Internal Revenue
bulletin

Bulletin No. 2002–23
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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

T.D. 8994, page 1078.
Final regulations under sections 444, 641, 1361, 1362, and 1377 of the Code relate to the qualification and taxation of electing small business trusts (ESBTs), and to the definition of deferral entities for purposes of electing a taxable year other than the required taxable year. Notices 97–12 and 97–49 and Rev. Proc. 98–23 superseded.

T.D. 8995, page 1070.
Final regulations under section 460 of the Code provide rules applicable when there is a mid-contract change in the taxpayer accounting for a long-term contract that has been under a long-term contract method of accounting.

Notice 2002–37, page 1095.
This notice announces that regulations will be issued addressing partnership transactions involving contracts accounted for under a long-term contract method of accounting.

EMPLOYEE PLANS

Rev. Rul. 2002–32, page 1069.
Cafeteria plans. In an asset sale, transferred employees who have elected to participate in health flexible spending arrangements (FSAs) under the seller's cafeteria plan may continue to exclude salary reduction amounts and medical reimbursements from gross income without interruption at the same level of coverage after becoming employees of the buyer.

REG–105885–99, page 1103.
Proposed regulations under section 457 of the Code would provide guidance on compensation deferred under eligible section 457 deferred compensation plans of state and local governmental employers and tax-exempt entities. The regulations reflect changes made to section 457 by the Tax Reform Act of 1986, the Small Business Job Protection Act of 1996, the Economic Growth and Tax Relief Reconciliation Act of 2001, and other legislation. These regulations would also make various technical changes and clarifications to the existing final regulations. A public hearing is scheduled for August 28, 2002.

EMPLOYMENT TAX

Rev. Rul. 2002–35, page 1067.
Wages subject to federal employment tax. This ruling clarifies that payments to employees for equipment they are required to provide as a condition of employment are wages for federal employment tax purposes, unless paid under an accountable plan. Rev. Rul. 68–624 revoked.

Rev. Proc. 2002–41, page 1098.
This procedure provides that employers in the pipeline construction industry may use an optional expense substantiation rule to provide reimbursements under an accountable plan to employees who also furnish welding rigs or mechanics rigs as a condition of employment and use those rigs in their performance of services as employees.

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Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

ADMINISTRATIVE

Rev. Proc. 2002–40, page 1096.
Net operating losses; 5-year carryback. This document provides procedures that certain taxpayers with net operating losses incurred in 2001 or 2002 must follow on or before October 31, 2002, for applying or electing out of the new 5-year carryback period enacted by the Job Creation and Worker Assistance Act of 2002.

Announcement 2002–55, page 1125.
This document contains corrections to final regulations (T.D. 8985, 2002–14 I.R.B. 707) relating to the character of gain or loss from hedging transactions.

Announcement 2002–56, page 1126.
The Service announces that an updated edition of Publication 597, *Information on the U.S. – Canada Income Tax Treaty* (revised May 2002), is now available.

Announcement 2002–57, page 1126.
The Service announces that an updated edition of Publication 1544, *Reporting Cash Payments of Over $10,000* (revised March 2002), is now available. The Spanish version of this publication, Publication 1544SP, *Informe de Pagos en Efectivo en Exceso de $10,000* (revised April 2002), is also available.

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 consolidated 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 first 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 first Bulletin of the succeeding semiannual period, respectively.

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

Section 62.—Adjusted Gross Income Defined

(Also §§ 3121(a), 3306(b), 3401(a), 7805(b).)
26 CFR 1.62–2: Reimbursements and other expense allowance arrangements.
(Also §§ 31.3121(a), 31.3306(b), 31.3401(a), 301.7805–1.)

Wages subject to federal employment tax. This ruling clarifies that payments to employees for equipment they are required to provide as a condition of employment are wages for federal employment tax purposes, unless paid under an accountable plan.

Rev. Rul. 2002–35

ISSUE

Whether amounts paid to employees for employee-provided equipment, including vehicles, that are used by the employee to provide services as an employee are wages subject to federal employment taxes?

FACTS

Situation 1 — Business *A* is engaged in pipeline construction and repair. *A* hires welder *B* and heavy equipment mechanic *C* to perform services as employees in connection with the construction of a pipeline. Business *A* requires *B* to provide and maintain a welding rig for *B*'s use in providing welding services and requires *C* to provide and maintain a mechanics rig for *C*'s use in performing repair and maintenance services at the work site on the employer's heavy equipment. *B* and *C* are required to provide rigs sufficient to perform the required employee services. (Neither employee *B* nor *C* is an independent contractor.)

A welding rig consists of a truck equipped with a welding machine and other specialized welding equipment required to perform welding services. *B* is paid an hourly wage of $X for the performance of services as an employee. In addition, *A* pays *B* an hourly amount of $Y per hour for providing the welding rig. This rig reimbursement is only paid for those hours that *B* performs services as *A*'s employee.

A mechanics rig consists of a heavy truck equipped with a crane, welding machine, and various other equipment used in the repair of heavy construction equipment. *C* is paid an hourly wage of $X for the performance of services as an employee. In addition *A* pays *C* an additional $Y amount per day for providing the mechanics rig. This rig reimbursement is only paid for the days that *C* performs services as *A*'s employee.

Business *A* requires *B* and *C* to each execute a document specifying that the employee owns the rig provided and will insure and maintain the rig. Employees *B* and *C* bear all expenses associated with the operation and maintenance of their respective rigs. The flat dollar amount paid as rig reimbursement is not related to the actual employee business expenses *B* or *C* incurs while performing services as an employee of *A*. Business *A* does not require *B* or *C* to substantiate expenses incurred related to the rig provided. Nor does *A* require *B* or *C* to return any amount paid as a rig reimbursement that exceeds the actual employee business expenses *B* or *C* incurs in connection with providing a rig while performing services as an employee of *A*.

Situation 2 — Business *A* also hires laborer *D* to perform services as an employee. Employee *D* uses *D*'s pickup truck for transportation along the pipeline. Employee *D* is paid an hourly wage of $X for the performance of services as an employee and is also paid an additional amount of $Y per day for providing the pickup truck. Business *A* does not require *D* to substantiate mileage or actual employee business expenses incurred while performing services as an employee of *A*. Employee *D* is not required to return any of the daily amounts paid for the pickup truck if the amount paid exceeds the employee business expenses *D* incurred in connection with the pickup truck while performing services as an employee of *A*. (Laborer *D* is not an independent contractor.)

LAW AND ANALYSIS

Section 3402(a) of the Internal Revenue Code (Code) requires employers paying wages to deduct and withhold income tax on wages. For income tax withholding purposes, § 3401(a) provides that the term "wages," with certain exceptions, means all remuneration for services performed by an employee for an employer. Under §§ 3111 and 3301, Federal Insurance Contributions Act (FICA) tax and Federal Unemployment Tax Act (FUTA) tax, respectively, excise taxes are imposed on the employer in an amount equal to a percentage of the wages paid by that employer. Under § 3101, FICA tax also is imposed on the employee. Under §§ 3121(a) and 3306(b), the term "wages" for FICA tax purposes and FUTA tax purposes, respectively, means, with certain exceptions, all remuneration for employment. Under §§ 3121(b) and 3306(c), "employment" is defined as any service, of whatever nature, performed by an employee for the person employing him.

Consistent with this definition, § 31.3121(a)–1(c) of the Employment Tax Regulations provides that the name by which the remuneration for employment is designated is immaterial. Section 31.3121(a)–1(d) further provides that generally, the basis upon which remuneration is paid to an employee is immaterial in determining whether the remuneration constitutes wages under FICA.

No specific section of the Code or regulations excepts from wages amounts paid to employees for providing equipment used in the performance of services as an employee. However, amounts paid to employees for certain employee business expenses incurred in connection with such equipment are excluded from wages if paid under a reimbursement or other expense allowance arrangement that meets the requirements of § 62(c).

Under § 1.62–2(c)(1) of the Income Tax Regulations, a reimbursement or other expense allowance arrangement satisfies the requirements of § 62(c) if it meets the requirements set forth in paragraphs (d), (e), and (f) of § 1.62–2 (business connection, substantiation, and return of excess). If an arrangement meets

these requirements, all amounts paid under the arrangement are treated as paid under an accountable plan. § 1.62–2(c)(2)(i). Amounts paid under an accountable plan are excluded from the employee's gross income, are not required to be reported on the employee's Form W-2, and are exempt from the withholding and payment of employment taxes. §§ 31.3121(a)–3, 31.3306(b)–2, 31.3401(a)–4, and 1.6041–3(h)(1).

If an arrangement does not satisfy one or more of these requirements, all amounts paid under the arrangement are paid under a "nonaccountable plan." Amounts paid under a nonaccountable plan are included in the employee's gross income for the taxable year, must be reported to the employee on Form W-2, and are subject to withholding and payment of employment taxes. §§ 1.62–2(c)(5), 31.3121(a)–3(b)(2), 31.3306(b)–2(b)(2), 31.3401(a)–4(b)(2), and § 1.6041–3(h)(1). Additionally, § 1.62–2(k) provides that 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 made under the arrangement will be treated as made under a nonaccountable plan.

