Internal Revenue
bulletin

Bulletin No. 2005-3
January 18, 2005

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Rev. Rul. 2005–3, page 334.

Section 901(j)(5) Presidential waiver; Libya. Pursuant to a section 901(j)(5) Presidential waiver, section 901(j)(1) of the Code ceased to apply to Libya effective December 10, 2004. Section 911(d)(8) is not applicable to Libya after September 20, 2004, and Iraq after July 29, 2004. Rev. Ruls. 92–63 and 95–63 modified and superseded. Rev. Rul. 2004–103 superseded.

Notice 2005–2, page 337.

This notice provides guidance to qualifying vessel operators on the procedure for electing into the tonnage tax regime under section 1354(a) of the Code, which was added by section 248 of the American Jobs Creation Act of 2004.

EMPLOYEE PLANS

T.D. 9164, page 320.
REG–129709–03, page 351.

Temporary and proposed regulations under section 409(p) of the Code provide guidance on the definition and effects of a prohibited allocation under section 409(p), identification of disqualified persons and determination of a nonallocation year, calculation of synthetic equity under section 409(p)(5), and standards for determining whether a transaction is an avoidance or evasion of section 409(p). A public hearing on the proposed regulations is scheduled for April 20, 2005.

Notice 2005–5, page 337.

Automatic rollover; section 657 of Economic Growth Tax Relief and Reconciliation Act of 2001. This notice provides guidance in question and answer format on the automatic rollover provisions of section 401(a)(31)(B) of the Code as amended by section 657 of the Economic Growth and Tax Relief Reconciliation Act of 2001.

EMPLOYMENT TAX

Announcement 2005–5, page 353.

This announcement advises employers about a new Code Z for use on the 2005 Form W–2. This code will be used to identify income recognized due to participation in a nonqualified deferred compensation plan that fails to meet the requirements of section 409A of the Code. Similar reporting is required on Form 1099–MISC for nonemployees.

ADMINISTRATIVE

Notice 2005–7, page 340.

This notice addresses the applicability of section 6043A of the Code and requests public comments on issues relating to information reporting for acquisitions under section 6043A by March 1, 2005. The notice provides that taxpayers required to report under regulations sections 1.6043–4T and 1.6045–3T must continue to report pursuant to those regulations.

Rev. Proc. 2005–10, page 341.

Per diem allowances. This procedure provides optional rules for deeming substantiated the amount of certain reimbursed traveling expenses of an employee as well as determining the amount of deductible meal and incidental expenses while traveling away from home. It updates Rev. Proc. 2004–60, 2004–42 I.R.B. 682, to revise the high-low substantiation method to conform to changes in the *per diem* rates made by the General Services Administration. Rev. Proc. 2004–60 superseded.

Announcements of Disbarments and Suspensions begin on page 352.
Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are compiled semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.

For sale by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 62.—Adjusted Gross Income Defined

26 CFR 1.62–2: Reimbursements and other expense allowance arrangements.

Rules are provided under which a reimbursement or other expense allowance arrangement for the cost of lodging, meal, and incidental expenses, of meal and incidental expenses, or of incidental expenses only, incurred by an employee while traveling away from home will satisfy the requirements of § 62(c) of the Code as to substantiation of the amount of the expenses. See Rev. Proc. 2005-10, page 341.

Section 162.—Trade or Business Expenses

26 CFR 1.162–17: Reporting and substantiation of certain business expenses of employees.

Rules are provided for substantiating the amount of a deduction of an expense for meal and incidental expenses, or for incidental expenses only, incurred while traveling away from home. See Rev. Proc. 2005-10, page 341.

Section 267.—Losses, Expenses, and Interest With Respect to Transactions Between Related Taxpayers

26 CFR 1.267(a)–1: Deductions disallowed.

Optional rules for substantiating the amount of ordinary and necessary business expenses of an employee for lodging, meal, and incidental expenses, for meal and incidental expenses, or for incidental expenses only, incurred while traveling away from home when a payor provides a *per diem* allowance under a reimbursement or other expense allowance arrangement do not apply if a payor and an employee are related within the meaning of § 267(b). See Rev. Proc. 2005-10, page 341.

Section 274.—Disallowance of Certain Entertainment, etc., Expenses

26 CFR 1.274–5: Substantiation requirements.

Rules are provided for an optional method for substantiating the amount of ordinary and necessary business expenses of an employee for lodging, meal, and incidental expenses, for meal and incidental expenses, or for incidental expenses only, incurred while traveling away from home when a payor provides a *per diem* allowance under a reimbursement or other expense allowance arrangement. Rules are also provided for an optional method for employees and self-employed individuals to use in computing the deductible costs of business meal and incidental expenses, or incidental expenses only, paid or incurred while traveling away from home. See Rev. Proc. 2005-10, page 341.

Section 409.—Qualifications for Tax Credit Employee Stock Ownership Plans

26 CFR 1.409(p)–1T: Prohibited allocations of securities in an S corporation (temporary).

T.D. 9164

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Prohibited Allocations of Securities in an S Corporation

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations concerning requirements for employee stock ownership plans (ESOPs) holding stock of Subchapter S corporations. The temporary regulations provide guidance on the definition and effects of a prohibited allocation under section 409(p), identification of disqualified persons and determination of a nonallocation year, calculation of synthetic equity under section 409(p)(5), and standards for determining whether a transaction is an avoidance or evasion of section 409(p). These temporary regulations generally affect plan sponsors of, and participants in, ESOPs holding stock of Subchapter S corporations. The text of the temporary regulations also serves as the text of the proposed regulations (REG–129709–03) set forth in the notice of proposed rulemaking on this subject in this issue of the Bulletin.

DATES: *Effective Date*: These regulations are effective December 17, 2004.

Applicability Dates: These temporary regulations are applicable with respect to plan years beginning on or after January 1, 2005, but see §1.409–1T(i)(2) for specific exceptions.

FOR FURTHER INFORMATION CONTACT: John T. Ricotta at (202) 622–6060 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Section 409(p) was enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) (115 Stat. 38) (2001) to address concerns about ownership structures involving S corporations and ESOPs that concentrate the benefits of the ESOP, directly or indirectly, in a small number of persons. Under the statute, an ESOP is generally permitted to hold S corporation stock, provided that the ESOP benefits a sufficiently broad-based group of employees.

Section 4975(e)(7) provides that an ESOP is a defined contribution plan that is designed to invest primarily in qualifying employer securities and that is either a stock bonus plan which is qualified, or a stock bonus plan and money purchase pension plan both of which are qualified, under section 401(a). A plan is not treated as an ESOP under the Internal Revenue Code (Code) unless it meets the following requirements, to the extent applicable: section 409(e) (relating to participants' voting rights if the employer has a registration-type class of securities); section 409(h) (relating to participants' right to receive employer securities; put options); section 409(o) (relating to participants' distribution rights and payment requirements); section 409(n) (relating to securities received in transactions to which section 1042 applies); section 409(p) (relating to prohibited allocations of securities in an S corporation); and section 664(g) (relating to qualified gratuitous transfers of qualified employer securities). As authorized by section 4975(e)(7), additional requirements for ESOPs are imposed under §54.4975–11 of the Excise Tax Regulations.

Section 511 imposes an income tax on unrelated business taxable income (UBTI), as defined in section 512. Section 512(e)(1) generally provides that an interest in an S corporation held by an organization described in section 1361(c)(6), including a qualified plan, is treated as an interest in an unrelated trade or business. However, section 512(e)(3) has an exception for employer securities held by an ESOP, so that an ESOP of an S corporation generally does not have UBTI under section 512 with respect to the S corporation stock held by the ESOP.

Section 409(p)(1) requires an ESOP holding employer securities consisting of stock in an S corporation to 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, as defined in section 409(p). 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 whether someone is a "disqualified person" depends on a person's deemed-owned shares of S corporation stock held by an ESOP (deemed-owned ESOP shares). Section 409(p)(4) provides, in general, that a "disqualified person" means any person whose deemed-owned ESOP shares are at least 10 percent of the number of deemed-owned ESOP shares or for whom the aggregate number of deemed-owned ESOP shares of such person and the members of such person's family is at least 20 percent of the number of deemed-owned ESOP shares.

The determination of whether someone is a disqualified person and whether a plan year is a nonallocation year is also made separately taking into account synthetic equity. Synthetic equity is a general classification unique to section 409(p). The provisions relating to synthetic equity do not modify the rules relating to S corporations, *e.g.*, the circumstances in which options or similar interests are treated as creating a second class of stock. H.R. Conf. Rep. No. 107–84, at 102 n. 52. Under the rules for the treatment of synthetic equity at section 409(p)(5), if a person owns synthetic equity in an S corporation, then the shares of stock in such corporation on which such synthetic equity is based are treated as outstanding stock in such corporation, and as deemed-owned shares of such person, "if such treatment of synthetic equity *of 1 or more such persons* results in ... the treatment of any person as a disqualified person or ... the treatment of any year as a nonallocation year." [Emphasis added.]

Section 409(p)(7)(A) authorizes the Secretary to prescribe such regulations as may be necessary to carry out the purposes of section 409(p). Section 409(p)(7)(B) provides that the Secretary may, by regulation or other guidance of general applicability, 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).

Section 4979A imposes a 50 percent excise tax on certain prohibited allocations in an ESOP, including any allocation of employer securities that violates section 409(p), and on any synthetic equity owned by a disqualified person during a nonallocation year under section 409(p). In addition, section 4979A includes special rules for the first nonallocation year of an ESOP under which the excise tax applies with respect to all deemed-owned ESOP shares and all synthetic equity of disqualified persons, even if there is no prohibited allocation in that year. Section 4979A(a)(3), (a)(4), and (e)(2)(C). Thus, for example, any unallocated shares in an ESOP loan suspense account that are treated as deemed-owned shares of a disqualified person pursuant to section 409(p)(4)(C) are taken into account in determining the amount involved under 4979A(e)(2)(C). In addition, under section 4979A(e)(3)(D), a special statute of limitations applies to the first year of an ESOP that is a nonallocation year.

Temporary regulations under section 409(p) were issued on July 21, 2003 (T.D. 9081, 2003–2 C.B. 420 [68 FR 42970]). The text of those temporary regulations also served as the text of a notice of proposed rulemaking (REG–129709–03, 2003–2 C.B. 506) published at 68 FR 43058. The 2003 regulations provide guidance on identifying disqualified persons, determining whether an ESOP has a nonallocation year, and on the definition of synthetic equity under section 409(p)(5).

In January 2004, the IRS issued Rev. Rul. 2004–4, 2004–6 I.R.B. 414, which addresses three factual situations involving an S corporation with qualified subchapter S subsidiaries (QSUBs). Pursuant to the authority of section 409(p)(7)(B) and §1.409(p)–1T(c)(3) of the 2003 regulations, Rev. Rul. 2004–4 states that a nonallocation year occurs and the individual is a disqualified person in any case in which (i) shares of an S corporation are employer securities held by an ESOP, (ii) the profits of the S corporation generated by the business activities of a specific individual are accumulated and held for the benefit of that individual in a QSUB or similar entity (such as a limited liability company), (iii) these profits are not paid to the individual as compensation within 2½ months after the end of the year in which earned, and (iv) the individual has rights to acquire shares of stock (or similar interests) of the QSUB or similar entity representing 50 percent or more of the fair market value of the stock of such QSUB or similar entity. Rev. Rul. 2004–4 also provides that such individual's right to acquire shares of stock (or similar interests) of the QSUB or similar entity is synthetic equity. Accordingly, Rev. Rul. 2004–4 holds in each of the three factual situations that, for purposes of sections 409(p) and 4979A, certain individuals are disqualified persons, the ESOP has a nonallocation year, and the disqualified persons are treated as owning synthetic equity in the form of their options to acquire shares of the corresponding QSUB.[1]

[1] Rev. Rul. 2004–4 also states that arrangements that are the same as, or substantially similar to, the following transaction are identified as "listed transactions" for purposes of §§1.6011–4(b)(2), 301.6111–2(b)(2) and 301.6112–1(b)(2), effective January 23, 2004: any transaction in which (i) at least 50 percent of the outstanding shares of an S corporation are employer securities held by an ESOP, (ii) the profits of the S corporation generated by the business activities of a specific individual are accumulated and held for the benefit of that individual in a QSUB or similar entity (such as a limited liability company), (iii) these profits are not paid to the individual as compensation within 2½ months after the end of the year in which earned, and (iv) the individual has rights to acquire shares of stock (or similar interests) of the QSUB or similar entity representing 50 percent or more of the fair market value of the stock of such QSUB or similar entity.

Rev. Rul. 2004–4 also stated that Treasury and the IRS intend to reflect the guidance in that revenue ruling in regulations under section 409(p), effective for plan years ending after October 20, 2003, and that it is expected that the regulations would apply to similar transactions that have the effect of reserving profits from an individual's business activities to provide similar tax benefits to the individual, either with the use of a QSUB or through the use of another method.

Comments were received on the 2003 regulations. A public hearing on the 2003 regulations was held on November 17, 2003. After consideration of comments received and views expressed at the hearing, and taking into account Rev. Rul. 2004–4 and that section 409(p) applies to all ESOPs for plan years beginning on or after January 1, 2005, these new temporary regulations are being issued effective generally for plan years that begin on or after January 1, 2005, subject to a number of special effective date and transition rules that are described in this preamble under the heading *Effective date*.

Explanation of Provisions

Definition of Prohibited Allocation

In order to satisfy section 409(p), 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. This requirement has two elements; it prohibits accruals and allocations. These regulations provide two new terms, impermissible accrual and impermissible allocation, to reflect these two elements. Under the regulations, if there is an impermissible accrual or an impermissible allocation, then there is a prohibited allocation in violation of this requirement.

Under the definition of impermissible accrual in these regulations, there is a prohibited allocation to the extent (and only 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. This rule was recommended by a commentator. For this purpose, assets attributable to S corporation securities include not only S corporation stock held in a disqualified person's account in the ESOP, but also 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).

Under the definition of impermissible allocation, prohibited allocations include any allocation for a disqualified person directly or indirectly under any plan of the employer qualified under section 401(a) that occurs during a nonallocation year to the extent that a contribution or other annual addition is made, or the disqualified person otherwise accrues additional benefits, 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)) that, for the nonallocation year, would otherwise 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 to comply with section 409(p).

Effect of a Prohibited Allocation

Under section 409(p)(2) and these regulations, if there is a prohibited allocation, then the amount of the prohibited allocation is treated as distributed to the disqualified person at the time of the prohibited allocation. Accordingly, the fair market value of the disqualified person's account under the ESOP would generally be included in his or her gross income (to the extent in excess of his or her allocable investment in the contract, if any, under section 72). The additional income tax imposed by section 72(t) would also apply if the disqualified person is less than age 59½ (and no other exception applies).

