¶ 11.06 Qualified Deferred Compensation Plans

¶ 11.06[1] Current Law

S corporations generally can use the same kinds of qualified deferred compensation plans that are available to C corporations. For taxable years starting after 1983, Congress repealed the special restrictions that applied to S corporations.[156] Thus, S corporations, C corporations, and partnerships are largely subject to the same rules in this area.[157]

Adoption of a qualified deferred compensation plan offers three principal income tax advantages. First, the corporation ordinarily may currently deduct contributions made under the plan.[158] Second, the employees who are beneficiaries of the plan generally are not taxed until they receive actual distributions.[159] Third, the plan's income generally accumulates without any tax.[160]

A major drawback of a qualified plan, however, is the requisite delay in the employees' receipt of their benefits under the plan.[161] A second disadvantage (from the point of view of employed shareholders) is that the plan must also cover employees of the corporation who are not shareholders in the corporation (and must do so on a relatively nondiscriminatory basis).[162] Contributions under a qualified plan are deductible only to the extent that the contributions, together with other compensation, are reasonable in amount.[163] In judging whether a corporation's contributions under the plan are reasonable, courts apparently may consider prior work done for the corporation, but not for another entity such as a partnership or proprietorship.[164]

Section 414(b) combines certain S corporations if they are "members" of a controlled group. An S corporation may be a "member" for this purpose even if it is an "excluded member" for other purposes. [165]

Section 1372 treats an S corporation as a partnership with respect to "employee fringe benefits." The statute, however, fails to define the term "employee fringe benefits." [166] Presumably, a qualified deferred compensation plan is not such a benefit.

To support deductions with respect to a qualified retirement plan, an S corporation must pay compensation to a shareholder-employee. The income that passes through under **Section 1366** is not enough. [167]

Qualified plan as the shareholder of an S corporation. In 1996, Congress for this first time allowed qualified retirement plans to own the stock of S corporations. [168] An S corporation may have only seventy-five shareholders. For this purpose, a qualified retirement plan counts as one shareholder. [169]

In general, a qualified retirement plan pays no income taxes. Special rules, however, may impose the unrelated business income tax with respect to the S corporation stock held by such a plan. [170]

An "employee stock ownership plan" may provide certain special tax benefits for a corporate employer and its shareholders. These special benefits, however, do not apply if the employer is an S corporation. [171]

Rollover from employee stock ownership plan to IRA. The Service has issued special procedures for a direct rollover of S corporation shares from an employee stock ownership plan to the individual retirement account of a participant. [171.1] To keep S status, the corporation must immediately buy the shares. The Service has also ruled regarding the calculation of "net unrealized appreciation" for purposes of **Section 402(e)(4)** when an employee stock ownership plan distributes S corporation shares. [171.2]

Special rules for employee stock ownership plan that owns S shares (Section 409(p)). In 2001, Congress adopted special rules that apply to an employee stock ownership plan that owns the shares of an S corporation. [171.3] Congress wanted to "limit the establishment of ESOPs by S

corporations to those that provide broad-based employee coverage and that benefit rank-and-file employees as well as highly compensated employees and historical owners." [171.4]

In 2003, the Service issued temporary regulations on this topic. [171.5] The Service then revised the temporary regulations in 2004. [171.6] In 2007, the Service issued final regulations. [171.7]

An employee stock ownership plan that holds employer securities consisting of S corporation stock must provide that no portion of the assets attributable to such employer securities (or allocable in lieu of them) may, during a *nonallocation year*, accrue (or be allocated directly or indirectly under a qualified plan) for the benefit of any *disqualified person*. [171.8] A violation of this rule may occur, for example, "if income on S corporation stock held by an ESOP is allocated to the account of an individual who is a disqualified person." [171.9] If the plan does not meet this requirement, the Code treats any offending allocation as a distribution to the disqualified person. [171.10] That person must pay taxes on the distribution. [171.11] Excise taxes may apply. [171.12] Finally, the regulations indicate that the employee stock ownership plan will cease to qualify under **Section 401**, and, as a result, the corporation may lose its S status. [171.13]

Prevention of prohibited allocations. Because of the severe consequences of violating the rules in a nonallocation year, an employee stock ownership plan and an S corporation will wish to avoid any violation. To help, the regulations allow an employee stock ownership plan to prevent a violation by transferring certain assets to a qualified plan that is not an employee stock ownership plan. [171.14]

Nonallocation year. A "nonallocation year" is any plan year of an employee stock ownership plan if, at any time during the year, the plan holds employer securities consisting of S corporation stock and disqualified persons own at least 50 percent of the number of shares of stock of the S corporation. [171.15] For this purpose, the attribution rules of **Section 318(a)** apply, [171.16] but with a modified definition of "family" [171.17] and without the option attribution rule. [171.18] Further, the Code treats an individual as owning the "deemed-owned shares," which are shares actually held by the ESOP. [171.19] The regulations treat a person as owning certain outstanding shares subject to an option if the effect is to create a nonallocation year. [171.20]

Special rules on "synthetic equity" may apply to help create a nonallocation year. [171.21] Those rules are discussed below.

