409(p), including the rules relating to structures similar to those addressed in Rev. Rul. 2004-4, apply for plan years ending on or after December 31, 2004.

Under the transition rules, ESOP shares that are held for a disqualified person before the first plan year beginning on or after January 1, 2005 will not be treated as an impermissible accrual in 2005 if the shares are disposed of before July 1, 2005 (e.g., by distribution or transfer to a non-ESOP) and no amount is contributed for the benefit of the disqualified person under any plan of the employer intended to meet the requirements of section 401(a) (including the ESOP) during the period from the first day of the first plan year beginning on or after January 1, 2005 through June 30, 2005. However, even if no amount is allocated to a disqualified person during this period, but this period is part of the first nonallocation year of the ESOP, an excise tax will apply

under section 4979A with respect to either ESOP shares held for a disqualified person or synthetic equity that is treated as owned under these regulations on the first day of the plan year, regardless of whether there is an impermissible accrual or impermissible allocation. See section 4979A(a)(3), (a)(4), and (e)(2)(C).

Under another transition rule, the new person-by-person rules in these regulations on how to determine whether a person is a disqualified person and whether a year is a nonallocation year generally do not go into effect until July 1, 2005. However, comments indicated that the 2003 regulations could be easily avoided or evaded by granting options or stock appreciation rights with artificially high strike prices or where the strike price is periodically increased to exceed the expected value before the option or right is to expire. Thus, with respect to the period from (and including) December 31, 2004 through June 30, 2005, the new rules apply to plans under which a nonallocation year would occur under the 2003 temporary regulations if synthetic equity were to exclude stock options, stock appreciation rights, or similar rights to acquire shares of the S corporation or a related entity where the facts and circumstances indicate that there is no reasonable likelihood that the holder of the right will receive the shares (or equivalent value), e.g., cases in which the option is based on an exercise price that is more than 200% of the fair market value of the shares on the date of grant or a stock appreciation right is payable only if the appreciation exceeds 100% of the fair market value of the shares on the date of grant. This special rule applies for plan years ending on or after December 31, 2004 in order to ensure that an employer cannot avoid

or evade the purposes of section 409(p) -- even for the calendar year 2004 -- by using artificial grants that are unlikely to ever be paid.

Under a third transition rule, the new rules in these regulations, including the rules relating to the right to receive shares with disproportional voting rights, do not go into effect until July 1, 2005, if there would be no prohibited allocation before then under these regulations if the new rules in these regulations relating to the right to receive shares with disproportional voting rights were disregarded.

Further, the IRS will permit plans to rely on the exception for pre-ESOP nonqualified deferred compensation for periods before January 1, 2005, (described in this preamble under the heading Synthetic Equity).

### **Special Analyses**

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6) refer to the Special Analyses section of the preamble to the cross-referencing notice of proposed rulemaking published in the Proposed Rules section in this issue of the **Federal Register**. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact.

### **Drafting Information**



The principal author of these regulations is John T. Ricotta of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury participated in their development.

### **List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

### **Amendments to the Regulations**

Accordingly, 26 CFR part 1 is amended as follows:

#### **PART 1--INCOME TAXES**

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Section 1.409(p)-1T is also issued under 26 U.S.C. 409(p)(7). \* \* \*

Par. 2. Section 1.409(p)-1T is revised to read as follows:

#### **§1.409(p)-1T Prohibited allocation of securities in an S corporation (temporary).**

(a) Organization of this section. Section 409(p) applies if a nonallocation year occurs in an employee stock ownership plan (ESOP), as defined in section 4975(e)(7), that holds shares of stock of an S corporation, as defined in section 1361, that are employer securities as defined in section 409(l). Paragraph (b) of this section sets forth the general rule under section 409(p)(1) and (2) prohibiting any accrual or allocation to a disqualified person in a nonallocation year. Paragraph (c) of this section sets forth rules under section 409(p)(3), (5), and (7) for determining whether a year is a nonallocation year, generally based on whether disqualified persons own at least 50 percent of the

shares of the S corporation, either taking into account only the outstanding shares of the S corporation (including shares held by the ESOP) or taking into account both the outstanding shares and synthetic equity of the S corporation. Paragraphs (d), (e), and (f) of this section contain definitions of disqualified person under section 409(p)(4) and (5), deemed-owned ESOP shares under section 409(p)(4)(C), and synthetic equity under section 409(p)(6)(C). Paragraph (g) of this section contains a standard for determining when the principal purpose of the ownership structure of an S corporation constitutes an avoidance or evasion of section 409(p). The definitions used in section 409(p) and this section are also applicable for purposes of section 4979A, which imposes an excise tax on certain events, including a nonallocation year under section 409(p).

(b) Prohibited allocation in a nonallocation year--(1) General rule. An ESOP holding employer securities consisting of stock in an S corporation must 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 under the ESOP, or be allocated directly or indirectly under any plan of the employer (including the ESOP) meeting the requirements of section 401(a), for the benefit of any disqualified person (a prohibited allocation).

(2) Additional rules-- (i) Prohibited allocation definition. For purposes of section 409(p)(2)(A) and paragraph (b)(1) of this section, there is a prohibited allocation (i.e., assets accrue or are allocated as prohibited under paragraph (b)(1) of this section) if there is either an impermissible accrual as defined in paragraph (b)(2)(ii) of this section

or an impermissible allocation as defined in paragraph (b)(2)(iii) of this section. The amount of the prohibited allocation is equal to the sum of the impermissible accrual plus the amount of the impermissible allocation (if any).