Rev. Rul. 68–624, 1968–2 C.B. 424, considered what portion of the total amount paid by a corporation for the use of a truck and the services of a driver was allocable as wages of the driver for federal employment tax purposes. The driver hauled stone from the corporation's quarry to its river loading dock at a fixed amount per load. The corporation allocated one-third of the amount paid to the employee as wages and two-thirds as payment for the use of the truck. The ruling held that an allocation of the amounts paid to an individual when the payment is for both personal services and the use of equipment must be governed by the facts in each case. If the contract of employment did not specify a reasonable division of the total amount paid between wages and equipment, a proper allocation could have been arrived at by reference to the prevailing wage scale in a particular locality for similar services in operating the same class of equipment or the fair rental value of similar equipment.

Rev. Rul. 68–624 pre-dates the Tax Reform Act of 1986 (TRA '86), Pub. L. 99–514, and the Family Support Act of 1988, Pub. L. 100–485, which limit the deductions of employee business expenses. Pursuant to section 132 of TRA '86, which added § 67 to the Code, employee business expenses are allowed only as miscellaneous itemized deductions, to the extent that the aggregate of those deductions exceeds 2 percent of adjusted gross income. Section 62(c), which was enacted in the Family Support Act of 1988, in part limits employee business expense reimbursements that can be excluded from adjusted gross income to those paid under an accountable plan. Further, Rev. Rul. 68–624 does not address whether the truck driver was engaged in the trade or business of truck rental in addition to the trade or business of being an employee.

An arrangement that merely allocates compensation paid to an employee between wages and a reimbursement for business expenses will not meet the requirements of § 62(c). For example, in *Shotgun Delivery, Inc. v. United States*, 269 F.3d 969 (9th Cir. 2001), the court held that a courier company's arrangement that paid employee drivers 40 percent of the delivery charge rate less an hourly minimum wage payment did not meet the business connection requirement because the drivers were reimbursed regardless of actual mileage driven or expenses incurred. Accordingly, the arrangement was not a valid accountable plan under § 62(c).

CONCLUSION

Under the facts specified in Situations 1 and 2, the amounts paid to employees *B*, *C*, and *D* for providing equipment, including vehicles, used in performing services for the employer as an employee are not paid under an accountable plan. Each arrangement fails the business connection requirement because in each situation the employer pays an amount to the employee regardless of whether the employee incurs (or is reasonably expected to incur) business expenses that would be deductible under §§ 161 through 198. Each arrangement fails to require the employee to substantiate employee business expenses, as required by § 1.62–2(e). Finally, the arrangements do not require the return of excess as required under § 1.62–2(f).

HOLDING

In Situations 1 and 2, because the amounts paid to the employee for providing equipment, including vehicles, for use in performing services as an employee are not paid under an accountable plan, they are wages subject to the withholding and payment of income and employment taxes.

This ruling is not intended to provide guidance regarding the treatment of payment for equipment, including vehicles, provided by independent contractors.

See Rev. Proc. 2002–41, published elsewhere in this Internal Revenue Bulletin, regarding a deemed substantiation rule for use in implementing an accountable plan in connection with reimbursements to certain employees for costs associated with providing welding rigs or mechanics rigs.

EFFECT ON OTHER REVENUE RULINGS

This ruling revokes Rev. Rul. 68–624.

EFFECTIVE DATE

This revenue ruling is effective for payments to employees after October 13, 1988 (the date of enactment for § 62(c), as part of the Family Support Act of 1988).

Under the authority of § 7805(b), a taxpayer that actually paid amounts separate from wages for the use of employee-provided equipment (such as described in Situation 1 and the truck described in Rev. Rul. 68–624) and reported these payments on timely issued Forms 1099 for calendar years beginning before January 1, 2002, may continue to report these payments on Form 1099 for periods ending on or before December 31, 2002.

DRAFTING INFORMATION

The principal author of this revenue ruling is Joe Spires of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities), IRS. However, other personnel from the IRS and Treasury Department participated in its development. For further information regarding this revenue ruling, call Mr. Spires at (202) 622–6040 (not a toll-free number).

Section 125.—Cafeteria Plans

(Also sections 106, 4980B.)

Cafeteria Plans. In an asset sale, transferred employees who have elected to participate in health flexible spending arrangements (FSAs) under the seller's cafeteria plan may continue to exclude salary reduction amounts and medical reimbursements from gross income without interruption at the same level of coverage after becoming employees of the buyer.

Rev. Rul. 2002–32

ISSUE

In an asset sale, may transferred employees who have elected to participate in health flexible spending arrangements (FSAs) under seller's I.R.C. § 125 cafeteria plan continue that benefit without interruption at the same level of coverage after becoming employees of buyer?

FACTS

Situation (1). Employer S maintains a cafeteria plan under section 125. One of the benefits available under the plan is a health FSA that provides for the reimbursement of participating employees' medical care expenses that are not covered by other insurance. To participate in the health FSA, employees elect pre-tax salary reduction for the right to receive medical care expense reimbursements during the plan year up to a maximum amount equal to the amount of the reduction elected for the year. Employer B is an unrelated business entity.

During a plan year, S and B enter into an agreement under which B acquires a portion of the assets of S and, as part of the acquisition, employees of S who work in connection with the acquired assets terminate employment with S and are transferred to and become employees of B. Employer B has, or agrees to create, a cafeteria plan that offers a health FSA through pre-tax salary reduction. It is the objective of both S and B that the administration of the transferred employees' health FSAs following the asset sale have as little impact on the transferred employees as possible. Following the sale, S will continue its business operations, including its health FSA. S and B agree that the transferred employees who have elected to participate in S's FSA will continue in S's FSA for the agreed upon period. S and B also agree on the extent, if any, to which the existing salary reduction elections made by the transferred employees for the FSAs under S's plan will continue as if made under B's plan.

Situation (2). Same facts as in Situation (1) except that, as part of the sale, B agrees to cover the transferred employees who have elected to participate in S's health FSA under B's health FSA. Under B's health FSA, the transferred employees will have the same level of coverage provided under S's health FSA and will be treated as if their participation had been continuous from the beginning of S's plan year. The transferred employees' existing salary reduction elections will be taken into account for the remainder of B's plan year as if made under B's health FSA. To implement this arrangement, B amends its plan documents to provide that transferred employees who elected to participate in S's health FSA become participants in B's health FSA as of the beginning of S's plan year and at the level of coverage provided under S's health FSA, except that transferred employees who continue participation in S's health FSA after the sale (*e.g.*, by election of COBRA continuation coverage) are not covered by B's health FSA for that year. In addition, B's health FSA is amended to provide for reimbursement of medical care expenses incurred by the transferred employees at any time during S's plan year (including claims incurred before the sale), up to the amount of the employees' election and reduced by amounts previously reimbursed by S. Thus, medical care expenses incurred prior to the closing date of the sale but not previously reimbursed as well as medical care expenses incurred after the closing date of the sale are reimbursable under B's health FSA. S amends its plan documents to provide that the transferred employees cease to be eligible for medical care expense reimbursements from S as of the closing date, except to the extent of any COBRA continuation coverage election. S and B have determined that the agreements between them are consistent with applicable law.

LAW AND ANALYSIS

In general, section 106(a) provides that gross income of an employee does not include employer-provided coverage under an accident or health plan. Under section 105(b), an employee may exclude amounts received through employer-provided accident or health insurance if those amounts are paid to reimburse expenses incurred by the employee during the period of coverage for medical care (of the employee, the employee's spouse, or the employee's dependents) for personal injuries or sickness.

Section 125(a) states that no amount will be included in the gross income of a participant in a cafeteria plan solely because, under the plan, the participant may choose among the benefits in the plan.

Section 125(d) defines a cafeteria plan as a written benefit plan under which all participants are employees, and the participants may choose among two or more benefits consisting of cash and certain qualified benefits.

Section 125(f) defines qualified benefits as any benefit not includible in the gross income of the employee by reason of an express provision of Chapter 1 of the Code other than certain specified benefits that are not qualified benefits. A qualified benefit includes employer-provided accident or health coverage under section 106(a) and reimbursements for medical care expenses under section 105(b).

Section 1.125–4 of the Income Tax Regulations provides the circumstances under which an employer can permit a cafeteria plan participant to change an existing election during a period of coverage and make a new election for the remaining portion of the period of coverage. Generally, cafeteria plan participants are permitted to make election changes if there has been a change in status event and the election change satisfies the consistency rule. An election change satisfies the consistency rule with respect to accident or health coverage only if the election change is on account of and corresponds with a change in status that affects eligibility for coverage under an employer's plan.

Under the asset sale described in both Situation (1), where transferred employees maintain their existing health FSAs under S's cafeteria plan, and in Situation (2), where B agrees to cover the transferred employees who have elected to participate in S's health FSA, there is no loss of eligibility for coverage under § 1.125–4. Therefore, transferred employees continue to be subject to their existing FSA elections and may not change those elections during the remainder of the plan year of the asset sale (unless an event occurs thereafter which permits an election change under § 1.125–4).

