

Section 409(p).—Qualifications for Tax Credit Employee Stock Ownership Plans — Prohibited Allocations of Securities in an S-Corporation

T.D. 9081

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

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 identifying disqualified persons and determining whether a plan year is a nonallocation year under section 409(p) and on the definition of synthetic equity under section 409(p)(5). These temporary regulations would 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 (REG-129709-03) set forth in the notice of proposed rulemaking on this subject on page 506 of this issue of the Bulletin.

DATES: *Effective Date:* These regulations are effective July 21, 2003.

Applicability Date: These temporary regulations are applicable with respect to plan years ending after October 20, 2003.

FOR FURTHER INFORMATION CONTACT: John T. Ricotta at (202) 622-6060 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

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). Section 4975(e)(7) authorizes the Secretary to issue regulations imposing additional requirements for ESOPs (see §54.4975-11 of the Excise Tax Regulations). A plan is not treated as an ESOP under the Code unless it meets the following requirements, to the extent applicable: 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); section 664(g) (relating to qualified gratuitous transfers of qualified employer securities); and section 409(e) (relating to participants' voting rights if the employer has a registration-type class of securities). As authorized by section 4975(e)(7), additional requirements are imposed under §54.4975-11.

Section 1361(b)(1)(D) provides that a Subchapter S corporation (S corporation) may not have more than one class of stock. Section 1361(b)(1)(B) provides that an S corporation may not have as a shareholder a person that is not an estate, a trust described in section 1361(c)(2), an organization described in section 1361(c)(6), or an individual. In 1996, section 1361(c)(6) was amended to permit a qualified plan under section 401(a) to be a shareholder in an S corporation. Section 1316(a) of the Small Business Job Protection Act of 1996 (SBJPA) (110 Stat. 1755) (1996).

Section 511(a)(1) imposes a tax on the unrelated business taxable income (as defined in section 512(a)) of organizations described in section 511(a)(2),

which include plans that qualify under section 401(a). Section 512(e)(1) provides that if an organization described in section 1361(c)(6) holds stock in an S corporation, the interest is treated as an interest in an unrelated trade or business and, notwithstanding the organization's general tax-exempt status, all items of income, loss, or deduction taken into account under section 1366(a) and any gain or loss on the disposition of the stock in the S corporation are taken into account in computing the unrelated business taxable income of the organization. In 1997, section 512(e) was amended to provide that section 512(e) does not apply to employer securities (within the meaning of section 409(l)) held by an ESOP described in section 4975(e)(7). Section 1523 of the Taxpayer Relief Act of 1997 (TRA '97) (111 Stat. 788) (1997). Accordingly, S corporation income allocable to stock held by an ESOP is not subject to regular income or unrelated business income tax, but S corporation income allocable to stock held by any other qualified plan or tax-exempt entity under section 501(c)(3) is subject to the unrelated business income tax under section 511.

Congress became aware that the tax exemption for earnings on S corporation stock held by an ESOP may lead to inappropriate tax deferral or avoidance in some cases. In order to address these concerns, Congress enacted section 409(p) as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) (115 Stat. 38) (2001). Section 409(p) is intended to limit the tax benefits of ESOPs maintained by S corporations unless the ESOP provides meaningful benefits to rank-and-file employees. As explained in the legislative history:

The Committee continues to believe that S corporations should be able to encourage employee ownership through an ESOP. The Committee does not believe, however, that ESOPs should be used by S corporation owners to obtain inappropriate tax deferral or avoidance.

Specifically, the Committee believes that the tax deferral opportunities provided by an S corporation ESOP should be limited to those situations in which there is broad-based employee coverage

under the ESOP and the ESOP benefits rank-and-file employees as well as highly compensated employees and historical owners.

H. R. Rep. No. 107–51, part 1, at 100 (2001).

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).¹

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 at least 50 percent of its shares. Section 409(p)(3)(B) provides that, in determining the shares owned by an individual for purposes of section 409(p)(3)(A), the attribution rules of section 318(a) apply, with certain exceptions, and the individual is treated as owning his or her deemed-owned ESOP shares.