(ii) Impermissible accrual. There is an impermissible accrual to the extent (and only to the extent) that employer securities consisting of stock in an S corporation owned by the ESOP and any assets attributable thereto are held under the ESOP for the benefit of a disqualified person during a nonallocation year. For this purpose, assets attributable to S corporation securities include any distributions, within the meaning of section 1368, made on S corporation stock held in a disqualified person's account in the ESOP (including earnings thereon), plus any proceeds from the sale of S corporation securities held for a disqualified person's account in the ESOP (including any earnings thereon). Thus, for example, in the event of a nonallocation year, all S corporation shares and all other ESOP assets attributable to S corporation stock, including distributions, sales proceeds, and earnings on either the distribution or proceeds, held for the account of such disqualified person in the ESOP during that year are an impermissible accrual for the benefit of that person, whether attributable to contributions in the current year or in prior years.

(iii) Impermissible allocation. An impermissible allocation means any allocation for a disqualified person directly or indirectly under any plan of the employer qualified under section 401(a) that occurs during a nonallocation year to the extent that a contribution or other annual addition is made, or the disqualified person otherwise accrues additional benefits, under the ESOP or any other plan of the employer qualified

under section 401(a) (including a release and allocation of assets from a suspense account, as described at §54.4975-11(c) and (d) of this chapter) that, for the nonallocation year, would otherwise have been added to the account of the disqualified person under the ESOP and invested in employer securities consisting of stock in an S corporation owned by the ESOP but for a provision in the ESOP to comply with section 409(p).

(iv) Effects of prohibited allocation -- (A) Deemed distribution. If there is a prohibited allocation, the amount of the prohibited allocation, as determined under this paragraph (b)(2), is treated as distributed from the ESOP (or other plan of the employer) to the disqualified person on the first day of the plan year on which there is an impermissible accrual or on the date of the allocation in the case of an additional impermissible accrual or impermissible allocation during the plan year but after the first day of the plan year. Thus, the fair market value of assets in the disqualified person's account that constitutes an impermissible accrual or allocation is included in gross income (to the extent in excess of any investment in the contract allocable to such amount) and is subject to any additional income tax that applies under section 72(t). A deemed distribution under this paragraph (b)(2)(iv)(A) is not an actual distribution from the ESOP. Thus, the amount of the prohibited allocation is not an eligible rollover distribution under section 402(c). However, for purposes of applying sections 72 and 402 with respect to any subsequent distribution from the ESOP, the amount that the disqualified person previously took into account as income as a result of the deemed distribution is treated as an investment in the contract.

(B) Other effects. If there is a prohibited allocation, then the plan fails to satisfy the requirements of section 4975(e)(7) and ceases to be an ESOP. In such a case, the exemption from the excise tax on prohibited transactions for loans to leveraged ESOPs contained in section 4975(d)(3) would cease to apply to any loan (with the result that the employer would owe an excise tax with respect to the previously exempt loan) and, further, the exception in section 512(e)(3) would not apply to the plan (with the result that the plan may owe income tax as a result of unrelated business taxable income under section 512 with respect to S corporation stock held by the plan). See also section 4979A(a) which imposes an excise tax in certain events, including a prohibited allocation under section 409(p).

(v) Prevention of prohibited allocation.--(A) Transfer of account to non-ESOP. An ESOP may prevent a nonallocation year or a prohibited allocation during a nonallocation year by permitting assets (including S corporation securities) allocated to the account of a disqualified person (or a person reasonably expected to become a disqualified person absent a transfer described in this paragraph (b)(2)(v)(A)) to be transferred into a separate portion of the plan that is not an ESOP, as described in §54.4975-11(a)(5) of this chapter, or to another plan of the employer that satisfies the requirements of section 401(a) (and that is not an ESOP). In the event of such a transfer involving S corporation securities, the recipient plan is subject to tax on unrelated business taxable income under section 512.

(B) Relief from nondiscrimination requirement. Pursuant to this paragraph (b)(2)(v)(B), if a transfer described in paragraph (b)(2)(v)(A) of this section is made from

an ESOP to a separate portion of the plan or to another qualified plan of the employer that is not an ESOP, then both the ESOP and the plan or portion of a plan that is not an ESOP will not fail to satisfy the requirements of §1.401(a)(4)-4 merely because of the transfer. Further, subsequent to the transfer, that plan will not fail to satisfy the requirements of §1.401(a)(4)-4 merely because of the benefits, rights, or features with respect to the transferred benefits if those benefits, rights, or features would satisfy the requirements of §1.401(a)(4)-4 if the mandatory disaggregation rule for ESOPs at §1.410(b)-7(c)(2) did not apply.

(c) Nonallocation year -- (1) Definition generally. For purposes of section 409(p) and this section, a nonallocation year means a plan year of an ESOP during which, at any time, the ESOP holds any employer securities that are shares of an S corporation and either --

(i) Disqualified persons own at least 50 percent of the number of outstanding shares of stock in the S corporation (including deemed-owned ESOP shares); or

(ii) Disqualified persons own at least 50 percent of the sum of:

(A) The outstanding shares of stock in the S corporation (including deemed-owned ESOP shares); plus

(B) The shares of synthetic equity in the S corporation owned by disqualified persons.

