(1) In the case of a material imported by the producer of the good, the adjusted value of the material with respect to that importation;

* * * * *

(b) *Permissible additions to, and deductions from, the value of materials.*

* * * * *

(1) * * *

(i) The costs of freight, insurance, packing and all other costs incurred in transporting the material to the location of the producer;

* * * * *

(2) * * *

(i) The costs of freight, insurance, packing and all other costs incurred in transporting the material to the location of the producer;

(c) *Accounting method.* Any cost or value referenced in General Note 26(n), HTSUS, and this subpart, must be recorded and maintained in accordance with the generally accepted accounting principles applicable in the territory of the Party in which the good is produced (whether Chile or the United States).

**§ 10.457 [Amended]**

■ 20. In § 10.457, paragraph (a)(4) is amended by removing the word ''country'' each place it appears and adding, in its place, the word ''Party''.

**§ 10.458 [Amended]**

■ 21. In § 10.458, paragraph (a) is amended by removing the word ''country'' each it appears and adding, in its place, the word ''Party''.

**§ 10.460 [Amended]**

■ 22. Section 10.460 is amended by removing the term ''§ 10.402(n)'' and adding, in its place, the term ''§ 10.402(o)''.

**§ 10.461 [Amended]**

■ 23. Section 10.461 is amended by adding in Example 1 the words ''of this subpart'' at the end of the parenthetical phrase ''see § 10.454(a)'' in the third sentence.

■ 24. In § 10.470, paragraph (a) is amended by revising the heading and the first two sentences of the introductory text, to read as follows:

**§ 10.470 Verification and justification of claim for preferential tariff treatment.**

(a) *Verification.* A claim for preferential tariff treatment made under § 10.410 of this subpart, including any statements or other information submitted to CBP in support of the claim, will be subject to such verification as the port director deems necessary. In the event that the port director is provided with insufficient information to verify or substantiate the claim, the port director may deny the claim for preferential tariff treatment.

* * *

* * * * *

■ 25. Section 10.473 is amended by revising the introductory text and paragraph (c) to read as follows:

**§ 10.473 Issuance of negative origin determinations.**

If CBP determines, as a result of an origin verification initiated under this subpart, that the good which is the subject of the verification does not qualify as an originating good, it will issue a determination in writing or via an authorized electronic data interchange system to the importer that sets forth the following:

* * * * *

(c) With specific reference to the rules applicable to originating goods as set forth in General Note 26, HTSUS, and in §§ 10.450 through 10.463 of this subpart, the legal basis for the determination; and

* * * * *

**§ 10.474 [Amended]**

■ 26. Section 10.474 is amended by removing the words ''CBP finds'' and adding, in their place, the words ''verification or other information reveals'';

■ 27. In § 10.483, paragraph (a)(2) is amended by removing the word ''part'' and adding, in its place, the word ''chapter,'' and paragraph (c) introductory text is revised to read as follows:

**§ 10.483 Framework for correcting declarations and certifications.**

* * * * *

(c) *Statement.* For purposes of this subpart, each corrected declaration or notification of an incorrect certification must be accompanied by a statement, submitted in writing or via an authorized electronic data interchange system, which:

* * * * *

## PART 191—DRAWBACK

■ 28. The general authority citation for part 191 continues to read as follows:

**Authority:** 5 U.S.C. 301; 19 U.S.C. 66, 1202 (General Note 3(i), Harmonized Tariff Schedule of the United States), 1313, 1624.

* * * * *

**§ 191.0 [Amended]**

■ 29. Section 191.0 is amended by removing the last sentence.

**Deborah J. Spero,**

*Acting Commissioner, Customs and Border Protection.*

Approved: December 15, 2006.

**Timothy E. Skud,**

*Deputy Assistant Secretary of the Treasury.*

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## DEPARTMENT OF THE TREASURY

## Internal Revenue Service

## 26 CFR Part 1

**[TD 9302]**

**RIN 1545–BC34**

## Prohibited Allocations of Securities in an S Corporation

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Final regulations.

**SUMMARY:** This document contains final regulations that provide guidance concerning requirements under section 409(p) of the Internal Revenue Code for employee stock ownership plans (ESOPs) holding stock of Subchapter S corporations. These final regulations generally affect plan sponsors of, and participants in, ESOPs holding stock of Subchapter S corporations.

**DATES:** *Effective Date:* These regulations are effective December 20, 2006.

*Applicability Dates:* These regulations are generally applicable with respect to plan years beginning on or after January 1, 2006. See the Effective Date section of the preamble for specific information.

**FOR FURTHER INFORMATION CONTACT:** John T. Ricotta or Veronica A. Rouse at (202) 622–6090 (not a toll-free number).

**SUPPLEMENTARY INFORMATION:**

### Background

This document contains final regulations (26 CFR Part 1) under section 409(p) of the Internal Revenue Code (Code).

Section 409(p)(1) requires an ESOP holding employer securities consisting of stock in an S corporation to provide that, during an allocation year, no portion of the assets of the plan attributable to, or allocable in lieu of, the employer securities may 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. 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 or are deemed to own at least 50 percent of its shares. Section 409(p)(4) provides, in general, that a disqualified person is any person whose deemed-owned ESOP shares (allocated ESOP shares and proportion of suspense account shares) are at least 10 percent of the number of deemed-owned shares of S corporation stock held by an ESOP or for whom the aggregate number of shares owned by such person and the members of such person's family is at least 20 percent of deemed-owned ESOP shares. Under section 409(p)(5), the determination of whether a person is a disqualified person and whether a plan year is a nonallocation year is also made separately taking into account synthetic equity if such treatment results in treating the person as a disqualified person or the year as a nonallocation year.

Temporary regulations under section 409(p) were issued on July 21, 2003, (68 FR 42970). The text of those temporary regulations also served as the text of a notice of proposed rulemaking (REG–129709–03) published at 68 FR 43058. The 2003 regulations provided guidance on identifying disqualified persons, determining whether an ESOP has a nonallocation year, and defining synthetic equity under section 409(p)(5), and reserved some issues, including the definition of a prohibited allocation, the tax effect of a prohibited allocation, and certain issues relating to the definition of synthetic equity.

A public hearing on the 2003 regulations was held on November 17, 2003. New temporary regulations under section 409(p) (TD 9164) were published in the **Federal Register** on December 17, 2004, (69 FR 75455). The new temporary regulations (2004 temporary regulations) addressed certain issues raised in the comments, as well as addressing the topics reserved in the 2003 temporary regulations. The text of the 2004 temporary regulations also served as the text for a notice of proposed rulemaking (REG–129709–03) published at (69 FR 75492).

A public hearing on the 2004 proposed regulations was held on April 20, 2005. After consideration of the comments received, these final regulations adopt the provisions of the proposed regulations with certain modifications discussed in this preamble.

**Explanation of Provisions**

*Definition of Prohibited Allocation*

These regulations retain the rule of the 2004 temporary regulations concerning prohibited allocations under which there is an impermissible accrual to the extent employer securities consisting of stock in an S corporation are held under the ESOP for the benefit of a disqualified person during a nonallocation year. Thus, in the event of a nonallocation year, S corporation shares held in a disqualified person's account and all other ESOP assets attributable to S corporation stock, including distributions, sales proceeds, and earnings, are treated as an impermissible accrual whether attributable to contributions in the current year or a prior year. A commentator questioned whether the definition of prohibited allocation in the 2004 temporary regulations should include account balances of disqualified persons from prior years. The rule of the 2004 temporary regulations has been retained because it is consistent with the intent of the statute, and the IRS and Treasury Department believe it is necessary to prevent the concentration of ownership interests that section 409(p) was intended to prevent.