Like a deemed distribution under section 72(p),[2] a deemed distribution under section 409(p) is not an actual distribution from the ESOP. Thus, the amount of the prohibited allocation is not an eligible rollover distribution and, for purposes of applying sections 72 and 402 with respect to any subsequent distribution from the ESOP, the amount previously taken into account by the disqualified person as income as a result of the deemed distribution is treated as an investment in the contract.

Under these regulations, if there is a nonallocation year and there are prohibited allocations in that year, the plan would fail to satisfy the requirements of section 4975(e)(7) and would cease to be an ESOP. As a result, not only would the plan 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), but also the exception in section 512(e)(3) would cease to apply to the plan, so that the plan would owe income tax as a result of unrelated business taxable income under section 512 with respect to S corporation stock held by the plan from and after the date of the prohibited allocation.[3] Other consequences include imposition of an excise tax under section 4979A and, assuming that the plan's provisions do not permit a prohibited allocation under section 409(p), loss of tax qualification for failure to operate the plan in accordance with its terms.

Prevention of a Nonallocation Year

As part of the regulations that were proposed in 2003, comments were requested with respect to issues raised by S corporation ESOPs established by March 14, 2001, that will need to comply with the requirements of section 409(p) beginning in 2005, including transition approaches

[2] See §1.72(p)–1, Q&A–11 and 12.

[3] It should be noted that transactions that give rise to loss of the prohibited transaction exemptions under section 4975(d)(3) of the Internal Revenue Code and section 408(b)(3) of Title I of ERISA for loans to an ESOP could also give rise to other prohibited transactions under section 4975 of the Internal Revenue Code, as well as violations of Title I of ERISA, including prohibited transactions under section 406 of Title I of ERISA, resulting in, among other things, the assessment of additional excise taxes under section 4975(a) and (b) of the Internal Revenue Code, as well as civil penalties under section 502(i) of ERISA.

for ESOPs that become subject to section 409(p) in 2005. One commentator requested a transition rule under which nonqualified deferred compensation would be disregarded if it was granted at a time when it was not synthetic equity and was distributed within 12 months after it became synthetic equity.

These issues are particularly important because compliance with the requirements of section 409(p) is required on a current operational basis, as well as a plan document basis. Thus, for example, if S corporation shares are held in a disqualified person's account during a nonallocation year, then there is a failure to satisfy section 409(p), without regard to whether the terms of the ESOP prohibit such actions or require preventative action to be taken. Factors that might be considered in determining whether there has been a failure to comply with the requirements of section 409(p) on a current operational basis include, for example, the exercise of voting rights of shares in the disqualified person's account, distributions from the S corporation to the disqualified person's account, and plan account statements showing allocations to the disqualified person's account.

A plan might choose to take a number of steps before the beginning of a year in order to ensure that the year is not a nonallocation year, such as steps to prevent an individual from becoming a disqualified person. These include:

- Reduction of synthetic equity, *e.g.*, by cancellation or distribution of the synthetic equity.

- A sale of the S corporation securities held in the participant's ESOP account so that the account is not invested in S corporation stock.

- A distribution of the S corporation securities held in the participant's account from the ESOP to the participant. Such a distribution is only permissible to the extent the amount is otherwise permitted to be distributed (*e.g.*, for amounts that are subject to section 401(k), the distribution does not violate the distribution restrictions of section 401(k)(2)(B)(i)).

- 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 (as permitted under §54.4975–11(a)(5) of the Excise Tax Regulations) or to another qualified plan of the employer that is not an ESOP.

Any of these steps must satisfy applicable legal and qualification requirements, including the nondiscrimination requirements of section 401(a)(4).[4] 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. Further, subsequent to the transfer, the plan that is not an ESOP will not fail to satisfy the requirements of §1.401(a)(4)–4 merely because of the benefits, rights, or features with respect to the transferred benefits if those benefits, rights, or 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.

In the event of such a transfer, the transferee plan would be subject to tax on unrelated business taxable income with respect to its *pro rata* share of income from the S corporation securities, with that expense to be charged to the account holding the transferred amount. However, the ESOP would be able to continue to satisfy the requirements of section 4975(e)(7) and the allocations could be made for the participant for the year.

Determination of Nonallocation Year

Under section 409(p), a nonallocation year generally means a plan year during which on any date disqualified persons own 50 percent or more of the stock in the S corporation, separately applied by taking into account all outstanding shares of stock in the S corporation (including shares held by the ESOP) and by taking into account all outstanding shares of stock in the S corporation and synthetic equity. These regulations include some changes from the rules in the 2003 regulations for purposes of determining whether there is a nonallocation year.

The 2003 regulations generally treat a person as owning outstanding non-ESOP stock that the person has the right to acquire, but only in very limited cases. These regulations treat a person as owning outstanding non-ESOP stock that the person has the right to acquire unless the actual owner is a person who is subject to federal income tax, the right is one that would not be taken into account in determining whether an S corporation has a second class of stock under §1.1361–1(l)(2)(iii) or (l)(4)(iii)(C), and a principal purpose of the right is not to avoid or evade a nonallocation year under section 409(p).

Other differences from the 2003 regulations include a change relating to synthetic equity (discussed in this preamble under the heading *Determination of disqualified persons on person-by-person basis*) and, in response to comments, clarification that, if 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.

Determination of Disqualified Persons on Person-by-person Basis

Under the 2003 regulations, a person's synthetic equity shares are added to his or her deemed-owned ESOP shares to determine whether he or she is a disqualified person. This total number of shares is then compared with the total outstanding synthetic equity shares in determining whether that person is a disqualified person. The 2003 regulations were criticized for this approach in the case of options because it allowed options held by other shareholders to dilute the interests of the person being tested and prevent them from being treated as a disqualified person.

These regulations change this approach by looking only at the synthetic equity of the person being tested to determine if he or she is a disqualified person. In addition, a nonallocation year occurs as a result of synthetic equity if the total share ownership of disqualified persons (actual ownership, deemed-owned ESOP shares, plus synthetic equity) is at least 50 percent of the total shares outstanding plus the syn-

[4] Further, any sale or transfer of plan assets must comply with the requirements of Part 4 of Subtitle B of Title I of ERISA.

thetic equity of disqualified persons. This 'person-by-person approach' is more consistent with the statutory rule that synthetic equity is counted for one person if it results in any person being treated as a disqualified person.

The person-by-person approach applies to synthetic equity in the form of nonqualified deferred compensation, as well as in the form of options or other rights related to stock. This approach prevents dilution of the disqualified person's ownership and also addresses a known abuse identified by several commentators involving stock options or stock appreciation rights that are unlikely to be exercised. In this abuse, the S corporation issues a large number of stock options or stock appreciation rights to lower paid employees which are only exercisable at a strike price far exceeding even the likely future value of the shares or the strike price is periodically reset to exceed the expected value during the term of the option or right. These options or rights would never be exercised by the employees, but are designed to count as synthetic equity shares in order to prevent shareholders who actually have the right to own 10 percent or more of the S corporation from being treated as disqualified persons. Several commentators urged Treasury and the IRS to prevent this abuse. Under the person-by person approach adopted in these regulations, these options or rights would be ignored in determining whether other shareholders were disqualified persons and would not prevent persons who have actual rights to become 10 percent shareholders from being treated as disqualified persons.

Synthetic Equity

These regulations are generally similar to the 2003 regulations regarding what constitutes synthetic equity. Differences include the expansion of the definition of synthetic equity to include the right to acquire stock or assets of a related entity and an exclusion for nonqualified deferred compensation that was taken into account before January 1, 2005, for purposes of the Federal Insurance Contributions Act (FICA) and that was outstanding before the first date on which the ESOP acquired any employer securities.

Determination of Number of Shares of Synthetic Equity

The 2003 regulations include rules under which the number of synthetic equity shares attributed for a stock option is based on the number of shares that are subject to that option. The same rule also applies to any other 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. These regulations provide that in the case of synthetic equity determined by reference to shares of stock in the S corporation, the number of shares of synthetic equity depends on the gross number of shares deliverable pursuant to the synthetic equity. In the case of synthetic equity determined by reference to S corporation shares but payable in cash or other property (other than S corporation shares), the number of synthetic equity shares treated as owned is equal to the number of shares of stock having a fair market value equal to the cash or other property paid (disregarding lapse restrictions as described in §1.83–3(i)). Accordingly, the number of shares of synthetic equity attributed for a stock appreciation right (payable in stock or in cash) equals the number of shares having a value equal to the appreciation at the time of measurement (determined without regard to lapse restrictions).

In addition, the 2003 regulations provide that rights to acquire stock or interests in an entity related to the S corporation are treated as synthetic equity if the interests in the related entity are the only significant assets of the S corporation and the S corporation is the only significant owner of the related entity. These regulations broaden that rule by providing that synthetic equity includes all rights to acquire stock or similar interests in a related entity to the extent of the S corporation's ownership. The regulations provide that 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.

In the case of synthetic equity that is not determined by reference to shares of stock of the S corporation (or shares of stock or similar interests in a related entity), the 2003 regulations provided 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 include a similar rule, but include three rules that were not in the 2003 regulations.

First, these regulations include a special rule with respect to voting rights. While sections 409(l) and 4975(e)(7) generally require that the employer securities of an ESOP have voting rights at least equal to the voting rights of that class of common stock having the greatest voting rights (assuming the employer has no stock readily traded on an established securities market), there might be rights to acquire a class of shares that are not currently outstanding and that have greater voting rights. Under these regulations, 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 at least equal to the number of shares that would have the same voting rights if such shares had the same per-share voting rights as shares held by the ESOP.

Second, like the 2003 regulations, these regulations permit the number of synthetic equity shares for nonqualified deferred compensation (that is not determined by reference to shares of stock of the S corporation or shares of stock or similar interests in a related entity) 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 ESOP for this purpose for all persons. These regulations require that the date used be reasonably representative of the share value of the S corporation's stock. 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 pe-

riod. In addition, these regulations include a new rule intended to address concerns expressed in the comments regarding administrative and planning difficulties that arise from a daily, or even annual, determination of synthetic equity shares where the number is affected both by the potential volatility of the S corporation stock value and separately by the potential volatility of the nonqualified deferred compensation. Under these regulations, the ESOP may provide, on a reasonable and consistent basis used by the ESOP for this purpose for all persons, that the number of shares of synthetic equity treated as owned on an identified determination date remain constant for the period from that determination date until the date that is immediately preceding the third anniversary of the identified determination date. As new grants are made during this three-year period, the appropriate number of shares of synthetic equity resulting from the new grant would be determined at the next determination date, which would likewise remain constant during the remainder of the same three-year period. However, the ESOP must recalculate the number of shares of this type of synthetic equity at least every three years, based on the S corporation share value on the applicable determination date and the aggregate present value of nonqualified deferred compensation on that determination date. The regulations include an example illustrating this rule.

Third, these regulations include a new rule for cases in which the ESOP does not own all of the stock of the S corporation. This rule reflects the view that the dilutive effect of synthetic equity only affects an ESOP to the extent of the ESOP's ownership interest in the S corporation. Under this rule, the number of synthetic shares otherwise determined is reduced 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 as owning 200 synthetic equity shares of the S corporation but for the special rule for cases in which the ESOP does not own all of the stock of the S corporation, then the number of synthetic shares treated as owned by B is decreased from 200 to 150 (because the ESOP only owns 75% of the outstanding stock of the S corporation, rather than 100%).

Avoidance or Evasion of Section 409(p)

These regulations include 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). Under this standard, 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. An avoidance or evasion of section 409(p) does not occur where the ESOP receives the economic benefits of ownership in the S corporation, taking into account 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 rights of the ESOP, 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 these 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.

This standard is promulgated pursuant to the authority of Treasury and the IRS to act promptly to issue guidance to prevent ownership structures that deny an ESOP the economic benefits of ownership and, in addition, these regulations identify certain specific ownership structures that constitute an avoidance or evasion of section 409(p). Specifically, the regulations identify the transactions described in Rev. Rul. 2004–4 as being an avoidance or evasion of section 409(p) and provide that there is a nonallocation year not only in the situations described in the revenue ruling but also in situations in which profits are segregated using a method other than QSUBs. Under the regulations, the principal purpose of the ownership structure of an S corporation constitutes an avoidance or evasion of section 409(p), and a nonallocation year results, in any case in which (i) the profits of the S corporation generated by the business activities of a specific individual or individuals are substantially accumulated and held for the benefit of that 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 through any other method that has the same effect of segregating profits for the benefit of such individual or individuals (such as nonqualified deferred compensation), (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). This conclusion both reflects the holding in Rev. Rul. 2004–4 (discussed in this preamble under the heading *Background*) and treats similar transactions as resulting in a nonallocation year, as Rev. Rul. 2004–4 indicated would be reflected in these regulations.

Effective Dates

These temporary regulations are applicable for plan years beginning on or after January 1, 2005. However, there are a number of special effective date and transition rules.

These regulations preserve the rules of the 2003 temporary regulations with respect to plan years beginning before Jan-

uary 1, 2005, with the new rules in these regulations to apply thereafter. However, as described in this section, the rules in these regulations dealing with ownership structures that constitute an avoidance or evasion of section 409(p), including the rules relating to structures similar to those addressed in Rev. Rul. 2004–4, apply for plan years ending on or after December 31, 2004.

Under the transition rules, ESOP shares that are held for a disqualified person before the first plan year beginning on or after January 1, 2005, will not be treated as an impermissible accrual in 2005 if the shares are disposed of before July 1, 2005 (*e.g.*, by distribution or transfer to a non-ESOP) and no amount is contributed for the benefit of the disqualified person under any plan of the employer intended to meet the requirements of section 401(a) (including the ESOP) during the period from the first day of the first plan year beginning on or after January 1, 2005, through June 30, 2005. However, even if no amount is allocated to a disqualified person during this period, but this period is part of the first nonallocation year of the ESOP, an excise tax will apply under section 4979A with respect to either ESOP shares held for a disqualified person or synthetic equity that is treated as owned under these regulations on the first day of the plan year, regardless of whether there is an impermissible accrual or impermissible allocation. See section 4979A(a)(3), (a)(4), and (e)(2)(C).

Under another transition rule, the new person-by-person rules in these regulations on how to determine whether a person is a disqualified person and whether a year is a nonallocation year generally do not go into effect until July 1, 2005. However, comments indicated that the 2003 regulations could be easily avoided or evaded by granting options or stock appreciation rights with artificially high strike prices or where the strike price is periodically increased to exceed the expected value before the option or right is to expire. Thus, with respect to the period from (and including) December 31, 2004, through June 30, 2005, the new rules apply to plans under which a nonallocation year would occur under the 2003 temporary regulations if synthetic equity were to exclude stock options, stock appreciation rights, or similar rights to acquire shares of the S corporation or a related entity where the facts and circumstances indicate that there is no reasonable likelihood that the holder of the right will receive the shares (or equivalent value), *e.g.*, cases in which the option is based on an exercise price that is more than 200% of the fair market value of the shares on the date of grant or a stock appreciation right is payable only if the appreciation exceeds 100% of the fair market value of the shares on the date of grant. This special rule applies for plan years ending on or after December 31, 2004, in order to ensure that an employer cannot avoid or evade the purposes of section 409(p) — even for the calendar year 2004 — by using artificial grants that are unlikely to ever be paid.