Disqualified person. A person may be a disqualified person under any of five definitions. First, a person is a disqualified person if the total number of deemed-owned shares of that person and that person's family[171.22] are at least 20 percent of the number of deemed-owned shares in the S corporation.[171.23] Second, a person is a disqualified person if the total number of deemed-owned shares and synthetic equity shares of that person and that person's family are at least 20 percent of the sum of the number of deemed-owned shares in the S corporation and the synthetic equity shares owned by the person in question and that person's family.[171.24] Third, if either of the prior two sentences makes a person a disqualified person, then any member of that person's family who owns deemed-owned shares or synthetic equity shares is a disqualified person.[171.25] Fourth, a person is a disqualified person if the deemed-owned shares of that person are at least 10 percent of the number of deemed-owned shares of the S corporation.[171.26] Fifth, a person is a disqualified person if that person's deemed-owned shares and synthetic equity shares are at least 10 percent of the sum of the total number of deemed-owned shares and that person's synthetic equity shares of the S corporation.[171.27]

These definitions of disqualified person depend on deemed-owned shares and synthetic equity.[171.28] Note, however, that they ignore stock owned directly by individuals.[171.29]

A special rule may apply in a case involving tax avoidance. Under certain conditions, the Service may treat any person as a disqualified person.[171.30]

A person's “deemed-owned shares” include the shares of the S corporation that constitute employer securities and that are allocated to that person's account under the employee stock ownership plan.[171.31] Further, a person's “deemed-owned shares” include that person's “share” of the S corporation's stock that is held by the plan, but that is not allocated under the plan to participants.[171.32] To define that “share,” the Code looks to amount of unallocated stock that would be allocated in the same proportions as the most recent stock allocation under the plan.[171.33] Note that deemed-owned shares do not include stock that an individual employee owns directly.[171.34]

Synthetic equity. **Section 409(p)** contains rules on “synthetic equity” that may help create a nonallocation year or a disqualified person.[171.35] In no event will the rules help a taxpayer avoid such a result.[171.36]

Suppose that a person owns “synthetic equity” in an S corporation. If either of the following two results occurs, then the Code treats the shares on which the synthetic equity is based as outstanding stock of the corporation and deemed-owned shares held by such person.[171.37] The first result is that the person becomes a disqualified person.[171.38] The second result is that a year is treated as a nonallocation year.[171.39]

Under the Code, “synthetic equity” means any stock option, warrant, restricted stock, deferred issuance stock right, or similar interest or right that gives the holder the right to acquire stock of the S corporation.[171.40] Further, synthetic equity also includes a stock appreciation right, phantom stock unit, or similar right to a cash payment based on the value of stock or appreciation in value.[171.41] On the other hand, under narrow conditions, a right of first refusal to acquire stock held by an employee stock ownership plan is not synthetic equity.[171.42]

Under the regulations, synthetic equity includes a right to acquire stock or a similar interests in a related entity to the extent of the S corporation's ownership.[171.43] For this purpose, a “related entity” is an entity in which the S corporation holds an interest and that is a partnership, trust, qualified subchapter S subsidiary, or disregarded entity.[171.44]

The regulations treat several types of nonqualified deferred compensation as synthetic equity.[171.45] Synthetic equity includes pay for services rendered to the S corporation or a related entity to which **Section 404(a)(5)** applies.[171.46] Synthetic equity includes any right to receive property to which **Section 83** applies in a future year for the performance of services to an S corporation or a related entity.[171.47] Synthetic equity includes 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 by the end of the plan year in which transferred.[171.48] Finally, synthetic equity includes any other remuneration for services under a plan deferring the receipt of compensation to a date that is after the fifteenth day of the third calendar month after the end of the entity's taxable year in which the services are rendered.[171.49] Nevertheless, synthetic equity does not include benefits under a plan that is an “eligible retirement plan”.[171.50]