A commentator also questioned the treatment of proceeds from the sale of stock previously allocated to a disqualified person's account under the 2004 temporary regulations. The commentator expressed concern that treating the sales proceeds as an impermissible accrual when the original allocation of stock is already a prohibited allocation is a double penalty. The final regulations do not change this rule in the 2004 temporary regulations. An allocation of sales proceeds from stock held for the benefit of a disqualified person back into the account of the disqualified person is as valuable an accrual for the disqualified person as an investment in employer stock. This treatment is also consistent with the prohibition in section 409(p)(1) with respect to amounts that are ''allocable in lieu of'' employer stock.

*Effect of a Prohibited Allocation*

These regulations retain the rule of the 2004 regulations that if there is a prohibited allocation during a nonallocation year, the ESOP fails to satisfy the requirements of section 4975(e)(7) and ceases to be an ESOP. As a result, the exemption from the excise tax on prohibited transactions for loans to leveraged ESOPs contained in section 4975(d)(3) would cease to apply to any loan (with the result that the employer would owe an excise tax with respect to the previously exempt loan). These regulations clarify that an additional result would be the plan's failure to satisfy the qualification requirements under section 401(a) for not operating the plan in accordance with its terms to reflect section 409(p). Other consequences include imposition of an excise tax on the S corporation under section 4979A. An example has been added to these final regulations to illustrate the impact of these rules on an S corporation ESOP.

These regulations include the rule from the 2004 regulations under which a prohibited allocation is a deemed distribution that is not an eligible rollover distribution. These regulations also add that same rule to the list of distributions that are not eligible rollover distributions in the regulations under section 402(c) (at § 1.402(c)–2 of the Treasury Regulations). As a result, under recently proposed regulations relating to designated Roth contributions under section 402A, a deemed distribution as a result of a section 409(p) prohibited allocation with respect to a designated Roth account would not constitute a qualified distribution for purposes of section 402A. See proposed § 1.402A–1, A–11, at 71 FR 4320 (January 26, 2006).

*Prevention of Nonallocation Year*

The preamble to the 2004 regulations described methods that a plan might use to prevent the occurrence of a nonallocation year, including (1) a reduction of synthetic equity (for example, through cancellation or distribution), (2) a sale of the S corporation securities held in the participant's ESOP account before a nonallocation year occurs so that the account is not invested in S corporation stock, or (3) a transfer of the S corporation securities held for the participant under the ESOP into a separate portion of the plan that is not an ESOP or to another qualified plan of the employer that is not an ESOP.

Any methods of preventing a nonallocation year must satisfy applicable legal and qualification requirements, including the nondiscrimination requirements of section 401(a)(4) (including the rules at § 1.401(a)(4)–4 relating to benefits, rights and features), and implementation of these methods must be completed before a nonallocation year occurs. These regulations retain the special rule provided in the 2004 regulations for applying the nondiscrimination requirements under section 401(a)(4) for a plan that uses the transfer method. Thus, these regulations provide that, if a transfer is made from

an ESOP to a separate portion of the plan (or to another qualified plan of the employer) that is not an ESOP in order to prevent a nonallocation year, then both the ESOP and the plan that is not an ESOP will not fail to satisfy the requirements of § 1.401(a)(4)–4 merely because of the transfer. Similarly, these regulations provide that, subsequent to the transfer, the plan will not fail to satisfy the requirements of § 1.401(a)(4)–4 merely because of the benefits, rights, and features with respect to the transferred benefits if those benefits, rights, and features would satisfy the requirements of § 1.401(a)(4)–4 if the mandatory disaggregation rule for ESOPs at § 1.410(b)–7(c)(2) did not apply. These regulations clarify that any such transfers must be effectuated by an affirmative action taken no later than the date of the transfer, and all subsequent actions (including benefit statements) must be consistent with the transfer having occurred on that date. Further, in order to use the transfer method to prevent a nonallocation year, the plan must provide for the transfer of the stock to the non-ESOP portion of the plan.

A commentator described another method of preventing a nonallocation year under which stock of a participant is exchanged for cash or other assets, which are already in the accounts of other participants in order to change the stock holdings among participants before a nonallocation year occurs, but which does not change the overall stock holding of the ESOP trust. This method has been referred to as reshuffling. The commentator requested that relief from the nondiscriminatory availability requirements be extended to this method.

Absent a special rule for applying the nondiscrimination requirements of section 401(a)(4), it will be difficult for a plan to prevent a nonallocation year through reshuffling without violating section 401(a)(4). The right of each participant to have or not have a particular investment in his or her account (either as a participant-directed investment or as a trustee-directed investment) is a plan right or feature that is subject to the current and effective availability requirements of § 1.401(a)(4)–4. Accordingly, if assets in the accounts of one or more non-highly compensated employees (NHCEs) are mandatorily exchanged, then, in the absence of other relevant factors, the plan would generally be expected to fail to satisfy the nondiscriminatory availability requirements of § 1.401(a)(4)–4.

The IRS and Treasury Department do not believe that it would be appropriate to provide a special rule that would materially weaken the standard for nondiscriminatory availability of participant rights to a particular investment under the plan. By contrast, the special nondiscrimination rules for stock transferred out of the ESOP do not change the rights of NHCEs to any particular investment in the plan as a whole, but simply allow the transfer and allow the rights of participants whose stock is transferred out of the ESOP to be taken into account in determining whether the rights of participants whose stock remains in the ESOP satisfy the nondiscriminatory availability requirements of § 1.401(a)(4)–4.

An S corporation may be able to achieve the same result as reshuffling by reducing contributions for HCEs who are or may become disqualified persons, by providing additional benefits to NHCEs who are not disqualified persons, by expanding coverage to include all employees, or by diversifying out of employer stock for HCEs who are or may become disqualified persons and who are qualified participants within the meaning of section 401(a)(28)(B)(iii) (that is, by mandating diversification using one of the diversification options that are offered to all qualified participants, for which there is an existing special nondiscrimination rule at § 1.401(a)(4)–4(d)(6)). Thus, in addition to plan transfers, any of these actions may help prevent the concentration of deemed-owned ESOP shares that section 409(p) prohibits, without the nondiscrimination problems otherwise associated with reshuffling. Of course, any transfer or other method used to ensure compliance with section 409(p) must also satisfy any other legal requirements that may apply, including section 407(b)(2) of the Employee Retirement Income Security Act of 1974 (ERISA) (88 Stat. 829) Public Law 93–406 (which, in relevant part, generally prohibits a plan from investing more than 10 percent of elective deferral accounts in employer stock, unless the plan is an ESOP, the investment is at the direction of the participant, or another exception applies).

*Treatment of Family Members as Disqualified Persons*

The 2004 regulations included a number of attribution rules, which these regulations retain, including the application of the section 318 attribution rules to ownership of synthetic equity in determining who is a disqualified person. Section 409(p) contains references to the section 318 rules in certain cases, such as in determining a nonallocation year, but commentators pointed out that the section 318 rules did not apply for purposes of the disqualified person definition, which was not reflected in an example. Another commentator pointed out that the rules for determining whether family members are disqualified persons varies according to the individual being tested. For example, the technical language of section 409(p)(4)(D) treats parents-in-law as members of a married child's family when testing whether a child is a disqualified person, but not as members of the same family as the child's parents when testing whether the child's parents are disqualified persons. In response to comments, the regulations have been modified to clarify these rules, including revisions in the examples to illustrate the application of the rules to specific factual patterns.