Under a third transition rule, the new rules in these regulations, including the rules relating to the right to receive shares with disproportional voting rights, do not go into effect until July 1, 2005, if there would be no prohibited allocation before then under these regulations if the new rules in these regulations relating to the right to receive shares with disproportional voting rights were disregarded.

Further, the IRS will permit plans to rely on the exception for pre-ESOP nonqualified deferred compensation for periods before January 1, 2005, (described in this preamble under the heading *Synthetic Equity*).

Special Analyses

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

Drafting Information

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

* * * * *

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 continues to read, in part, as follows:

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

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

Par. 2. Section 1.409(p)–1T is revised to read as follows:

§1.409(p)–1T Prohibited allocations of securities in an S corporation (temporary).

(a) *Organization of this section*. Section 409(p) applies if a nonallocation year occurs in an employee stock ownership plan (ESOP), as defined in section 4975(e)(7), that holds shares of stock of an S corporation, as defined in section 1361, 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 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). The definitions used in section 409(p) and this section are also applicable for purposes of section 4979A, which imposes an excise tax on certain events, including a nonallocation year under section 409(p).

(b) *Prohibited allocation 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 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 (a prohibited allocation).

(2) *Additional rules*— (i) *Prohibited allocation definition*. For purposes of section 409(p)(2)(A) and paragraph (b)(1) of this section, there is a prohibited allocation (*i.e.*, assets accrue or are allocated as prohibited under paragraph (b)(1) of this section) if there is either an impermissible accrual as defined in paragraph (b)(2)(ii) of this section or an impermissible allocation as defined in paragraph (b)(2)(iii) of this section. The amount of the prohibited allocation is equal to the sum of the impermissible accrual plus the amount of the impermissible allocation (if any).

(ii) *Impermissible accrual*. There is an impermissible accrual to the extent (and only 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 S corporation securities 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, for example, 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 the distribution 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 means any allocation for a disqualified person directly or indirectly under any plan of the employer qualified under section 401(a) that occurs during a nonallocation year to the extent that a contribution or other annual addition is made, or the disqualified person otherwise accrues additional benefits, 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 otherwise 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 to comply with section 409(p).

(iv) *Effects of prohibited allocation* — (A) *Deemed distribution*. If there is a prohibited allocation, the amount of the prohibited allocation, 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 on which there is an impermissible accrual or on the date of the allocation in the case of an additional impermissible accrual or impermissible allocation during the plan year but after the first day of the plan year. 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 an 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) and, further, the exception in section 512(e)(3) would not apply to the plan (with the result that the plan may owe income tax as a result of unrelated business taxable income under section 512 with respect to S corporation stock held by the plan). See also section 4979A(a) which imposes an excise tax in certain events, including a prohibited allocation under section 409(p).

(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 permitting 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). 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 will 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, or features with respect

to the transferred benefits if those benefits, rights, or 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* — (1) *Definition generally*. 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); plus

(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 the rules of this paragraph (c)(2).

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

(ii) 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. 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 that the person has a right to acquire if, at all times during the period when such right is 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)(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 subject to Federal income tax 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 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* — (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; 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; 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 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 individ-

ual under a decree of divorce or separate maintenance is not treated as such individual's spouse under paragraph (d)(2)(ii)(A) of this section.

(iv) *Attribution rules*. For purposes of this paragraph (d), 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)(ii) 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 the rules 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 special rules permitting certain persons to be treated as disqualified persons in certain nonallocation years.

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

Example. (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 2005, including 200 shares held in the ESOP account of O, 65 shares held in the ESOP account of participant P, and 40 shares held in the ESOP account of participant Q who is P's spouse. The S corporation has no synthetic equity.

(ii) *Conclusion*. O is a disqualified person during 2005 because O's account in the ESOP holds at least 10 percent of the shares owned by the ESOP (200 is 28.6 percent of 700). In addition, P is a disqualified person during 2005 because, under paragraph (d)(2) of this section, P is treated as owning the shares held by Q and P's total deemed-owned shares are thus at least 10 percent of the shares owned by the plan (65 plus 40 is more than 10 percent of 700). In addition, Q is a disqualified person as a result of the rules in paragraph (d)(2) of this section. As a result, disqualified persons own at least 50 percent of the outstanding shares of the S corporation during 2005 (O's 100 directly owned shares, O's 200 deemed-owned shares, P's 65 deemed-owned shares, plus Q's 40 deemed owned shares are 50.6 percent of 800).

(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* 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 this chapter, 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 loan repayment).

(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 (who are subject to federal income taxes) 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, such as appreciation in such value. Thus, 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 to which section 83 applies (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 (to which section 83 applies) in connection with the performance of services 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, 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. 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 permitted 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 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) 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) *Special rules* — (*1*) *Use of annual or more frequent determination dates*. For purposes of this paragraph (f)(4)(iii), while the determination of whether there is a nonallocation year depends on day-by-day determinations under paragraph (c) of this section, 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 permitted to be determined only 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.

(*2*) *Use of triannual recalculations*. In addition, 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 a date that is not later than the day before the determination date that is on or immediately preceding the third anniversary of the identified determination date. 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). However, 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. See *Example 3* of paragraph (h) of this section for an example illustrating this paragraph (f)(4)(iii)(B)(*2*).

(*3*) *Conditions for application of rules*. Paragraph (f)(4)(iii)(B) of this section only applies with respect to grants of synthetic equity to which this paragraph

(f)(4)(iii) applies. In addition, paragraph (f)(4)(iii)(B)(*1*) 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)(B)(*1*) of this section which are consistently used by the ESOP for all persons. In addition, paragraph (f)(4)(iii)(B)(*2*) of this section applies only if the terms of the ESOP include provisions conforming to paragraphs (f)(4)(iii)(B)(*1*) and (*2*) 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% of S corporation*. Under this paragraph (f)(4)(iv), 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 200 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 200 to 150 (because the ESOP only owns 75% of the outstanding stock of the S corporation, rather than 100%).

(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) 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 these 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 that 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, 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	330	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 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 Shareholders	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)
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	400 (none exceeds 10 shares)	1% or less			No

(ii) *Conclusion with respect to disqualified persons*. Applying the rule of paragraph (f)(4)(iv) of this section, E's option to acquire 110 shares of the S corporation converts 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). Accordingly, as shown in column 6 in the table above, 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, but the synthetic equity shares owned by any person do not affect the calculation for any other person's ownership of shares. Accordingly, 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, and the ESOP uses the special rules in paragraph (f)(4)(iii) of this section to determine the number of shares of synthetic equity owned by that individual, 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 the preceding day, 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 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) *Regulation effective date* — (i) *General effective date*. Except as otherwise provided in paragraph (i)(2)(ii) of this section, this section applies for plan years beginning on or after January 1, 2005.

(ii) *Rules for plan years beginning before January 1, 2005*. (A) Except as provided in this paragraph (i)(2)(ii), §1.409(p)–1T as in effect prior to December 17, 2004, (see §1.409(p)–1T in 26 CFR Part 1 revised as of April 1, 2004) applies for plan years ending after October 20, 2003, and beginning before January 1, 2005.

(B) Paragraphs (c)(3) and (g) of this section apply for plan years ending on or after December 31, 2004, but do not apply with respect to an interest held in a qualified subchapter S subsidiary (QSUB) of an S corporation or another entity to which paragraph (g)(3) of this section applies before March 15, 2004 if:

(1) All interests in the entity held by individuals who would be disqualified persons under paragraph (g)(3) of this section or under guidance issued by the Commissioner before March 15, 2004, are dis-

tributed to those individuals as compensation on or before March 15, 2004; and

(2) No such individual has been a participant in the ESOP of the S corporation at any time after October 20, 2003, and before March 15, 2004.

(C) Paragraph (f)(2)(iv)(B) of this section (providing that synthetic equity does not include certain preexisting nonqualified deferred compensation) applies for plan years ending before January 1, 2005.

(D) Paragraph (f)(4)(iv) of this section (permitting an adjustment of the number of synthetic equity shares where an ESOP owns less than 100% of an S corporation) applies for plan years ending before January 1, 2005.

(E) In no event does this paragraph (i)(2)(ii) apply for any plan year ending before January 1, 2005, for an ESOP holding stock in an S corporation that was established on or before March 14, 2001, if the election under section 1362(a) with respect to that S Corporation was in effect on March 14, 2001.

(iii) *Transition rules*. (A) Assets held in the account of a disqualified person as of the last day of the first plan year beginning before January 1, 2005, will not be treated as an impermissible accrual with respect to that disqualified person under paragraph (b)(2)((ii) of this section for the first plan year beginning on or after January 1, 2005, to the extent those assets are not held in that person's account on or after July 1, 2005. Thus, for example, to the extent the assets allocated to the account of a disqualified person as of the last day of the first plan year beginning before January 1, 2005, are transferred to a non-ESOP portion of the plan as described in paragraph (b)(2)(v)(A) of this section before July 1, 2005, those assets will not be treated as an impermissible accrual under paragraph (b)(2)((ii) of this section for the period from the first day of the first plan year beginning on or after January 1, 2005, through June 30, 2005. However, see section 4979A(a)(3), (a)(4), and (e)(2)(C) for excise tax provisions that apply to all deemed-owned shares during the first nonallocation year for the ESOP.

(B) An individual is not treated as a disqualified person during the period from the first day of the first plan year beginning on or after January 1, 2005, through June 30, 2005, if that person would not be a disqualified person during that period under the modified rules of this paragraph (i)(2)(iii)(B) as of any date during that same period. Further, solely for the purpose of determining whether the first plan year beginning on or after January 1, 2005, is a nonallocation year under section 409(p) and this section, if that plan year would not have been a nonallocation year under the modified rules of this paragraph (i)(2)(iii)(B), then synthetic equity that is not owned by a person on July 1, 2005, is disregarded during the period from the first day of the first plan year beginning on or after January 1, 2005, through June 30, 2005. For purposes of this paragraph (i)(2)(iii)(B), the *modified rules of this paragraph (i)(2)(iii)(B)* are the rules in §1.409(p)–1T as in effect prior to December 17, 2004 (see §1.409(p)–1T in 26 CFR Part 1 revised as of April 1, 2004), modified to exclude from the definition of synthetic equity any stock option, stock appreciation right (payable in cash or stock), or similar rights with respect to shares of the S corporation or a related entity where the facts and circumstances indicate that there is no reasonable likelihood that the holder of the right will receive the shares (or equivalent value). For this purpose, there is no reasonable likelihood that the holder of the right will receive the shares (or equivalent value) in any case in which the option is based on an exercise price that is more than 200% of the fair market value of the shares on the date of grant or the right (in the case of a stock appreciation right or similar right to acquire shares of the S corporation or a related entity) is payable only if the appreciation exceeds 100% of the fair market value of the shares on the date of grant.

(C) For the period from the first day of the first plan year beginning on or after January 1, 2005, through June 30, 2005, there is no nonallocation year under this section if there would be no nonallocation year under this section during that period if this section were applied without regard to paragraph (f)(4)(v) of this section (relating to voting rights).

(D) This paragraph (iii) does not apply to an ESOP for which the first plan year beginning on or after January 1, 2005, begins after June 30, 2005.

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

Approved December 7, 2004.

Gregory F. Jenner,
Acting Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on December 16, 2004, 8:45 a.m., and published in the issue of the Federal Register for December 17, 2004, 69 F.R. 75455)

Section 901.—Taxes of Foreign Countries and of Possessions of United States

Section 901(j)(5) Presidential waiver; Libya. Pursuant to a section 901(j)(5) Presidential waiver, section 901(j)(1) of the Code ceased to apply to Libya effective December 10, 2004. Section 911(d)(8) is not applicable to Libya after September 20, 2004, and Iraq after July 29, 2004. Rev. Ruls. 92–63 and 95–63 modified and superseded. Rev. Rul. 2004–103 superseded.

Rev. Rul. 2005–3

This ruling sets forth guidance regarding the application of section 901(j) of the Internal Revenue Code (Code) with respect to Libya and the application of section 911(d)(8) of the Code with respect to Iraq and Libya. This ruling modifies and supersedes Rev. Rul. 95–63, 1995–2 C.B. 85, which lists countries subject to special tax rules under sections 901(j) and 952(a)(5) of the Code, and also supersedes Rev. Rul. 2004–103, 2004–45 I.R.B. 783, which modified Rev. Rul. 95–63. This ruling also modifies and supersedes Rev. Rul. 92–63, 1992–2 C.B. 195, which lists countries subject to section 911(d)(8) of the Code.

SECTION 901(j)

LAW AND ANALYSIS

Sections 901, 902, and 960 of the Code generally allow U.S. taxpayers to claim a foreign tax credit for income, war profits, and excess profits taxes paid or accrued (or deemed paid or accrued) to any foreign country or to any possession of the United States. The foreign tax credit is subject to various limitations and restrictions under section 901.

Section 901(j)(1) imposes restrictions in the case of income and taxes attributable to certain countries. Section 901(j)(1)(A) denies the credit for taxes paid or accrued (or deemed paid or accrued under sections 902 or 960) to any country described in section 901(j)(2)(A) if the taxes are with respect to income attributable to a period during which section 901(j) applies. Section 901(j)(1)(B) requires taxpayers to apply subsections (a), (b), and (c) of section 904 and sections 902 and 960 separately with respect to income attributable to such a period from sources within such country. In addition, section 952(a)(5) provides that subpart F income includes income derived by a controlled foreign corporation from any foreign country during any period during which section 901(j) applies to that foreign country.

Pursuant to section 901(j)(5), the restrictions of section 901(j)(1) will not apply with respect to a country if the President determines that a waiver of the application of that paragraph is in the national interest of the United States and will expand trade and investment opportunities for U.S. companies in such country. This provision provides for the President, not less than 30 days before the date on which a waiver is granted, to report to Congress the intention to grant such a waiver and the reason for the determination under section 901(j)(5)(A)(i).

The President issued Presidential Determination 2004–48 on September 20, 2004. In that Presidential Determination, the President determined that a waiver of the application of section 901(j)(1) with respect to Libya is in the national interest of the United States and will expand trade and investment opportunities for U.S. companies in Libya. The Presidential Determination directed the Secretary of the Treasury to report to Congress, in accordance with section 901(j)(5)(B), the President's intention to grant the waiver and the reasons for the determination. The Secretary of the Treasury submitted such report to Congress on October 7, 2004.