The definition of synthetic equity will not produce any duplication. Any deemed-owned ESOP shares cannot be synthetic equity.[171.51] An item that is synthetic equity under one rule will not be synthetic equity under another rule.[171.52]

If synthetic equity exists, the regulations have to define the number of synthetic equity shares. Suppose that the synthetic equity is determined by reference to a number of shares of the S corporation. In that case, the number of shares that are deliverable is the number of synthetic equity shares. [171.53] For example, a person who has an option to buy 100 shares of S corporation stock owns 100 synthetic equity shares. [171.54]

Matters become more complex if the synthetic equity is determined by reference to an interest in a related entity. If the synthetic equity is determined by reference to shares (or similar interests) in a related entity, the owner is treated as owning shares of the S corporation with the same total value as the number of shares (or similar interests) of the related entity. [171.55]

For other types of synthetic equity, the regulations treat the owner of the synthetic equity as owning, as of any date, a number of S corporation shares equal to the present value of the synthetic equity divided by the fair market value of a share of the S corporation's stock. [171.56] An employee stock ownership plan may apply this test annually or more often by setting one or more determination dates during the year. [171.57] Furthermore, a plan may fix the number of shares of synthetic equity for three years. [171.58]

Suppose that an employee stock ownership plan owns less than 100 percent of the stock of an S corporation. Suppose further that persons that are subject to income taxes own the rest of the stock. In that case, the regulations reduce ratably the synthetic equity that would otherwise be determined under the regulations. [171.59]

Suppose that synthetic equity gives the holder the right to shares of an S corporation with greater per-share voting rights than the shares held by the employee stock ownership plan. In that case, the regulations treat the holder as owning an increased number of shares of synthetic equity based on the extra voting rights. [171.60]

The rules on synthetic equity interact with the rules of attribution. The Code provides that synthetic equity shall be treated as owned by a person in the same manner as stock under **Sections 318(a)(2)** (from entity) and **318(a)(3)** (to entity). [171.61] After the application of **Sections 318(a)(2)** and **318(a)(3)**, other attribution rules apply for certain purposes. [171.62]

Avoidance or evasion. The Code allows the Service to issue regulations or guidance providing that a nonallocation year occurs if the principal purpose of the ownership structure of an S corporation is an avoidance or evasion of **Section 409(p)**.[171.63] Congress was concerned that several businesses might combine in one S corporation owned by one employee stock ownership plan to avoid **Section 409(p)**.[171.64] If a nonallocation year arises under this rule, the Service may treat any person as a disqualified person.[171.65]

The regulations contain general standards on when the principal purpose of an ownership structure involving synthetic equity constitutes avoidance or evasion.[171.66] The regulations look at all the facts and circumstances.[171.67] The regulations are specifically concerned about whether the employee stock ownership plan receives the economic benefits of its ownership in the S corporation.[171.68] The regulations state that dilution of ownership by the employee stock ownership plan does not occur if the synthetic equity is a "relatively small portion" of the total number of shares and deemed-owned shares of the S corporation.[171.69]

A principal purpose of avoiding or evading **Section 409(p)** will exist in any case in which the following three tests are met:

1. The profits of the S corporation generated by the activities of specific individuals are not provided to the employee stock ownership plan but instead are accumulated for the individuals on a tax-deferred basis within an entity related to the S corporation or by some other method;[171.70]

2. The individuals have the right to acquire 50 percent or more of those profits;[171.71] and

3. A nonallocation year would occur if the regulations were applied to those profits and the entity or method in question.[171.72]

If these three tests are met, a nonallocation year results.[171.73] Furthermore, the individuals in question are disqualified persons.[171.74] Finally, the interests that the individuals have in the subsidiary entity are synthetic equity.[171.75]

Effective date. For certain plans and S corporations, **Section 409(p)** applies to plan years starting after 2004.[171.76] For other plans, however, **Section 409(p)** took effect for plan years ending after March 14, 2001.[171.77] The final regulations apply for plan years starting after 2005.[171.78]

ESOP loan payments. An ESOP may borrow money and buy stock in an S corporation. In 2004, Congress added **Section 4975(f)(7)** to provide that such an ESOP generally may use distributions from the S corporation to make payments on such a loan.[171.79] This change applies to distributions made after 1997.[171.80]

Section 4975(f)(7) provides that a plan generally will not violate **Section 401** or **409**, and will not engage in a prohibited transaction, by reason of a distribution[171.81] with respect to S corporation stock that is qualifying employer securities that in accordance with the plan is used to make payments on a loan used to acquire those securities.[171.82] This favorable rule does not apply, however, in the case of a distribution that is paid with respect to any employer security that is allocated to a participant unless the plan provides that employer securities with a fair market value of not less than the amount of such distribution are allocated to such participant for the year for which the distribution would have been allocated to such participant (but for the favorable rule).[171.83]

156

See Tax Equity and Fiscal Responsibility Act of 1982, § 241(a), Pub. L. No. 97-248, 96 Stat. 324.