For COBRA purposes, transferred employees in Situation (1) do not suffer a loss of coverage under S's FSA during the plan year. Consequently, if S's FSA satisfies the requirements of Q&A-8(c) in § 54.4980B–2, there is no obligation to make COBRA continuation coverage available to the transferred employees with respect to their coverage under S's FSA. However, if S's FSA does not satisfy the requirements of Q&A-8(c) in § 54.4980B–2 and is otherwise subject to COBRA, then it will be obligated to make COBRA continuation coverage available beginning on the first day of the plan year after the current plan year. For additional information, see § 54.4980B–2, Q&A-8 and § 54.4980B–9. In Situation (2), the obligation of S to extend to COBRA qualified beneficiaries the right to elect COBRA continuation coverage is not affected by the coverage provided by B.

HOLDING

In an asset sale, transferred employees who have elected to participate in health FSAs under seller's cafeteria plan may continue to exclude the salary reduction amounts and medical expense reimbursements from gross income without interruption and at the same level of coverage after becoming employees of buyer either when seller agrees to continue its existing health FSAs for the transferred employees as described in Situation (1) or when buyer agrees to adopt a continuation of seller's health FSAs for the transferred employees as described in Situation (2).

EFFECT ON OTHER REVENUE RULING(S)

None

DRAFTING INFORMATION

The principal author of this revenue ruling is Shoshanna Chaiton of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this revenue ruling, contact her at (202) 622–6080 (not a toll-free call).

Section 172.—Net Operating Loss Deduction

Procedures are provided that certain taxpayers with net operating losses incurred in 2001 or 2002 must follow on or before October 31, 2002, if they wish to apply, or elect out of, the new 5-year carryback period enacted by section 102 of the Job Creation and Worker Assistance Act of 2002. See Rev. Proc. 2002–40, page 1096.

Section 460.—Special Rules for Long-Term Contracts

26 CFR 1.460–4: Methods of accounting for long-term contracts.

T.D. 8995

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 602

Mid-Contract Change in Taxpayer

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations concerning a mid-contract change in taxpayer of a contract accounted for under a long-term contract method of accounting. A taxpayer that is a party to such a contract will be affected by these regulations.

DATES: *Effective Date*: These regulations are effective May 15, 2002.

Applicability Date: These regulations apply to transactions on or after May 15, 2002.

FOR FURTHER INFORMATION CONTACT: John Aramburu at (202) 622–4960 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545–1732.

The collection of information in these final regulations is in § 1.460–6(g)(3)(ii)(D). This information is required to enable taxpayers to make look-back computations when the income from a long-term contract has been previously reported by another taxpayer.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number.

The estimated average annual disclosure burden per respondent is 2 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:FP, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to a collection of information must be retained as long as their contents might become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

Section 460 generally requires that long-term contracts be accounted for

under the percentage-of-completion method (PCM), under which a taxpayer must recognize income according to the estimated percentage of the contract that is completed during each taxable year and make a look-back computation of interest to compensate the government (or the taxpayer) for any underestimation (or overestimation) of income from the contract. However, home construction contracts and certain contracts of smaller construction contractors are exempt from these requirements. Moreover, residential builders are entitled to use the 70/30 percentage-of-completion/capitalized cost method (PCCM), and certain shipbuilders are entitled to use the 40/60 PCCM. A long-term contract or a portion of a long-term contract that is exempt from the PCM may be accounted for under any permissible method, including the completed contract method (CCM), under which a taxpayer does not report income until a contract is complete, even though progress payments are received in years prior to completion.

This document contains amendments to 26 CFR part 1. On February 16, 2001, a notice of proposed rulemaking (REG–105946–00, 2001–1 C.B. 1069) relating to a mid-contract change in taxpayer of a contract accounted for under a long-term contract method of accounting was published in the **Federal Register** (66 FR 10643). Written comments were received from the public in response to the notice of proposed rulemaking. No public hearing was requested or held. After consideration of all comments, the proposed regulations are adopted as amended by this Treasury decision.

Explanation and Summary of Comments

The proposed regulations divide the rules regarding a mid-contract change in taxpayer of a contract accounted for under a long-term contract method of accounting into two categories—constructive completion transactions and step-in-the-shoes transactions. Generally, a constructive completion transaction results in the taxpayer originally accounting for the long-term contract (old taxpayer) recognizing income from the contract based on a contract price that takes into account any amounts realized from the transaction or paid by the old taxpayer to the taxpayer subsequently accounting for the long-term contract (new taxpayer) that are allocable to the contract. Similarly, the new taxpayer in a constructive completion transaction is treated as though it entered into a new contract as of the date of the transaction, with the contract price taking into account the purchase price and any amount paid by the old taxpayer that is allocable to the contract. In the case of a step-in-the-shoes transaction, the old taxpayer's obligation to account for the contract terminates on the date of the transaction and is assumed by the new taxpayer. The new taxpayer must assume the old taxpayer's methods of accounting for the contract, with both the contract price and allocable contract costs based on amounts taken into account by both parties.

Commentators raised concerns regarding the general application of step-in-the-shoes treatment to contracts of S corporations accounted for using the CCM. For example, these commentators were concerned with the potential for income shifting that can occur when the stock of an S corporation that is accounting for a long-term contract using the CCM is sold to a party with a lower marginal tax rate or to a tax indifferent shareholder. Similarly, income from a CCM contract could be shifted to a party with a lower tax rate or a tax indifferent party by making an S election or transferring the contract in a section 351 transaction, followed by an S election and a sale of stock. To prevent such a shifting of income, these commentators generally recommend that the transferor be required to apply the PCM to CCM contracts in progress as of the transaction date.

While these commentators' concerns and recommendations relate solely to CCM contracts, the potential for such income shifting also exists with PCM contracts due to the fact that recognition of income under both the PCM and the CCM does not correspond to the receipt of progress payments. In addition, many of the commentators' concerns are not unique to the section 460 regulations as similar opportunities are presented whenever an S corporation or an electing S corporation has assets with built-in gain or loss. Moreover, adoption of the commentators' recommendation would trigger tax as of the transaction date and thus would be inconsistent with the policy of providing for tax-free reorganizations of going concerns. Thus, the commentators' proposals for addressing this potential abuse were not adopted. However, as in the proposed regulations, the final regulations contain an anti-abuse rule that is designed to prevent such income shifting.

Commentators suggested that for purposes of the section 1374 built-in gain rules applicable to S corporation elections, long-term contracts should be valued at the amount of income reportable under the PCM on the date of the election. The section 1374 regulations currently measure recognized built-in gain attributable to a long-term contract accounted for using the CCM based on the amount of income reportable under the PCM on the date of the election. See § 1.1374–4(g). These final regulations, however, do not provide a specific rule to determine the value of a long-term contract because the fair market value of a long-term contract reflects a variety of factors, including the amount earned by the old taxpayer as compared to the progress payments received and retained by the old taxpayer, and the new taxpayer's estimates of future revenues and costs.

One commentator pointed out that while the preamble indicates the treatment of partnership transactions (*i.e.*, transactions described in sections 721 and 731, and transfers of partnership interests) have been reserved, the proposed regulations, by default, place these transactions in the taxable, constructive completion category. This commentator suggested that the regulations reserve the treatment of partnership transactions and provide only that taxpayers use reasonable methods.

The final regulations provide that a contribution to a partnership in a transaction described in section 721(a), a transfer of a partnership interest, and a distribution by a partnership to which section 731 applies (other than a distribution of a contract accounted for using a long-term contract method of accounting) are step-in-the-shoes transactions. The final regulations, however, reserve on the special rules that will apply to such transfers. As described in Notice 2002–37, 2002–23 I.R.B. 1030, the IRS and Treasury Department intend to publish regulations

that will set forth the special rules that will apply to such partnership transactions in a separate project. These regulations will be effective for contributions of long-term contracts to partnerships and transfers of interests in partnerships that are engaged in long-term contracts on or after May 15, 2002.

One commentator objected to the required use of the simplified marginal impact method of computing look back interest in the case of a step-in-the-shoes transaction. In response to this comment, the final regulations give taxpayers the option of using this method without requiring it, except in those cases in which the existing regulations require its use. See § 1.460–6(d)(4).

Questions have arisen as to whether the implementation of these rules requires a taxpayer to request a change in method of accounting by filing a Form 3115, "*Application for Change in Accounting Method*." In response to these questions, the final regulations clarify that the application of these rules to a transaction occurring after the effective date is not a change in method of accounting and, therefore, does not require the filing of Form 3115.

In addition to changes made in response to the comments and questions described above, the final regulations clarify the application of the step-in-the-shoes rules to certain transfers of contracts that result in the old taxpayer recognizing income with respect to the contract. Specifically, the final regulations explain how the old taxpayer calculates the gain realized with respect to the contract in these transactions, clarify the operation of the basis adjustment rule in certain cases of successive transfers of a contract, and provide that the contract price of a new taxpayer should be reduced to the extent that the old taxpayer recognizes income with respect to the contract in connection with these transactions. The final regulations also clarify that a taxpayer is not entitled to a loss in the amount of its basis in the contract (including the uncompleted property, if applicable) where that basis is determined under section 362 or 334. In addition, to the extent the basis of the contract (including the uncompleted property, if applicable) reflects the old taxpayer's recognition of income attributable to the contract in the step-in-the-shoes transaction, such income recognition reduces the total contract price. Accordingly, the new taxpayer recovers this additional basis over the time that it performs the contract. To the extent the basis of the contract (including the uncompleted property, if applicable) reflects costs incurred by the old taxpayer that have not yet been deducted (*i.e.*, in the case of a CCM contract), such costs will give rise to a deduction upon completion of the contract. Therefore, disallowing the new taxpayer a loss for its basis in the contract (including the uncompleted property, if applicable) is necessary to prevent the new taxpayer from benefitting twice from the same item. Finally, the final regulations include new examples to illustrate these rules.