On December 10, 2004, the President issued Presidential Determination 2005–12 which waives the application of section 901(j)(1) with respect to Libya. Pursuant to Presidential Determination 2005–12, sections 901(j)(1) and 952(a)(5) no longer apply to Libya, effective December 10, 2004. Therefore, United States taxpayers may be entitled to claim a foreign tax credit for income, war profits, and excess profits taxes paid or accrued (or deemed paid or accrued under sections 902 and 960) to Libya, with respect to income attributable to the period beginning after December 9, 2004.

HOLDING AND EFFECTIVE DATES

Sections 901(j)(1) and 952(a)(5) apply to the following countries for the following periods:

Country	Starting Date	Ending Date
Afghanistan	January 1, 1987	August 4, 1994
Albania	January 1, 1987	March 15, 1991
Angola	January 1, 1987	June 18, 1993
Cambodia	January 1, 1987	August 4, 1994
Cuba	January 1, 1987	still in effect
Iran	January 1, 1987	still in effect
Iraq	February 1, 1991	June 27, 2004
Libya	January 1, 1987	December 9, 2004
North Korea	January 1, 1987	still in effect
South Africa	January 1, 1988	July 10, 1991
Sudan	February 12, 1994	still in effect
Syria	January 1, 1987	still in effect
Vietnam	January 1, 1987	July 21, 1995
People's Democratic Republic of Yemen	January 1, 1987	May 22, 1990

For guidance on issues arising in a taxable year when section 901(j) ceases to apply to a country, *see* Rev. Rul. 92–62, 1992–2 C.B. 193.

SECTION 911

LAW AND ANALYSIS

Section 911(a) of the Code allows a "qualified individual" to elect to exclude from gross income his or her "foreign earned income" (as defined in section 911(b)) and "housing cost amount" (as defined in section 911(c)). Section 911(d)(1) generally defines a "qualified individual" as a citizen or resident of the United States whose tax home is in a foreign country and who meets certain requirements of residence or presence in a foreign country.

Section 911(d)(8)(A) provides generally that if travel with respect to any foreign country (or any transaction in connection with such travel) is proscribed by certain regulations during any period, then: (1) foreign earned income does not include income from sources within that country attributable to services performed during that period; (2) housing expenses do not include any expenses allocable to such period for housing in that country, or for housing of the taxpayer's spouse or dependents in another country while the taxpayer is present in that country; and (3) an individual is not treated as a *bona fide* resident of, or as present in, a foreign country for any day during which the individual was present in that country.

Section 911(d)(8)(B) provides that the regulations described in section 911(d)(8) are those that have been adopted pursuant to the Trading With the Enemy Act, 50 U.S.C. App. 1 *et seq.*, or the Interna-

tional Emergency Economic Powers Act, 50 U.S.C. 1701 *et seq.*, and that include provisions generally prohibiting citizens and residents of the United States from engaging in transactions related to travel to, from, or within a foreign country. Section 911(d)(8)(C), however, provides that the limitations of section 911(d)(8)(A) do not apply to any individual during any period in which that individual's activities are not in violation of the regulations described in section 911(d)(8)(B).

Rev. Rul. 92–63, 1992–2 C.B. 195, identifies three countries subject to regulations described in section 911(d)(8)(B): Cuba (31 CFR 515.560) (1989), Libya (31 CFR 550.207) (1989), and Iraq (31 CFR 575.207) (1991).

On July 29, 2004, the President issued Executive Order 13350 which effectively lifted the sanctions against Iraq effective July 30, 2004. On September 20, 2004, the President issued Executive Order 13357 which effectively lifted the sanctions against Libya, effective September 21, 2004.

HOLDING AND EFFECTIVE DATES

Section 911(d)(8) applies to the following countries for the following periods:

Country	**Starting Date**	**Ending Date**
Cuba	January 1, 1987	still in effect
Libya	January 1, 1987	September 20, 2004
Iraq	August 2, 1990	July 29, 2004

With respect to periods prior to (or ending on) the ending dates listed above for Libya and Iraq, individuals whose activities in Libya and Iraq were not in violation of the regulations described in section 911(d)(8)(B) are not subject to the limitations of section 911(d)(8). *See, e.g.*, Notice 2003–52, 2003–2 C.B. 296, which states that pursuant to section 911(d)(8)(C), the limitations of section 911(d)(8)(A) do not apply to individuals engaged in activities in Iraq that are permitted by a specific or general license issued by the United States Department of Treasury Office of Foreign Assets Control.

EFFECT ON OTHER ADMINISTRATIVE GUIDANCE

This ruling modifies and supersedes Rev. Rul. 95–63, 1995–2 C.B. 85, and supersedes Rev. Rul. 2004–103, 2004–45 I.R.B. 783, with respect to the list of countries for which section 901(j) is applicable. This ruling modifies and supersedes Rev. Rul. 92–63, 1992–2 C.B. 195, with respect to the list of countries for which section 911(d)(8) is applicable.

DRAFTING INFORMATION

The principal author of this revenue ruling is Mark R. Pollard of the Office of Associate Chief Counsel (International). For further information regarding this revenue ruling, contact Mr. Pollard at (202) 622–3850 (not a toll-free call).

Part III. Administrative, Procedural, and Miscellaneous

Election to Determine Corporate Tax on Certain International Shipping Activities Under Tonnage Tax Regime

Notice 2005–2

This notice provides guidance on the procedure for making an election to determine corporate tax on certain international shipping activities under the tonnage tax regime.

Code section 1354(a), as added by section 248 of the American Jobs Creation Act of 2004, P.L. 108–357, 118 Stat. 1418 (October 22, 2004), allows a qualifying vessel operator to elect to be subject to the tonnage tax regime, under which tax is imposed on notional income from qualifying shipping activities rather than on actual income from such activities. A corporation is a qualifying vessel operator if the corporation operates one or more qualifying vessels within the meaning of section 1355(a)(4) and meets the shipping activity requirement of section 1355(c). Pursuant to section 1355(c)(2), the shipping activity requirement is satisfied with respect to the first year for which the election is made only if the requirement of section 1355(c)(4) is satisfied for the preceding taxable year. Thus, a corporation cannot be considered a qualifying vessel operator prior to the first day of the first year for which the election is made.

A corporation making the election is subject to tax with respect to its income from qualifying shipping activities at the maximum corporate income tax rate on a notional amount based on the net tonnage of the corporation's qualifying vessels. An election made by a member of a controlled group, as defined in section 1355(a)(2)(B), applies to all qualifying vessel operators that are members of such group. The election is available for taxable years beginning after October 22, 2004, and is effective for the taxable year for which it is made and for all succeeding taxable years until terminated. If a corporation ceases to be a qualifying vessel operator, the election is terminated effective on or after the date of such cessation.

The election must be made before the due date (including extensions) of the income tax return for the year for which the corporation elects to be subject to the tonnage tax regime. An election may be made prior to the filing of such return by filing a statement with the Internal Revenue Service at the address where the corporation ordinarily files its income tax return. The statement must set forth the name, address, and employer identification number of the electing corporation and the taxable year for which the section 1354(a) election is being made. A copy of the statement must be attached to the income tax return for the year for which the corporation elects to be subject to the tonnage tax regime.

An election to be subject to the tonnage tax regime is effective only if the corporation is a qualifying vessel operator for the taxable year for which the election is made. If a corporation that files the statement does not satisfy the requirements to be a qualifying vessel operator, the election is not valid.

All electing corporations must provide such additional information relating to the tonnage tax as is required by the applicable corporate income tax return and the instructions thereto, which will include information regarding satisfaction of the requirements to be a qualifying vessel operator.

DRAFTING INFORMATION

The principal author of this notice is David L. Lundy of the Office of Associate Chief Counsel (International). For further information regarding this notice, contact Mr. Lundy at (202) 622–3880 (not a toll-free call).

Automatic Rollover

Notice 2005–5

I. PURPOSE

This notice provides guidance relating to automatic rollover provisions under § 401(a)(31)(B) of the Internal Revenue Code ("Code") as amended by the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. 107–16 ("EGTRRA").

II. BACKGROUND

Section 401(a)(31)(A) of the Code and §1.401(a)(31)–1 of the Income Tax Regulations provide that a distributee of any eligible rollover distribution, as defined in § 402(f)(2)(A), may elect to have such distribution paid directly to an eligible retirement plan and that such distribution must be made in the form of a direct rollover to the specified eligible retirement plan. Section 402(f)(1) requires that the plan administrator provide a written explanation to the recipient of the provisions under which the recipient may have the distribution paid directly to an eligible retirement plan as defined in § 402(c)(8) in a direct rollover.

Sections 411(a)(11) and 417(e) permit plans qualified under § 401(a) to include provisions allowing for the immediate distribution of a separating participant's benefit without such participant's consent where the present value of the nonforfeitable accrued benefit is less than $5,000.

Section 657 of EGTRRA amended § 401(a)(31)(B) of the Code to require that mandatory distributions of more than $1,000 from a plan qualified under § 401(a) be paid in a direct rollover to an individual retirement plan (*i.e.*, an individual retirement account as described in § 408(a) or an individual retirement annuity described in § 408(b)) of a designated trustee or issuer if the distributee does not make an affirmative election to have the amount paid in a direct rollover to an eligible retirement plan or to receive the distribution directly. Section 657(a) of EGTRRA also added a notice provision to § 401(a)(31)(B)(i) of the Code which requires that the plan administrator notify the distributee in writing (either separately or as part of the § 402(f) notice) that the distribution may be paid in a direct rollover to an individual retirement plan.

Section 657(c)(2)(A) of EGTRRA directed the Department of Labor to issue regulations providing safe harbors under which 1) a plan administrator's designation of an institution to receive the automatic rollover and 2) the initial investment choice for the rolled-over funds would be deemed to satisfy the fiduciary responsibility provisions of § 404(a) of the Employee Retirement Income Security Act of 1974 ("ERISA").

Section 657(d) of EGTRRA provided that the § 401(a)(31)(B) of the Code requiring automatic rollovers of certain mandatory distributions to individual retirement plans will not become effective until the Department of Labor issues safe harbor regulations.

On September 28, 2004, the Department of Labor issued final regulations (29 CFR § 2550.404a–2) pursuant to § 657(c)(2)(A) of EGTRRA. 69 FR 58017. Section 2550.404a–2 of those regulations establishes a safe harbor under which a fiduciary of an employee pension benefit plan subject to Title I of ERISA will be deemed to have satisfied his or her fiduciary duties under § 404(a) of ERISA in connection with an automatic rollover of a mandatory distribution described in § 401(a)(31)(B) of the Code. Section 2550.404a–2(c) provides the conditions under which a fiduciary qualifies for the safe harbor described in the preceding sentence. The safe harbor contained in § 2550.404a–2 applies only to employee pension benefit plans covered under Title I of ERISA. The safe harbor contained in § 2550.404a–2 also applies to automatic rollovers of $1,000 or less.

III. QUESTIONS AND ANSWERS

Q–1. To what distributions do the automatic rollover requirements of § 401(a)(31)(B) apply?

A–1. The automatic rollover requirements apply to any mandatory distribution that is more than $1,000 and is an eligible rollover distribution that is subject to the direct rollover requirements that are in § 401(a)(31). Thus, in order for a plan that provides for such mandatory distributions to be qualified under § 401(a), it must satisfy the automatic rollover provisions of § 401(a)(31)(B). Pursuant to Q&A–16 of § 1.401(a)(31)–1 of the Income Tax Regulations, an eligible rollover distribution in the form of a plan loan offset amount is not subject to the automatic rollover provisions of § 401(a)(31)(B).

Q–2. What is a mandatory distribution?

A–2. A mandatory distribution is a distribution that is made without the participant's consent and that is made to a participant before the participant attains the later of age 62 or normal retirement age. A distribution to a surviving spouse or alternate payee is not a mandatory distribution for purposes of the automatic rollover requirements of § 401(a)(31)(B). Although § 411(a)(11) generally prohibits mandatory distributions of accrued benefits attributable to employer contributions with a present value exceeding $5,000, the automatic rollover provisions of § 401(a)(31)(B) apply without regard to the amount of the distribution as long as the amount exceeds $1,000.

Q–3. How is the automatic rollover requirement of § 401(a)(31)(B) satisfied?

A–3. In order to satisfy the automatic rollover requirement of § 401(a)(31)(B), a plan must provide that, when making a mandatory distribution that exceeds $1,000 and that is an eligible rollover distribution, if, after receiving the notice described in § 402(f), a participant fails to elect to receive a mandatory distribution directly or have it paid in a direct rollover to an eligible retirement plan, the distribution will be paid in a direct rollover to an individual retirement plan.

Q–4. When do the automatic rollover provisions of § 401(a)(31)(B) become effective with respect to mandatory distributions?

A–4. The automatic rollover requirements of § 401(a)(31)(B) apply to mandatory distributions made on or after March 28, 2005. Thus, the automatic rollover requirements of § 401(a)(31)(B) do not apply to mandatory distributions made prior to March 28, 2005. Section 657(d) of EGTRRA provides that the requirements of § 401(a)(31)(B) of the Code requiring automatic rollovers of mandatory distributions to individual retirement plans do not become effective until the Department of Labor prescribes final regulations implementing a fiduciary safe harbor related to automatic rollovers. The final regulations issued by the Department of Labor on September 28, 2004, provide that the regulations apply to any rollover of mandatory distributions made on or after March 28, 2005.

Q–5. Do the automatic rollover requirements of § 401(a)(31)(B) apply to governmental plans as described in § 414(d)?

A–5. Yes, the automatic rollover requirements apply to governmental plans (within the meaning of § 414(d)) that are required to comply with § 401(a)(31), even though these plans are not subject to the provisions of § 411. Thus, for example, in order for a plan of a state or local government to be qualified under § 401(a), the plan must comply with § 401(a)(31)(B). However, governmental plans will not be treated as failing to satisfy the requirements of § 401(a)(31)(B) if the automatic rollover provisions are not applied to mandatory distributions from such plans that are made prior to the close of the first regular legislative session of the legislative body with the authority to amend the plan that begins on or after January 1, 2006.

Q–6. Do the automatic rollover provisions of § 401(a)(31)(B) apply to governmental eligible deferred compensation plans described in § 457(b)?

A–6. Yes, § 457(d)(1)(C) provides that, in order to satisfy the distribution requirements of § 457(b)(5), a governmental eligible deferred compensation plan described in subsection (e)(1)(A) must meet requirements similar to the requirements of § 401(a)(31). However, the delayed compliance date set forth in Q&A–5 applies. The automatic rollover requirements of § 401(a)(31)(B) do not apply to non-governmental § 457(b) plans.

Q–7. Do the automatic rollover provisions of § 401(a)(31)(B) apply to § 403(b) plans?