157

See generally Ness & Vogel, ¶ 4.02[5]. Lassila, “The Top-Heavy Plan Rules and S Corporations,” 7 J. S Corp. Tax'n 84 (1995).

158

IRC §§ 404(a), **162**. The Code limits the amount of deductions that may be claimed for contributions to a qualified plan. See, e.g., **Leonard R. Rubin, 103 TC 200 (1994)** .

159

IRC § 402.

160

IRC § 501(a).

161

If the shareholders of an S corporation use the property of a deferred compensation trust as their own, the trust may lose its qualification and the corporation may lose its deductions. See **Harry F. Lansing, P-H TC Memo ¶ 76,313 (1976)** .

162

See **IRC §§ 401(a)(4)**, regarding contributions and benefits, and 410(b) regarding coverage; **Loevsky v. Comm'r, 471 F2d 1178 (3d Cir.), cert. denied, 412 US 919 (1973)** (S corporation could not deduct contributions under pension plan that discriminated in favor of shareholders by failing to cover almost all other employees); **Elgin B. Robertson, Jr., 61 TC 727 (1974)** (S corporation's plan discriminated in favor of shareholders by basing contributions on undistributed taxable income as well as compensation). See generally Ness & Vogel, ¶¶ 9.13–9.15.

163

Treas. Reg. § 1.404(a)-1(b). **IRC § 404(a)** refers to general standards of deductibility.

164

Angelo J. Bianchi, 66 TC 324 (1976), aff'd without published opinion, 553 F2d 93 (2d Cir. 1977) (contribution by new S corporation was unreasonably high; court would not consider prior services rendered by employee when self-employed in same dental practice; corporation's net operating loss was lower by the amount of the disallowed deduction); **Anthony LaMastro, 72 TC 377 (1979)** (same). The Tax Court discussed and distinguished the *Bianchi* and *LaMastro* cases in **Plastic Eng'r & Mfg. Co., 78 TC 1187, 1192 n.4 (1982)** .

165

See generally **¶ 3.07[4]**. See also **Treas. Reg. § 1.414(b)-1(a)**.

166

See supra **¶ 11.04**.

167

See **Durando v. US, 70 F3d 548 (9th Cir. 1995)** .

168

See **IRC § 1361(c)(6)**, discussed at **¶ 3.03[17]**.

This provision does *not* allow an individual retirement account to be an S shareholder. See **Ltr. Rul. 200035017 (May 30, 2000)**.

169

HR Rep. No. 737, 104th Cong., 2d Sess. 231, reprinted in 1996-3 CB 741, 971. **Section 1361(b)(1)(A)** now allows an S corporation to have up to 100 shareholders. See **¶ 3.04**.

170

See **¶ 7.13**. As discussed at **¶ 7.13**, the unrelated business income tax does not apply with respect to employer securities held by an employee stock ownership plan. See **IRC § 512(e)(3)**.

171

See **¶ 3.03[17]**.

171.1

See **Rev. Proc. 2003-23, 2003-11 IRB 599**, discussed at **¶ 3.03[17]**.

171.2

Rev. Rul. 2003-27, 2003-11 IRB 597, discussed at **¶ 3.03[17]**.

171.3

Economic Growth and Tax Relief Reconciliation Act of 2001, § 656, adding **IRC § 409(p)**. For an example of an S corporation owned by an ESOP, see **Weekend Warrior Trailers, Inc., RIA TC Memo ¶ 2011-105 (2011)** (held that S corporation should not be disregarded for tax purposes). See discussion in Sullivan, "Taxpayer Wins Economic Substance Argument But Loses Most Deductions," 13 Bus. Entities 24 (Sept./Oct. 2011).

Diamond, "Subchapter S and ESOP: The Perfect Marriage," 62 NYU Inst. on Fed. Tax'n 2-1 (2004).

171.4

HR Conf. Rep. No. 84, 107th Cong., 1st Sess. 274 (2001). **TD 9081, 2003-35 IRB 420, 421**, stated “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.”

171.5

TD 9081, 2003-2 CB 420, adopting former Temp. Reg. § 1.409(p)-1T.