(2) Attribution rules. For purposes of this paragraph (c), the rules of section 318(a) apply to determine ownership of shares in the S corporation (including deemed-owned ESOP shares) and synthetic equity. However, for this purpose, section

318(a)(4) (relating to options to acquire stock) is disregarded and, in applying section 318(a)(1), the members of an individual's family include members of the individual's family under paragraph (d)(2) of this section. In addition, an individual is treated as owning deemed-owned ESOP shares of that individual notwithstanding the employee trust exception in section 318(a)(2)(B)(i). If the attribution rules in paragraph (f)(1) of this section apply, then the rules of paragraph (f)(1) of this section are applied before the rules of this paragraph (c)(2).

(3) Special rule for avoidance or evasion. (i) The ownership structures described in paragraph (g)(3) of this section result in a nonallocation year. In addition, under the ownership structures described in paragraph (g)(3) of this section, the individual referred to in paragraph (g)(3) of this section is treated as a disqualified person and that person's interest in the separate entity is treated as synthetic equity.

(ii) Under section 409(p)(7)(B), the Commissioner, in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(b) of this chapter), may 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 section 409(p). For any year that is a nonallocation year under this paragraph (c)(3), the Commissioner may treat any person as a disqualified person. See paragraph (g) of this section for guidance regarding when the principal purpose of an ownership structure of an S corporation involving synthetic equity constitutes an avoidance or evasion of section 409(p).

(4) Special rule for certain stock rights. (i) For purposes of paragraph (c)(1) of this section, a person is treated as owning stock that the person has a right to acquire if, at all times during the period when such right is effective, the stock that the person has the right to acquire is both issued and outstanding and is held by persons other than the ESOP, the S corporation, or a related entity (as defined in paragraph (f)(3) of this section).

(ii) This paragraph (c)(4) applies only if treating persons as owning the shares described in paragraph (c)(4)(i) of this section results in a nonallocation year. This paragraph (c)(4) does not apply to a right to acquire stock of an S corporation held by a shareholder subject to Federal income tax that, under §1.1361-1(l)(2)(iii) or (l)(4)(iii)(C), would not be taken into account in determining if an S corporation has a second class of stock provided that a principal purpose of the right is not the avoidance or evasion of section 409(p). Under the last sentence of paragraph (f)(2)(i) of this section, this paragraph (c)(4)(ii) does not apply for purposes of determining ownership of deemed-owned ESOP shares or whether an interest constitutes synthetic equity.

(5) Application with respect to shares treated as owned by more than one person. For purposes of applying paragraph (c)(1) of this section, if, by application of the rules of paragraph (c)(2), (c)(4), or (f)(1) of this section, any share is treated as owned by more than one person, then that share is counted as a single share and that share is treated as owned by disqualified persons if any of the owners is a disqualified person.



(6) Effect of nonallocation year. See paragraph (b) of this section for a prohibition applicable during a nonallocation year. See also section 4979A for an excise tax applicable in certain cases, including section 4979A(a)(3) and (4) which applies during a nonallocation year (whether or not there is a prohibited allocation during the year).

(d) Disqualified persons -- (1) General definition. For purposes of section 409(p) and this section, a disqualified person means any person for whom --

(i) The number of such person's deemed-owned ESOP shares of the S corporation is at least 10 percent of the number of the deemed-owned ESOP shares of the S corporation;

(ii) The aggregate number of such person's deemed-owned ESOP shares and synthetic equity shares of the S corporation is at least 10 percent of the sum of:

(A) The total number of deemed-owned ESOP shares; and

(B) The person's synthetic equity shares of the S corporation;

(iii) The aggregate number of the S corporation's deemed-owned ESOP shares of such person and of the members of such person's family is at least 20 percent of the number of deemed-owned ESOP shares of the S corporation; or

(iv) The aggregate number of the S corporation's deemed-owned ESOP shares and synthetic equity shares of such person and of the members of such person's family is at least 20 percent of the sum of:

(A) The total number of deemed-owned ESOP shares; and

(B) The synthetic equity shares of the S corporation owned by such person and the members of such person's family.

(2) Treatment of family members; definition -- (i) Rule. Each member of the family of any person who is a disqualified person under paragraph (d)(1)(iii) or (iv) of this section is a disqualified person.

(ii) General definition. For purposes of section 409(p) and this section, member of the family means, with respect to an individual --

(A) The spouse of the individual;

(B) An ancestor or lineal descendant of the individual or the individual's spouse;

(C) A brother or sister of the individual or of the individual's spouse and any lineal descendant of the brother or sister; and

(D) The spouse of any individual described in paragraph (d)(2)(ii)(B) or (C) of this section.

(iii) Spouse. A spouse of an individual who is legally separated from such individual under a decree of divorce or separate maintenance is not treated as such individual's spouse under paragraph (d)(2)(ii)(A) of this section.

(3) Special rule for certain nonallocation years. See paragraph (c)(3) of this section (relating to avoidance or evasion of section 409(p)) for special rules permitting certain persons to be treated as disqualified persons in certain nonallocation years.

(4) Example. The rules of this paragraph (d) are illustrated by the following example:

Example. (i) Facts. An S corporation has 800 outstanding shares of which 100 are owned by individual O and 700 are held in an employee stock ownership plan

(ESOP) during 2005, including 200 shares held in the ESOP account of O, 65 shares held in the ESOP account of participant P, and 40 shares held in the ESOP account of participant Q who is P's spouse. The S corporation has no synthetic equity.

(ii) Conclusion. O is a disqualified person during 2005 because O's account in the ESOP holds at least 10 percent of the shares owned by the ESOP (200 is 28.6 percent of 700). In addition, P is a disqualified person during 2005 because, under paragraph (d)(2) of this section, P is treated as owning the shares held by Q and P's total deemed-owned shares are thus at least 10 percent of the shares owned by the plan (65 plus 40 is more than 10 percent of 700). In addition, Q is a disqualified person as a result of the rules in paragraph (d)(2) of this section. As a result, disqualified persons own at least 50 percent of the outstanding shares of the S corporation during 2005 (O's 100 directly owned shares, O's 200 deemed-owned shares, P's 65 deemed-owned shares, plus Q's 40 deemed owned shares are 50.6 percent of 800).

