

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