171.6

TD 9164, 2005-1 CB 320, adopting **Temp. Reg. § 1.409(p)-1T**. Regarding the application of these temporary regulations, see **Treas. Reg. § 1.409(p)-1(i)(2)**.

171.7

TD 9302, 2007-1 CB 382, adopting **Treas. Reg. § 1.409(p)-1**.

171.8

IRC § 409(p)(1); **Treas. Reg. §§ 1.409(p)-1(a)(1)**, **1.409(p)-1(b)(1)**. For detailed rules on impermissible accruals and allocations, see **Treas. Reg. § 1.409(p)-1(b)(2)**, discussed in **TD 9302, 2007-1 CB 382, 383**.

Regarding the definition of employee stock ownership plan, **IRC § 409(p)(6)(A)** and **Treas. Reg. § 1.409(p)-1(a)(2)(v)** refer to **IRC § 4975(e)(7)**. Regarding the definition of employer securities, **IRC § 409(p)(6)(B)** and **Treas. Reg. § 1.409(p)-1(a)(2)(iv)** refer to **IRC § 409(l)**.

171.9

HR Conf. Rep. No. 84, 107th Cong., 1st Sess. 276 (2001).

171.10

IRC § 409(p)(2)(A). Regarding the consequences of an impermissible allocation or accrual, see **Treas. Reg. § 1.409(p)-1(b)(2)(iv)**. See discussion in **TD 9302, 2007-1 CB 382, 383**. For an example, see **Treas. Reg. § 1.409(p)-1(b)(2)(iv)(C)**.

171.11

Treas. Reg. § 1.409(p)-1(b)(2)(iv)(A) (deemed distribution is not eligible for rollover). HR Conf. Rep. No. 84, 107th Cong., 1st Sess. 274 (2001), stated "... is treated as distributed to such individual (i.e., the value of the prohibited allocation is includible in the gross income of the individual receiving the prohibited allocation)."

171.12

IRC § 409(p)(2)(B) refers to **IRC § 4979A**. For an example, see **Treas. Reg. § 1.409(p)-1(b)(2)(iv)(C)**. **Treas. Reg. § 1.409(p)-1(b)(2)(iv)(B)** indicates that an excise tax will apply to the amount of the loan to the S corporation. HR Conf. Rep. No. 84, 107th Cong., 1st Sess. 274 (2001), stated "...(2) an excise tax is imposed on the S corporation equal to 50 percent of the amount involved in a prohibited allocation; and (3) an excise tax is imposed on the S corporation with respect to any synthetic equity owned by a disqualified person." See HR Conf. Rep. No. 84, 107th Cong., 1st Sess. 274, n.122 (2001).

171.13

Treas. Reg. § 1.409(p)-1(b)(2)(iv)(B). For an example, see **Treas. Reg. § 1.409(p)-1(b)(2)(iv)(C)**.

171.14

Treas. Reg. § 1.409(p)-1(b)(2)(v); **TD 9302, 2007-1 CB 382, 383–384**.

171.15

IRC § 409(p)(3)(A); **Treas. Reg. §§ 1.409(p)-1(a)(1)**, **1.409(p)-1(c)(1)**.

Treas. Reg. § 1.409(p)-1(c)(1) applies the 50 rule in either of two ways. A nonallocation year occurs if either (1) disqualified persons own at least 50 percent of the number of outstanding shares of the S corporation (including deemed-owned ESOP shares), or (2) disqualified persons own at least 50 percent of the total number of outstanding shares (including deemed-owned ESOP shares and synthetic equity owned by disqualified persons).

171.16

IRC § 409(p)(3)(B)(i); **Treas. Reg. § 1.409(p)-1(c)(2)** (attribution rules determine ownership of shares, including deemed-owned ESOP shares and synthetic equity).

171.17

IRC § 409(p)(3)(B)(i)(I) provides that for applying **IRC § 318(a)(1)**, the members of a family include the persons listed in **IRC § 409(p)(4)(D)**. **Treas. Reg. § 1.409(p)-1(c)(2)** refers to the persons listed in **Treas. Reg. § 1.409(p)-1(d)(2)**. See discussion in **TD 9302, 2007-1 CB 382, 384**.

171.18

IRC § 409(p)(3)(B)(i)(II) provides that **IRC § 318(a)(4)** does not apply; **Treas. Reg. § 1.409(p)-1(c)(2)**. HR Conf. Rep. No. 84, 107th Cong., 1st Sess. 275 (2001), stated “...option attribution does not apply (but instead special rules relating to synthetic equity described below apply).”