A–7. Yes, § 403(b)(10) provides that rules similar to the rules of § 401(a)(31) apply to § 403(b) plans. Thus, the automatic rollover provisions of § 401(a)(31)(B) apply to annuity contracts described in § 403(b)(1), custodial accounts described in § 403(b)(7), and retirement income accounts described in § 403(b)(9). If a § 403(b) plan is a governmental plan within the meaning of § 414(d), then the delayed compliance date in A–5 applies.

Q–8. Do the automatic rollover provisions of § 401(a)(31)(B) apply to church plans within the meaning of § 414(e) with respect to which the election provided in § 410(d) has not been made?

A–8. Yes, the requirements of § 401(a)(31)(B) of the Code apply to non-electing church plans even though these plans are not subject to the provisions of § 411. However, a non-electing church plan maintained for which the authority to amend the plan is held by a church convention (within the meaning of § 414(e)(3)) will not be treated as failing to satisfy the requirements of § 401(a)(31)(B) if the automatic rollover

provisions are not applied to mandatory distributions from such plan that are made prior to the date that is 60 days after the close of the earliest church convention that occurs on or after January 1, 2006.

Q–9. If a plan that provides for mandatory distributions does not make a distribution to a participant who fails to affirmatively elect direct payment or a direct rollover for a mandatory distribution on or after March 28, 2005, because the plan administrator has not sufficiently established administrative procedures that allow the plan administrator to accomplish the automatic rollover of a mandatory distribution by that date, will the plan be treated as failing to operate in accordance with its terms?

A–9. No, a plan will not be treated as failing to operate in accordance with its terms (including the automatic rollover provisions) with respect to mandatory distributions merely because it does not process mandatory distributions for which the participant does not affirmatively elect direct rollover or direct payment due to a lack of sufficient administrative procedures for automatic rollovers, including establishing individual retirement plans to accept automatic rollovers, provided the mandatory distributions are made on or before December 31, 2005.

Q–10. Can a plan administrator set up an individual retirement plan for a participant who is receiving a mandatory distribution and who has not elected to have such distribution paid directly to an eligible retirement plan in a direct rollover or to receive the distribution directly?

A–10. Yes, if a participant receiving a mandatory distribution fails to elect to have such distribution paid to an eligible retirement plan in a direct rollover or to receive the distribution directly, the plan administrator may execute the necessary documents to establish an individual retirement plan on the participant's behalf with a financial institution selected by the plan administrator.[1] For this purpose, the plan administrator may use the participant's most recent mailing address in the records of the employer and plan administrator. The trustee or issuer of the individual retirement plan must provide a disclosure statement to the participant and provide a revocation period as prescribed in § 1.408–6. The trustee or issuer of the individual retirement plan will not be treated as failing to satisfy the disclosure requirements of § 1.408–6 merely because the disclosure statement is returned by the United States Postal Service as undeliverable after it was mailed to the participant using the address for the participant provided by the plan administrator as the participant's most recent mailing address in the records of the employer and plan administrator.

Q–11. May a mandatory distribution be paid to an individual retirement account under § 408(c) or a deemed individual retirement account under § 408(q) that is part of the plan that is making the distribution?

A–11. Yes, a mandatory distribution may be paid to a participant's individual retirement account that meets the requirements of § 408(c) or to a participant's deemed individual retirement account that meets the requirements of § 408(q).

Q–12. Can a plan sponsor eliminate mandatory distributions from its plan without violating the anti-cutback provisions of § 411(d)(6) of the Code?

A–12. Yes, § 1.411(d)–4, A–2(b)(2)(v), provides that a plan sponsor may amend or change a plan to eliminate a provision which requires the plan to make a mandatory single-sum distribution to participants pursuant to § 411(a)(11) without violating § 411(d)(6).

Q–13. If a plan is subject to the joint and survivor annuity and preretirement survivor annuity requirements of § 401(a)(11) and the plan provides that an accrued benefit greater than $1,000 but not greater than $5,000 will be distributed to a participant only with the consent of the participant, would a distribution of such an accrued benefit be subject to spousal consent requirements?

A–13. No. Section 1.417(e)–1(b)(2)(i) provides that no spousal consent is required before the annuity starting date if the present value of the nonforfeitable benefit is not more than the cash-out limit in effect under § 411(a)(11).

Q–14. Are amounts attributable to rollover contributions that exceed $5,000 subject to the automatic rollover provisions of § 401(a)(31)(B)?

A–14. Yes. Section 401(a)(31)(B) applies to the entire amount of a mandatory distribution. Thus, for example, the portion of the distribution attributable to a rollover contribution is subject to the automatic rollover requirements of § 401(a)(31)(B), even if that amount is excludable (under § 411(a)(11)(D)) from the determination of whether the present value of the nonforfeitable accrued benefit exceeds $5,000.

Q–15. Is a plan administrator required to notify a participant to whom a mandatory distribution is going to be made that, absent the participant's affirmative election, the distribution will automatically be paid to an individual retirement plan in a direct rollover?

A–15. Yes. Section 401(a)(31)(B)(i) requires that the plan administrator notify the participant in writing (either separately or as part of the § 402(f) notice) that, absent an affirmative election by the participant, the distribution will be paid to an individual retirement plan. The notice must identify the trustee or issuer of the individual retirement plan. A plan administrator will not be treated as failing to satisfy this notice requirement merely because the notice is sent using electronic media in accordance with A–5 of § 1.402(f)–1. Further, for an eligible rollover distribution paid as an automatic direct rollover, a plan administrator will not be treated as failing to satisfy this notice requirement or section 402(f) with respect to an eligible rollover distribution merely because the notice is returned as undeliverable by the United States Postal Service after having been mailed to the participant using the participant's most recent mailing address in the records of the employer and plan administrator.

Q–16. When must a plan that provides for mandatory distributions be amended to include a provision that satisfies the requirements of § 401(a)(31)(B)?

A–16. Plans that provide for mandatory distributions and that do not already

[1] The staffs of the federal functional regulators that issued joint regulations requiring financial institutions to implement customer identification programs ("CIP") pursuant to § 326 of the USA PATRIOT Act have interpreted these regulations to require that when a plan administrator transfers funds of a former employee to a financial institution pursuant to § 401(a)(31)(B), the financial institution will not be required to implement its CIP until the former employee first contacts such institution to assert ownership or exercise control over the account. Accordingly, CIP compliance is not required at the time an employee benefit plan establishes an account and transfers the funds to the bank or other financial institution for purposes of a complying with the automatic rollover requirements of § 401(a)(31)(B).

include the automatic rollover provisions must adopt a good faith plan amendment reflecting the automatic rollover requirements by the end of the first plan year ending on or after March 28, 2005 (or in the case of a governmental plan in accordance with A–5). Included in the Appendix is a sample plan amendment that individual plan sponsors and sponsors (or volume submitter practitioners) of pre-approved plans can adopt or use in drafting individualized plan amendments. This sample plan amendment, or a plan amendment that is materially similar to this sample, will be a "good faith" plan amendment. The adoption of this sample amendment by a sponsor (or volume submitter practitioner) of a pre-approved plan will not cause such a plan to be treated as an individually designed plan. If a plan is amended by a timely good faith amendment reflecting the automatic rollover requirements, a plan amendment to a disqualifying provision related to the automatic rollover requirements can be made within the plan's EGTRRA remedial amendment period to the extent necessary to satisfy the automatic rollover requirements, as interpreted in published guidance. See § 2.03, Rev. Proc. 2004–25, 2004–16 I.R.B. 791. To the extent necessary, such a remedial amendment may be made retroactively effective as of March 28, 2005, or, if later, the date on which the plan becomes subject to the automatic rollover requirements of § 401(a)(31)(B).

DRAFTING INFORMATION

The principal authors of this notice are Kathleen J. Herrmann and Angelique V. Carrington of Employee Plans, Tax Exempt and Government Entities Division. Ms. Herrmann and Ms. Carrington may be reached at (202) 283–9888 (not a toll-free number).

APPENDIX

Section 401(a)(31)(B) Sample Amendment

"In the event of a mandatory distribution greater than $1,000 in accordance with the provisions of section _____, if the participant does not elect to have such distribution paid directly to an eligible retirement plan specified by the participant in a direct rollover or to receive the distribution directly in accordance with section(s) _____, then the plan administrator will pay the distribution in a direct rollover to an individual retirement plan designated by the plan administrator."

Section 6043A and Request for Comments

Notice 2005–7

Background

This notice addresses the new information reporting rules provided in section 6043A as enacted by the American Jobs Creation Act of 2004.

Temporary and Proposed Regulations under Sections 6043(c) and 6045

Proposed regulations under sections 6043(c) and 6045 provide for information reporting in the case of an acquisition of control of a corporation or a substantial change in corporate structure of a corporation. Pursuant to these proposed regulations, information reporting would be required when there is an acquisition of control of a domestic corporation or a substantial change in capital structure of a domestic corporation, and shareholders are required to recognize gain (if any) from the transaction. The proposed regulations would require the reporting corporation (defined as the acquired corporation in the case of an acquisition) to file with the IRS Form 8806 describing the transaction on or before the 45th day following the transaction, and to file with the IRS and furnish to shareholders Form 1099-CAP with respect to cash, stock, and other property received by shareholders. Brokers holding stock for customers would be required to file with the IRS and furnish to shareholders Form 1099-B reporting the amounts received. Reporting would be required only with respect to transactions involving distributions of assets of $100 million or more, and certain reporting exceptions are provided with respect to specified shareholders.

Pursuant to temporary regulations §§ 1.6043–4T and 1.6045–3T, reporting rules have applied to any acquisition of control and any substantial change in capital structure occurring after December 31, 2001, if the reporting corporation or any shareholder is required to recognize gain (if any) as a result of the application of section 367(a).

Section 6043A

Section 805 of the American Jobs Creation Act of 2004, Pub. L. 108–357, 118 Stat. 1418, added section 6043A to the Internal Revenue Code. Section 6043A provides for information reporting by an acquiring corporation in any taxable acquisition, according to forms or regulations prescribed by the Secretary. Section 6043A supplements the information reporting provisions of sections 6043(c) and 6045.

Reporting and Request for Comments

Treasury and the IRS continue to consider comments regarding the proposed regulations under sections 6043(c) and 6045. Treasury and the IRS also are considering the proper implementation of the additional information reporting provided in section 6043A.

Treasury and the IRS request public comments relating to information reporting for acquisitions under section 6043A, including, but not limited to, comments regarding:

a. coordination with the requirements of the temporary and proposed regulations under sections 6043(c) and 6045;
b. rules for reporting by nominees;
c. whether dollar thresholds (*e.g.*, regarding the size of the acquisition or the amount received by a shareholder) should be adopted and, if so, the appropriate amount of such thresholds;
d. design of forms; and
e. appropriate filing deadlines.

Taxpayers required to report under Treas. Reg. §§ 1.6043–4T and 1.6045–3T must continue to report pursuant to those regulations.

Consideration will be given to written or electronic comments submitted by March 1, 2005. All comments will be made available for public inspection and copying. Send submissions to CC:PA:LPD:PR (NOT–156854–04), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be

hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (NOT–156854–04), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit electronic comments directly to the IRS Internet site at *www.irs.gov/regs*.

The principal author of this notice is Michael Hara of the Office of Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice Division. For further information regarding this notice, contact Mr. Hara at (202) 622–4910 (not a toll-free number).

---

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also Part I, §§ 62, 162, 267, 274; 1.62–2, 1.162–17, 1.267(a)–1, 1.274–5.)

Rev. Proc. 2005–10

SECTION 1. PURPOSE

This revenue procedure updates Rev. Proc. 2004–60, 2004–42 I.R.B. 682 (which supersedes Rev. Proc. 2003–80, 2003–2 C.B. 1037), revising the high-low rates in section 5 to conform to changes to the *per diem* rates released by the General Services Administration (GSA) on October 5, 2004, that are retroactively effective as of October 1, 2004. See 69 Fed. Reg. 60,152 (Oct. 7, 2004). As a result of these changes, this revenue procedure revises the high and low rates contained in section 5.02 from $199 to $204 and from $127 to $129, respectively. In addition, section 5.04 of this revenue procedure describes changes to the list of high-cost localities. This revenue procedure also revises the description of incidental expenses in section 3.02(3) relating to transportation between places of lodging or business and places where meals are taken to conform to the Federal Travel Regulations as codified in the Code of Federal Regulations.

This revenue procedure provides rules under which the amount of ordinary and necessary business expenses of an employee for lodging, meal, and incidental expenses or for meal and incidental expenses incurred while traveling away from home are deemed substantiated under § 1.274–5 of the Income Tax Regulations when a payor (the employer, its agent, or a third party) provides a *per diem* allowance under a reimbursement or other expense allowance arrangement to pay for the expenses. This revenue procedure provides an optional method for employees and self-employed individuals who pay or incur meal costs to use in computing the deductible costs of business meal and incidental expenses paid or incurred while traveling away from home. This revenue procedure also provides an optional method for use in computing the deductible costs of incidental expenses paid or incurred while traveling away from home by employees and self-employed individuals who do not pay or incur meal costs and who are not reimbursed for the incidental expenses. Use of a method described in this revenue procedure is not mandatory, and a taxpayer may use actual allowable expenses if the taxpayer maintains adequate records or other sufficient evidence for proper substantiation. This revenue procedure does not provide rules under which the amount of an employee's lodging expenses will be deemed substantiated when a payor provides an allowance to pay for those expenses but not meal and incidental expenses.

SECTION 2. BACKGROUND

.01 Section 162(a) of the Internal Revenue Code allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Under that provision, an employee or self-employed individual may deduct expenses paid or incurred while traveling away from home in pursuit of a trade or business. However, under § 262, no portion of the travel expenses that is attributable to personal, living, or family expenses is deductible.

.02 Section 274(n) generally limits the amount allowable as a deduction under § 162 for any expense for food, beverages, or entertainment to 50 percent of the amount of the expense that otherwise would be allowable as a deduction. In the case of any expenses for food or beverages consumed while away from home (within the meaning of § 162(a)(2)) by an individual during, or incident to, the period of duty subject to the hours of service limitations of the Department of Transportation, § 274(n)(3) gradually increases the deductible percentage to 80 percent for taxable years beginning in 2008. For taxable years beginning in 2004 and 2005, the deductible percentage for these expenses is 70 percent.

.03 Section 274(d) provides, in part, that no deduction is allowed under § 162 for any travel expense (including meals and lodging while away from home) unless the taxpayer complies with certain substantiation requirements. Section 274(d) further provides that regulations may prescribe that some or all of the substantiation requirements do not apply to an expense that does not exceed an amount prescribed by the regulations.

.04 Section 1.274–5(g), in part, grants the Commissioner the authority to prescribe rules relating to reimbursement arrangements or *per diem* allowances for ordinary and necessary expenses paid or incurred while traveling away from home. Pursuant to this grant of authority, the Commissioner may prescribe rules under which these arrangements or allowances, if in accordance with reasonable business practice, will be regarded (1) as equivalent to substantiation, by adequate records or other sufficient evidence, of the amount of travel expenses for purposes of § 1.274–5(c), and (2) as satisfying the requirements of an adequate accounting to the employer of the amount of travel expenses for purposes of § 1.274–5(f).