*Determination of Number of Shares of Non-Stock-Based Synthetic Equity*

These regulations retain the rules from both the 2003 and the 2004 regulations regarding calculation of the number of shares of synthetic equity that are not determined by reference to shares of stock of the S corporation. These regulations provide that 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 under the section 83 regulations) divided by the fair market value of a share of the S corporation's stock as of the same date. 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.

A commentator questioned whether the triennial method of the 2004 regulations should be expanded to permit a more flexible triennial period that allows for the acceleration or delay of the triennial determination date. The commentator argued that, since the triennial method's purpose is to eliminate the risk attributable to volatility of the present value of the nonqualified deferred compensation

stock and the risk attributable to the fair market value of company stock, the inability to delay or accelerate the date, automatically and daily if necessary, weakens the purpose of the method.

These regulations include changes in the triennial methodology to permit the ability, during the 3-year period, to accelerate a determination date prospectively in the event of a change in the plan year or any merger, consolidation, or transfer of ESOP assets under section 414(l). However, a determination date may not be changed retroactively and the change must be effectuated by a plan amendment adopted before the new determination date.[1]

A commentator also requested clarification regarding how shares of synthetic equity are calculated with respect to nonqualified deferred compensation. Specifically, the commentator wanted to know what discount rate should be used to calculate the present value of nonqualified deferred compensation, and how to determine the number of equivalent shares for a split-dollar life insurance arrangement. These regulations do not mandate a specific discount rate for calculating the present value of nonqualified deferred compensation or a specific method for determining the equivalent number of shares for a split dollar arrangement. However, any assumptions used for such purposes must be reasonable.

Finally, a commentator asked whether an individual S corporation shareholder's right of first refusal to acquire S corporation stock from an ESOP for its fair market value is considered synthetic equity. The regulations have been revised to clarify that the right of first refusal to acquire stock held by an ESOP is not treated as a right to acquire stock of an S corporation under these regulations if the right to acquire stock would not be taken into account under § 1.1361–1(l)(2)(iii)(A) in determining whether an S corporation has a second class of stock and the price at which the stock is acquired under the right of first refusal is not less than the price determined for purposes of the put right required by section 409(h). See § 54.4975–11(d)(5) of the Excise Tax Regulations. Of course, any right of first refusal must comply with the requirements of § 54.4975–7(b)(9) of the Excise Tax Regulations. In addition, these regulations give the Commissioner the authority to treat a right of first refusal as synthetic equity if the Commissioner determines, based on the facts and circumstances, that the right to acquire stock held by the ESOP constitutes an avoidance or evasion of section 409(p).

[1] As indicated in Notice 2005–95, 2005–51 IRB, dated December 19, 2005, the general deadline for discretionary amendments in Rev. Proc. 2005–66, 2005–37 IRB 509, does not apply if a statute or regulation specifically provides an earlier deadline. These regulations provide such an earlier deadline.

**Effective Dates**

These regulations generally are applicable for plan years beginning on or after January 1, 2006. However, these regulations retain, by cross reference, the 2004 regulations for plan years beginning before January 1, 2006.

**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, and because the regulation does not impose a collection of information requirement upon small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the temporary and proposed regulations preceding these final regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

**Drafting Information**

The principal authors of these regulations are John T. Ricotta and Veronica A. Rouse 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.

**Adoption of 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 is amended by adding an entry to read, in part, as follows:

**Authority:** 26 U.S.C. 7805 * * *

Section 1.409(p)–1 is also issued under 26 U.S.C. 409(p)(7). * * *

■ **Par. 2.** Section 1.402(c)–2, A–4, is revised by redesignating paragraph (g) as (h) and adding a new paragraph (g) to read as follows:

**§ 1.402(c)–2 Eligible rollover distributions; questions and answers.**

* * * * *

A–4. * * *

(g) Prohibited allocations that are treated as deemed distributions pursuant to section 409(p).

* * * * *

■ **Par. 3.** Section 1.409(p)–1 is added to read as follows:

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

(a) *Organization of this section and definition*—(1) *Organization of this section.* Section 409(p) applies if a nonallocation year occurs in an ESOP that holds shares of stock of an S corporation that are employer securities. Paragraph (b) of this section sets forth the general rule under section 409(p)(1) and (2) prohibiting any accrual or 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 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). Paragraph (g) of this section contains a standard for determining when the principal purpose of the ownership structure of an S corporation constitutes an avoidance or evasion of section 409(p).

(2) *Definitions.* The following definitions apply for purposes of section 409(p) and this section, as well as for purposes of section 4979A, which imposes an excise tax on certain events.

(i) *Deemed-owned ESOP shares* has the meaning set forth in paragraph (e) of this section.

(ii) *Disqualified person* has the meaning set forth in paragraph (d) of this section.

(iii) *Employer* has the meaning set forth in § 1.410(b)–9.

(iv) *Employer securities* means employer securities within the meaning of section 409(l).

(v) *ESOP* means an employee stock ownership plan within the meaning of section 4975(e)(7).

(vi) *Prohibited allocation* has the meaning set forth in paragraph (b)(2) of this section.

(vii) *S corporation* means S corporation within the meaning of section 1361.

(viii) *Synthetic equity* has the meaning set forth in paragraph (f) of this section.

(b) *Prohibited allocation in a nonallocation year*—(1) *General rule.* Section 409(p)(1) provides that 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 under the ESOP, or be allocated directly or indirectly under any plan of the employer (including the ESOP) meeting the requirements of section 401(a), for the benefit of any disqualified person.

(2) *Additional rules*—(i) *Prohibited allocation definition.* For purposes of section 409(p) and this section, a *prohibited allocation* means an impermissible accrual or an impermissible allocation. Whether there is impermissible accrual is determined under paragraph (b)(2)(ii) of this section and whether there is an impermissible allocation is determined under paragraph (b)(2)(iii) of this section. The amount of the prohibited allocation is equal to the sum of the amount of the impermissible accrual plus the amount of the impermissible allocation.

(ii) *Impermissible accrual.* There is an impermissible accrual to the extent that employer securities consisting of stock in an S corporation owned by the ESOP and any assets attributable thereto are held under the ESOP for the benefit of a disqualified person during a nonallocation year. For this purpose, assets attributable to stock in an S corporation owned by an ESOP include any distributions, within the meaning of section 1368, made on S corporation stock held in a disqualified person's account in the ESOP (including earnings thereon), plus any proceeds from the sale of S corporation securities held for a disqualified person's account in the ESOP (including any earnings thereon). Thus, in the event of a nonallocation year, all S corporation shares and all other ESOP assets attributable to S corporation stock, including distributions, sales proceeds, and earnings on either distributions or proceeds, held for the account of such disqualified person in the ESOP during that year are an impermissible accrual for the benefit of that person, whether attributable to contributions in the current year or in prior years.

(iii) *Impermissible allocation.* An impermissible allocation occurs during a nonallocation year to the extent that a contribution or other annual addition (within the meaning of section 415(c)(2)) is made with respect to the account of a disqualified person, or the disqualified person otherwise accrues additional benefits, directly or indirectly under the ESOP or any other plan of the employer qualified under section 401(a) (including a release and allocation of assets from a suspense account, as described at § 54.4975–11(c) and (d) of this chapter) that, for the nonallocation year, would have been added to the account of the disqualified person under the ESOP and invested in employer securities consisting of stock in an S corporation owned by the ESOP but for a provision in the ESOP that precludes such addition to the account of the disqualified person, and investment in employer securities during a nonallocation year.

