

(i) During the taxable year of the registered owner in which a retirement bond is redeemed, the registered owner becomes disabled within the meaning of section 72(m)(7), or

(ii) A retirement bond is tendered for redemption in accordance with paragraph (b)(2)(i) of this section.

[T.D. 7714, 45 FR 52799, Aug. 8, 1980]

§ 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 non-allocation 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 non-allocation 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 deemed-owned ESOP and synthetic equity shares of the S corporation;

(iii) The aggregate number of 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 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 aggregate number of deemed-owned ESOP and synthetic equity shares of the S corporation.

(2) *Treatment of family members; definition.* (i) Each member of the family of any person who is a disqualified person under paragraph (d)(1)(iii) or (iv) of this section is a disqualified person. *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) or (iii) of this section.

(ii) 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 for purposes of this paragraph (d)(2).

(3) *Special rule for certain nonallocation years.* See paragraph (c)(3) of this section (relating to avoidance or evasion of section 409(p)) for a special rule permitting any person to be treated as a disqualified person in certain nonallocation years.

(e) *Deemed-owned ESOP shares.* A person is treated as owning his or her deemed-owned ESOP shares. *Deemed-owned ESOP shares* 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 most recent stock allocation under the ESOP).

(f) *Synthetic equity*—(1) *Ownership of synthetic equity.* For purposes of section 409(p) and this section, synthetic equity is treated as owned by a person in the same manner as stock is treated as owned by a person, directly or under the rules of section 318(a)(2) and (3). *Synthetic equity* means the rights described in paragraph (f)(2) of this section.

(2) *Synthetic equity*—(i) *Rights to acquire stock of the S corporation.* *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 persons other than the ESOP, the S corporation, or a related entity, are not synthetic equity (but see paragraph (c)(4) of this section).

(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 or appreciation in such value, such as 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 assets of an S corporation or related entity—(A) Rights to acquire interests in a related entity—(1) Treatment as synthetic equity.* *Synthetic equity* includes a right to acquire stock or other similar interests in a related entity that is described in this paragraph (f)(2)(iii)(A).

(2) *Significant interests.* *Synthetic equity* includes a right to acquire stock or other similar interests in a related entity if such interests in the related entity are the only significant asset of the S corporation and the S corporation is the only significant owner of the related entity. Whether an asset is the only significant asset of the S corporation or the S corporation is the only significant owner of the related entity depends on the relevant facts and circumstances.

(3) *Rights to acquire interests in other related entities.* [Reserved]

(4) *Related entity.* For purposes of this section, *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).

(B) *Rights to acquire assets of an S corporation or related entity other than rights to acquire stock or similar interests in a related entity—(1) General rule.* [Reserved]

(2) *Exception for rights to acquire goods or services in ordinary course of business.* *Synthetic equity* does not include rights

to acquire goods or services at fair market value in the ordinary course of business.

(C) *Authority to provide guidance.* 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 *synthetic equity* includes a right to acquire stock or other similar interests in a related entity in cases in which such interests in the related entity are not the only significant asset of the S corporation or the S corporation is not the only significant owner of the related entity if necessary to carry out the purposes of section 409(p).

(D) *Synthetic equity includes comparable rights.* An option or right to acquire assets of the S corporation or another person is treated as synthetic equity if such option or right is part of a structure that provides rights to the holder comparable to the rights provided by arrangements identified as synthetic equity under this paragraph (f)(2)(iii) and the principal purpose of the structure is the avoidance or evasion of section 409(p).

(iv) *Special rule for nonqualified deferred compensation.* *Synthetic equity* also includes any remuneration for services rendered to the S corporation, or a related entity, to which section 404(a)(5) applies (including remuneration for which a deduction would be permitted under section 404(a)(5) if separate accounts were maintained), any right to receive property (to which section 83 applies) in a future year for the performance of services to an S corporation, or related entity, and any transfer of property (to which section 83 applies) in connection with the performance of services to an S corporation, or a related entity, to the extent that the property is not substantially vested within the meaning of §1.83-3(i) by the end of the plan year in which transferred. *Synthetic equity* also includes any other remuneration for services rendered to the S corporation, or a related entity, under a plan, or 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, other than a plan that is an eligible retirement plan within the meaning of section 402(c)(7)(B).

(3) *No overlap among shares of deemed-owned ESOP shares or synthetic equity.* Synthetic equity under this paragraph (f) does not include shares that are deemed-owned ESOP shares. In addition, synthetic equity under a specific subparagraph of this paragraph (f) does not include anything that is synthetic equity under a preceding subparagraph of this paragraph (f).

(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 corresponding number of shares of stock. For example, if a corporation grants an employee of an S corporation an option to purchase 100 shares of the corporation's stock, the employee is the deemed owner of 100 synthetic equity shares of the stock of the corporation.

