

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 **Federal Register**, which asks for comments with respect to issues raised by S corporation ESOPs.

Special Analyses

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

Drafting Information

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

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendments to the Regulations

■ Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

■ 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). * * *

■ 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 nonallocation 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 (b)(1) of this section apply, those rules must be followed before applying the rules in 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