171.19

IRC § 409(p)(3)(B)(ii) treats an individual as owning deemed-owned shares, as defined in **IRC § 409(p)(4)(C)**. **IRC § 409(p)(3)(B)(ii)** overrides the exception in **IRC § 318(a)(2)(B)(i)**. **Treas. Reg. § 1.409(p)-1(c)(2)** treats an individual as owning deemed-owned ESOP shares, which are defined in **Treas. Reg. § 1.409(p)-1(e)**. HR Conf. Rep. No. 84, 107th Cong., 1st Sess. 275 (2001), stated "...'deemed-owned shares' held by the ESOP are treated as held by the individual with respect to whom they are deemed owned."

171.20

Treas. Reg. § 1.409(p)-1(c)(4)(i) may treat a person as owning stock that the person has a right to acquire, if the stock is issued and outstanding and is held by a person other than the ESOP, the S corporation, or a related entity. **Treas. Reg. § 1.409(p)-1(c)(4)(ii)** provides that this rule applies only if the effect is to create a nonallocation year. Further, this rule does not apply to a right to acquire stock held by a person subject to income tax that would not be taken into account, under **Treas. Reg. § 1.1361-1(l)(2)(iii)(A)** or **Treas. Reg. § 1.1361-1(l)(4)(iii)(C)**, in deciding if an S corporation has a second class of stock (provided that a principal purpose is not the avoidance of **IRC § 409(p)**). **Treas. Reg. § 1.409(p)-1(c)(4)(ii)**. See discussion in **TD 9081, 2003-35 IRB 420, 423**.

171.21

See **IRC § 409(p)(5)**; **Treas. Reg. § 1.409(p)-1(c)(1)(ii)**. For an example, see **Treas. Reg. § 1.409(p)-1(h), Ex. 2**.

171.22

For the definition of "family," see **IRC § 409(p)(4)(D)**; **Treas. Reg. § 1.409(p)-1(d)(2)**.

171.23

IRC § 409(p)(4)(A)(i); **Treas. Reg. § 1.409(p)-1(d)(1)(iii)** (using the term “deemed-owned ESOP shares”). For examples, see **Treas. Reg. § 1.409(p)-1(d)(4), Exs. 1**, **2**.

171.24

IRC § 409(p)(4)(A)(i) in conjunction with **IRC § 409(p)(5)**; **Treas. Reg. § 1.409(p)-1(d)(1)(iv)** (using the term “deemed-owned ESOP shares”).

171.25

IRC § 409(p)(4)(B) (which applies only to a person who is not already a disqualified person under **IRC § 409(p)(4)(A)**); **Treas. Reg. § 1.409(p)-1(d)(2)(i)**. For an example, see **Treas. Reg. § 1.409(p)-1(d)(4), Ex. 2**.

171.26

IRC § 409(p)(4)(A)(ii) (which applies only to a person who is not already a disqualified person under **IRC § 409(p)(4)(A)(i)**); **Treas. Reg. § 1.409(p)-1(d)(1)(i)** (which uses the term “deemed-owned ESOP shares”). For examples, see **Treas. Reg. § 1.409(p)-1(h), Exs. 1**, **2**.

171.27

IRC § 409(p)(4)(A)(ii) in conjunction with **IRC § 409(p)(5)**; **Treas. Reg. § 1.409(p)-1(d)(1)(ii)** (using the term “deemed-owned ESOP shares”). For an example, see **Treas. Reg. § 1.409(p)-1(h), Ex. 2**.

171.28

See **Treas. Reg. § 1.409(p)-1(h), Ex. 2**.

171.29

See **Treas. Reg. § 1.409(p)-1(h), Ex. 1**, which ignores the direct ownership of stock by *B* in determining that *B* is a disqualified person. By contrast, this example does count the direct ownership by *B* in judging whether there is a nonallocation year. On the same points, see **Treas. Reg. § 1.409(p)-1(d)(4), Ex. 1**.

171.30

Treas. Reg. §§ 1.409(p)-1(c)(3), **1.409(p)-1(d)(3)**, **1.409(p)-1(g)**.

171.31

IRC § 409(p)(4)(C)(i)(I); **Treas. Reg. § 1.409(p)-1(e)(1)**. Regarding the meaning of "employer securities," see **IRC § 409(p)(6)(B)**. Regarding the meaning of "employee stock ownership plan," see **IRC § 409(p)(6)(A)**.