(iv) *Effects of prohibited allocation*—(A) *Deemed distribution.* If a plan year is a nonallocation year, the amount of any prohibited allocation in the account of a disqualified person as of the first day of the plan year, as determined under this paragraph (b)(2), is treated as distributed from the ESOP (or other plan of the employer) to the disqualified person on the first day of the plan year. In the case of an impermissible accrual or impermissible allocation that is not in the account of the disqualified person as of the first day of the plan year, the amount of the prohibited allocation, as determined under this paragraph (b)(2), is treated as distributed on the date of the prohibited allocation. Thus, the fair market value of assets in the disqualified person's account that constitutes an impermissible accrual or allocation is included in gross income (to the extent in excess of any investment in the contract allocable to such amount) and is subject to any additional income tax that applies under section 72(t). A deemed distribution under this paragraph (b)(2)(iv)(A) is not an actual distribution from the ESOP. Thus, the amount of the prohibited allocation is not an eligible rollover distribution under section 402(c). However, for purposes of applying sections 72 and 402 with respect to any subsequent distribution from the ESOP, the amount that the disqualified person previously took into account as income as a result of the deemed distribution is treated as investment in the contract.

(B) *Other effects.* If there is a prohibited allocation, then the plan fails to satisfy the requirements of section 4975(e)(7) and ceases to be an ESOP. In such a case, the exemption from the excise tax on prohibited transactions for loans to leveraged ESOPs contained in section 4975(d)(3) would cease to apply to any loan (with the result that the employer would owe an excise tax with respect to the previously exempt loan). As a result of these failures, the plan would lose the prohibited transaction exemption for loans to an ESOP under section 4975(d)(3) of the Code and section 408(b)(3) of Title I of the Employee Retirement Income Security Act of 1974, as amended (ERISA). Finally, a plan that does not operate in accordance with its terms to reflect section 409(p) fails to satisfy the qualification requirements of section 401(a), which would cause the corporation's S election to terminate under section 1362. See also section 4979A(a) which imposes an excise tax in certain events, including a prohibited allocation under section 409(p).

(C) *Example.* The rules of this paragraph (b)(2)(iv) are illustrated by the following example:

*Example.* (i) *Facts.* Corporation M, an S corporation under section 1361, establishes Plan P as an ESOP in 2006, with a calendar plan year. Plan P is a qualified plan that includes terms providing that a prohibited allocation will not occur during a nonallocation year in accordance with section 409(p). On December 31, 2006, all of the 1,000 outstanding shares of stock of Corporation M, with a fair market value of $30 per share, are contributed to Plan P and allocated among accounts established within Plan P for the benefit of Corporation M's three employees, individuals A, B, and C, based on their compensation for 2006. As a result, on December 31, 2006, participant A's account includes 800 of the shares ($24,000); participant B's account includes 140 of the shares ($4,200); and participant C's account includes the remaining 60 shares ($1,800). The plan year 2006 is a nonallocation year, participants A and B are disqualified persons on December 31, 2006, and a prohibited allocation occurs for A and B on December 31, 2006.

(ii) *Conclusion.* On December 31, 2006, participants A and B each have a deemed distribution as a result of the prohibited allocation, resulting in income of $24,000 for participant A and $4,200 for participant B. Corporation M owes an excise tax under section 4979A, based on an amount involved of $28,200. Plan P ceases to be an ESOP on the date of the prohibited allocation (December 31, 2006) and also fails to satisfy the qualification requirements of section 401(a) on that date due to the failure to comply with the provisions requiring compliance with section 409(p). As a result of having an ineligible shareholder under section 1361(b)(1)(B), Corporation M ceases to be an S corporation under section 1361 on December 31, 2006.

(v) *Prevention of prohibited allocation*—(A) *Transfer of account to*

*non-ESOP.* An ESOP may prevent a nonallocation year or a prohibited allocation during a nonallocation year by providing for assets (including S corporation securities) allocated to the account of a disqualified person (or a person reasonably expected to become a disqualified person absent a transfer described in this paragraph (b)(2)(v)(A)) to be transferred into a separate portion of the plan that is not an ESOP, as described in § 54.4975–11(a)(5) of this chapter, or to another plan of the employer that satisfies the requirements of section 401(a) and that is not an ESOP. Any such transfer must be effectuated by an affirmative action taken no later than the date of the transfer, and all subsequent actions (including benefit statements) generally must be consistent with the transfer having occurred on that date. In the event of such a transfer involving S corporation securities, the recipient plan is subject to tax on unrelated business taxable income under section 512.

(B) *Relief from nondiscrimination requirement.* Pursuant to this paragraph (b)(2)(v)(B), if a transfer described in paragraph (b)(2)(v)(A) of this section is made from an ESOP to a separate portion of the plan or to another qualified plan of the employer that is not an ESOP, then both the ESOP and the plan or portion of a plan that is not an ESOP do not fail to satisfy the requirements of § 1.401(a)(4)–4 merely because of the transfer. Further, subsequent to the transfer, that plan will not fail to satisfy the requirements of § 1.401(a)(4)–4 merely because of the benefits, rights, and features with respect to the transferred benefits if those benefits, rights, and features would satisfy the requirements of § 1.401(a)(4)–4 if the mandatory disaggregation rule for ESOPs at § 1.410(b)–7(c)(2) did not apply.

(c) *Nonallocation year.* A year is a nonallocation year if it is described in the general definition in paragraph (c)(1) of this section or if the special rule of paragraph (c)(3) of this section applies.

(1) *General definition.* For purposes of section 409(p) and this section, 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 sum of:

(A) The outstanding shares of stock in the S corporation (including deemed-owned ESOP shares); and

(B) The shares of synthetic equity in the S corporation owned by disqualified persons.

(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 (and in addition to) the rules of this paragraph (c)(2).

(3) *Special rule for avoidance or evasion.* (i) Any ownership structure described in paragraph (g)(3) of this section results in a nonallocation year. In addition, each individual referred to in paragraph (g)(3) of this section is treated as a disqualified person and the individual's interest in the separate entity described in paragraph (g)(3) of this section is treated as synthetic equity.

(ii) Pursuant to 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. See paragraph (g) of this section for guidance regarding when the principal purpose of an ownership structure of an S corporation involving synthetic equity constitutes an avoidance or evasion of section 409(p).

(4) *Special rule for certain stock rights.* (i) For purposes of paragraph (c)(1) of this section, a person is treated as owning stock if the person has an exercisable right to acquire the stock, the stock is both issued and outstanding, and the stock is held by persons other than the ESOP, the S corporation, or a related entity (as defined in paragraph (f)(3) of this section).

(ii) This paragraph (c)(4) applies only if treating persons as owning the shares described in paragraph (c)(4)(i) of this section results in a nonallocation year. This paragraph (c)(4) does not apply to a right to acquire stock of an S corporation held by a shareholder that is subject to Federal income tax that, under § 1.1361–1(l)(2)(iii)(A) or (l)(4)(iii)(C), would not be taken into account in determining if an S corporation has a second class of stock, provided that a principal purpose of the right is not the avoidance or evasion of section 409(p). Under the last sentence of paragraph (f)(2)(i) of this section, this paragraph (c)(4)(ii) does not apply for purposes of determining ownership of deemed-owned ESOP shares or whether an interest constitutes synthetic equity.

(5) *Application with respect to shares treated as owned by more than one person.* For purposes of applying paragraph (c)(1) of this section, if, by application of the rules of paragraph (c)(2), (c)(4), or (f)(1) of this section, any share is treated as owned by more than one person, then that share is counted as a single share and that share is treated as owned by disqualified persons if any of the owners is a disqualified person.