(e) Deemed-owned ESOP shares. For purposes of section 409(p) and this section, a person is treated as owning his or her deemed-owned ESOP shares.

Deemed-owned ESOP shares mean, with respect to any person --

(1) Any shares of stock in the S corporation constituting employer securities that are allocated to such person's account under the ESOP; and

(2) Such person's share of the stock in the S corporation that is held by the ESOP but is not allocated to the account of any participant or beneficiary (with such person's share to be determined in the same proportion as the shares released and allocated from a suspense account, as described at §54.4975-11(c) and (d) of this chapter, under the ESOP for the most recently ended plan year for which there were shares released and allocated from a suspense account, or if there has been no such prior release and allocation from a suspense account, then determined in proportion to a reasonable estimate of the shares that would be released and allocated in the first year of loan repayment).

(f) Synthetic equity -- (1) Ownership of synthetic equity. For purposes of section 409(p) and this section, synthetic equity is treated as owned by a person in the same manner as stock is treated as owned by a person, directly or under the rules of section 318(a)(2) and (3). Synthetic equity means the rights described in paragraph (f)(2) of this section.

(2) Synthetic equity-- (i) Rights to acquire stock of the S corporation. Synthetic equity includes any stock option, warrant, restricted stock, deferred issuance stock right, stock appreciation right payable in stock, or similar interest or right that gives the holder the right to acquire or receive stock of the S corporation in the future. Rights to acquire stock in an S corporation with respect to stock that is, at all times during the period when such rights are effective, both issued and outstanding and held by persons (who are subject to federal income taxes) other than the ESOP, the S corporation, or a related entity are not synthetic equity (but see paragraph (c)(4) of this section).

(ii) Special rule for certain stock rights. Synthetic equity also includes a right to a future payment (payable in cash or any other form other than stock of the S corporation) from an S corporation that is based on the value of the stock of the S corporation, such as appreciation in such value. Thus, synthetic equity includes a stock appreciation right with respect to stock of an S corporation that is payable in cash or a phantom stock unit with respect to stock of an S corporation that is payable in cash.

(iii) Rights to acquire interests in or assets of an S corporation or a related entity. 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.

(iv) Special rule for nonqualified deferred compensation. (A) Synthetic equity also includes any of the following with respect to an S corporation or a related entity: any remuneration to which section 404(a)(5) applies; remuneration for which a deduction would be permitted under section 404(a)(5) if separate accounts were maintained; any right to receive property to which section 83 applies (including a payment to a trust described in section 402(b) or to an annuity described in section 403(c)) in a future year for the performance of services; any transfer of property (to which section 83 applies) in connection with the performance of services to the extent that the property is not substantially vested within the meaning of §1.83-3(i) by the end of the plan year in which transferred; and a split-dollar life insurance arrangement under §1.61-22(b) entered into in connection with the performance of services (other than one under which, at all times, the only economic benefit that will be provided under the arrangement is current life insurance protection as described in §1.61-22(d)(3)). Synthetic equity also includes any other remuneration for services under a plan, or method or arrangement, deferring the receipt of compensation to a date that is after the 15th day of the 3<sup>rd</sup> calendar month after the end of the entity's taxable year in which the related services are rendered. However, synthetic equity does not include benefits under a plan that is an eligible retirement plan within the meaning of section 402(c)(8)(B).

(B) For purposes of applying paragraph (f)(2)(iv)(A) of this section with respect to an ESOP, synthetic equity does not include any interest described in such paragraph (f)(2)(iv)(A) of this section to the extent that--

(1) The interest is nonqualified deferred compensation (within the meaning of section 3121(v)(2)) that was outstanding on December 17, 2004;

(2) The interest is an amount that was taken into account (within the meaning of §31.3121(v)(2)-1(d) of this chapter) prior to January 1, 2005, for purposes of taxation under chapter 21 of the Internal Revenue Code (or income attributable thereto); and

(3) The interest was held before the first date on which the ESOP acquires any employer securities.

(v) No overlap among shares of deemed-owned ESOP shares or synthetic equity. Synthetic equity under this paragraph (f)(2) does not include shares that are deemed-owned ESOP shares (or any rights with respect to deemed-owned ESOP shares to the extent such rights are specifically permitted under section 409(h)). In addition, synthetic equity under a specific subparagraph of this paragraph (f)(2) does not include anything that is synthetic equity under paragraph (f)(2)(i), (ii), (iii) or (iv) of this section.

(3) Related entity. For purposes of this paragraph (f), related entity means any entity in which the S corporation holds an interest and which is a partnership, a trust, an eligible entity that is disregarded as an entity that is separate from its owner under §301.7701-3 of this chapter, or a Qualified Subchapter S Subsidiary under section 1361(b)(3).