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. It is hereby certified that the collection of information in this Treasury decision will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the relevant information is already maintained by taxpayers. Therefore, 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 Code, the proposed regulations preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is John Aramburu, Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

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

Par. 2. In § 1.358–1, a sentence is added at the end of paragraph (a) to read as follows:

§ 1.358–1 Basis to distributees.

(a) * * * See § 1.460–4(k)(3)(iv)(A) for rules relating to stock basis adjustments required where a contract accounted for using a long-term contract method of accounting is transferred in a transaction described in section 351 or a reorganization described in section 368(a)(1)(D) with respect to which the requirements of section 355 (or so much of section 356 as relates to section 355) are met.

* * * * *

Par. 3. In § 1.334–1, a sentence is added at the end of paragraph (b) to read as follows:

§ 1.334–1 Basis of property received in liquidations.

* * * * *

(b) * * * See § 1.460–4(k)(3)(iv)(B)(*2*) for rules relating to adjustments to the basis of certain contracts accounted for using a long-term contract method of accounting that are acquired in certain liquidations described in section 332.

* * * * *

Par. 4. In § 1.362–1, a sentence is added at the end of paragraph (a) to read as follows:

§ 1.362–1 Basis to corporations.

(a) * * * See § 1.460–4(k)(3)(iv)(B)(*2*) for rules relating to adjustments to the basis of certain contracts accounted for using a long-term contract method of accounting that are acquired in certain transfers described in section 351 and certain reorganizations described in section 368(a).

* * * * *

Par. 5. In § 1.381(c)(4)–1, a sentence is added at the end of paragraph (a)(2) to read as follows:

§ 1.381(c)(4)–1 Method of accounting.

(a) * * *

(2) * * *See § 1.460–4(k) for rules relating to transfers of contracts accounted for using a long-term contract method of accounting in a transaction to which section 381 applies.

* * * * *

Par. 6. Section 1.460–0 is amended by:

1. Revising the entry for paragraph (k) of § 1.460–4.

2. Adding entries for paragraphs (k)(1) through (k)(6) of § 1.460–4.

3. Adding entries for paragraphs (g) through (g)(4) of § 1.460–6.

§ 1.460–0 Outline of regulations under section 460.

* * * * *

§ 1.460–4 Methods of accounting for long-term contracts.

* * * * *

(k) Mid-contract change in taxpayer.
(1) In general.
(2) Constructive completion transactions.
(i) Scope.
(ii) Old taxpayer.
(iii) New taxpayer.
(iv) Special rules relating to distributions of certain contracts by a partnership. [Reserved.]
(3) Step-in-the-shoes transactions.
(i) Scope.
(ii) Old taxpayer.
(A) In general.
(B) Gain realized on the transaction.
(iii) New taxpayer.
(A) Method of accounting.
(B) Contract price.
(C) Contract costs.
(iv) Special rules related to certain corporate transactions.
(A) Old taxpayer — basis adjustment.
(*1*) In general.
(*2*) Basis adjustment in excess of stock basis.
(*3*) Subsequent dispositions of certain contracts.
(B) New taxpayer.
(*1*) Contract price adjustment.
(*2*) Basis in contract.
(v) Special rules related to certain partnership transactions. [Reserved.]
(4) Anti-abuse rule.
(5) Examples.
(6) Effective date.

* * * * *

§ 1.460–6 Look-back method.

* * * * *

(g) Mid-contract change in taxpayer.
(1) In general.
(2) Constructive completion transactions.
(3) Step-in-the-shoes transactions.
(i) General rules.
(ii) Application of look-back method to pre-transaction period.
(A) Contract Price
(B) Method.
(C) Interest accrual period.
(D) Information old taxpayer must provide.
(iii) Application of look-back method to post-transaction years.
(iv) S corporation elections.
(4) Effective date.

* * * * *

Par. 7. Section 1.460–4 is amended by:

1. Adding a sentence at the end of paragraph (a).

2. Adding paragraph (k).

The additions read as follows:

§ 1.460–4 Methods of accounting for long-term contracts.

(a) * * * Finally, paragraph (k) of this section provides rules relating to a mid-contract change in taxpayer of a contract accounted for using a long-term contract method of accounting.

* * * * *

(k) *Mid-contract change in taxpayer* — (1) *In general*. The rules in this paragraph (k) apply if prior to the completion of a long-term contract accounted for using a long-term contract method by a taxpayer (old taxpayer), there is a transaction that makes another taxpayer (new taxpayer) responsible for accounting for income from the same contract. For purposes of this paragraph (k) and § 1.460–6(g), an old taxpayer also includes any old taxpayer(s) (*e.g.*, predecessors) of the old taxpayer. In addition, a change in status from taxable to tax exempt or from domestic to foreign, or vice versa, will be considered a change in taxpayer. Finally, a contract will be treated as the same contract if the terms of the contract are not substantially changed in connection with the transaction, whether or not the customer agrees to release the old taxpayer from any or all of its obligations under the contract. The rules governing constructive completion transactions are provided in paragraph (k)(2) of this section, while the rules governing step-in-the-shoes transactions are provided in paragraph (k)(3) of this section. Special rules related to the treatment of certain partnership transactions are reserved under paragraphs (k)(2)(iv) and (k)(3)(v) of this section. For application of the look-back method to mid-contract changes in taxpayers for contracts accounted for using the PCM, see § 1.460–6(g).

(2) *Constructive completion transactions* — (i) *Scope*. The constructive completion rules in this paragraph (k)(2) apply to transactions (constructive completion transactions) that result in a change in the taxpayer responsible for reporting income from a contract and that are not described in paragraph (k)(3)(i) of this section. Constructive completion transactions generally include, for example, taxable sales under section 1001 and deemed asset sales under section 338.

(ii) *Old taxpayer*. The old taxpayer is treated as completing the contract on the date of the transaction. The total contract price (or, gross contract price in the case of a long-term contract accounted for under the CCM) for the old taxpayer is the sum of any amounts realized from the transaction that are allocable to the contract and any amounts the old taxpayer has received or reasonably expects to receive under the contract. Total contract price (or gross contract price) is reduced by any amount paid by the old taxpayer to the new taxpayer, and by any transaction costs, that are allocable to the contract. Thus, the old taxpayer's allocable contract costs determined under paragraph (b)(5) of this section do not include any consideration paid, or costs incurred, as a result of the transaction that are allocable to the contract. In the case of a

transaction subject to section 338 or 1060, the amount realized from the transaction allocable to the contract is determined by using the residual method under §§ 1.338–6 and 1.338–7.

(iii) *New taxpayer*. The new taxpayer is treated as entering into a new contract on the date of the transaction. The new taxpayer must evaluate whether the new contract should be classified as a long-term contract within the meaning of § 1.460–1(b) and account for the contract under a permissible method of accounting. For a new taxpayer who accounts for a contract using the PCM, the total contract price is any amount the new taxpayer reasonably expects to receive under the contract consistent with paragraph (b)(4) of this section. Total contract price is reduced by the amount of any consideration paid by the new taxpayer as a result of the transaction, and by any transaction costs, that are allocable to the contract and is increased by the amount of any consideration received by the new taxpayer as a result of the transaction that is allocable to the contract. Similarly, the gross contract price for a contract accounted for using the CCM is all amounts the new taxpayer is entitled by law or contract to receive consistent with paragraph (d)(3) of this section, adjusted for any consideration paid (or received) by the new taxpayer as a result of the transaction, and for any transaction costs, that are allocable to the contract. Thus, the new taxpayer's allocable contract costs determined under paragraph (b)(5) of this section do not include any consideration paid, or costs incurred, as a result of the transaction that are allocable to the contract. In the case of a transaction subject to sections 338 or 1060, the amount of consideration paid that is allocable to the contract is determined by using the residual method under §§ 1.338–6 and 1.338–7.

(iv) *Special rules relating to distributions of certain contracts by a partnership*. [Reserved]

(3) *Step-in-the-shoes transactions* — (i) *Scope*. The step-in-the-shoes rules in this paragraph (k)(3) apply to the following transactions that result in a change in the taxpayer responsible for reporting income from a contract accounted for using a long-term contract method of accounting (step-in-the-shoes transactions) —

(A) Transfers to which section 361 applies if the transfer is in connection with a reorganization described in section 368(a)(1)(A), (C) or (F);

(B) Transfers to which section 361 applies if the transfer is in connection with a reorganization described in section 368(a)(1)(D) or (G), provided the requirements of section 354(b)(1)(A) and (B) are met;

(C) Distributions to which section 332 applies, provided the contract is transferred to an 80-percent distributee;

(D) Transfers described in section 351;

(E) Transfers to which section 361 applies if the transfer is in connection with a reorganization described in section 368(a)(1)(D) with respect to which the requirements of section 355 (or so much of section 356 as relates to section 355) are met;

(F) Transfers (*e.g.*, sales) of S corporation stock;

(G) Conversion to or from an S corporation;

(H) Members joining or leaving a consolidated group;

(I) Contributions to which section 721(a) applies;

(J) Transfers of partnership interests;

(K) Distributions to which section 731 applies (other than the distribution of the contract); and

(L) Any other transaction designated in the Internal Revenue Bulletin by the Internal Revenue Service. See § 601.601 (d)(2)(ii) of this chapter.