.05 For purposes of determining adjusted gross income, § 62(a)(2)(A) allows an employee a deduction for expenses allowed by Part VI (§ 161 and following), subchapter B, chapter 1 of the Code, paid or incurred by the employee in connection with the performance of services as an employee under a reimbursement or other expense allowance arrangement with a payor.

.06 Section 62(c) provides that an arrangement will not be treated as a reimbursement or other expense allowance arrangement for purposes of § 62(a)(2)(A) if it—

(1) does not require the employee to substantiate the expenses covered by the arrangement to the payor, or

(2) provides the employee with the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

Section 62(c) further provides that the substantiation requirements described therein

do not apply to any expense to the extent that, under the grant of regulatory authority prescribed in § 274(d), the Commissioner has provided that substantiation is not required for the expense.

.07 Under § 1.62–2(c)(1) a reimbursement or other expense allowance arrangement satisfies the requirements of § 62(c) if it meets the requirements of business connection, substantiation, and returning amounts in excess of expenses as specified in the regulations. Section 1.62–2(e)(2) specifically provides that substantiation of certain business expenses in accordance with rules prescribed under the authority of § 1.274–5(g) or 1.274–5(j) will be treated as substantiation of the amount of the expenses for purposes of § 1.62–2. Under § 1.62–2(f)(2), the Commissioner may prescribe rules under which an arrangement providing *per diem* allowances is treated as satisfying the requirement of returning amounts in excess of expenses, even though the arrangement does not require the employee to return the portion of the allowance that relates to days of travel substantiated and that exceeds the amount of the employee's expenses deemed substantiated pursuant to rules prescribed under § 274(d), provided the allowance is reasonably calculated not to exceed the amount of the employee's expenses or anticipated expenses and the employee is required to return within a reasonable period of time any portion of the allowance that relates to days of travel not substantiated.

.08 Section 1.62–2(h)(2)(i)(B) provides that, if a payor pays a *per diem* allowance that meets the requirements of § 1.62–2(c)(1), the portion, if any, of the allowance that relates to days of travel substantiated in accordance with § 1.62–2(e), that exceeds the amount of the employee's expenses deemed substantiated for the travel pursuant to rules prescribed under § 274(d) and § 1.274–5(g) or § 1.274–5(j), and that the employee is not required to return, is subject to withholding and payment of employment taxes. See §§ 31.3121(a)–3, 31.3231(e)–1(a)(5), 31.3306(b)–2, and 31.3401(a)–4 of the Employment Tax Regulations. Because the employee is not required to return this excess portion, the reasonable period of time provisions of § 1.62–2(g) (relating to the return of excess amounts) do not apply to this portion.

.09 Under § 1.62–2(h)(2)(i)(B)(*4*), the Commissioner has the discretion to prescribe special rules regarding the timing of withholding and payment of employment taxes on *per diem* allowances.

.10 Section 1.274–5(j)(1) grants the Commissioner the authority to establish a method under which a taxpayer may elect to use a specified amount for meals paid or incurred while traveling away from home in lieu of substantiating the actual cost of meals.

.11 Section 1.274–5(j)(3) grants the Commissioner the authority to establish a method under which a taxpayer may elect to use a specified amount for incidental expenses paid or incurred while traveling away from home in lieu of substantiating the actual cost of incidental expenses.

.12 On August 31, 2004, GSA published the FY 2005 domestic *per diem* rates, effective on October 1, 2004. On October 1, 2004, the Internal Revenue Service released Rev. Proc. 2004–60, the annual update of procedures for substantiating the amount of ordinary and necessary business lodging, meal, and incidental expenses incurred while traveling away from home. Section 5 of Rev. Proc. 2004–60 includes high-low *per diem* rates based on the GSA *per diem* rates published on August 30, 2004.

.13 On October 5, 2004, GSA released revised FY 2005 *per diem* rates that are retroactively effective on October 1, 2004. This revenue procedure revises the high-low *per diem* rates in section 5 based on GSA's revised rates.

SECTION 3. DEFINITIONS

.01 *Per diem allowance*. The term "*per diem allowance*" means a payment under a reimbursement or other expense allowance arrangement that meets the requirements specified in § 1.62–2(c)(1) and that is —

(1) paid with respect to ordinary and necessary business expenses incurred, or which the payor reasonably anticipates will be incurred, by an employee for lodging, meal, and incidental expenses, or for meal and incidental expenses for travel away from home in connection with the performance of services as an employee of the employer,

(2) reasonably calculated not to exceed the amount of the expenses or the anticipated expenses, and

(3) paid at or below the applicable federal *per diem* rate, a flat rate or stated schedule, or in accordance with any other Service-specified rate or schedule.

.02 *Federal per diem rate and federal M&IE rate*.

(1) *In general*. The federal *per diem* rate is equal to the sum of the applicable federal lodging expense rate and the applicable federal meal and incidental expense (M&IE) rate for the day and locality of travel.

(a) *CONUS rates*. The rates for localities in the continental United States (CONUS) are set forth in Appendix A to 41 C.F.R. ch. 301.

(b) *OCONUS rates*. The rates for localities outside the continental United States (OCONUS) are established by the Secretary of Defense (rates for non-foreign localities, including Alaska, Hawaii, Puerto Rico, the Northern Mariana Islands, and the possessions of the United States) and by the Secretary of State (rates for foreign localities), and are published in the *Per Diem* Supplement to the Standardized Regulations (Government Civilians, Foreign Areas) (updated on a monthly basis).

(c) *Internet access to the rates*. The CONUS and OCONUS rates may be found on the Internet at *www.policyworks.gov/perdiem*.

(2) *Locality of travel*. The term "*locality of travel*" means the locality where an employee traveling away from home in connection with the performance of services as an employee of the employer stops for sleep or rest.

(3) *Incidental expenses*. The term "*incidental expenses*" has the same meaning as in the Federal Travel Regulations, 41 C.F.R. 300–3.1 (2004). Thus, based on the current definition of "incidental expenses" in the Federal Travel Regulations, "incidental expenses" means fees and tips given to porters, baggage carriers, bellhops, hotel maids, stewards or stewardesses and others on ships, and hotel servants in foreign countries; transportation between places of lodging or business and places where meals are taken, if suitable meals can be obtained at the temporary duty site; and the mailing cost associated with filing travel vouchers and payment of employer-sponsored charge card billings.

.03 *Flat rate or stated schedule*.

(1) *In general*. Except as provided in section 3.03(2) of this revenue procedure,

an allowance is paid at a flat rate or stated schedule if it is provided on a uniform and objective basis with respect to the expenses described in section 3.01 of this revenue procedure. The allowance may be paid with respect to the number of days away from home in connection with the performance of services as an employee or on any other basis that is consistently applied and in accordance with reasonable business practice. Thus, for example, an hourly payment to cover meal and incidental expenses paid to a pilot or flight attendant who is traveling away from home in connection with the performance of services as an employee is an allowance paid at a flat rate or stated schedule. Likewise, a payment based on the number of miles traveled (such as cents per mile) to cover meal and incidental expenses paid to an over-the-road truck driver who is traveling away from home in connection with the performance of services as an employee is an allowance paid at a flat rate or stated schedule.

(2) *Limitation*. For purposes of this revenue procedure, an allowance that is computed on a basis similar to that used in computing the employee's wages or other compensation (such as the number of hours worked, miles traveled, or pieces produced) does not meet the business connection requirement of § 1.62–2(d), is not a *per diem* allowance, and is not paid at a flat rate or stated schedule, unless, as of December 12, 1989, (a) the allowance was identified by the payor either by making a separate payment or by specifically identifying the amount of the allowance, or (b) an allowance computed on that basis was commonly used in the industry in which the employee is employed. See § 1.62–2(d)(3)(ii).

SECTION 4. PER DIEM SUBSTANTIATION METHOD

.01 *Per diem allowance*. If a payor pays a *per diem* allowance in lieu of reimbursing actual lodging, meal, and incidental expenses incurred or to be incurred by an employee for travel away from home, the amount of the expenses that is deemed substantiated for each calendar day is equal to the lesser of the *per diem* allowance for that day or the amount computed at the federal *per diem* rate (see section 3.02 of this revenue procedure) for the locality of travel for that day (or partial day, see section 6.04 of this revenue procedure).

.02 *Meal and incidental expenses only per diem allowance*. If a payor pays a *per diem* allowance only for meal and incidental expenses in lieu of reimbursing actual meals and incidental expenses incurred or to be incurred by an employee for travel away from home, the amount of the expenses that is deemed substantiated for each calendar day is equal to the lesser of the *per diem* allowance for that day or the amount computed at the federal M&IE rate for the locality of travel for that day (or partial day). A *per diem* allowance is treated as paid only for meal and incidental expenses if (1) the payor pays the employee for actual expenses for lodging based on receipts submitted to the payor, (2) the payor provides the lodging in kind, (3) the payor pays the actual expenses for lodging directly to the provider of the lodging, (4) the payor does not have a reasonable belief that lodging expenses were or will be incurred by the employee, or (5) the allowance is computed on a basis similar to that used in computing the employee's wages or other compensation (such as the number of hours worked, miles traveled, or pieces produced).

.03 *Optional method for meal and incidental expenses only deduction*. In lieu of using actual expenses in computing the amount allowable as a deduction for ordinary and necessary meal and incidental expenses paid or incurred for travel away from home, employees and self-employed individuals who pay or incur meal expenses may use an amount computed at the federal M&IE rate for the locality of travel for each calendar day (or partial day) the employee or self-employed individual is away from home. This amount will be deemed substantiated for purposes of paragraphs (b)(2) and (c) of § 1.274–5, provided the employee or self-employed individual substantiates the elements of time, place, and business purpose of the travel for that day (or partial day) in accordance with those regulations. See section 6.05(1) of this revenue procedure for rules related to the application of the limitation under § 274(n) to amounts determined under this section 4.03. See section 4.05 of this revenue procedure for a method for substantiating incidental expenses that may be used by employees or self-employed individuals who do not pay or incur meal expenses.

.04 *Special rules for transportation industry*.

(1) *In general*. This section 4.04 applies to (a) a payor that pays a *per diem* allowance only for meal and incidental expenses for travel away from home as described in section 4.02 of this revenue procedure to an employee in the transportation industry, or (b) an employee or self-employed individual in the transportation industry who computes the amount allowable as a deduction for meal and incidental expenses for travel away from home in accordance with section 4.03 of this revenue procedure.

(2) *Transportation industry defined*. For purposes of this section 4.04, an employee or self-employed individual is in the transportation industry only if the employee's or individual's work (a) is of the type that directly involves moving people or goods by airplane, barge, bus, ship, train, or truck, and (b) regularly requires travel away from home which, during any single trip away from home, usually involves travel to localities with differing federal M&IE rates. For purposes of the preceding sentence, a payor must determine that an employee or a group of employees is in the transportation industry by using a method that is consistently applied and in accordance with reasonable business practice.

(3) *Rates*. A taxpayer described in section 4.04(1) of this revenue procedure may treat $41 as the federal M&IE rate for any CONUS locality of travel, and $46 as the federal M&IE rate for any OCONUS locality of travel. A payor that uses either (or both) of these special rates with respect to an employee must use the special rate(s) for all amounts subject to section 4.02 of this revenue procedure paid to that employee for travel away from home within CONUS and/or OCONUS, as the case may be, during the calendar year. Similarly, an employee or self-employed individual that uses either (or both) of these special rates must use the special rate(s) for all amounts computed pursuant to section 4.03 of this revenue procedure for travel away from home within CONUS and/or OCONUS, as the case may be, during the calendar year.

(4) *Periodic rule*. A payor described in section 4.04(1) of this revenue procedure may compute the amount of the employee's expenses that is deemed substantiated under section 4.02 of this revenue

procedure periodically (not less frequently than monthly), rather than daily, by comparing the total *per diem* allowance paid for the period to the sum of the amounts computed either at the federal M&IE rate(s) for the localities of travel, or at the special rate described in section 4.04(3), for the days (or partial days) the employee is away from home during the period.

(5) *Examples*.

(a) *Example 1*. Taxpayer, an employee in the transportation industry, travels away from home on business within CONUS on 17 days (including partial days) during a calendar month and receives a *per diem* allowance only for meal and incidental expenses from a payor that uses the special rule under section 4.04(3) of this revenue procedure. The amount deemed substantiated under section 4.02 of this revenue procedure is equal to the lesser of the total *per diem* allowance paid for the month or $697 (17 days at $41 per day).

(b) *Example 2*. Taxpayer, a truck driver employee in the transportation industry, is paid a "cents-per-mile" allowance that qualifies as an allowance paid under a flat rate or stated schedule as defined in section 3.03 of this revenue procedure. Taxpayer travels away from home on business for 10 days. Based on the number of miles driven by Taxpayer, Taxpayer's employer pays an allowance of $400 for the 10 days of business travel. Taxpayer actually drives for 8 days, and does not drive for the other 2 days Taxpayer is away from home. Taxpayer is paid under the periodic rule used for transportation industry employers and employees in accordance with section 4.04(4) of this revenue procedure. The amount deemed substantiated and excludable from Taxpayer's income is the full $400 because that amount does not exceed $410 (ten days away from home at $41 per day).

.05 *Optional method for incidental expenses only deduction*. In lieu of using actual expenses in computing the amount allowable as a deduction for ordinary and necessary incidental expenses paid or incurred for travel away from home, employees and self-employed individuals who do not pay or incur meal expenses for a calendar day (or partial day) of travel away from home may use, for each calendar day (or partial day) the employee or self-employed individual is away from home, an amount computed at the rate of $3 per day for any CONUS or OCONUS locality of travel. This amount will be deemed substantiated for purposes of paragraphs (b)(2) and (c) of § 1.274–5, provided the employee or self-employed individual substantiates the elements of time, place, and business purpose of the travel for that day (or partial day) in accordance with those regulations. See section 4.03 of this revenue procedure for a method that may be used by employees or self-employed individuals who pay or incur meal expenses. The method authorized by this section 4.05 may not be used by payors that use section 4.01, 4.02, or 5.01 of this revenue procedure, or by employees or self-employed individuals who use the method described in section 4.03 of this revenue procedure. See section 6.05(4) of this revenue procedure for rules related to the application of the limitation under § 274(n) to amounts determined under this section 4.05.