Under section 409(p)(4)(C)(i), the term *deemed-owned shares* includes, with respect to any person, the stock in the S corporation constituting employer securities of an ESOP which is allocated to that person under the ESOP, and that person’s share of the stock in the S corporation which is held by the ESOP but which is not allocated to participants under the ESOP. Suspense account stock is deemed to be allocated to participants in the same proportion as the most recent plan allocation.

Section 409(p)(4) provides, in general, that whether someone is a “disqualified person” depends on a person’s ownership of 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 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 made without regard to “synthetic equity” attributable to that person and 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 section 409(p)(6)(C), synthetic equity is defined as:

any stock option, warrant, restricted stock, deferred issuance stock right, or similar interest or right that gives the holder the right to acquire or receive stock of the S corporation in the future. Except to the extent provided in regulations, synthetic equity also includes a stock appreciation right, phantom stock unit, or similar right to a future cash payment based on the value of such stock or appreciation in such value.

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 generally treated as outstanding stock in such corporation, and as deemed-owned shares of such person, if such treatment of synthetic equity results either in the treatment of any person as a disqualified person or the treatment of any year as a nonallocation year. Accordingly, if a person is treated as a disqualified person or a year is treated as a nonallocation year without regard to synthetic equity, then the inclusion of synthetic equity as outstanding stock does not cause the person to fail to be treated as a disqualified person or the year to fail to be treated as a nonallocation year.

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). As indicated by the legislative history above, section 409(p) is intended to limit the tax benefits of ESOPs maintained by S corporations unless the

ESOP provides meaningful benefits to rank-and-file employees. See H.R. Rep. No. 107–51, part 1, at 100 (2001). 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). “For example, this might apply if more than 10 independent businesses are combined in an S corporation owned by an ESOP in order to take advantage of the income tax treatment of S corporations owned by an ESOP.” H.R. Conf. Rep. No. 107–84, at 277 (2001).

Under section 656 of EGTRRA, section 409(p) is effective for plan years ending after March 14, 2001, except for those ESOPs eligible for a delayed effective date applicable to certain ESOPs that were established on or before March 14, 2001. See Rev. Rul. 2003–6, 2003–3 I.R.B. 286.

Section 4979A imposes a 50 percent excise tax in certain cases, including an allocation of employer securities that is prohibited by section 409(p), the ownership of any synthetic equity by a disqualified person during a nonallocation year, and the occurrence of the first nonallocation year of an ESOP, as described in section 4979A(e)(2)(C).

Explanation of Provisions

Overview

Section 409(p) was enacted to address concerns about ownership structures involving S corporations and ESOPs that concentrate the benefits of the ESOP in a small number of persons. Under the statute as amended, an ESOP is still permitted to hold S corporation stock, provided that the ESOP benefits a sufficiently broad-based group of employees.

These temporary regulations reflect the statutory language under section 409(p)(1) prohibiting an accrual or allocation in a nonallocation year, but do not provide additional guidance on what constitutes a prohibited accrual or allocation. It is expected that this issue will be addressed in additional regulations.

An ESOP has a nonallocation year for any plan year during which, at any

¹ This definition is different from the definition of disqualified person for purposes of section 4975.

time, disqualified persons hold at least 50 percent of the outstanding shares of stock in the S corporation or 50 percent of the outstanding shares of stock and synthetic equity in the S corporation. These temporary regulations provide guidance on the rules applicable for this purpose. In addition, pursuant to section 409(p)(7)(B), these temporary regulations authorize the Commissioner to provide that a nonallocation year exists in any year in which the principal purpose of the ownership structure is avoidance or evasion of section 409(p). These temporary regulations also provide guidance on identification of disqualified persons.

Synthetic Equity

As discussed above, disqualified persons and nonallocation years are identified both with and without synthetic equity. Section 409(p) defines synthetic equity very broadly. Synthetic equity includes restricted stock, rights to acquire stock in the corporation, such as stock options or warrants, and other similar interests. It also includes payments denominated in share value, including a phantom stock unit, stock appreciation right, or similar interest.