(ii) *Old taxpayer* — (A) *In general*. The new taxpayer will "step into the shoes" of the old taxpayer with respect to the contract. Thus, the old taxpayer's obligation to account for the contract terminates on the date of the transaction and is assumed by the new taxpayer, as set forth in paragraph (k)(3)(iii) of this section. As a result, an old taxpayer using the PCM is required to recognize income from the contract based on the cumulative allocable contract costs incurred as of the date of the transaction. Similarly, an old taxpayer using the CCM is not required to recognize any revenue and may not deduct allocable contract costs incurred with respect to the contract.

(B) *Gain realized on the transaction*. The amount of gain the old taxpayer realizes on the transfer of a contract in a step-in-the-shoes transaction must be determined after application of paragraph (k)(3)(ii)(A) of this section using the rules of paragraph (k)(2) of this section that apply to constructive completion transactions. (The amount of gain realized on a transfer of a contract is relevant, for example, in determining the amount of gain recognized with respect to the contract in a section 351 transaction in which the old taxpayer receives from the new taxpayer money or property other than stock of the transferee.)

(iii) *New taxpayer* — (A) *Method of accounting*. Beginning on the date of the transaction, the new taxpayer must account for the long-term contract by using the same method of accounting used by the old taxpayer prior to the transaction. The same method of accounting must be used for such contract regardless of whether the old taxpayer's method is the new taxpayer's principal method of accounting under § 1.381(c)(4)–1(b)(3) or whether the new taxpayer is otherwise eligible to use the old taxpayer's method. Thus, if the old taxpayer uses the PCM to account for the contract, the new taxpayer steps into the shoes of the old taxpayer with respect to its completion factor and percentage of completion methods (such as the 10-percent method), even if the new taxpayer has not elected such methods for similarly classified contracts. Similarly, if the old taxpayer uses the CCM, the new taxpayer steps into the shoes of the old taxpayer with respect to the CCM, even if the new taxpayer is not otherwise eligible to use the CCM. However, the new taxpayer is not necessarily bound by the old taxpayer's method for similarly classified contracts entered into by the new taxpayer subsequent to the transaction and must apply general tax principles, including section 381, to determine the appropriate method to account for these subsequent contracts. To the extent that general tax principles allow the taxpayer to account for similarly classified contracts using a method other than the old taxpayer's method, the taxpayer is

not required to obtain the consent of the Commissioner to begin using such other method.

(B) *Contract price*. In the case of a long-term contract that has been accounted for under PCM, the total contract price for the new taxpayer is the sum of any amounts the old taxpayer or the new taxpayer has received or reasonably expects to receive under the contract consistent with paragraph (b)(4) of this section. Similarly, the gross contract price in the case of a long-term contract accounted for under the CCM includes all amounts the old taxpayer or the new taxpayer is entitled by law or by contract to receive consistent with paragraph (d)(3) of this section.

(C) *Contract costs*. Total allocable contract costs for the new taxpayer are the allocable contract costs as defined under paragraph (b)(5) of this section incurred by either the old taxpayer prior to, or the new taxpayer after, the transaction. Thus, any payments between the old taxpayer and the new taxpayer with respect to the contract in connection with the transaction are not treated as allocable contract costs.

(iv) *Special rules related to certain corporate transactions*—(A) *Old taxpayer—basis adjustment*—(*1*) *In general*. Except as provided in paragraph (k)(3)(iv)(A)(*2*) of this section, in the case of a transaction described in paragraph (k)(3)(i)(D) or (E) of this section, the old taxpayer must adjust its basis in the stock of the new taxpayer by—

(*i*) Increasing such basis by the amount of gross receipts the old taxpayer has recognized under the contract; and

(*ii*) Reducing such basis by the amount of gross receipts the old taxpayer has received or reasonably expects to receive under the contract.

(*2*) *Basis adjustment in excess of stock basis*. If the old and new taxpayer do not join in the filing of a consolidated Federal income tax return, the old taxpayer may not adjust its basis in the stock of the new taxpayer under paragraph (k)(3)(iv)(A)(*1*) of this section below zero and the old taxpayer must recognize ordinary income to the extent the basis in the stock of the new taxpayer otherwise would be adjusted below zero. If the old and new taxpayer join in the filing of a consolidated Federal income tax return, the old taxpayer must create an (or increase an existing) excess loss account to the extent the basis in the stock of the new taxpayer otherwise would be adjusted below zero under paragraph (k)(3)(iv)(A)(*1*) of this section. See §§ 1.1502–19 and 1.1502–32(a)(3)(ii).

(*3*) *Subsequent dispositions of certain contracts*. If the old taxpayer disposes of a contract in a transaction described in paragraph (k)(3)(i)(D) or (E) of this section that the old taxpayer acquired in a transaction described in paragraph (k)(3)(i)(D) or (E) of this section, the basis adjustment rule of this paragraph (k)(3)(iv)(A) is applied by treating the old taxpayer as having recognized the amount of gross receipts recognized by the previous old taxpayer under the contract and any amount recognized by the previous old taxpayer with respect to the contract in connection with the transaction in which the old taxpayer acquired the contract. In addition, the old taxpayer is treated as having received or as reasonably expecting to receive under the contract any amount the previous old taxpayer received or reasonably expects to receive under the contract. Similar principles will apply in the case of multiple successive transfers described in paragraph (k)(3)(i)(D) or (E) of this section involving the contract.

(B) *New Taxpayer*—(1) *Contract price adjustment*. Generally, payments between the old taxpayer and the new taxpayer with respect to the contract in connection with the transaction do not affect the contract price. Notwithstanding the preceding sentence and paragraph (k)(3)(iii)(B) of this section, however, in the case of transactions described in paragraph (k)(3)(i)(B), (D) or (E) of this section, the total contract price (or gross contract price) must be reduced to the extent of any amount recognized by the old taxpayer with respect to the contract in connection with the transaction (*e.g.*, any amount recognized under section 351(b) or 357 that is attributable to the contract and any income recognized by the old taxpayer pursuant to the basis adjustment rule of paragraph (k)(3)(iv)(A)).

(2) *Basis in Contract*. The new taxpayer's basis in a contract (including the uncompleted property, if applicable) acquired in a transaction described in paragraphs (k)(3)(i)(A) through (E) of this section will be computed under section 362 or section 334, as applicable. Upon a new taxpayer's completion (actual or constructive) of a CCM or a PCM contract acquired in a transaction described in paragraphs (k)(3)(i)(A) through (E) of this section, the new taxpayer's basis in the contract (including the uncompleted property, if applicable) is reduced to zero. The new taxpayer is not entitled to a deduction or loss in connection with any basis reduction pursuant to this paragraph (k)(3)(iv)(B)(*2*).

(v) *Special rules related to certain partnership transactions*. [Reserved]

(4) *Anti-abuse rule*. Notwithstanding this paragraph (k), in the case of a transaction entered into with a principal purpose of shifting the tax consequences associated with a long-term contract in a manner that substantially reduces the aggregate U.S. Federal income tax liability of the parties with respect to that contract, the Commissioner may allocate to the old (or new) taxpayer the income from that contract properly allocable to the old (or new) taxpayer. For example, the Commissioner may reallocate income from a long-term contract in a transaction in which a contract accounted for using the CCM, or using the PCM where the old taxpayer has received advance payments in excess of its contribution to the contract, is transferred to a tax indifferent party (*e.g.*, a foreign person not subject to U.S. Federal income tax).

(5) *Examples*. The following examples illustrate the rules of this paragraph (k). For purposes of these examples, it is assumed that the contract is a long-term construction contract accounted for using the PCM prior to the transaction unless stated otherwise and the contract is not transferred with a principal purpose of shifting the tax consequences associated with a long-term contract in a manner that substantially reduces the aggregate U.S. Federal income tax liability of the parties with respect to that contract. The examples are as follows:

Example 1. Constructive completion—PCM—(i) *Facts*. In Year 1, X enters into a contract. The total contract price is $1,000,000 and the estimated total allocable contract costs are $800,000. In Year 1, X incurs costs of $200,000. In Year 2, X incurs additional costs of $400,000 before selling the contract as part of a taxable sale of its business in Year 2 to Y, an unrelated party. At the time of sale, X has received $650,000 in progress payments under the contract. The consideration allocable to the contract

under section 1060 is $150,000. Pursuant to the sale, the new taxpayer Y immediately assumes X's contract obligations and rights. Y is required to account for the contract using the PCM. In Year 2, Y incurs additional allocable contract costs of $50,000. Y correctly estimates at the end of Year 2 that it will have to incur an additional $75,000 of allocable contract costs in Year 3 to complete the contract.