(6) *Effect of nonallocation year.* See paragraph (b) of this section for a prohibition applicable during a nonallocation year. See also section 4979A for an excise tax applicable in certain cases, including section 4979A(a)(3) and (4) which applies during a nonallocation year (whether or not there is a prohibited allocation during the year).

(d) *Disqualified persons.* A person is a disqualified person if the person is described in paragraph (d)(1), (d)(2), or (d)(3) of this section.

(1) *General definition.* For purposes of section 409(p) and this section, a *disqualified person* means any person for whom—

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

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

(A) The total number of deemed-owned ESOP shares of the S corporation; and

(B) The person's synthetic equity shares of the S corporation;

(iii) The aggregate number of the S corporation's 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 the S corporation's 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 sum of—

(A) The total number of deemed-owned ESOP shares of the S corporation; and

(B) The synthetic equity shares of the S corporation owned by such person and the members of such person's family.

(2) *Treatment of family members; definition*—(i) *Rule.* Each member of the family of any person who is a disqualified person under paragraph (d)(1)(iii) or (iv) of this section and who owns any deemed-owned ESOP shares or synthetic equity shares is a disqualified person.

(ii) *General definition.* For purposes of section 409(p) and this section, *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)(B) or (C) of this section.

(iii) *Spouse.* 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 under paragraph (d)(2)(ii) of this section.

(3) *Special rule for certain nonallocation years.* See paragraph (c)(3) of this section (relating to avoidance or evasion of section 409(p)) for special rules under which certain persons are treated as disqualified persons.

(4) *Example.* The rules of this paragraph (d) are illustrated by the following examples:

*Example 1.* (i) *Facts.* An S corporation has 800 outstanding shares, of which 100 are owned by individual O and 700 are held in an employee stock ownership plan (ESOP) during 2006, including 200 shares held in the ESOP account of O, 65 shares held in the ESOP account of participant P, 65 shares held in the ESOP account of participant Q who is P's spouse, and 14 shares held in the ESOP account of R, who is the daughter of P and Q. There are no unallocated suspense account shares in the ESOP. The S corporation has no synthetic equity.

(ii) *Conclusion.* Under paragraph (d)(1)(i) of this section, O is a disqualified person during 2006 because O's account in the ESOP holds at least 10% of the shares owned by the ESOP (200 is 28.6% of 700). During 2006, neither P, Q, nor R is a disqualified person under paragraph (d)(1)(i) of this section, because each of their accounts holds less than 10% of the shares owned by the ESOP. However, each of P, Q, and R is a disqualified person under paragraph (d)(1)(iii) of this section because P and members of P's family own at least 20% of the deemed-owned ESOP shares (144 (the sum of 65, 65 and 14) is 20.6% of 700). As a result, disqualified persons own at least 50% of the outstanding shares of the S corporation during 2006 (O's 100 directly owned shares, O's 200 deemed-owned shares, P's 65 deemed-owned shares, Q's 65 deemed-owned shares, and R's 14 deemed-owned shares are 55.5% of 800).

*Example 2.* (i) *Facts.* An S corporation has shares that are owned by an ESOP and various individuals. Individuals S and T are married and have a son, U. Individuals V and W are married and have a daughter, X. Individuals U and X are married. Individual V has a brother Y. Their percentages of the deemed-owned ESOP shares of the S corporation are as follows: T has 6%; U has 7%; and V has 8%. Neither S, W, X, nor Y has any deemed-owned ESOP shares and the S corporation has no synthetic equity. However, individual S and individual Y each own directly a number of shares of the outstanding shares of the S corporation.

(ii) *Conclusion.* In this example, individual U is a disqualified person under paragraph (d)(1) of this section (because U's family consists of S, T, U, V, W, and X, and, in the aggregate, those persons own more than 20% of the deemed-owned ESOP shares) and individual X is also a disqualified person under paragraph (d)(1) of this section (because T's family consists of S, T, U, V, W, and X, and, in the aggregate, those persons own more than 20% of the deemed-owned ESOP shares). Further, individuals T and V are each a disqualified person under paragraph (d)(2) of this section because each is a member of a family that includes one or more disqualified persons and each has deemed-owned ESOP shares. However, individuals S, W, and Y are not disqualified persons under this paragraph (d). For example, S does not own more than 10% of the deemed-owned ESOP shares, and S's family, which consists of S, T, U, and X, owns, in the aggregate, only 13% of the deemed-owned ESOP shares (X's parents are not members of S's family because the family members of a person do not include the parents-in-law of the person's descendants). Further, note that, for purposes of determining whether the ESOP has a nonallocation year under paragraph (c) of this section, the shares directly owned by S and Y would be taken into account as shares owned by disqualified persons under the attribution rules in paragraph (c)(2) of this section.

(e) *Deemed-owned ESOP shares.* For purposes of section 409(p) and this section, a person is treated as owning his or her deemed-owned ESOP shares. Deemed-owned ESOP shares owned by a person 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 shares released and allocated from a suspense account, as described at § 54.4975–11(c) and (d) of the Excise Tax Regulations, under the ESOP for the most recently ended plan year for which there were shares released and allocated from a suspense account, or if there has been no such prior release and allocation from a suspense account, then determined in proportion to a reasonable estimate of the shares that would be released and allocated in the first year of a loan repayment).

(f) *Synthetic equity and rights to acquire stock of the S corporation*—(1) *Ownership of synthetic equity.* For purposes of section 409(p) and this section, synthetic equity means the rights described in paragraph (f)(2) of this section. Synthetic equity is treated as owned by the person that has any of the rights specified in paragraph (f)(2) of the section. In addition, the attribution rules as set forth in paragraph (c)(2) of this section apply for purposes of attributing ownership of synthetic equity.

(2) *Synthetic equity*—(i) *Rights to acquire stock of the S corporation*—(A) *General rule.* 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 a person other than the ESOP, the S corporation, or a related entity are not synthetic equity but only if that person is subject to federal income taxes. (See also paragraph (c)(4) of this section.)

(B) *Exception for certain rights of first refusal.* A right of first refusal to acquire stock held by an ESOP is not treated as a right to acquire stock of an S corporation under this paragraph if the right to acquire stock would not be taken into account under § 1.1361–1(l)(2)(iii)(A) in determining if an S corporation has a second class of stock

and the price at which the stock is acquired under the right of first refusal is not less than the price determined under section 409(h). See § 54.4975–11(d)(5) of the Excise Tax Regulations. The right of first refusal must also comply with the requirements of § 54.4975–7(b)(9) of the Excise Tax Regulations. This paragraph (f)(2)(i)(B) does not apply if, based on the facts and circumstances, the Commissioner finds that the right to acquire stock held by the ESOP constitutes an avoidance or an evasion of section 409(p). See also section 408(d) of ERISA, under which the exemption provided by section 408(e) of ERISA (and the related exemption at section 4975(d)(13) of the Code) does not apply to an owner-employee, including an employee or officer of an S corporation who is a 5 percent owner.

(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, such as appreciation in such value. Thus, for example, synthetic equity includes 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 interests in or assets of an S corporation or a related entity.* Synthetic equity includes a right to acquire stock or other similar interests in a related entity to the extent of the S corporation's ownership. Synthetic equity also includes a right to acquire assets of an S corporation or a related entity other than either rights to acquire goods, services, or property at fair market value in the ordinary course of business or fringe benefits excluded from gross income under section 132.