171.32

IRC § 409(p)(4)(C)(i)(II); **Treas. Reg. § 1.409(p)-1(e)(2)**.

171.33

IRC § 409(p)(4)(C)(ii); **Treas. Reg. § 1.409(p)-1(e)(2)** (generally based on allocation from a suspense account).

171.34

See **Treas. Reg. §§ 1.409(p)-1(d)(4), Ex. 1**, **1.409(p)-1(h), Ex. 1**.

171.35

IRC § 409(p)(5). Regarding the effect of synthetic equity on the definition of nonallocation year, see **Treas. Reg. § 1.409(p)-1(c)(1)(ii)**. Regarding the effect of synthetic equity on the definition of disqualified person, see **Treas. Reg. § 1.409(p)-1(d)(1)(ii)**. For an example, see **Treas. Reg. § 1.409(p)-1(h), Ex. 2**. **TD 9081, 2003-35 IRB 420, 421**, stated "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."

HR Conf. Rep. No. 84, 107th Cong., 1st Sess. 275 (2001), stated "Thus, for example, disqualified persons for a year include those individuals who are disqualified persons under the general rule (i.e., treating only those shares held by the ESOP as deemed-owned shares) and those individuals who are disqualified individuals if synthetic equity interests are treated as deemed-owned shares."

171.36

IRC § 409(p)(5) (last sentence). See also **TD 9081, 2003-35 IRB 420, 421**.

171.37

IRC § 409(p)(5) (but regulations may provide for a contrary result).

171.38

IRC § 409(p)(5)(A).

171.39

IRC § 409(p)(5)(B).

171.40

IRC § 409(p)(6)(C). To define synthetic equity, **Treas. Reg. § 1.409(p)-1(a)(2)(viii)** refers to **Treas. Reg. § 1.409(p)-1(f)**. **Treas. Reg. § 1.409(p)-1(f)(2)(i)(A)** includes stock appreciation rights that are payable in stock.

Treas. Reg. § 1.409(p)-1(f)(2)(i)(A) excludes from "synthetic equity" an option to acquire outstanding stock from a person other than the ESOP, the S corporation, or a related entity if that person is subject to federal income taxes. The special rule in **Treas. Reg. § 1.409(p)-1(c)(4)** may apply, however.

171.41

IRC § 409(p)(6)(C) (unless regulations provide otherwise); **Treas. Reg. § 1.409(p)-1(f)(2)(ii)** (adding that the right to the payment must be from the S corporation; the payment may take any form other than stock of the S corporation).

171.42

Treas. Reg. § 1.409(p)-1(f)(i)(B). See discussion in **TD 9302, 2007-1 CB 382, 385**.

171.43

Treas. Reg. § 1.409(p)-1(f)(2)(iii).

171.44

Treas. Reg. § 1.409(p)-1(f)(3).

171.45

TD 9081, 2003-35 IRB 420, 422, explained that the Service was acting in the regulations to ensure that benefits are available "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 ESOP." The Service noted that arrangements had been promoted to use deferred compensation to suppress the value of an S corporation and deprive the rank-and-file employees of the chance to be the primary beneficiaries of the growth of the business. Id.

171.46

Treas. Reg. § 1.409(p)-1(f)(2)(iv)(A) (this rule applies to pay for which a deduction would be allowed under **Section 404(a)(5)** if separate accounts were kept).

171.47

Treas. Reg. § 1.409(p)-1(f)(2)(iv)(A).

171.48

Treas. Reg. § 1.409(p)-1(f)(2)(iv)(A), referring to **Treas. Reg. § 1.83-3(i)** for the meaning of substantially vested.

171.49

Treas. Reg. § 1.409(p)-1(f)(2)(iv)(A).

171.50

Treas. Reg. § 1.409(p)-1(f)(2)(iv), referring to **Section 402(c)(8)(B)** for the definition of "eligible retirement plan").

171.51

Treas. Reg. § 1.409(p)-1(f)(2)(v).

171.52

Treas. Reg. § 1.409(p)-1(f)(2)(v).

171.53

Treas. Reg. § 1.409(p)-1(f)(4)(i).

171.54

Treas. Reg. § 1.409(p)-1(f)(4)(i).

171.55

Treas. Reg. § 1.409(p)-1(f)(4)(ii) (value determined without regard to lapse restrictions, as defined in **Treas. Reg. § 1.83-3(i)**).