(ii) *Old taxpayer*. For Year 1, X reports receipts of $250,000 (the completion factor multiplied by total contract price ($200,000/$800,000 x $1,000,000)) and costs of $200,000, for a profit of $50,000. X is treated as completing the contract in Year 2 because it sold the contract. For purposes of applying the PCM in Year 2, the total contract price is $800,000 (the sum of the amounts received under the contract and the amount realized in the sale ($650,000 + $150,000)) and the total allocable contract costs are $600,000 (the sum of the costs incurred in Year 1 and Year 2 ($200,000 + $400,000)). Thus, in Year 2, X reports receipts of $550,000 (total contract price minus receipts already reported ($800,000 - $250,000)) and costs incurred in year 2 of $400,000, for a profit of $150,000.

(iii) *New taxpayer*. Y is treated as entering into a new contract in Year 2. The total contract price is $200,000 (the amount remaining to be paid under the terms of the contract less the consideration paid allocable to the contract ($1,000,000 - $650,000 - $150,000)). The estimated total allocable contract costs at the end of Year 2 are $125,000 (the allocable contract costs that Y reasonably expects to incur to complete the contract ($50,000 + $75,000)). In Year 2, Y reports receipts of $80,000 (the completion factor multiplied by the total contract price [($50,000/$125,000) x $200,000] and costs of $50,000 (the costs incurred after the purchase), for a profit of $30,000. For Year 3, Y reports receipts of $120,000 (total contract price minus receipts already reported ($200,000 - $80,000)) and costs of $75,000, for a profit of $45,000.

Example 2. Constructive completion—CCM—(i) *Facts*. The facts are the same as in *Example 1*, except that X and Y properly account for the contract under the CCM.

(ii) *Old taxpayer*. X does not report any income or costs from the contract in Year 1. In Year 2, the contract is deemed complete for X, and X reports its gross contract price of $800,000 (the sum of the amounts received under the contract and the amount realized in the sale ($650,000 + $150,000)) and its total allocable contract costs of $600,000 (the sum of the costs incurred in Year 1 and Year 2 ($200,000 + $400,000)) in that year, for a profit of $200,000.

(iii) *New taxpayer*. Y is treated as entering into a new contract in Year 2. Under the CCM, Y reports no gross receipts or costs in Year 2. Y reports its gross contract price of $200,000 (the amount remaining to be paid under the terms of the contract less the consideration paid allocable to the contract ($1,000,000 - $650,000 - $150,000)) and its total allocable contract costs of $125,000 (the allocable contract costs that Y incurred to complete the contract ($50,000 + $75,000)) in Year 3, the completion year, for a profit of $75,000.

Example 3. Step-in-the-shoes — PCM — (i) *Facts*. The facts are the same as in *Example 1*, except that X transfers the contract (including the uncompleted property) to Y in exchange for stock of Y in a transaction that qualifies as a statutory merger described in section 368(a)(1)(A) and does not result in gain or loss to X under section 361(a).

(ii) *Old taxpayer*. For Year 1, X reports receipts of $250,000 (the completion factor multiplied by total contract price ($200,000/$800,000 x $1,000,000)) and costs of $200,000, for a profit of $50,000. Because the mid-contract change in taxpayer results from a transaction described in paragraph (k)(3)(i) of this section, X is not treated as completing the contract in Year 2. In Year 2, X reports receipts of $500,000 (the completion factor multiplied by the total contract price and minus the Year 1 gross receipts [($600,000/$800,000 x $1,000,000) - $250,000]) and costs of $400,000, for a profit of $100,000.

(iii) *New taxpayer*. Because the mid-contract change in taxpayer results from a step-in-the-shoes transaction, Y must account for the contract using the same methods of accounting used by X prior to the transaction. Total contract price is the sum of any amounts that X and Y have received or reasonably expect to receive under the contract, and total allocable contract costs are the allocable contract costs of X and Y. Thus, the estimated total allocable contract costs at the end of Year 2 are $725,000 (the cumulative allocable contract costs of X and the estimated total allocable contract costs of Y ($200,000 + $400,000 + $50,000 + $75,000)). In Year 2, Y reports receipts of $146,552 (the completion factor multiplied by the total contract price minus receipts reported by the old taxpayer ([($650,000/$725,000) x $1,000,000] - $750,000) and costs of $50,000, for a profit of $96,552. For Year 3, Y reports receipts of $103,448 (the total contract price minus prior year receipts ($1,000,000 - $896,552)) and costs of $75,000, for a profit of $28,448.

Example 4. Step-in-the-shoes — CCM — (i) *Facts*. The facts are the same as in *Example 3*, except that X properly accounts for the contract under the CCM.

(ii) *Old taxpayer*. X reports no income or costs from the contract in Years 1, 2 or 3.

(iii) *New taxpayer*. Because the mid-contract change in taxpayer results from a step-in-the-shoes transaction, Y must account for the contract using the same method of accounting used by X prior to the transaction. Thus, in Year 3, the completion year, Y reports receipts of $1,000,000 and total contract costs of $725,000, for a profit of $275,000.

Example 5. Step in the shoes — PCM — basis adjustment. The facts are the same as in *Example 3*, except that X transfers the contract (including the uncompleted property) with a basis of $0 and $125,000 of cash to a new corporation, Z, in exchange for all of the stock of Z in a section 351 transaction. Thus, under section 358(a), X's basis in the Z stock is $125,000. Pursuant to paragraph (k)(3)(iv)(A)(*1*) of this section, X must increase its basis in the Z stock by the amount of gross receipts X recognized under the contract, $750,000 ($250,000 receipts in Year 1 + $500,000 receipts in Year 2), and reduce its basis by the amount of gross receipts X received under the contract, the $650,000 in progress payments. Accordingly, X's basis in the Z stock is $225,000. All other results are the same.

Example 6. Step in the shoes—CCM—basis adjustment—(i) *Facts*. The facts are the same as in *Example 4*, except that X receives progress payments of $800,000 (rather than $650,000) and transfers the contract (including the uncompleted property) with a basis of $600,000 and $125,000 of cash to a new corporation, Z, in exchange for all of the stock of Z in a section 351 transaction. X and Z do not join in filing a consolidated Federal income tax return.

(ii) *Old taxpayer*. X reports no income or costs under the contract in Years 1, 2, or 3. Under section 358(a), X's basis in Z is $725,000. Pursuant to paragraph (k)(3)(iv)(A)(*1*), X must reduce its basis in the stock of Z by $800,000, the progress payments received by X. However, X may not reduce its basis in the Z stock below zero pursuant paragraph (k)(3)(iv)(A)(*2*) of this section. Accordingly, X's basis in the Z stock is reduced by $725,000 to zero and X must recognize ordinary income of $75,000.

(iii) *New taxpayer*. Upon completion of the contract in Year 3, Z reports gross receipts of $925,000 ($1,000,000 original contract price - $75,000 income recognized by the old taxpayer pursuant to the basis adjustment rule of paragraph (k)(3)(iv)(A)) and total contract costs of $725,000, for a profit of $200,000.

Example 7. Step in the shoes—PCM—gain recognized in transaction—(i) *Facts*. The facts are the same as in *Example 3*, except that X transfers the contract (including the uncompleted property) with a basis of $0 and an unrelated capital asset with a value of $100,000 and a basis of $0 to a new corporation, Z, in exchange for stock of Z with a value of $200,000 and $50,000 of cash in a section 351 transaction.

(ii) *Old taxpayer*. For year 1, X reports receipts of $250,000 ($200,000/$800,000 x $1,000,000) and costs of $200,000, for a profit of $50,000. X is not treated as completing the contract in Year 2. In Year 2, X reports receipts of $500,000 (($600,000/$800,000 x $1,000,000 = $750,000 cumulative gross receipts) - $250,000 prior year cumulative gross receipts) and costs of $400,000, for a profit of $100,000. Under paragraph (k)(3)(ii)(B) of this section, X determines that the gain realized on the transfer of the contract to Z under the constructive completion rules of paragraph (k)(2)(ii) of this section is $50,000 (total contract price of $800,000 ($150,000 value allocable to the contract + $650,000 progress payments) - $750,000 previously recognized cumulative gross receipts — $0 costs incurred but not recognized). The gain realized on the transfer of the unrelated capital asset to Z is $100,000. The amount of gain X must recognize due to the receipt of $50,000 cash in the exchange is $50,000, of which $30,000 is allocated to the contract ($150,000 value of contract/$250,000 total value of property transferred to Z x $50,000) and is treated as ordinary income, and $20,000 is allocated to the unrelated capital asset ($100,000 value of capital asset/$250,000 total value of property transferred to Z x $50,000). Under section 358(a), X's basis in the Z stock is $0. However, pursuant to paragraph (k)(3)(iv)(A)(*1*) of this section, X must increase its basis in the Z stock by $750,000, the amount of gross receipts recognized under the contract, and must reduce its basis in the Z stock by $650,000, the amount of gross receipts X received under the contract. Therefore, X's basis in the Z stock is $100,000.