In addition, under these temporary regulations, synthetic equity includes two other categories of interests or payments: nonqualified deferred compensation (even though it is neither payable in, nor calculated by reference to, stock in the S corporation) and rights to acquire interests in certain related entities. In each case, treatment of these interests as synthetic equity is necessary to carry out the Congressional purpose of section 409(p) of limiting the tax deferral opportunities provided by an S corporation ESOP to those situations in which the benefits of the ESOP ownership are available, at a minimum, to a broad group of rank-and-file employees who have the opportunity to be the primary beneficiaries of the growth of the business through the ESOP. Unless these interests are treated as synthetic equity, the benefits associated with ownership of an interest in an S Corporation by means of the ESOP could be concentrated in a small group, and diverted away from the rank-and-file employees, through use of these interests. In this respect, these interests have the same effect as stock

appreciation rights payable in cash, which are explicitly included in synthetic equity by statute.

Nonqualified Deferred Compensation as Synthetic Equity

Since the addition of section 409(p), arrangements have been promoted to taxpayers in which an S corporation that is either entirely or substantially owned by an ESOP is used to shelter the income of an active business while the profits of the business are primarily provided for certain management employees of the business through various obligations to make future payments to the employees. Typically in these arrangements, the obligation to make future payments to the management employees suppresses the value of the company's stock that is allocated to rank-and-file employees through the ESOP, depriving them of the opportunity to be the primary beneficiaries of the growth of the business through the ESOP.

For example, under some of these arrangements, the owners of the operating company establish a management company and the operating company agrees to pay management fees equal to substantially all (or most) of the profits of the operating company. The management company agrees to provide future compensation to certain executives or other employees of the operating company or the management company in an amount equal to substantially all of the profits of the management company. Finally, the management company elects to be treated as an S corporation and transfers all, or a substantial portion, of its stock to an ESOP established to cover rank-and-file employees. Under this arrangement, the operating company claims a deduction for the fees paid to the management corporation. The management corporation in turn retains these fees to satisfy its obligations to pay future compensation. Although the stock of the management corporation is owned by the ESOP, the ownership interest held for rank-and-file employees through the ESOP has a substantially reduced value. Rather than being a mechanism for the transfer of not only ownership, but also the rights associated with ownership, to the employees of the S corporation, the ESOP is used as part of a structure designed to shelter profits that will be paid

as future compensation for a small group of executives or management employees.

These temporary regulations treat nonqualified deferred compensation provided by the S corporation or certain related entities as synthetic equity, including deferred compensation that is neither payable in stock of the S corporation nor calculated by reference to stock of the S corporation. S Corporations that do not maintain ESOPs typically do not provide nonqualified deferred compensation to owners. By treating nonqualified deferred compensation provided by the S corporation (or certain related entities) as synthetic equity, these temporary regulations address ownership structures that are designed to avoid or evade section 409(p) and provide guidance allowing individuals to determine when these interests result in a failure to comply with section 409(p). Nonqualified deferred compensation is appropriately characterized as synthetic equity because it functions similarly to other forms of synthetic equity by diverting value away from shareholders, thereby reducing the value of the S corporation and diminishing the ESOP's interest in the value that, absent the nonqualified deferred compensation, would be reflected in the shares of the S corporation held by the ESOP. This effect occurs even if the nonqualified deferred compensation is a fixed dollar amount, and even if such deferred compensation is not payable in stock of the S corporation or measured by reference to that stock (directly, such as a stock appreciation right payable in cash, or less directly, such as percentage of the future profits of the S corporation).

Right to Acquire Assets as Synthetic Equity

Under these temporary regulations, rights to acquire stock or other similar interests in a related entity are treated as synthetic equity if the ownership of such interests in the related entity is the only significant asset of the S corporation and the S corporation is the only significant holder of stock (or other similar interests) of the related entity. For this purpose, related entities are entities in which the S corporation holds an interest and with respect to which income is passed through to the S corporation. These rights are

properly treated as synthetic equity because they provide the holders of these rights with an opportunity to benefit from the S corporation ESOP structure that is comparable to the opportunity provided through synthetic equity issued directly by the S corporation. Taking rights to acquire stock or other similar interests in a related entity into account as synthetic equity provides a method for identifying situations in which the interests in the S corporation (and its assets) have, directly or indirectly, become concentrated in a manner that should result in a nonallocation year under section 409(p).