(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.* In the case of any other synthetic equity, the per-

son 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 at § 1.83-3(i)) divided by the fair market value of a share of the S corporation's stock as of the same date. For purposes of this paragraph (f)(4)(iii), the number of shares of S corporation is permitted to be determined as of the first day of the ESOP's plan year, or any other reasonable determination date or dates during a plan year that is consistently used by the corporation for this purpose for all persons. The number of shares of synthetic equity treated as owned for any period from a determination date through the date immediately preceding the next following determination date is the number of shares treated as owned on the first day of that period.

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

Example 1. (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, individual B 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	33	33	Yes.
C	145	14.5	Yes.
D	75	7.5	No.
E	30	3	No.
F	20	2	No.
Other participants	400 (none exceed 10 shares)	1 or less	No

(ii) *Conclusion with respect to disqualified persons.* As shown in column 4 in the table above, 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.

(iii) *Conclusion with respect to nonallocation year.* However, 2006 is not a nonallocation year under section 409(p) because disqualified

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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 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. (1) *Facts.* The facts are the same as in *Example 1*, except that, as shown in column 4 of the table below, individual E has an option to acquire 500 shares of the common stock of X from X:

1—Shareholders	2—Deemed-Owned ESOP shares (total of 1,000)	3—Percentage deemed-owned ESOP shares	4—Synthetic equity (500)	5—Percentage deemed-owned ESOP plus Synthetic equity shares (total of 1,500)	6—Disqualified person
B	330	33		22	Yes (cols. 3 and 5).
C	145	14.5		9.7	Yes (col. 3).
D	75	7.5		5	No.
E	30	3	500	35.3	Yes (col. 5).
F	20	2		1.3	No.
Other participants	400 (none exceed 10 shares)	1 or less		under 1	No.

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(ii) *Conclusion with respect to disqualified persons.* E's option constitutes 500 shares of synthetic equity. Accordingly, as shown in column 6 in the table above, individuals B, C, and E are disqualified persons for 2006 because each owns at least 10% of X's deemed-owned ESOP shares or X's total deemed-owned ESOP and synthetic equity shares.

(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, plus E's 500 synthetic equity shares equals 65% of the 1,700 outstanding and synthetic equity shares of X. Thus, 2006 is a nonallocation year for X's ESOP under section 409(p) because disqualified persons own at least 50% of X's total shares of outstanding stock and synthetic equity. 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, plus E's 30 deemed-owned ESOP shares equals 50.4% of the 1,200 outstanding shares of X.

(h) *Effective date—(1) General effective dates.* Except as provided in paragraph (h)(2) of this section, section 409(p) applies for plan years ending after March 14, 2001 and this section applies for plan years ending after October 20, 2003, except that paragraph (f)(2)(iv) of this section is disregarded with respect to nonqualified deferred compensation that is distributed on or before July 21, 2004.

(2) *Certain ESOPs established on or before March 14, 2001.* 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,

[T.D. 9081, 68 FR 42974, July 21, 2003]

§ 1.410(a)-1 Minimum participation standards; general rules.

(a) *In general.* A plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) unless the plan satisfies—

(1) The minimum age and service requirements of section 410(a)(1) and § 1.410(a)-3,

(2) The maximum age requirements of section 410(a)(2) and § 1.410(a)-4, and

(3) The minimum coverage requirements of section 410(b)(1) and § 1.410(b)-1.

(b) *Organization of regulations relating to minimum participation standards—(1) General rules.* This section prescribes general rules relating to the minimum participation standards provided by Section 410.

(2) *Effective dates.* Section 1.410(a)-2 provides rules under section 1017 of the Employee Retirement Income Security Act of 1974 relating to effective dates under section 410.

(3) *Age and service conditions.* Section 1.410(a)-3 provides rules under section 410(a)(1) relating to minimum age and service conditions.

(4) *Maximum age and time of participation.* Section 1.410(a)-4 provides rules under section 410(a)(2) and (4) relating to maximum age and time of participation.

(5) *Year of service; breaks in service.* For rules relating to years of service and breaks in service, see 29 CFR Part 2530 (Department of Labor regulations relating to minimum standards for employee pension benefit plans). See § 1.410(a)-5 for rules under section 410(a)(3)(B) relating to seasonal industries and for certain rules under section 410(a)(5) relating to breaks in service.

(6) *Breaks in service.* Section 1.410(a)-6 provides special rules under section 1017(f) of the Employee Retirement Income Security Act of 1974 relating to amendment of break in service rules.

(7) *Elapsed time.* Section 1.410(a)-7 provides rules under sections 410 and 411 relating to the elapsed time method of crediting years of service.

(8) *Coverage.* Section 1.410(b)-1 provides rules relating to the minimum coverage requirements provided by section 410(b)(1).

(9) *Church election.* Section 1.410(d)-1 provides rules relating to the election by a church to have participation, vesting, funding, etc., provisions apply.

(c) *Application of participation standards to certain plans—(1) General rule.* Except as provided in subparagraph (2) of this paragraph, section 410 does not apply to—

(i) A governmental plan (within the meaning of section 414(d) and the regulations thereunder),