(4) Number of synthetic shares-- (i) Synthetic equity determined by reference to S corporation shares. In the case of synthetic equity that is determined by reference to shares of stock of the S corporation, the person who is entitled to the synthetic equity is treated as owning the number of shares of stock deliverable pursuant to such synthetic equity. In the case of synthetic equity that is determined by reference to shares of stock of the S corporation, but for which payment is made in cash or other property (besides stock of the S corporation), the number of shares of synthetic equity treated as owned is equal to the number of shares of stock having a fair market value equal to the cash or other property (disregarding lapse restrictions as described in §1.83-3(i)). Where such synthetic equity is a right to purchase or receive S corporation shares, the corresponding number of shares of synthetic equity is determined without regard to lapse restrictions as described in §1.83-3(i) or to any amount required to be paid in exchange for the shares. Thus, for example, if a corporation grants an employee of an S corporation an option to purchase 100 shares of the corporation's stock, exercisable in the future only after the satisfaction of certain performance conditions, the employee is the deemed owner of 100 synthetic equity shares of the corporation as of the date the option is granted. If the same employee were granted 100 shares of restricted S corporation stock (or restricted stock units), subject to forfeiture until the satisfaction of performance or service conditions, the employee would likewise be the deemed owner of 100 synthetic equity shares from the grant date. However, if the same employee were granted a stock appreciation right with regard to 100 shares of S corporation stock (whether payable in stock or in cash), the number of synthetic equity shares the

employee is deemed to own equals the number of shares having a value equal to the appreciation at the time of measurement (determined without regard to lapse restrictions).

(ii) Synthetic equity determined by reference to shares in a related entity. In the case of synthetic equity that is determined by reference to shares of stock (or similar interests) in a related entity, the person who is entitled to the synthetic equity is treated as owning shares of stock of the S corporation with the same aggregate value as the number of shares of stock (or similar interests) of the related entity (with such value determined without regard to any lapse restriction as defined at §1.83-3(i)).

(iii) Other synthetic equity -- (A) General rule. In the case of any synthetic equity to which neither paragraph (f)(4)(i) nor paragraph (f)(4)(ii) of this section apply, the person who is entitled to the synthetic equity is treated as owning on any date a number of shares of stock in the S corporation equal to the present value (on that date) of the synthetic equity (with such value determined without regard to any lapse restriction as defined at §1.83-3(i)) divided by the fair market value of a share of the S corporation's stock as of that date.

(B) Special rules -- (1) Use of annual or more frequent determination dates. For purposes of this paragraph (f)(4)(iii), while the determination of whether there is a nonallocation year depends on day-by-day determinations under paragraph (c) of this section, the number of shares of S corporation stock treated as owned by a person who is entitled to synthetic equity to which this paragraph (f)(4)(iii) applies is permitted to be determined only annually (or more frequently), as of the first day of the ESOP's plan



year or as of any other reasonable determination date or dates during a plan year. If the ESOP so provides, the number of shares of synthetic equity to which this paragraph (f)(4)(iii) applies that are treated as owned by that person for any period from a given determination date through the date immediately preceding the next following determination date is the number of shares treated as owned on the given determination date.

(2) Use of triannual recalculations. In addition, if the terms of the ESOP so provide, then the number of shares of synthetic equity with respect to grants of synthetic equity to which this paragraph (f)(4)(iii) applies may be fixed for a specified period from a determination date identified under the ESOP through a date that is not later than the day before the determination date that is on or immediately preceding the third anniversary of the identified determination date. Additional accruals, allocations, or grants (to which this paragraph (f)(4)(iii) applies) that are made during such three-year period are taken into account on each determination date during that period, based on the number of synthetic equity shares resulting from the additional accrual, allocation, or grant (determined as of the determination date on or next following the date of the accrual, allocation, or grant). However, the ESOP must provide for the number of shares of synthetic equity to which this paragraph (f)(4)(iii) applies to be re-determined not less frequently than every three years, based on the S corporation share value on a determination date that is not later than the third anniversary of the identified determination date and the aggregate present value of the synthetic equity to which this paragraph (f)(4)(iii) applies (including all grants made during the three-year period) on

that determination date. See Example 3 of paragraph (h) of this section for an example illustrating this paragraph (f)(4)(iii)(B)(2).

(3) Conditions for application of rules. Paragraph (f)(4)(iii)(B) of this section only applies with respect to grants of synthetic equity to which this paragraph (f)(4)(iii) applies. In addition, paragraph (f)(4)(iii)(B)(1) of this section applies only if the fair market value of a share of the S corporation securities on any determination date is not unrepresentative of the value of the S corporation securities throughout the rest of the plan year and only if the terms of the ESOP include provisions conforming to paragraph (f)(4)(iii)(B)(1) of this section which are consistently used by the ESOP for all persons. In addition, paragraph (f)(4)(iii)(B)(2) of this section applies only if the terms of the ESOP include provisions conforming to paragraphs (f)(4)(iii)(B)(1) and (2) of this section which are consistently used by the ESOP for all persons.

(iv) Adjustment of number of synthetic equity shares where ESOP owns less than 100% of S corporation. Under this paragraph (f)(4)(iv), the number of synthetic shares otherwise determined under this paragraph (f)(4) is decreased ratably to the extent that shares of the S corporation are owned by a person who is not an ESOP (and who is subject to federal income taxes). For example, if an S corporation has 200 outstanding shares, of which individual A owns 50 shares and the ESOP owns the other 150 shares, and individual B would be treated under this paragraph (f)(4) as owning 200 synthetic equity shares of the S corporation but for this paragraph (f)(4)(iv), then, under the rule of this paragraph (f)(4)(iv), the number of synthetic shares treated as owned by B under

this paragraph (f)(4) is decreased from 200 to 150 (because the ESOP only owns 75% of the outstanding stock of the S corporation, rather than 100%).

(v) Special rule for shares with greater voting power than ESOP shares.