(iv) *Special rule for nonqualified deferred compensation.* (A) Synthetic equity also includes any of the following with respect to an S corporation or a related entity: any remuneration to which section 404(a)(5) applies; remuneration for which a deduction would be permitted under section 404(a)(5) if separate accounts were maintained; any right to receive property, as defined in § 1.83–3(e) of the Income Tax Regulations (including a payment to a trust described in section 402(b) or to an annuity described in section 403(c)) in a future year for the performance of services; any transfer of property in connection with the performance of services to which section 83 applies 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; and a split-dollar life insurance arrangement under § 1.61–22(b) entered into in connection with the performance of services (other than one under which, at all times, the only economic benefit that will be provided under the arrangement is current life insurance protection as described in § 1.61–22(d)(3)). Synthetic equity also includes any other remuneration for services under a plan, 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. However, synthetic equity does not include benefits under a plan that is an eligible retirement plan within the meaning of section 402(c)(8)(B).

(B) For purposes of applying paragraph (f)(2)(iv)(A) of this section with respect to an ESOP, synthetic equity does not include any interest described in such paragraph (f)(2)(iv)(A) of this section to the extent that—

(*1*) The interest is nonqualified deferred compensation (within the meaning of section 3121(v)(2)) that was outstanding on December 17, 2004;

(*2*) The interest is an amount that was taken into account (within the meaning of § 31.3121(v)(2)–1(d) of this chapter) prior to January 1, 2005, for purposes of taxation under chapter 21 of the Internal Revenue Code (or income attributable thereto); and

(*3*) The interest was held before the first date on which the ESOP acquires any employer securities.

(v) *No overlap among shares of deemed-owned ESOP shares or synthetic equity.* Synthetic equity under this paragraph (f)(2) does not include shares that are deemed-owned ESOP shares (or any rights with respect to deemed-owned ESOP shares to the extent such rights are specifically provided under section 409(h)). In addition, synthetic equity under a specific subparagraph of this paragraph (f)(2) does not include anything that is synthetic equity under a preceding provision of paragraph (f)(2)(i), (ii), (iii), or (iv) of this section.

(3) *Related entity.* For purposes of this paragraph (f), *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).

(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 number of shares of stock deliverable pursuant to such synthetic equity. In the case of synthetic equity that is determined by reference to shares of stock of the S corporation, but for which payment is made in cash or other property (besides stock of the S corporation), the number of shares of synthetic equity treated as owned is equal to the number of shares of stock having a fair market value equal to the cash or other property (disregarding lapse restrictions as described in § 1.83–3(i)). Where such synthetic equity is a right to purchase or receive S corporation shares, the corresponding number of shares of synthetic equity is determined without regard to lapse restrictions as described in § 1.83–3(i) or to any amount required to be paid in exchange for the shares. Thus, for example, if a corporation grants an employee of an S corporation an option to purchase 100 shares of the corporation's stock, exercisable in the future only after the satisfaction of certain performance conditions, the employee is the deemed owner of 100 synthetic equity shares of the corporation as of the date the option is granted. If the same employee were granted 100 shares of restricted S corporation stock (or restricted stock units), subject to forfeiture until the satisfaction of performance or service conditions, the employee would likewise be the deemed owner of 100 synthetic equity shares from the grant date. However, if the same employee were granted a stock appreciation right with regard to 100 shares of S corporation stock (whether payable in stock or in cash), the number of synthetic equity shares the employee is deemed to own equals the number of shares having a value equal to the appreciation at the time of measurement (determined without regard to lapse restrictions).

(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*—(A) *General rule.* In the case of any synthetic equity to which neither

paragraph (f)(4)(i) of this section nor paragraph (f)(4)(ii) of this section apply, the person who is entitled to the synthetic equity is treated as owning on any date a number of shares of stock in the S corporation equal to the present value (on that date) 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 that date.

(B) *Use of annual or more frequent determination dates.* A year is a nonallocation year if the thresholds in paragraph (c) of this section are met at any time during that year. However, for purposes of this paragraph (f)(4)(iii), an ESOP may provide that the number of shares of S corporation stock treated as owned by a person who is entitled to synthetic equity to which this paragraph (f)(4)(iii) applies is determined annually (or more frequently), as of the first day of the ESOP's plan year or as of any other reasonable determination date or dates during a plan year. If the ESOP so provides, the number of shares of synthetic equity to which this paragraph (f)(4)(iii) applies that are treated as owned by that person for any period from a given determination date through the date immediately preceding the next following determination date is the number of shares treated as owned on the given determination date.

(C) *Use of triennial recalculations.* (*1*) Although an ESOP must have a determination date that is no less frequent than annually, if the terms of the ESOP so provide, then the number of shares of synthetic equity with respect to grants of synthetic equity to which this paragraph (f)(4)(iii) applies may be fixed for a specified period from a determination date identified under the ESOP through the day before a determination date that is not later than the third anniversary of the identified determination date. Thus, the ESOP must provide for the number of shares of synthetic equity to which this paragraph (f)(4)(iii) applies to be re-determined not less frequently than every three years, based on the S corporation share value on a determination date that is not later than the third anniversary of the identified determination date and the aggregate present value of the synthetic equity to which this paragraph (f)(4)(iii) applies (including all grants made during the three-year period) on that determination date.

(*2*) However, additional accruals, allocations, or grants (to which this paragraph (f)(4)(iii) applies) that are made during such three-year period are taken into account on each determination date during that period, based on the number of synthetic equity shares resulting from the additional accrual, allocation, or grant (determined as of the determination date on or next following the date of the accrual, allocation, or grant). See *Example 3* of paragraph (h) of this section for an example illustrating this paragraph (f)(4)(iii)(C).

(*3*) If, as permitted under this paragraph (f)(4)(iii)(C), an ESOP provides for the number of shares of synthetic equity to be fixed for a specified period from a determination date to a subsequent determination date, then that subsequent determination date can be changed to a new determination date, subject to the following conditions:

(*i*) The change in the subsequent determination date must be effectuated through a plan amendment adopted before the new determination date;

(*ii*) The new determination date must be earlier than the prior determination date (that is, the new determination date must be earlier than the determination date applicable in the absence of the plan amendment);

(*iii*) The conditions in paragraph (f)(4)(iii)(C)(*2*) of this section must be satisfied measured from the new determination date; and

(*iv*) Except to the extent permitted by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(b) of this chapter), the change must be adopted in connection with either a change in the plan year of the ESOP or a merger, consolidation, or transfer of plan assets of the ESOP under section 414(l) (and the new determination date must consistent with that plan year change or section 414(l) event).

(4) *Conditions for application of rules.* This paragraph (f)(4)(iii)(C) only applies with respect to grants of synthetic equity to which this paragraph (f)(4)(iii) applies. In addition, paragraph (f)(4)(iii)(C) of this section applies only if the fair market value of a share of the S corporation securities on any determination date is not unrepresentative of the value of the S corporation securities throughout the rest of the plan year and only if the terms of the ESOP include provisions conforming to paragraph (f)(4)(iii)(C)(*1*) of this section which are consistently used by the ESOP for all persons. In addition, paragraph (f)(4)(iii)(C)(*1*) of this section applies only if the terms of the ESOP include provisions conforming to paragraphs (f)(4)(iii)(C)(*1*) of this section which are consistently used by the ESOP for all persons.

(iv) *Adjustment of number of synthetic equity shares where ESOP owns less than 100 percent of S corporation.* The number of synthetic shares otherwise determined under this paragraph (f)(4) is decreased ratably to the extent that shares of the S corporation are owned by a person who is not an ESOP and who is subject to Federal income taxes. For example, if an S corporation has 200 outstanding shares, of which individual A owns 50 shares and the ESOP owns the other 150 shares, and individual B would be treated under this paragraph (f)(4) as owning 100 synthetic equity shares of the S corporation but for this paragraph (f)(4)(iv), then, under the rule of this paragraph (f)(4)(iv), the number of synthetic shares treated as owned by B under this paragraph (f)(4) is decreased from 100 to 75 (because the ESOP only owns 75 percent of the outstanding stock of the S corporation, rather than 100 percent).