(iii) *New taxpayer*. Z must account for the contract using the same PCM method used by X prior to the transaction. Pursuant to paragraph

(k)(3)(iv)(B)(*1*) of this section, the total contract price is $970,000 ($1,000,000 amount X and Z have received or reasonably expect to receive under the contract - $30,000 income recognized by X with respect to the contract as a result of the receipt of $50,000 cash in the transaction). In Year 2, Z reports gross receipts of $119,655 ($650,000/$725,000 x $970,000 = $869,655 current year cumulative gross receipts - $750,000 cumulative gross receipts reported by the old taxpayer) and costs of $50,000, for a profit of $69,655. In Year 3, Z reports gross receipts of $100,345 ($970,000-$869,655) and costs of $75,000, for a profit of $25,345.

Example 8. Step in the shoes—CCM—gain recognized in transaction—(i) *Facts*. The facts are the same as in *Example 4*, except that X transfers the contract (including the uncompleted property) with a basis of $600,000 and an unrelated capital asset with a value of $125,000 and a basis of $0 to a new corporation, Z, in exchange for all the stock of Z with a value of $175,000 and $100,000 of cash in a section 351 transaction. X and Z do not join in filing a consolidated Federal income tax return.

(ii) *Old taxpayer*. X reports no income or costs under the contract in Years 1, 2, or 3. Under paragraph (k)(3)(ii)(B), X determines that the gain realized on the transfer of the contract to Z under the constructive completion rules of paragraph (k)(2)(ii) of this section is $200,000 ($800,000 total contract price ($150,000 value allocable to the contract + $650,000 progress payments) - $600,000 costs incurred but not recognized). The gain realized on the transfer of the unrelated capital asset to Z is $125,000. The amount of gain X must recognize due to the receipt of $100,000 of cash in the exchange is $100,000, of which $54,545 is allocated to the contract ($150,000 value of the contract/$275,000 total value of property transferred to Z x $100,000) and is treated as ordinary income, and $45,455 is allocated to the unrelated capital asset ($125,000 value of capital asset/$275,000 total value of property transferred to Z x $100,000). Under section 358(a), X's basis in the Z stock is $600,000 ($600,000 basis in the contract and unrelated capital asset transferred - $100,000 cash received + $100,000 gain recognized). Pursuant to paragraph (k)(3)(iv)(A)(*1*) of this section, X must reduce its basis in the stock of Z by $650,000, the progress payments received under the contract. However, X may not reduce its basis in the Z stock below zero pursuant to paragraph (k)(3)(iv)(A)(*2*) of this section. Accordingly, X's basis in the Z stock is reduced by $600,000 to zero and X must recognize income of $50,000.

(iii) *New taxpayer*. Z must account for the contract using the same CCM used by X prior to the transaction. Pursuant to paragraph (k)(3)(iv)(B)(1) of this section, the total contract price is $895,455 ($1,000,000 original contract price - $54,545 income recognized by old taxpayer with respect to the contract as a result of the receipt of cash in the transaction - $50,000 income recognized by the old taxpayer pursuant to the basis adjustment rule of paragraph (k)(3)(iv)(A)). Accordingly, upon completion of the contract in Year 3, Z reports gross receipts of $895,455 and total contract costs of $725,000, for a profit of $170,455.

(6) *Effective date*. This paragraph (k) is applicable for transactions on or after May 15, 2002. Application of the rules of this paragraph (k) to a transaction that occurs on or after May 15, 2002, is not a change in method of accounting.

Par. 8. In § 1.460–6, paragraph (g) is revised to read as follows:

§ 1.460–6 Look-back method.

* * * * *

(g) *Mid-contract change in taxpayer* — (1) *In general*. The rules in this paragraph (g) apply if, as described in § 1.460–4(k), prior to the completion of a long-term contract accounted for using the PCM or the PCCM by a taxpayer (old taxpayer), there is a transaction that makes another taxpayer (new taxpayer) responsible for accounting for income from the same contract. The rules governing constructive completion transactions are provided in paragraph (g)(2) of this section, while the rules governing step-in-the-shoes transactions are provided in paragraph (g)(3) of this section. For purposes of this paragraph, pre-transaction years are all taxable years of the old taxpayer in which the old taxpayer accounted for (or should have accounted for) gross receipts from the contract, and post-transaction years are all taxable years of the new taxpayer in which the new taxpayer accounted for (or should have accounted for) gross receipts from the contract.

(2) *Constructive completion transactions*. In the case of a transaction described in § 1.460–4(k)(2)(i) (constructive completion transaction), the look-back method is applied by the old taxpayer with respect to pre-transaction years upon the date of the transaction and, if the new taxpayer uses the PCM or the PCCM to account for the contract, by the new taxpayer with respect to post-transaction years upon completion of the contract. The contract price and allocable contract costs to be taken into account by the old taxpayer or the new taxpayer in applying the look-back method are described in § 1.460–4(k)(2).

(3) *Step-in-the-shoes transactions* — (i) *General rules*. In the case of a transaction described in § 1.460–4(k)(3)(i) (step-in-the-shoes transaction), the look-back method is not applied at the time of the transaction, but is instead applied for the first time when the contract is completed by the new taxpayer. Upon completion of the contract, the look-back method is applied by the new taxpayer with respect to both pre-transaction years and post-transaction years, taking into account all amounts reasonably expected to be received by either the old or new taxpayer and all allocable contract costs incurred during both periods as described in § 1.460–4(k)(3). The new taxpayer is liable for filing the Form 8697 and for interest computed on hypothetical underpayments of tax, and is entitled to receive interest with respect to hypothetical overpayments of tax, for both pre- and post-transaction years. The old taxpayer will be secondarily liable for any interest required to be paid with respect to pre-transaction years reduced by any interest on pre-transaction overpayments.

(ii) *Application of look-back method to pre-transaction period* — (A) *Contract price*. The actual contract price for pre-transaction taxable years must be determined by the new taxpayer without regard to any contract price adjustment described in paragraph (k)(3)(iv)(B)(1) of this section.

(B) *Method*. The new taxpayer may apply the look-back method to each pre-transaction taxable year that is a redetermination year using the simplified marginal impact method described in paragraph (d) of this section (regardless of whether or not the old taxpayer would have actually used that method and without regard to the tax liability ceiling). But see paragraph (d)(4) of this section, which requires use of the simplified marginal impact method by certain pass-through entities.

(C) *Interest accrual period*. With respect to any hypothetical underpayment or overpayment of tax for a pre-transaction taxable year, interest accrues from the due date of the old taxpayer's tax return (not including extensions) for the taxable year of the underpayment or overpayment until the due date of the new taxpayer's return (not including extensions) for the completion year or the year of a post-completion adjustment, whichever is applicable.

(D) *Information old taxpayer must provide*. In order to help the new taxpayer to apply the look-back method with respect to pre-transaction taxable years, any old taxpayer that accounted for income from a long-term contract under the PCM or PCCM for either regular or

alternative minimum tax purposes is required to provide the information described in this paragraph to the new taxpayer by the due date (not including extensions) of the old taxpayer's income tax return for the first taxable year ending on or after a step-in-the-shoes transaction described in § 1.460–4(k)(3)(i). The required information is as follows —

(*1*) The portion of the contract reported by the old taxpayer under PCM for regular and alternative minimum tax purposes (*i.e.*, whether the old taxpayer used PCM, the 40/60 PCCM method, or the 70/30 PCCM method);

(*2*) Any submethods used in the application of PCM (*e.g.*, the simplified cost-to-cost method or the 10-percent method);

(*3*) The amount of total contract price reported by year;

(*4*) The numerator and the denominator of the completion factor by year;

(*5*) The due date (not including extensions) of the old taxpayer's income tax returns for each taxable year in which income was required to be reported;

(*6*) Whether the old taxpayer was a corporate or a noncorporate taxpayer by year; and

(*7*) Any other information required by the Commissioner by administrative pronouncement.

(iii) *Application of look-back method to post-transaction years*. With respect to post-transaction taxable years, the new taxpayer must use the same look-back method it uses for other contracts (*i.e.*, the simplified marginal impact method or the actual method) to determine the amount of any hypothetical overpayment or underpayment of tax and the time period for computing interest on these amounts.

(iv) *S corporation elections*. Following the conversion of a C corporation into an S corporation, the look-back method is applied at the entity level with respect to contracts entered into prior to the conversion, notwithstanding section 460(b)(4)(B)(i).

(4) *Effective date*. This paragraph (g) is applicable for transactions on or after May 15, 2002.

§ 1.1362–2 [Amended]

Par. 9. In § 1.1362–2, paragraph (c)(6) *Example 2*, first sentence is amended by removing the language "§ 1.451–3(b)" and adding "§ 1.460–1(b)(1)" in its place, and removing the language "§ 1.451–3(c)(1)" and adding "§ 1.460–4(b)" in its place.

§ 1.1374–4 [Amended]

Par. 10. In § 1.1374–4, paragraph (g), first sentence is amended by removing the language "§ 1.451–3(d)" and adding "§ 1.460–4(d)" in its place, and removing the language "§ 1.451–3(c)" and adding "§ 1.460–4(b)" in its place.

PART 602 — OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 11. The authority section for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805

Par. 12. In § 602.101, paragraph (b) is amended by revising the following entry in numerical order to the table to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.460–6	1545–1031 1545–1572 1545–1732
* * * * *	

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved May 2, 2002.