Notwithstanding any other provision of this paragraph (f)(4), if a synthetic equity right includes (directly or indirectly) a right to purchase or receive shares of S corporation stock that have per-share voting rights greater than the per-share voting rights of one or more shares of S corporation stock held by the ESOP, then the number of shares of deemed owned synthetic equity attributable to such right is not less than the number of shares that would have the same voting rights if the shares had the same per-share voting rights as shares held by the ESOP with the least voting rights. For example, if shares of S corporation stock held by the ESOP have one voting right per share, then an individual who holds an option to purchase one share with 100 voting rights is treated as owning 100 shares of synthetic equity.

(g) Avoidance or evasion of section 409(p) involving synthetic equity--(1) General rule. Paragraph (g)(2) of this section sets forth a standard for determining whether the principal purpose of the ownership structure of an S corporation involving synthetic equity constitutes an avoidance or evasion of section 409(p). Paragraph (g)(3) of this section identifies certain specific ownership structures that constitute an avoidance or evasion of section 409(p). See also paragraph (c)(3) of this section for a rule under which the ownership structures in paragraph (g)(3) result in a nonallocation year for purposes of section 409(p).

(2) Standard for determining when there is an avoidance or evasion of section 409(p) involving synthetic equity- For purposes of section 409(p) and this section, whether the principal purpose of the ownership structure of an S corporation involving synthetic equity constitutes an avoidance or evasion of section 409(p) is determined by taking into account all the surrounding facts and circumstances, including all features of the ownership of the S corporation's outstanding stock and related obligations (including synthetic equity), any shareholders who are taxable entities, and the cash distributions made to shareholders, to determine whether, to the extent of the ESOP's stock ownership, the ESOP receives the economic benefits of ownership in the S corporation that occur during the period that stock of the S corporation is owned by the ESOP. Among the factors indicating that the ESOP receives these economic benefits include shareholder voting rights, the right to receive distributions made to shareholders, and the right to benefit from the profits earned by the S corporation, including the extent to which actual distributions of profits are made from the S corporation to the ESOP and the extent to which the ESOP's ownership interest in undistributed profits and future profits is subject to dilution as a result of synthetic equity, for example, the ESOP's ownership interest is not subject to dilution if the total amount of synthetic equity is a relatively small portion of the total number of shares and deemed-owned shares of the S corporation.

(3) Specific transactions that constitute an avoidance or evasion of section 409(p) involving segregated profits. Taking into account the standard in paragraph (g)(2) of this section, the principal purpose of the ownership structure of an S

corporation constitutes an avoidance or evasion of section 409(p) in any case in which--

(i) The profits of the S corporation generated by the business activities of a specific individual or individuals are not provided to the ESOP, but are instead substantially accumulated and held for the benefit of that individual or individuals on a tax-deferred basis within an entity related to the S corporation, such as a partnership, trust, or corporation (such as in a subsidiary that is a disregarded entity), or any other method that has the same effect of segregating profits for the benefit of such individual or individuals (such as nonqualified deferred compensation described in paragraph (f)(2)(iv) of this section);

(ii) The individual or individuals for whom profits are segregated have rights to acquire 50 percent or more of those profits directly or indirectly (for example, by purchase of the subsidiary); and

(iii) A nonallocation year would occur if this section were separately applied with respect to either the separate entity or whatever method has the effect of segregating profits of the individual or individuals, treating such entity as a separate S corporation owned by an ESOP (or in the case of any other method of segregation of profits by treating those profits as the only assets of a separate S corporation owned by an ESOP).

(h) Examples. The rules of this section are illustrated by the following examples:

Example 1. Relating to determination of disqualified persons and nonallocation year if there is no synthetic equity. (i) Facts. Corporation X is a calendar year S corporation that maintains an ESOP. X has a single class of common stock, of which there are a total of 1,200 shares outstanding. X has no synthetic equity. In 2006, individual A, who is not an employee of X (and is not related to any employee of X), owns 100 shares directly, individual B owns 100 shares directly, and the remaining

1,000 shares are owned by an ESOP maintained by X for its employees. The ESOP's 1,000 shares are allocated to the accounts of individuals who are employees of X (none of whom are related), as set forth in columns 1 and 2 in the following table:

1 Shareholders	2 Deemed-Owned ESOP Shares (total of 1,000)	3 Percentage Deemed-Owned ESOP Shares	4 Disqualified Person
B	330	33%	Yes
C	145	14.5%	Yes
D	75	7.5%	No
E	30	3%	No
F	20	2%	No
Other participants	400 (none exceed 10 shares)	1% or less	No

(ii) Conclusion with respect to disqualified persons. As shown in column 4 in the table above, individuals B and C are disqualified persons for 2006 under paragraph (d)(1) of this section because each owns at least 10% of X's deemed-owned ESOP shares.

(iii) Conclusion with respect to nonallocation year. However, 2006 is not a nonallocation year under section 409(p) because disqualified persons do not own at least 50% of X's outstanding shares (the 100 shares owned directly by B, B's 330 deemed-owned ESOP shares, plus C's 145 deemed-owned ESOP shares equal only 47.9% of the 1,200 outstanding shares of X).