(v) *Special rule for shares with greater voting power than ESOP shares.* Notwithstanding any other provision of this paragraph (f)(4), if a synthetic equity right includes (directly or indirectly) a right to purchase or receive shares of S corporation stock that have per-share voting rights greater than the per-share voting rights of one or more shares of S corporation stock held by the ESOP, then the number of shares of deemed owned synthetic equity attributable to such right is not less than the number of shares that would have the same voting rights if the shares had the same per-share voting rights as shares held by the ESOP with the least voting rights. For example, if shares of S corporation stock held by the ESOP have one voting right per share, then an individual who holds an option to purchase one share with 100 voting rights is treated as owning 100 shares of synthetic equity.

(g) *Avoidance or evasion of section 409(p) involving synthetic equity*—(1) *General rule.* Paragraph (g)(2) of this section sets forth a standard for determining whether the principal purpose of the ownership structure of an S corporation involving synthetic equity constitutes an avoidance or evasion of section 409(p). Paragraph (g)(3) of this section identifies certain specific ownership structures that constitute an avoidance or evasion of section 409(p). See also paragraph (c)(3) of this section for a rule under which the ownership structures in paragraph (g)(3) of this section result in a nonallocation year for purposes of section 409(p).

(2) *Standard for determining when there is an avoidance or evasion of*

*section 409(p) involving synthetic equity.* For purposes of section 409(p) and this section, whether the principal purpose of the ownership structure of an S corporation involving synthetic equity constitutes an avoidance or evasion of section 409(p) is determined by taking into account all the surrounding facts and circumstances, including all features of the ownership of the S corporation's outstanding stock and related obligations (including synthetic equity), any shareholders who are taxable entities, and the cash distributions made to shareholders, to determine whether, to the extent of the ESOP's stock ownership, the ESOP receives the economic benefits of ownership in the S corporation that occur during the period that stock of the S corporation is owned by the ESOP. Among the factors indicating that the ESOP receives those economic benefits include shareholder voting rights, the right to receive distributions made to shareholders, and the right to benefit from the profits earned by the S corporation, including the extent to which actual distributions of profits are made from the S corporation to the ESOP and the extent to which the ESOP's ownership interest in undistributed profits and future profits is subject to dilution as a result of synthetic equity. For example, the ESOP's ownership interest is not subject to dilution if the total amount of synthetic equity is a relatively small portion of the total number of shares and deemed-owned shares of the S corporation.

(3) *Specific transactions that constitute an avoidance or evasion of section 409(p) involving segregated profits.* Taking into account the standard in paragraph (g)(2) of this section, the principal purpose of the ownership structure of an S corporation constitutes an avoidance or evasion of section 409(p) in any case in which—

(i) The profits of the S corporation generated by the business activities of a specific individual or individuals are not provided to the ESOP, but are instead substantially accumulated and held for the benefit of the individual or individuals on a tax-deferred basis within an entity related to the S corporation, such as a partnership, trust, or corporation (such as in a subsidiary that is a disregarded entity), or any other method that has the same effect of segregating profits for the benefit of such individual or individuals (such as nonqualified deferred compensation described in paragraph (f)(2)(iv) of this section);

(ii) The individual or individuals for whom profits are segregated have rights to acquire 50 percent or more of those profits directly or indirectly (for example, by purchase of the subsidiary); and

(iii) A nonallocation year would occur if this section were separately applied with respect to either the separate entity or whatever method has the effect of segregating profits of the individual or individuals, treating such entity as a separate S corporation owned by an ESOP (or in the case of any other method of segregation of profits by treating those profits as the only assets of a separate S corporation owned by an ESOP).

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

*Example 1. Relating to determination of disqualified persons and nonallocation year if there is no synthetic equity.* (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, B, who is an employee of *X*, 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 | [1] 400 | ([2]) | No. |

[1] None exceed 10 shares.
[2] 1% or less.

(ii) *Conclusion with respect to disqualified persons.* As shown in column 4 in the table contained in paragraph (i) of *Example 1*, 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. However, the synthetic equity shares owned by any person do not affect the calculation for any other person's ownership of shares.

(iii) *Conclusion with respect to nonallocation year.* 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. Relating to determination of disqualified persons and nonallocation year if there is synthetic equity.* (i) *Facts.* The facts are the same as in *Example 1*, except that, as shown in column 4 of the table in this *Example 2*, individuals E and F have options to acquire 110 and 130 shares, respectively, of the common stock of X from X:

| 1 Shareholder | 2 Deemed-owned ESOP shares (total of 1,000) | 3 Percentage deemed-owned ESOP shares | 4 Options (240) | 5 Shareholder percentage of deemed-owned ESOP plus synthetic equity shares | 6 Disqualified person |
|---|---|---|---|---|---|
| B | 330 | 33 | | | Yes (col. 3). |

| 1 Shareholder | 2 Deemed-owned ESOP shares (total of 1,000) | 3 Percentage deemed-owned ESOP shares | 4 Options (240) | 5 Shareholder percentage of deemed-owned ESOP plus synthetic equity shares | 6 Disqualified person |
|---|---|---|---|---|---|
| C | 145 | 14.5 | | | Yes (col. 3). |
| D | 75 | 7.5 | | | No. |
| E | 30 | 3 | 110 | 11.1% ([30+ 91.7] divided by 1,091.7). | Yes (col. 5). |
| F | 20 | 2 | 130 | 11.6% ([20 +108.3] divided by 1,108.3). | Yes (col. 5). |
| Other participants | [1] 400 | ([2]) | | | No. |

[1] None exceeds 10 shares.
[2] 1% or less.

(ii) *Conclusion with respect to disqualified persons.* Individual E's synthetic equity shares are counted in determining whether E is a disqualified person for 2006, and individual F's synthetic equity shares are counted in determining whether F is a disqualified person for 2006. Applying the rule of paragraph (f)(4)(iv) of this section, E's option to acquire 110 shares of the S corporation converts under paragraph (f)(4)(iv) of this section, into 91.7 shares of synthetic equity (110 times the ratio of the 1,000 deemed-owned ESOP shares to the sum of the 1,000 deemed-owned ESOP shares plus the 200 shares held outside the ESOP by A and B). Similarly, F's option to acquire 130 shares of the S corporation converts into 108.3 shares of synthetic equity (130 times the ratio of the 1,000 deemed-owned ESOP shares to the sum of the 1,000 deemed-owned ESOP shares plus the 200 shares held outside the ESOP by A and B). However, the synthetic equity shares owned by any person do not affect the calculation for any other person's ownership of shares. Accordingly, as shown in column 6 in the table contained in paragraph (i) of *Example 2*, individuals B, C, E, and F are disqualified persons for 2006.

(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, E's 91.7 synthetic equity shares, F's 20 deemed-owned ESOP shares, plus F's 108.3 synthetic equity shares total 825, which equals 58.9% of 1,400, which is the sum of the 1,200 outstanding shares of X and the 200 shares of synthetic equity shares of X held by disqualified persons. Thus, 2006 is a nonallocation year for X's ESOP under section 409(p) because disqualified persons own at least 50% of the total shares of outstanding stock of X and the total synthetic equity shares of X held by disqualified persons. 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, E's 30 deemed-owned ESOP shares, plus F's 20 deemed-owned ESOP shares equal 52.1% of the 1,200 outstanding shares of X.

