

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 nonqualified 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