Example 2. Relating to determination of disqualified persons and nonallocation year if there is synthetic equity. (i) Facts. The facts are the same as in Example 1, except that, as shown in column 4 of the table in this example 2, individuals E and F have options to acquire 110 and 130 shares, respectively, of the common stock of X from X:

1 Shareholders	2 Deemed-Owned ESOP Shares (total of 1,000)	3 Percentage Deemed-Owned ESOP Shares	4 Options (240)	5 Shareholder Percentage of Deemed-Owned ESOP plus Synthetic Equity Shares	6 Disqualified Person
B	330	33%			Yes (col. 3)
C	145	14.5%			Yes (col.3)
D	75	7.5%			No
E	30	3%	110	11.1% ([30+91.7] divided by 1,091.7)	Yes (col. 5)
F	20	2%	130	11.6% ([20+108.3] divided by 1,108.3)	Yes (col. 5)
Other participants	400 (none exceeds 10 shares)	1% or less			No

(ii) Conclusion with respect to disqualified persons. Applying the rule of paragraph (f)(4)(iv) of this section, E's option to acquire 110 shares of the S corporation converts into 91.7 shares of synthetic equity (110 times the ratio of the 1,000 deemed-owned ESOP shares to the sum of the 1,000 deemed-owned ESOP shares plus the 200 shares held outside the ESOP by A and B). Similarly, F's option to acquire 130 shares of the S corporation converts into 108.3 shares of synthetic equity (130 times the ratio of the 1,000 deemed-owned ESOP shares to the sum of the 1,000 deemed-owned ESOP shares plus the 200 shares held outside the ESOP by A and B). Accordingly, as shown in column 6 in the table above, individual E's synthetic equity shares are counted in determining whether E is a disqualified person for 2006, and individual F's synthetic equity shares are counted in determining whether F is a disqualified person for 2006, but the synthetic equity shares owned by any person do not affect the calculation for any other person's ownership of shares. Accordingly, individuals B, C, E, and F are disqualified persons for 2006.

(iii) Conclusion with respect to nonallocation year. The 100 shares owned directly by B, B's 330 deemed-owned ESOP shares, C's 145 deemed-owned ESOP shares, E's 30 deemed-owned ESOP shares, E's 91.7 synthetic equity shares, F's 20 deemed-owned ESOP shares, plus F's 108.3 synthetic equity shares total 825, which equals 58.9% of 1,400, which is the sum of the 1,200 outstanding shares of X and the 200 shares of synthetic equity shares of X held by disqualified persons. Thus, 2006 is a nonallocation year for X's ESOP under section 409(p) because disqualified persons own at least 50% of the total shares of outstanding stock of X and the total synthetic equity shares of X held by disqualified persons. In addition, independent of the preceding conclusion, 2006 would be a nonallocation year because disqualified persons own at least 50% of X's outstanding shares because the 100 shares owned directly by B, B's 330 deemed-owned ESOP shares, C's 145 deemed-owned ESOP shares, E's 30 deemed-owned ESOP shares, plus F's 20 deemed-owned ESOP shares equal 52.1% of the 1,200 outstanding shares of X.

Example 3. Relating to determination of number of shares of synthetic equity. (i) Facts. Corporation Y is a calendar year S corporation that maintains an ESOP. Y has a single class of common stock, of which there are a total of 1,000 shares outstanding, all of which are owned by the ESOP. Y has no synthetic equity, except for four grants of nonqualified deferred compensation that are made to an individual during the period from 2005 through 2011, as set forth in column 2 in the following table, and the ESOP uses the special rules in paragraph (f)(4)(iii) of this section to determine the number of shares of synthetic equity owned by that individual, as shown in columns 4 and 5:

1 Determination Date	2 Present Value of Nonqualified Deferred Compensation on Determination Date	3 Share Value on Determination Date	4 New Shares of Synthetic Equity on Determination Date	5 Aggregate Number of Synthetic Equity Shares on Determination Date
January 1, 2005	A grant is made on January 1, 2005 with a present value of \$1,000. An additional grant of nonqualified deferred compensation with a present value of \$775 is made on March	\$10 per share	100	100



	1, 2005.			
January 1, 2006	An additional grant is made on December 31, 2005 which has a present value of \$800 on January 1, 2006. The March 1, 2005 grant has a present value on January 1, 2006 of \$800.	\$8 per share	200	300
January 1, 2007	No new grants made.	\$12 per share		300
January 1, 2008	An additional grant is made on December 31, 2007 which has a present value of \$3,000 on January 1, 2008. The grants made during 2005 through 2007 have an aggregate present value on January 1, 2008 of \$3,750.	\$15 per share	200	450
January 1, 2009	No new grants are made.	\$11 per share		450
January 1, 2010	No new grants are made.	\$22 per share		450
January 1, 2011	No new grants are made. The grants made during 2005 through 2008 have an aggregate present value on January 1, 2011 of \$7,600.	\$20 per share		380

(ii) Conclusion. The grant made on January 1, 2005, is treated as 100 shares until the determination date in 2008. The grant made on March 1, 2005, is not taken into account until the 2006 determination date and its present value on that date, along with the then present value of the grant made on the preceding day, is treated as a number of shares that are based on the \$8 per share value on the 2006 determination date, with the resulting number of shares continuing to apply until the determination date in 2008. On the January 1, 2008, determination date, the grant made on the preceding day is taken into account at its present value of \$3,000 on January 1, 2008 and the \$15 per share value on that date with the resulting number of shares (200) continuing to apply until the next determination date. In addition, on the January 1, 2008, determination date, the number of shares determined under other grants made between January 1, 2005 and December 31, 2007, must be revalued. Accordingly, the aggregate value of all nonqualified deferred compensation granted during that period is determined to be \$3750 on January 1, 2008, and the corresponding number of shares of synthetic equity based on the \$15 per share value is determined to be 250 shares on the 2008 determination date, with the resulting aggregate number of shares (450) continuing to apply until the determination date in 2011. On the January 1, 2011, determination date, the aggregate value of all nonqualified deferred compensation is determined to be \$7,600 and the corresponding number of shares of synthetic equity based on the \$20 per share value on the 2011 determination date is determined to be 380 shares (with the resulting number of shares continuing to apply until the determination date in 2014, assuming no further grants are made).