These temporary regulations provide that synthetic equity does not include rights to acquire goods or services at fair market value in the ordinary course of business. The temporary regulations do not address, at this time, rights to acquire other assets of the S Corporation or assets of the related entity or other related entities. This absence should not be interpreted as a conclusion that a right to acquire these other assets cannot be synthetic equity. It may be appropriate to treat the right to acquire assets of the S Corporation, other than its interest in a related entity (such as its ownership of a manufacturing plant), as synthetic equity. It may also be appropriate to treat rights to acquire assets held by the related entity as synthetic equity.

The temporary regulations also do not address rights to acquire interests in related entities if the ownership of such interests in the related entity is not the only significant asset of the S corporation or the S corporation is not the only significant holder of stock (or other similar interests) of the related entity. Rights to acquire interests in other related entities is reserved because, for example, it may be appropriate in cases in which a related entity is not the only significant asset of the S Corporation to treat as synthetic equity only a portion of the value of the rights to acquire stock or other similar interests in the related entity.

The IRS and Treasury intend to issue additional regulations providing guidance on the definition of synthetic equity on a number of issues, including issues identified as reserved in these temporary regulations. For example, the IRS and Treasury intend to issue additional guidance relating to rights to acquire interests in other related entities and rights to acquire assets of an

S corporation or related entity. The additional regulations are expected to address the treatment of these interests, including how any such interests treated as synthetic equity should be converted into shares of synthetic equity in the S corporation and whether such conversion should take into account the extent to which income of the related entity is allocated to a shareholder that is subject to regular income tax or unrelated trade or business income tax. These items are reserved in order to allow for additional consideration of these issues, including consideration of comments on the proposed regulations accompanying these regulations. The additional regulations are expected to be issued in conjunction with guidance on prohibited accruals or allocations to disqualified persons in a nonallocation year, which is also identified as reserved in these temporary regulations.

In the meantime, these temporary regulations provide an anti-abuse provision treating acquisition rights as synthetic equity in certain situations. Specifically, this treatment applies to an option or right to acquire assets of the S corporation, or a related person, that is part of a structure that provides rights to the holder comparable to the rights provided by arrangements identified as synthetic equity under these temporary regulations and in which the principal purpose of the structure is the avoidance or evasion of section 409(p). In addition, the temporary regulations delegate authority to the Commissioner to provide, through revenue rulings, notices and other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(b) of this chapter), that synthetic equity includes a right to acquire stock or other similar interests in a related entity in cases in which the S corporation's interest in the related entity is not the only significant asset of the S corporation or the S corporation is not the only significant owner of the related entity.

Rights to Acquire Shares of Stock That are Issued and Outstanding

The definition of synthetic equity provides that rights to acquire shares in an S corporation with respect to shares that are, at all times during the period when such rights are effective, both issued and outstanding and held by persons other than the ESOP, S corporation, or a related entity are

not synthetic equity. These arrangements include, for example, rights of first refusal held by one shareholder in the S corporation with respect to the shares of another taxable shareholder (*i.e.*, shares held outside the tax-exempt structure created by the ESOP). However, in certain limited cases, a disqualified person who has the right to acquire such issued and outstanding stock is treated as owning the stock if such treatment results in a nonallocation year.

Conversion of Synthetic Equity

Synthetic equity that is determined by reference to shares of S corporation stock is treated as the corresponding number of shares of stock. Synthetic equity that is determined by reference to shares of stock (or similar interests) in a related entity is converted into an equivalent number of 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)). The value of any other synthetic equity interest, such as fixed dollar nonqualified deferred compensation, is converted into an equivalent number of shares of stock in the S corporation based on the present value of the interest or right to nonqualified deferred compensation (with such value determined without regard to any lapse restriction as defined at §1.83-3(i)) and the fair market value of the S corporation shares on the determination date (with both values determined as of any reasonable date during the plan year).

Identification of Disqualified Persons

Under these temporary regulations, a person is a disqualified person based either on deemed-owned ESOP shares or deemed-owned ESOP shares combined with synthetic equity. Whether there is a nonallocation year is then determined by taking into account the holdings of all disqualified persons, first based only on outstanding shares of stock of the corporation and then based on outstanding shares of stock and synthetic equity of the corporation. In accordance with the last sentence of section 409(p)(5), synthetic equity cannot result in a person who is

treated as a disqualified person for a year, or a year that is treated as a nonallocation year, not being so treated. In addition, these temporary regulations provide that, in any year in which the Commissioner provides that a nonallocation year occurs because the principal purpose of the ownership structure of the S corporation is an avoidance or evasion of section 409(p), the Commissioner may also treat any individual as a disqualified person.