171.56

Treas. Reg. § 1.409(p)-1(f)(4)(iii)(A) (value of synthetic equity determined without regard to lapse restrictions, as defined in **Treas. Reg. § 1.83-3(i)**). **TD 9302, 2007-1 CB 382, 385**, stated that the regulations do not provide the discount rate that should be used to compute the present value.

171.57

Treas. Reg. § 1.409(p)-1(f)(4)(iii)(B).

171.58

Treas. Reg. § 1.409(p)-1(f)(4)(iii)(C). **TD 9302, 2007-1 CB 382, 384** stated

> These regulations also retain the special rule under the 2004 regulations that permits the ESOP to provide, on a reasonable and consistent basis for all persons, for the number of synthetic equity shares treated as owned on a determination date to remain constant for up to a 3-year period from that date (triennial method). This rule addresses concerns raised in comments to the 2003 regulations regarding the volatility of the number of shares of synthetic equity where that calculation is based on the value of an S corporation share.

171.59

Treas. Reg. § 1.409(p)-1(f)(4)(iv).

171.60

Treas. Reg. § 1.409(p)-1(f)(4)(v).

171.61

IRC § 409(p)(5). HR Conf. Rep. No. 84, 107th Cong., 1st Sess. 276 (2001), stated “In addition, ownership of synthetic equity is attributed under the rules of **section 318(a)(2)** and (3) in the same manner as stock.”

171.62

IRC § 409(p)(3) (last sentence). HR Conf. Rep. No. 84, 107th Cong., 1st Sess. 276 (2001), stated “Ownership of synthetic equity is attributed in the same manner as stock is attributed under the House bill.…”

171.63

IRC § 409(p)(7)(B). **Treas. Reg. § 1.409(p)-1(c)(3)(ii)** states that the guidance may include revenue rulings or notices. The Service exercised its power to block perceived abuses in **Rev. Rul. 2004-4, 2004-6 IRB 414**. The Service has declared this abuse to be a “listed” transaction. **Notice 2009-59, § 2(26), 2009-1 CB 170**.

171.64

HR Conf. Rep. No. 84, 107th Cong., 1st Sess. 277 (2001), stated “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.” For the Service's position, see **Rev. Rul. 2004-4, 2004-1 CB 414**.

171.65

Treas. Reg. §§ 1.409(p)-1(c)(3)(ii), 1.409(p)-1(d)(3).

171.66

Treas. Reg. § 1.409(p)-1(a)(1) refers to **Treas. Reg. § 1.409(p)-1(g)**. **Treas. Reg. § 1.409(p)-1(g)(1)** refers to **Treas. Reg. § 1.409(p)-1(g)(2)**.

171.67

Treas. Reg. § 1.409(p)-1(g)(2).

171.68

Treas. Reg. § 1.409(p)-1(g)(2).

171.69

Treas. Reg. § 1.409(p)-1(g)(2).

171.70

Treas. Reg. § 1.409(p)-1(g)(3)(i) (pointing to the use of a partnership or a disregarded entity).

171.71

Treas. Reg. § 1.409(p)-1(g)(3)(ii) (referring, by way of example, to rights to buy the subsidiary of the S corporation).

171.72

Treas. Reg. § 1.409(p)-1(g)(3)(iii).

171.73

Treas. Reg. § 1.409(p)-1(c)(3).

171.74

Treas. Reg. §§ 1.409(p)-1(c)(3), 1.409(p)-1(d)(3).

171.75

Treas. Reg. § 1.409(p)-1(c)(3).

171.76

Economic Growth and Tax Relief Reconciliation Act of 2001, § 656(d)(1); **Treas. Reg. § 1.409(p)-1(i)(1)(ii)**.

171.77

Economic Growth and Tax Relief Reconciliation Act of 2001, § 656(d)(2); **Treas. Reg. § 1.409(p)-1(i)(1)(i)**. For a specific holding, see **Rev. Rul. 2003-6, 2003-3 IRB 286**.

171.78

Treas. Reg. § 1.409(p)-1(i)(2) (with temporary regulations applying to certain prior years).

171.79

American Jobs Creation Act of 2004, § 240(a). See HR Conf. Rep. No. 755, 108th Cong., 2d Sess. 282–284 (2004).

171.80

American Jobs Creation Act of 2004, § 240(b); HR Conf. Rep. No. 755, 108th Cong., 2d Sess. 284 (2004).

171.81

IRC § 4975(f)(7) refers to **IRC § 1368(a)**.

171.82

See HR Conf. Rep. No. 755, 108th Cong., 2d Sess. 283–284 (2004).

171.83

IRC § 4975(f)(7).