(i) Effective dates -- (1) Statutory effective date. (i) Except as otherwise provided in paragraph (i)(1)(ii) of this section, section 409(p) applies for plan years ending after March 14, 2001.

(ii) If an ESOP holding stock in an S corporation was established on or before March 14, 2001, and the election under section 1362(a) with respect to that S corporation was in effect on March 14, 2001, section 409(p) applies for plan years beginning on or after January 1, 2005.

(2) Regulation effective date -- (i) General effective date. Except as otherwise provided in paragraph (i)(2)(ii) of this section, this section applies for plan years beginning on or after January 1, 2005.

(ii) Rules for plan years beginning before January 1, 2005. (A) Except as provided in this paragraph (i)(2)(ii), §1.409(p)-1T as in effect prior to December 17, 2004, (see §1.409(p)-1T in 26 CFR Part 1 revised as of April 1, 2004) applies for plan years ending after October 20, 2003, and beginning before January 1, 2005.

(B) Paragraphs (c)(3) and (g) of this section apply for plan years ending on or after December 31, 2004, but do not apply with respect to an interest held in a qualified subchapter S subsidiary (QSUB) of an S corporation or another entity to which paragraph (g)(3) of this section applies before March 15, 2004 if:

(1) All interests in the entity held by individuals who would be disqualified persons under paragraph (g)(3) of this section or under guidance issued by the Commissioner before March 15, 2004 are distributed to those individuals as compensation on or before March 15, 2004; and

(2) No such individual has been a participant in the ESOP of the S corporation at any time after October 20, 2003 and before March 15, 2004.

(C) Paragraph (f)(2)(iv)(B) of this section (providing that synthetic equity does not include certain preexisting nonqualified deferred compensation) applies for plan years ending before January 1, 2005.

(D) Paragraph (f)(4)(iv) of this section (permitting an adjustment of the number of synthetic equity shares where an ESOP owns less than 100% of an S corporation) applies for plan years ending before January 1, 2005.

(E) In no event does this paragraph (i)(2)(ii) apply for any plan year ending before January 1, 2005, for an ESOP holding stock in an S corporation that was established on

or before March 14, 2001, if the election under section 1362(a) with respect to that S Corporation was in effect on March 14, 2001.

(iii) Transition rules. (A) Assets held in the account of a disqualified person as of the last day of the first plan year beginning before January 1, 2005, will not be treated as an impermissible accrual with respect to that disqualified person under paragraph (b)(2)(ii) of this section for the first plan year beginning on or after January 1, 2005, to the extent those assets are not held in that person's account on or after July 1, 2005. Thus, for example, to the extent the assets allocated to the account of a disqualified person as of the last day of the first plan year beginning before January 1, 2005, are transferred to a non-ESOP portion of the plan as described in paragraph (b)(2)(v)(A) of this section before July 1, 2005, those assets will not be treated as an impermissible accrual under paragraph (b)(2)(ii) of this section for the period from the first day of the first plan year beginning on or after January 1, 2005 through June 30, 2005. However, see section 4979A(a)(3), (a)(4), and (e)(2)(C) for excise tax provisions that apply to all deemed-owned shares during the first nonallocation year for the ESOP.

(B) An individual is not treated as a disqualified person during the period from the first day of the first plan year beginning on or after January 1, 2005 through June 30, 2005 if that person would not be a disqualified person during that period under the modified rules of this paragraph (i)(2)(iii)(B) as of any date during that same period. Further, solely for the purpose of determining whether the first plan year beginning on or after January 1, 2005 is a nonallocation year under section 409(p) and this section, if that plan year would not have been a nonallocation year under the modified rules of this

paragraph (i)(2)(iii)(B), then synthetic equity that is not owned by a person on July 1, 2005 is disregarded during the period from the first day of the first plan year beginning on or after January 1, 2005 through June 30, 2005. For purposes of this paragraph (i)(2)(iii)(B), the modified rules of this paragraph (i)(2)(iii)(B) are the rules in §1.409(p)-1T as in effect prior to December 17, 2004 (see §1.409(p)-1T in 26 CFR Part 1 revised as of April 1, 2004), modified to exclude from the definition of synthetic equity any stock option, stock appreciation right (payable in cash or stock), or similar rights with respect to shares of the S corporation or a related entity where the facts and circumstances indicate that there is no reasonable likelihood that the holder of the right will receive the shares (or equivalent value). For this purpose, there is no reasonable likelihood that the holder of the right will receive the shares (or equivalent value) in any case in which the option is based on an exercise price that is more than 200% of the fair market value of the shares on the date of grant or the right (in the case of a stock appreciation right or similar right to acquire shares of the S corporation or a related entity) is payable only if the appreciation exceeds 100% of the fair market value of the shares on the date of grant.

(C) For the period from the first day of the first plan year beginning on or after January 1, 2005 through June 30, 2005, there is no nonallocation year under this section if there would be no nonallocation year under this section during that period if this section were applied without regard to paragraph (f)(4)(v) of this section (relating to voting rights).

(D) This paragraph (iii) does not apply to an ESOP for which the first plan year beginning on or after January 1, 2005 begins after June 30, 2005.

Mark M. Matthews,  
Deputy Commissioner for Services and Enforcement.

Approved: December 7, 2004

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