*Example 3. Relating to determination of number of shares of synthetic equity.* (i) *Facts.* Corporation Y is a calendar year S corporation that maintains an ESOP. Y has a single class of common stock, of which there are a total of 1,000 shares outstanding, all of which are owned by the ESOP. Y has no synthetic equity, except for four grants of nonqualified deferred compensation that are made to an individual during the period from 2005 through 2011, as set forth in column 2 in the following table. The ESOP provides for the special rules in paragraph (f)(4)(iii) of this section to determine the number of shares of synthetic equity owned by that individual with a determination date of January 1 and the triennial rule redetermining value, as shown in columns 4 and 5:

| 1 Determination date | 2 Present value of nonqualified deferred compensation on determination date | 3 Share value on determination date | 4 New shares of synthetic equity on determination date | 5 Aggregate number of synthetic equity shares on determination date |
|---|---|---|---|---|
| January 1, 2005 | A grant is made on January 1, 2005, with a present value of $1,000. An additional grant of nonqualified deferred compensation with a present value of $775 is made on March 1, 2005. | $10 per share | 100 | 100 |
| January 1, 2006 | An additional grant is made on December 31, 2005, which has a present value of $800 on January 1, 2006. The March 1, 2005, grant has a present value on January 1, 2006, of $800. | $8 per share | 200 | 300 |
| January 1, 2007 | No new grants made | $12 per share | | 300 |
| January 1, 2008 | An additional grant is made on December 31, 2007, which has a present value of $3,000 on January 1, 2008. The grants made during 2005 through 2007 have an aggregate present value on January 1, 2008, of $3,750. | $15 per share | 200 | 450 |
| January 1, 2009 | No new grants are made | $11 per share | | 450 |
| January 1, 2010 | No new grants are made | $22 per share | | 450 |
| January 1, 2011 | No new grants are made. The grants made during 2005 through 2008 have an aggregate present value on January 1, 2011, of $7,600. | $20 per share | | 380 |

(ii) *Conclusion.* The grant made on January 1, 2005, is treated as 100 shares until the determination date in 2008. The grant made on March 1, 2005, is not taken into account until the 2006 determination date and its present value on that date, along with the then present value of the grant made on December 31, 2005, is treated as a number of shares that are based on the $8 per share value on the 2006 determination date, with the resulting number of shares continuing to apply until the determination date in 2008. On the January 1, 2008, determination date, the grant made on the preceding day is taken into account at its present value of $3,000 on January 1, 2008 and the $15 per share value on that date with the resulting number of shares (200) continuing to apply until the next determination date. In addition, on the January 1, 2008, determination date, the number of shares determined under other grants made between January 1, 2005 and December 31, 2007, must be revalued. Accordingly, the aggregate value of all nonqualified deferred compensation granted during that period is determined to be $3750 on January 1, 2008, and the corresponding number of shares of synthetic equity based on the $15 per share value is determined to be 250 shares on the 2008 determination date, with the resulting aggregate number of shares (450) continuing to apply until the determination date in 2011. On the January 1, 2011, determination date, the aggregate value of all nonqualified deferred compensation is determined to be $7,600 and the corresponding number of shares of synthetic equity based on the $20 per share value on the 2011 determination date is determined to be 380 shares (with the resulting number of shares continuing to apply until the day before the determination date in 2014, assuming no further grants are made).

(i) *Effective dates*—(1) *Statutory effective date.* (i) Except as otherwise provided in paragraph (i)(1)(ii) of this section, section 409(p) applies for plan years ending after March 14, 2001.

(ii) 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) applies for plan years beginning on or after January 1, 2005.

(2) *Regulatory effective date.* This section applies for plan years beginning on or after January 1, 2006. For plan years beginning before January 1, 2006, § 1.409(p)–1T (as it appeared in the April 1, 2005, edition of 26 CFR part 1) applies.

**Mark E. Matthews,**

*Deputy Commissioner for Services and Enforcement.*

Approved: November 30, 2006.

**Eric Solomon,**

*Acting Deputy Assistant Secretary of the Treasury (Tax Policy).*

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## DEPARTMENT OF THE INTERIOR

## Office of Surface Mining Reclamation and Enforcement

## 30 CFR Part 934

**[SATS No. ND–049–FOR, Amendment No. XXXVI]**

## North Dakota Regulatory Program

**AGENCY:** Office of Surface Mining Reclamation and Enforcement, Interior.

**ACTION:** Final rule; approval of amendment.

**SUMMARY:** We are approving an amendment to the North Dakota regulatory program (the ''North Dakota program'') under the Surface Mining Control and Reclamation Act of 1977 (SMCRA or the Act).

**DATES:** *Effective Date:* December 20, 2006.

**FOR FURTHER INFORMATION CONTACT:** Jeff Fleischman, Telephone: 307/261–6550, E-mail address: *JFleischman@osmre.gov.*

**SUPPLEMENTARY INFORMATION:**

I. Background on the North Dakota Program
II. Submission of the Proposed Amendment
III. Office of Surface Mining Reclamation and Enforcement's (OSM) Findings
IV. Summary and Disposition of Comments
V. OSM's Decision
VI. Procedural Determinations

### I. Background on the North Dakota Program

Section 503(a) of the Act permits a State to assume primacy for the regulation of surface coal mining and reclamation operations on non-Federal and non-Indian lands within its borders by demonstrating that its State program includes, among other things, ''a State law which provides for the regulation of surface coal mining and reclamation operations in accordance with the requirements of this Act * * *; and rules and regulations consistent with regulations issued by the Secretary pursuant to this Act.'' See 30 U.S.C. 1253(a)(1) and (7). On the basis of these criteria, the Secretary of the Interior conditionally approved the North Dakota program on December 15, 1980. You can find background information on the North Dakota program, including the Secretary's findings, the disposition of comments, and conditions of approval in the December 15, 1980, **Federal Register** (45 FR 82214). You can also find later actions concerning North Dakota's program and program amendments at 30 CFR 934.10, 934.12, 934.13, 934.15 and 934.30.

### II. Submission of the Proposed Amendment

By letter dated May 24, 2006, North Dakota sent us an amendment to its program (Amendment number XXXVI, Administrative Record No. ND–KK–01) under SMCRA (30 U.S.C. 1201 *et seq.*). North Dakota sent the amendment to include changes made at its own initiative. The provisions of the North Dakota Administrative Code (NDAC) that North Dakota proposed to revise are: Rules about data requirements for proving reclamation success, and adding new language to revegetation success standards on the counting of volunteer trees and shrubs. Other changes are minor, including provisions that relate to lease documents in mining permits; newspaper notices for permit applications; copies of advertisements and other information needed for bond release applications; clarifying inspection requirements for sedimentation ponds and other impoundments; and correcting a cross reference error in a rule on roads. With these minor changes, North Dakota proposes to revise its program to improve operational efficiency. Specifically, North Dakota proposes to:

Add language to NDAC 69–05.2–06–03 (right-of-entry requirements) to allow a permittee to delete coal leases from the permit when mining on a tract covered by a lease is completed and the lease is no longer needed to show a right-of-entry. However, if the coal lease no longer provides the surface right of entry, other documents granting the permittee the right of entry must be added to the permit.

Delete language to NDAC 69–05.2–10–01 that required the newspaper notice for permit applications include a reference to the U.S. Geological Survey map that contains the area; and add language that limits the listing of coal owners in the notice to those that will be affected by the mining activities.

Revise the bond release application requirements in North Dakota's coal rules at NDAC 69–05.2–12–12 to require the filing of a copy of the newspaper advertisement instead of requiring the submittal of affidavits of publication.