SECTION 5. HIGH-LOW SUBSTANTIATION METHOD

.01 *In general*. If a payor pays a *per diem* allowance in lieu of reimbursing actual lodging, meal, and incidental expenses incurred or to be incurred by an employee for travel away from home and the payor uses the high-low substantiation method described in this section 5 for travel within CONUS, the amount of the expenses that is deemed substantiated for each calendar day is equal to the lesser of the *per diem* allowance for that day or the amount computed at the rate set forth in section 5.02 of this revenue procedure for the locality of travel for that day (or partial day, see section 6.04 of this revenue procedure). This high-low substantiation method may be used in lieu of the *per diem* substantiation method provided in section 4.01 of this revenue procedure, but may not be used in lieu of the meal and incidental expenses only substantiation method provided in section 4.02 or 4.03 of this revenue procedure or the incidental expenses only substantiation method provided in section 4.05 of this revenue procedure.

.02 *Specific high-low rates.* The *per diem* rate set forth in this section 5.02 is $204 for travel to any "high-cost locality" specified in section 5.03 of this revenue procedure, or $129 for travel to any other locality within CONUS. The high or low rate, as appropriate, applies as if it were the federal *per diem* rate for the locality of travel. For purposes of applying the high-low substantiation method and the § 274(n) limitation on meal expenses (see section 6.05 of this revenue procedure), the federal M&IE rate shall be treated as $46 for a high-cost locality and $36 for any other locality within CONUS.

.03 *High-cost localities*. The following localities have a federal *per diem* rate of $167 or more and are high-cost localities for all of the calendar year or the portion of the calendar year specified in parentheses under the key city name:

Key City	*County or other defined location*
Arizona	
Phoenix/Scottsdale (January 1-May 31)	Maricopa
California	
Monterey (February 1-November 30)	Monterey
Napa (May 1-October 31)	Napa
Palm Springs (January 1-May 31)	Riverside
San Diego	San Diego
San Francisco	San Francisco

Key City	*County or other defined location*
Santa Barbara	Santa Barbara
Santa Monica	City limits of Santa Monica
South Lake Tahoe (December 1-August 31)	El Dorado
Colorado	
Aspen	Pitkin
Crested Butte (December 1-March 31)	City limits of Crested Butte (Gunnison County)
Silverthorne/Breckenridge (December 1-March 31)	Summit
Telluride (December 1-September 30)	San Miguel
Vail	Eagle
District of Columbia	
Washington D.C. (also the cities of Alexandria, Falls Church, and Fairfax, and the counties of Arlington, Loudoun, and Fairfax, in Virginia; and the counties of Montgomery and Prince George's in Maryland) (See also Maryland and Virginia)	
Delaware	
Lewes (July 1-August 31)	Sussex
Florida	
Daytona Beach (February 1-March 31)	Volusia
Fort Lauderdale (January 1-May 31)	Broward
Key West	Monroe
Miami (October 1-May 31)	Miami-Dade
Naples (January 1-March 31)	Collier
Palm Beach (October 1-May 31)	Palm Beach (also the cities of Boca Raton, Delray Beach, Jupiter, Palm Beach Gardens, Palm Beach Shores, Singer Island and West Palm Beach)
Illinois	
Chicago	Cook and Lake
Louisiana	
New Orleans (February 1-April 30 and September 1-November 30)	Orleans and St. Bernard Parishes
Maryland	
(For the counties of Montgomery and Prince George's, see District of Columbia)	
Baltimore	Baltimore
Cambridge/St. Michaels (June 1-August 31)	Dorchester and Talbot
Ocean City (July 1-August 31)	Worcester

Key City	*County or other defined location*
Massachusetts	
Boston	Suffolk
Cambridge	City limits of Cambridge
Hyannis (July 1-August 31)	Barnstable
Martha's Vineyard (May 1-August 31)	Dukes
Nantucket	Nantucket
Michigan	
Traverse City (July 1-August 31)	Grand Traverse
New Jersey	
Atlantic City (May 1-October 31)	Atlantic
Cape May (June 1-August 31)	Cape May (except Ocean City)
Ocean City (June 1-October 31)	City limits of Ocean City
Princeton/Trenton	Mercer
New Mexico	
Santa Fe (July 1-August 31)	Santa Fe
New York	
Carle Place/Garden City/ Glen Cove/Great Neck/ Plainview/Rockville Centre/ Syosset/Uniondale/Woodbury	Nassau
Lake Placid (July 1-August 31)	Essex
Manhattan	Includes Richmond and the boroughs of Manhattan, Brooklyn, Queens and The Bronx
Riverhead/Ronkonkoma/ Melville	Suffolk
Tarrytown	Westchester (except White Plains)
White Plains	City limits of White Plains
North Carolina	
Kill Devil (April 1-October 31)	Dare
Pennsylvania	
Hershey (May 1-August 31)	City limits of Hershey
Philadelphia	Philadelphia

Key City	*County or other defined location*
Rhode Island	
Jamestown/Middletown/ Newport (May 1-October 31)	Newport
Providence	Providence
South Carolina	
Hilton Head (April 1-October 31)	Beaufort
Utah	
Park City (December 1-March 31)	Summit
Virginia	
(For the cities of Alexandria, Fairfax, and Falls Church, and the counties of Arlington, Fairfax, and Loudoun, see District of Columbia)	
Virginia Beach (June 1-August 31)	Cities of Virginia Beach, Norfolk, Portsmouth, Chesapeake, and Suffolk
Washington	
Seattle (May 1-October 31)	King

.04 *Changes to high-cost localities in Rev. Proc. 2004–60*. The list of high-cost localities in section 5.03 of this revenue procedure differs from the list of high-cost localities in section 5.03 of Rev. Proc. 2004–60 (changes listed by key cities).

(1) The following locality has been added to the list of high-cost localities: Traverse City, Michigan.

(2) The portion of the year for which the following are high-cost localities has been changed: Fort Lauderdale, Florida; New Orleans, Louisiana; and Silverthorne/Breckinridge, Colorado;

(3) The following localities have been removed from the list of high-cost localities: Las Vegas, Nevada; Mackinac Island, Michigan; Myrtle Beach, South Carolina; and Tom's River, New Jersey.

(4) The boroughs of Brooklyn, Queens, The Bronx, and Staten Island are no longer separately listed as a high-cost locality and are now combined with the borough of Manhattan.

.05 *Specific limitation*.

(1) Except as provided in section 5.05(2) of this revenue procedure, a payor that uses the high-low substantiation method with respect to an employee must use that method for all amounts paid to that employee for travel away from home within CONUS during the calendar year.

(2) With respect to an employee described in section 5.05(1) of this revenue procedure, the payor may reimburse actual expenses or use the meals only *per diem* method described in section 4.02 of this revenue procedure for any travel away from home, and may use the *per diem* substantiation method described in section 4.01 of this revenue procedure for any OCONUS travel away from home.

SECTION 6. LIMITATIONS AND SPECIAL RULES

.01 *In general*. The federal *per diem* rate and the federal M&IE rate described in section 3.02 of this revenue procedure for the locality of travel will be applied in the same manner as applied under the Federal Travel Regulations, 41 C.F.R. Part 301–11 (2004), except as provided in sections 6.02 through 6.04 of this revenue procedure.

.02 *Federal per diem rate*. A receipt for lodging expenses is not required in determining the amount of expenses deemed substantiated under section 4.01 or 5.01 of this revenue procedure. See section 7.01 of this revenue procedure for the requirement that the employee substantiate the time, place, and business purpose of the expense.

.03 *Federal per diem or M&IE rate*. A payor is not required to reduce the federal *per diem* rate or the federal M&IE rate for the locality of travel for meals provided in kind, provided the payor has a reasonable belief that meal and incidental expenses were or will be incurred by the employee during each day of travel.

.04 *Proration of the federal per diem or M&IE rate*. Pursuant to the Federal Travel Regulations, in determining the federal *per diem* rate or the federal M&IE rate for the locality of travel, the full applicable federal M&IE rate is available for a full day of travel from 12:01 a.m. to 12:00 midnight. The method described in section 6.04(1) of this revenue procedure must be used for purposes of determining the amount deemed substantiated under section 4.03 or 4.05 of this revenue procedure for partial days of travel away from home. For purposes of determining the amount deemed substantiated under section 4.01, 4.02, 4.04, or 5 of this revenue procedure for partial days of travel away from home, either of the following methods may be used to prorate the federal M&IE rate to

determine the federal *per diem* rate or the federal M&IE rate for the partial days of travel:

(1) The rate may be prorated using the method prescribed by the Federal Travel Regulations. Currently the Federal Travel Regulations allow three-fourths of the applicable federal M&IE rate for each partial day during which the employee or self-employed individual is traveling away from home in connection with the performance of services as an employee or self-employed individual. The same ratio may be applied to prorate the allowance for incidental expenses described in section 4.05 of this revenue procedure; or

(2) The rate may be prorated using any method that is consistently applied and in accordance with reasonable business practice. For example, if an employee travels away from home from 9 a.m. one day to 5 p.m. the next day, a method of proration that results in an amount equal to two times the federal M&IE rate will be treated as being in accordance with reasonable business practice (even though only one and a half times the federal M&IE rate would be allowed under the Federal Travel Regulations).

.05 *Application of the appropriate § 274(n) limitation on meal expenses*. Except as provided in section 6.05(4), all or part of the amount of an expense deemed substantiated under this revenue procedure is subject to the appropriate limitation under § 274(n) (see section 2.02 of this revenue procedure) on the deductibility of food and beverage expenses.

(1) If an amount for meal and incidental expenses is computed pursuant to section 4.03 of this revenue procedure, the taxpayer must treat that amount as an expense for food and beverages.

(2) If a *per diem* allowance is paid only for meal and incidental expenses, the payor must treat an amount equal to the lesser of the allowance or the federal M&IE rate for the locality of travel for each day (or partial day, see section 6.04 of this revenue procedure) as an expense for food and beverages.

(3) If a *per diem* allowance is paid for lodging, meal, and incidental expenses, the payor must treat an amount equal to the federal M&IE rate for the locality of travel for each calendar day (or partial day) the employee is away from home as an expense for food and beverages. For purposes of the preceding sentence, if a *per diem* allowance for lodging, meal, and incidental expenses is paid at a rate that is less than the federal *per diem* rate for the locality of travel for each day (or partial day), the payor may treat an amount equal to 40 percent of the allowance as the federal M&IE rate for the locality of travel for each day (or partial day).

(4) If an amount for incidental expenses is computed under section 4.05 of this revenue procedure, none of the amount so computed is subject to limitation under § 274(n) on the deductibility of food and beverage expenses.

.06 *No double reimbursement or deduction*. If a payor pays a *per diem* allowance in lieu of reimbursing actual lodging, meal, and incidental expenses or for meal and incidental expenses in accordance with section 4 or 5 of this revenue procedure, any additional payment with respect to those expenses is treated as paid under a nonaccountable plan, is included in the employee's gross income, is reported as wages or other compensation on the employee's Form W–2, "*Wage and Tax Statement*," and is subject to withholding and payment of employment taxes. Similarly, if an employee or self-employed individual computes the amount allowable as a deduction for meal and incidental expenses for travel away from home in accordance with section 4.03 or 4.04 of this revenue procedure, no other deduction is allowed to the employee or self-employed individual with respect to those expenses. For example, assume an employee receives a *per diem* allowance from a payor for lodging, meal, and incidental expenses or for meal and incidental expenses incurred while traveling away from home. During that trip, the employee pays for dinner for the employee and two business associates. The payor reimburses as a business entertainment meal expense the meal expense for the employee and the two business associates. Because the payor also pays a *per diem* allowance to cover the cost of the employee's meals, the amount paid by the payor for the employee's portion of the business entertainment meal expense is treated as paid under a nonaccountable plan, is reported as wages or other compensation on the employee's Form W–2, and is subject to withholding and payment of employment taxes.

.07 *Related parties*. Sections 4.01 and 5 of this revenue procedure do not apply if a payor and an employee are related within the meaning of § 267(b), but for this purpose the percentage of ownership interest referred to in § 267(b)(2) shall be 10 percent.

SECTION 7. APPLICATION

.01 If the amount of travel expenses is deemed substantiated under the rules provided in section 4 or 5 of this revenue procedure, and the employee substantiates to the payor the elements of time, place, and business purpose of the travel for that day (or partial day) in accordance with paragraphs (b)(2) and (c) (other than subparagraph (2)(iii)(A) thereof) of § 1.274–5, the employee is deemed to satisfy the adequate accounting requirements of § 1.274–5(f) as well as the requirement to substantiate by adequate records or other sufficient evidence for purposes of § 1.274–5(c). See § 1.62–2(e)(1) for the rule that an arrangement must require business expenses to be substantiated to the payor within a reasonable period of time.

.02 An arrangement providing *per diem* allowances will be treated as satisfying the requirement of § 1.62–2(f)(2) of returning amounts in excess of expenses if the employee is required to return within a reasonable period of time (as defined in § 1.62–2(g)) any portion of the allowance that relates to days of travel not substantiated, even though the arrangement does not require the employee to return the portion of the allowance that relates to days of travel substantiated and that exceeds the amount of the employee's expenses deemed substantiated. For example, assume a payor provides an employee an advance *per diem* allowance for meal and incidental expenses of $200, based on an anticipated 5 days of business travel at $40 per day to a locality for which the federal M&IE rate is $31, and the employee substantiates 3 full days of business travel. The requirement to return excess amounts will be treated as satisfied if the employee is required to return within a reasonable period of time (as defined in § 1.62–2(g)) the portion of the allowance that is attributable to the 2 unsubstantiated days of travel ($80), even though the employee is not required to return the portion of the allowance ($27) that exceeds the amount

of the employee's expenses deemed substantiated under section 4.02 of this revenue procedure ($93) for the 3 substantiated days of travel. However, the $27 excess portion of the allowance is treated as paid under a nonaccountable plan as discussed in section 7.04 of this revenue procedure.

.03 An employee is not required to include in gross income the portion of a *per diem* allowance received from a payor that is less than or equal to the amount deemed substantiated under the rules provided in section 4 or 5 of this revenue procedure if the employee substantiates the business travel expenses covered by the *per diem* allowance in accordance with section 7.01 of this revenue procedure. See § 1.274–5(f)(2)(i). In addition, that portion of the allowance is treated as paid under an accountable plan, is not reported as wages or other compensation on the employee's Form W–2, and is exempt from the withholding and payment of employment taxes. See § 1.62–2(c)(2) and (c)(4).

.04 An employee is required to include in gross income only the portion of the *per diem* allowance received from a payor that exceeds the amount deemed substantiated under the rules provided in section 4 or 5 of this revenue procedure if the employee substantiates the business travel expenses covered by the *per diem* allowance in accordance with section 7.01 of this revenue procedure. See § 1.274–5(f)(2)(ii). In addition, the excess portion of the allowance is treated as paid under a nonaccountable plan, is reported as wages or other compensation on the employee's Form W–2, and is subject to withholding and payment of employment taxes. See § 1.62–2(c)(3)(ii), (c)(5), and (h)(2)(i)(B).