As a result of the provisions of these temporary regulations relating to synthetic equity, employees who benefit from non-qualified deferred compensation arrangements or who hold rights to acquire interests in certain related entities will be treated as owning synthetic equity and may be treated as disqualified persons. As a result, certain plan years of the ESOP may be treated as nonallocation years. This result will not occur unless the aggregate interest held by disqualified persons — through synthetic equity, direct share ownership, and deemed-owned ESOP shares — constitutes at least half of the value of the outstanding stock and synthetic equity of the S corporation.

Effective Date

In the case of an ESOP holding stock in an S corporation that is eligible for the delayed effective date under section 656(d)(2) of EGTRRA applicable to certain ESOPs established on or before March 14, 2001, these temporary regulations do not apply until plan years beginning on or after January 1, 2005. For an ESOP to which the delayed effective date is not applicable, these temporary regulations are applicable with respect to plan years ending after October 20, 2003. The temporary regulations permit S corporations to avoid having nonqualified deferred compensation treated as synthetic equity under paragraph (f)(2)(iv) of these temporary regulations by distributing the deferred compensation by July 21, 2004.

Request for Comments in Proposed Regulations and Future Guidance

See the preamble of the cross-reference notice of proposed rulemaking published elsewhere in this issue of the Bulletin which asks for comments with respect to issues raised by S corporation ESOPs.

Special Analysis

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 this issue of the Bulletin. 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.

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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 added to read as follows:

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

(a) *Organization of this section.* Sections 409(p) and 4979A apply if a non-allocation year occurs in an employee stock ownership plan (ESOP), as defined in section 4975(e)(7), that holds shares of stock of a Subchapter S corporation (S corporation) 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 an 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 a 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).

(b) *Prohibited accruals 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 (or be allocated directly or indirectly under any plan of the employer meeting the requirements of section 401(a)) for the benefit of any disqualified person.

(2) *Additional rules.* [Reserved]

(c) *Nonallocation year—(1) Definition generally.* 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 aggregate number of outstanding shares of stock (including deemed-owned ESOP shares) and synthetic equity in the S corporation.

(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.* 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.

(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 rights are 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)(2)(iii)(A)(4) of this section).

(ii) This paragraph (c)(4) applies only if treating persons as owning the shares described in paragraph (c)(4)(i) results in a nonallocation year. This paragraph (c)(4) does not apply to a right 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, and does not apply for purposes of determining ownership of deemed-owned ESOP shares or whether an interest constitutes synthetic equity (see the last sentence of paragraph (f)(2)(i)).

(d) *Disqualified persons* — (1) *General rule.* A *disqualified person* is any person for whom —

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

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

(iii) The aggregate number of 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 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 aggregate number of deemed-owned ESOP and synthetic equity shares of the S corporation.

(2) *Treatment of family members; definition.* (i) 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. *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) or (iii) of this section.

(ii) 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 for purposes of this paragraph (d)(2).

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

(e) *Deemed-owned ESOP shares.* 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 most recent stock allocation under the ESOP).

(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 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 or appreciation in such value, such as 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 assets of an S corporation or related entity*—(A) *Rights to acquire interests in a related entity* — (1) *Treatment as synthetic equity.* *Synthetic equity* includes a right to acquire stock or other similar interests in a related entity that is described in this paragraph (f)(2)(iii)(A).

(2) *Significant interests.* *Synthetic equity* includes a right to acquire stock or other similar interests in a related entity if such interests in the related entity are the only significant asset of the S corporation and the S corporation is the only significant owner of the related entity. Whether an asset is the only significant asset of the

S corporation or the S corporation is the only significant owner of the related entity depends on the relevant facts and circumstances.

(3) *Rights to acquire interests in other related entities.* [Reserved]

(4) *Related entity.* For purposes of this section, *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).

(B) *Rights to acquire assets of an S corporation or related entity other than rights to acquire stock or similar interests in a related entity—(1) General rule.* [Reserved]

(2) *Exception for rights to acquire goods or services in ordinary course of business.* *Synthetic equity* does not include rights to acquire goods or services at fair market value in the ordinary course of business.