.05 If the amount of the expenses that is deemed substantiated under the rules provided in section 4.01, 4.02, or 5 of this revenue procedure is less than the amount of the employee's business expenses for travel away from home, the employee may claim an itemized deduction for the amount by which the business travel expenses exceed the amount that is deemed substantiated, provided the employee substantiates all the business travel expenses, includes on Form 2106, "*Employee Business Expenses*," the deemed substantiated portion of the *per diem* allowance received from the payor, and includes in gross income the portion (if any) of the *per diem* allowance received from the payor that exceeds the amount deemed substantiated. See § 1.274–5(f)(2)(iii). However, for purposes of claiming this itemized deduction with respect to meal and incidental expenses, substantiation of the amount of the expenses is not required if the employee is claiming a deduction that is equal to or less than the amount computed under section 4.03 of this revenue procedure minus the amount deemed substantiated under sections 4.02 and 7.01 of this revenue procedure. The itemized deduction is subject to the appropriate limitation (see section 2.02 of this revenue procedure) on meal and entertainment expenses provided in § 274(n) and the 2-percent floor on miscellaneous itemized deductions provided in § 67.

.06 An employee who pays or incurs amounts for meal expenses and does not receive a *per diem* allowance for meal and incidental expenses may deduct an amount computed pursuant to section 4.03 of this revenue procedure only as an itemized deduction. This itemized deduction is subject to the appropriate limitation on meal and entertainment expenses provided in § 274(n) and the 2-percent floor on miscellaneous itemized deductions provided in § 67. See section 7.07 of this revenue procedure for the treatment of an employee who does not pay or incur amounts for meal expenses and does not receive a *per diem* allowance for incidental expenses.

.07 An employee who does not pay or incur amounts for meal expenses and does not receive a *per diem* allowance for incidental expenses may deduct an amount computed pursuant to section 4.05 of this revenue procedure only as an itemized deduction. This itemized deduction is subject to the 2-percent floor on miscellaneous itemized deductions provided in § 67. See section 7.06 of this revenue procedure for the treatment of an employee who pays or incurs amounts for meal expenses and does not receive a *per diem* allowance for meal and incidental expenses.

.08 A self-employed individual who pays or incurs meal expenses for a calendar day (or partial day) of travel away from home may deduct an amount computed pursuant to section 4.03 of this revenue procedure in determining adjusted gross income under § 62(a)(1). This deduction is subject to the appropriate limitation on meal and entertainment expenses provided in § 274(n).

.09 A self-employed individual who does not pay or incur meal expenses for a calendar day (or partial day) of travel away from home may deduct an amount computed pursuant to section 4.05 of this revenue procedure in determining adjusted gross income under § 62(a)(1).

.10 If a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of § 62(c) and the regulations thereunder, all payments under the arrangement will be treated as made under a nonaccountable plan. See § 1.62–2(k). Thus, these payments are included in the employee's gross income, are reported as wages or other compensation on the employee's Form W–2, and are subject to withholding and payment of employment taxes. See § 1.62–2(c)(3), (c)(5), and (h)(2).

SECTION 8. WITHHOLDING AND PAYMENT OF EMPLOYMENT TAXES

.01 The portion of a *per diem* allowance, if any, that relates to the days of business travel substantiated and that exceeds the amount deemed substantiated for those days under section 4.01, 4.02, or 5 of this revenue procedure is subject to withholding and payment of employment taxes. See § 1.62–2(h)(2)(i)(B).

.02 In the case of a *per diem* allowance paid as a reimbursement, the excess described in section 8.01 of this revenue procedure is subject to withholding and payment of employment taxes in the payroll period in which the payor reimburses the expenses for the days of travel substantiated. See § 1.62–2(h)(2)(i)(B)(*2*).

.03 In the case of a *per diem* allowance paid as an advance, the excess described in section 8.01 of this revenue procedure is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the days of travel with respect to which the advance was paid are substantiated. See § 1.62–2(h)(2)(i)(B)(*3*). If some or all of the days of travel with respect to which the advance was paid are not substantiated within a reasonable period of time and the employee does not return the portion of the allowance that relates to those days within a reasonable period of time, the portion of the allowance

that relates to those days is subject to withholding and payment of employment taxes no later than the first payroll period following the end of the reasonable period. See § 1.62–2(h)(2)(i)(A).

.04 In the case of a *per diem* allowance only for meal and incidental expenses for travel away from home paid to an employee in the transportation industry by a payor that uses the rule in section 4.04(4) of this revenue procedure, the excess of the *per diem* allowance paid for the period over the amount deemed substantiated for the period under section 4.02 of this revenue procedure (after applying section 4.04(4) of this revenue procedure), is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the excess is computed. See § 1.62–2(h)(2)(i)(B)(*4*).

.05 For example, assume that an employer pays an employee a *per diem* allowance to cover business expenses for meals and lodging for travel away from home at a rate of 120 percent of the federal *per diem* rate for the localities to which the employee travels. The employer does not require the employee to return the 20 percent by which the reimbursement for those expenses exceeds the federal *per diem* rate. The employee substantiates 6 days of travel away from home: 2 days in a locality in which the federal *per diem* rate is $100 and 4 days in a locality in which the federal *per diem* rate is $125. The employer reimburses the employee $840 for the 6 days of travel away from home (2 x (120% x $100) + 4 x (120% x $125)), and does not require the employee to return the excess payment of $140 (2 days x $20 ($120-$100) + 4 days x $25 ($150-$125)). For the payroll period in which the employer reimburses the expenses, the employer must withhold and pay employment taxes on $140. See section 8.02 of this revenue procedure.

SECTION 9.. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2004–60 is superseded (1) for *per diem* allowances that are paid both (a) to an employee on or after January 1, 2005, and (b) with respect to lodging, meal, and incidental expenses or with respect to meal and incidental expenses paid or incurred for travel away from home on or after January 1, 2005; and (2) for purposes of computing the amount allowable as a deduction for meal and incidental expenses or for incidental expenses only paid or incurred by an employee or self-employed individual for travel away from home on or after January 1, 2005. However, taxpayers may apply Rev. Proc. 2004–60 in lieu of this revenue procedure (1) for *per diem* allowances that are paid both (a) to an employee on or after January 1, 2005, and before March 1, 2005, and (b) with respect to lodging, meal, and incidental expenses or with respect to meal and incidental expenses paid or incurred for travel away from home on or after January 1, 2005, and before March 1, 2005; and (2) for purposes of computing the amount allowable as a deduction for meal and incidental expenses or for incidental expenses only paid or incurred by an employee or self-employed individual for travel away from home on or after January 1, 2005, and before March 1, 2005.

DRAFTING INFORMATION

The principal author of this revenue procedure is Christian Wood of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Wood at (202) 622–4930 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations and Notice of Public Hearing

Prohibited Allocations of Securities in an S Corporation

REG–129709–03

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations and notice of public hearing.

SUMMARY: In this issue of the Bulletin, the IRS is issuing temporary regulations (T.D. 9164) that provide guidance on the definition and effects of a prohibited allocation under section 409(p), identification of disqualified persons and determination of a nonallocation year, calculation of synthetic equity under section 409(p)(5), and standards for determining whether a transaction is an avoidance or evasion of section 409(p). These proposed regulations would generally affect plan sponsors of, and participants in, ESOPs holding stock of Subchapter S corporations. The text of those temporary regulations also serves as the text of these proposed regulations. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by March 17, 2005. Requests to speak (with outlines of oral comments to be discussed) at the public hearing scheduled for April 20, 2005, at 10 a.m. must be received by March 30, 2005.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–129709–03), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG–129709–03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC. Alternatively, taxpayers may submit comments electronically via the IRS Internet site at *www.irs.gov/regs* or the Federal eRulemaking Portal at *www.regulations.gov* (indicate IRS and REG–129709–03).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, John Ricotta at 622–6060; concerning submissions of comments, contact Guy Traynor at 202–622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Temporary regulations in this issue of the Bulletin amend the Income Tax Regulations (26 CFR part 1) relating to section 409(p). The temporary regulations contain rules relating to the definition and effects of a prohibited allocation under section 409(p), identification of disqualified persons and determination of a nonallocation year, calculation of synthetic equity under section 409(p)(5), and standards for determining whether a transaction is an avoidance or evasion of section 409(p). The text of those temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking 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. Because §1.409(p)–1 imposes no new collection of information on small entities, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and 8 copies) or electronic comments that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for April 20, 2005, at 10 a.m. in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. All visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts at the Constitution Avenue entrance. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by March 30, 2005. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

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

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read, in part, as follows:

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

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

Par. 2. Section 1.409(p)–1 is added to read as follows:

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

[The text of proposed §1.409(p)–1 is the same as the text of §1.409(p)–1T published elsewhere in this issue of the Bulletin].

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on December 16, 2004, 8:45 a.m., and published in the issue of the Federal Register for December 17, 2004, 69 F.R. 75492)

Announcement of Disciplinary Actions Involving Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries — Suspensions, Censures, Disbarments, and Resignations

Announcement 2005-2

Under Title 31, Code of Federal Regulations, Part 10, attorneys, certified public accountants, enrolled agents, and enrolled actuaries may not accept assistance from, or assist, any person who is under disbarment or suspension from practice before the Internal Revenue Service if the assistance relates to a matter constituting practice before the Internal Revenue Service and may not knowingly aid or abet another person to practice before the Internal Revenue Service during a period of suspension, disbarment, or ineligibility of such other person.

To enable attorneys, certified public accountants, enrolled agents, and enrolled actuaries to identify persons to whom these restrictions apply, the Director, Office of Professional Responsibility, will announce in the Internal Revenue Bulletin their names, their city and state, their professional designation, the effective date of disciplinary action, and the period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for five successive weeks.

Consent Suspensions From Practice Before the Internal Revenue Service

Under Title 31, Code of Federal Regulations, Part 10, an attorney, certified public accountant, enrolled agent, or enrolled actuary, in order to avoid institution or conclusion of a proceeding for his or her disbarment or suspension from practice before the Internal Revenue Service, may offer his or her consent to suspension from such practice. The Director, Office of Professional Responsibility, in his discretion, may suspend an attorney, certified public accountant, enrolled agent, or enrolled actuary in accordance with the consent offered.

The following individuals have been placed under consent suspension from practice before the Internal Revenue Service:

Name	Address	Designation	Date of Suspension
Nadler, Herbert	New York, NY	Enrolled Actuary	November 1, 2004 to February 28, 2005

New Code Z for the 2005 Form W–2, Box 12

Announcement 2005–5

Purpose	The purpose of this announcement is to advise employers about an additional code for use on the 2005 Form W–2. Similar reporting is required on Form 1099–MISC for nonemployees. This code and other reporting will be used to identify income recognized due to participation in a nonqualified deferred compensation plan that fails to meet the requirements of Internal Revenue Code section 409A that was added by section 885 of the American Jobs Creation Act of 2004. This income is subject to an additional tax and interest imposed on the individual.
Reporting of Income Recognized Under a Nonqualified Deferred Compensation Plan	A new code **(Code Z-Income under section 409A on a nonqualified deferred compensation plan)**, for use in box 12 on the 2005 Form W–2, has been added to the 2005 Form W–2 and the Instructions for Forms W–2 and W–3. Employers must use code Z in box 12 of Form W–2 to report the income shown in box 1 that relates to the recognition of income due to participation in a nonqualified deferred compensation plan that fails to meet the requirements of section 409A. Report income recognized under section 409A for nonemployees both in box 7 and in box 15b of Form 1099–MISC.
No Change to Reporting of Social Security and Medicare Wages	Social security and Medicare wage reporting was not changed by section 409A. Nonqualified deferred compensation for employees is generally subject to social security and Medicare taxes when the related services are performed. However, the taxability of wages for social security and Medicare purposes is delayed during the period when an employee's right to receive payment of the wages is subject to a substantial risk of forfeiture. Employers should continue to report social security and Medicare wages from nonqualified deferred compensation plans in boxes 3, 5, and 11 of Form W–2, as appropriate.
Related Reporting	As provided by Internal Revenue Code sections 6051(a)(13) and 6041(g), applicable persons must report employee and nonemployee income deferrals under a nonqualified deferred compensation plan using code Y in box 12 of Form W–2 or in box 15a of Form 1099–MISC respectively. Report deferrals in box 12 or in box 15a even if the payee must recognize income under section 409A during the same year.

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statement of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D. —Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z —Corporation.

Numerical Finding List[1]

Bulletins 2005–1 through 2005–3

Announcements:

Notices:

Proposed Regulations:

Revenue Procedures:

Revenue Rulings:

Tax Conventions:

Treasury Decisions:

[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2004–27 through 2004–52 is in Internal Revenue Bulletin 2004–52, dated December 27, 2004.

Finding List of Current Actions on Previously Published Items[1]

Bulletins 2005–1 through 2005–3

Notices:

88-30
Obsoleted by
Notice 2005-4, 2005-2 I.R.B. *289*

88-132
Obsoleted by
Notice 2005-4, 2005-2 I.R.B. *289*

89-29
Obsoleted by
Notice 2005-4, 2005-2 I.R.B. *289*

89-38
Obsoleted by
Notice 2005-4, 2005-2 I.R.B. *289*

Revenue Procedures:

98-16
Modified and superseded by
Rev. Proc. 2005-11, 2005-2 I.R.B. *307*

2001-22
Superseded by
Rev. Proc. 2005-12, 2005-2 I.R.B. *311*

2002-9
Modified and amplified by
Rev. Proc. 2005-9, 2005-2 I.R.B. *303*

2004-1
Superseded by
Rev. Proc. 2005-1, 2005-1 I.R.B. *1*

2004-2
Superseded by
Rev. Proc. 2005-2, 2005-1 I.R.B. *86*

2004-3
Superseded by
Rev. Proc. 2005-3, 2005-1 I.R.B. *118*

2004-4
Superseded by
Rev. Proc. 2005-4, 2005-1 I.R.B. *128*

2004-5
Superseded by
Rev. Proc. 2005-5, 2005-1 I.R.B. *170*

2004-6
Superseded by
Rev. Proc. 2005-6, 2005-1 I.R.B. *200*

2004-7
Superseded by
Rev. Proc. 2005-7, 2005-1 I.R.B. *240*

Revenue Procedures— Continued:

2004-8
Superseded by
Rev. Proc. 2005-8, 2005-1 I.R.B. *243*

2004-35
Corrected by
Ann. 2005-4, 2005-2 I.R.B. *319*

2004-60
Superseded by
Rev. Proc. 2005-10, 2005-3 I.R.B. *341*

Revenue Rulings:

92-63
Modified and superseded by
Rev. Rul. 2005-3, 2005-3 I.R.B. *334*

95-63
Modified and superseded by
Rev. Rul. 2005-3, 2005-3 I.R.B. *334*

2004-103
Superseded by
Rev. Rul. 2005-3, 2005-3 I.R.B. *334*

[1] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2004–27 through 2004–52 is in Internal Revenue Bulletin 2004–52, dated December 27, 2004.