(C) *Authority to provide guidance.* 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 *synthetic equity* includes a right to acquire stock or other similar interests in a related entity in cases in which such interests in the related entity are not the only significant asset of the S corporation or the S corporation is not the only significant owner of the related entity if necessary to carry out the purposes of section 409(p).

(D) *Synthetic equity includes comparable rights.* An option or right to acquire assets of the S corporation or another person is treated as synthetic equity if such option or right is part of a structure that provides rights to the holder comparable to the rights provided by arrangements identified as synthetic equity under this paragraph (f)(2)(iii) and the principal purpose of the structure is the avoidance or evasion of section 409(p).

(iv) *Special rule for nonqualified deferred compensation.* *Synthetic equity*

also includes any remuneration for services rendered to the S corporation, or a related entity, to which section 404(a)(5) applies (including 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) in a future year for the performance of services to an S corporation, or related entity, and any transfer of property (to which section 83 applies) in connection with the performance of services to an S corporation, or a related entity, 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. *Synthetic equity* also includes any other remuneration for services rendered to the S corporation, or a related entity, under a plan, or method or arrangement, deferring the receipt of compensation to a date that is after the 15th day of the 3rd calendar month after the end of the entity's taxable year in which the related services are rendered, other than a plan that is an eligible retirement plan within the meaning of section 402(c)(7)(B).

(3) *No overlap among shares of deemed-owned ESOP shares or synthetic equity.* Synthetic equity under this paragraph (f) does not include shares that are deemed-owned ESOP shares. In addition, synthetic equity under a specific subparagraph of this paragraph (f) does not include anything that is synthetic equity under a preceding subparagraph of this paragraph (f).

(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 corresponding number of shares of stock. For example, if a corporation grants an employee of an S corporation an option to purchase 100 shares of the corporation's stock, the employee is the deemed owner of 100 synthetic equity shares of the stock of the corporation.

(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.* In the case of any other synthetic equity, 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 at §1.83-3(i)) divided by the fair market value of a share of the S corporation's stock as of the same date. For purposes of this paragraph (f)(4)(iii), the number of shares of S corporation is permitted 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 corporation for this purpose for all persons. 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.

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

Example 1. (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. (i) Facts. The facts are the same as in *Example 1*, except that, as shown in column 4 of the table below, individual E has an option to acquire 500 shares 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 Synthetic Equity (500)	5 Percentage Deemed-Owned ESOP plus Synthetic Equity Shares (total of 1,500)	6 Disqualified Person
B	330	33%		22%	Yes (cols. 3 and 5)
C	145	14.5%		9.7%	Yes (col. 3)
D	75	7.5%		5%	No
E	30	3%	500	35.3%	Yes (col. 5)
F	20	2%		1.3%	No
Other participants	400 (none exceed 10 shares)	1% or less		under 1%	No

(ii) *Conclusion with respect to disqualified persons.* E's option constitutes 500 shares of synthetic equity. Accordingly, as shown in column 6 in the table above, individuals B, C, and E are disqualified persons for 2006 because each owns at least 10% of X's deemed-owned ESOP shares or X's total deemed-owned ESOP and synthetic equity shares.

(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, plus E's 500 synthetic equity shares equals 65% of the 1,700 outstanding and synthetic equity shares of X. Thus, 2006 is a nonallocation year for X's ESOP under section 409(p) because disqualified persons own at least 50% of X's total shares of outstanding stock and synthetic equity. 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,

plus E's 30 deemed-owned ESOP shares equals 50.4% of the 1,200 outstanding shares of X.

(h) *Effective date* —(1) *General effective dates.* Except as provided in paragraph (h)(2) of this section, section 409(p) applies for plan years ending after March 14, 2001, and this section applies for plan years ending after October 20, 2003, except that paragraph (f)(2)(iv) of this section is disregarded with respect to nonqualified deferred compensation that is distributed on or before July 21, 2004.

(2) *Certain ESOPs established on or before March 14, 2001.* 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) and this section apply for plan years beginning on or after January 1, 2005.

Robert E. Wenzel,
Deputy Commissioner for Ser-
vices and Enforcement.

Approved July 9, 2003.

Pamela F. Olson,
Assistant Secretary of Treasury
(Tax Policy).

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