Pamela F. Olson,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on May 14, 2002, 8:45 a.m., and published in the issue of the Federal Register for May 15, 2002, 67 F.R. 34603)

Section 1361.—S Corporation Defined

26 CFR 1.1361–1: S corporation defined.

T.D. 8994

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 602

Electing Small Business Trust

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations relating to the qualification and treatment of electing small business trusts (ESBTs). The final regulations interpret the rules added to the Internal Revenue Code (Code) by section 1302 of the Small Business Job Protection Act of 1996, section 1601 of the Taxpayer Relief

Act of 1997, and section 316 of the Community Renewal Tax Relief Act of 2000. In addition, the final regulations provide that an ESBT, or a trust described in section 401(a) of the Code or section 501(c)(3) of the Code and exempt from taxation under section 501(a) of the Code, is not treated as a deferral entity for purposes of § 1.444–2T. The final regulations affect S corporations and certain trusts that own S corporation stock.

DATES: *Effective Date*: These regulations are effective May 14, 2002.

Dates of Applicability: The regulations regarding ESBTs under § 1.641(c)–1(d) through (k), (l) *Examples 2 – 5*, § 1.1361 –1(h)(1)(vi), (h)(3)(i)(F), (h)(3)(ii), (j)(12), and (m), § 1.1362–6(b)(2)(iv), § 1.1377–1(a)(2)(iii) and (c) *Example 3* apply for taxable years beginning on and after May 14, 2002. The regulations regarding taxation of ESBTs under § 1.641(c)–1(a), (b), (c), and (l) *Example 1* are applicable for taxable years of ESBTs that end on and after December 29, 2000. The regulations under § 1.444–4 are applicable to taxable years beginning on or after December 29, 2000.

FOR FURTHER INFORMATION CONTACT: Concerning the final regulations, Bradford Poston or James A. Quinn, (202) 622–3060; specifically concerning § 1.444–4, Michael F. Schmit, (202) 622–4960 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information in these final regulations have been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) and assigned control number 1545–1591.

The collections of information in these final regulations are in § 1.1361–1(j)(12), § 1.1361–1(m), and § 1.444–4(c). The information required by § 1.1361–1(j)(12) and § 1.1361–1(m) is needed to allow trusts to elect to be ESBTs and to allow for the conversion of a qualified subchapter S trust (QSST) to an ESBT and the conversion of an ESBT to a QSST. The likely respondents are trusts.

The information required by § 1.444–4 (c) is needed to allow certain S corporations to reinstate their previous taxable year that was terminated under § 1.444–2T. The likely respondents are businesses and other for-profit institutions.

Comments on the collections of information should be sent to the **Office of Management and Budget**, Attn.: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503 with copies to the **Internal Revenue Service**, Attn.: IRS Reports Clearance Officer, W:CAR:MP:FP:S, Washington, DC 20224. Comments on the collection of information should be received by July 15, 2002. Comments are specifically requested concerning:

Whether the collections of information are necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the collections of information;

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the collections of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs of operation, maintenance, and purchase of service to provide information.

The burden contained in § 1.444–4 is reflected in the burden of Form 8716.

Estimated total annual reporting burden: 7,500 hours.

Estimated annual burden per respondent: 1 hour.

Estimated number of respondents: 7,500.

Estimated annual frequency of responses: On occasion.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

On December 29, 2000, proposed regulations (REG–251701–96, 2001–1 C.B. 396) were published in the **Federal Register** (65 FR 82963) containing proposed amendments to the Income Tax Regulations (26 CFR Part 1) relating to S corporations and electing small business trusts (ESBTs). Section 1302 of the Small Business Job Protection Act of 1996, Public Law 104–188 (110 Stat. 1755) (August 20, 1996) (the 1996 Act), amended sections 641 and 1361 of the Code to permit an ESBT to be an S corporation shareholder. Further amendments were made to section 1361(e) by the Taxpayer Relief Act of 1997, Public Law 105–34 (111 Stat. 1601(c)(1)) (August 5, 1997), and the Community Renewal Tax Relief Act of 2000, Public Law 106–554 (114 Stat. 2763) (December 21, 2000). Prior section 641(d) was redesignated as section 641(c) by the Internal Revenue Service Restructuring and Reform Act of 1998, Public Law 105–206 (112 Stat. 6007(f)(2)) (July 22, 1998).

On December 29, 2000, proposed and temporary regulations were also published in the **Federal Register** (REG–251701–96, 2001–1 C.B. 396 [65 FR 82963]) and (T.D. 8915, 2001–1 C.B. 359 [65 FR 82926]) containing amendments to the Income Tax Regulations (26 CFR Part 1) relating to the election of a taxable year other than the required taxable year.

A public hearing was held on the proposed and temporary regulations on April 25, 2001. Written comments were received on the proposed and temporary regulations. The proposed regulations, with certain changes in response to the comments, are adopted as final regulations, and the temporary regulations are removed.

Summary of Comments and Explanation of Revisions

Beneficiaries and Potential Current Beneficiaries

For a trust to qualify as an electing small business trust (ESBT) and as a

shareholder in a subchapter S corporation, only certain types of persons are permitted to be beneficiaries of the trust. Once a trust makes the ESBT election, each potential current beneficiary (PCB) of the trust is treated as a shareholder of the S corporation. Thus, the identity of the beneficiaries affects whether a trust can be an ESBT, while the identity and number of PCBs affect whether the corporation can be a S corporation. It is possible under certain circumstances for a person to be a PCB, as that term is defined in section 1361(e)(2) and the proposed regulations, without being a beneficiary, as that term is defined in the proposed regulations. For example, a person who may receive a distribution from an ESBT under a currently exercisable power of appointment is a PCB but is not treated as a beneficiary until the power is actually exercised.

Some commentators expressed concerns about the possible adverse effects of the definition of PCBs, especially in situations involving potential recipients of a currently exercisable power of appointment. Some commentators suggested that a person should have to meet the definition of a beneficiary before the person could be considered a PCB. Commentators also suggested that a person who may receive a distribution under a currently exercisable power of appointment should not be treated as a PCB until exercise of the power. Several commentators suggested that a temporary waiver or release of a broad power of appointment should be sufficient to limit the number of PCBs during a period of time.

The final regulations do not change the basic definition of PCBs. While there is no statutory definition of beneficiary in section 1361(e), there is a statutory definition of PCB. Under section 1361(e)(2), a PCB is, "with respect to any period, any person who at any time during such period is entitled to, or, at the discretion of any person, may receive, a distribution from the principal or income of the trust." The IRS and the Treasury Department believe that it would be inconsistent with this statutory definition not to treat a person as a PCB until an actual distribution is made to that person pursuant to the exercise of a power of appointment. The final regulations provide that an attempt to temporarily waive, release, or limit a power of appointment would not be effective to limit the PCBs because of uncertainty as to the effectiveness of a temporary waiver, release, or limitation on the power of appointment under state law and the potential to manipulate a temporary waiver, release, or limitation on a power of appointment to avoid the S corporation shareholder limitation rules. However, a permanent release of a power of appointment that is effective under local law may reduce the number of PCBs of an ESBT.

Another commentator suggested that the separate share provisions of section 663(c) should apply so that beneficiaries or PCBs of the share holding the assets other than the S corporation stock would not be counted as beneficiaries or PCBs of the S portion. There is no authority to ignore beneficiaries and PCBs of a portion of a trust holding assets other than S corporation stock. The statutory definitions of an ESBT and of a PCB look to all the persons who are beneficiaries or PCBs of the trust, not just the S portion. In addition, the separate share provisions of section 663(c) are not applicable because they generally apply only for purposes of allocating distributable net income under sections 661 and 662.

Two commentators requested guidance on what period of time is considered in determining who are PCBs in light of the statutory definition. They suggested that *period* means any moment in time. Thus, if an event occurs during a taxable year that changes who the PCBs are, the PCBs before and after the event would not be counted cumulatively for purposes of the 75-shareholder limit. The shareholder limitation in section 1361(b)(1)(A) means that an S corporation may not have more than 75 shareholders at any particular time during the taxable year. See Rev. Rul. 78–390, 1978–2 C.B. 220. The final regulations clarify that a person is treated as a shareholder of the S corporation at any moment in time when that person is entitled to, or in the discretion of any person may, receive a distribution of principal or income of the trust. The final regulations also provide that a person who, after the exercise of a power of appointment, receives only a future interest in the trust is not a PCB.

One commentator was concerned about the statement in the proposed regulations that if a person holds a general lifetime power of appointment, the corporation will exceed the 75-shareholder limit and thus the corporation's S election will terminate. The commentator pointed out that a beneficiary's power to withdraw assets from a trust is considered a general power of appointment but the beneficiary is the only one who can receive those assets. The final regulations clarify that the potential recipients of current distributions pursuant to an exercise of the power are considered, not whether the power is a general or special power of appointment.

The proposed regulations provide that a person with a future beneficial interest is not a beneficiary of an ESBT if that interest is so remote as to be negligible. This provision permitted trusts to qualify as ESBTs even though there was a remote possibility that all the named beneficiaries would die and the trust assets would escheat to the state, an impermissible beneficiary of an ESBT. The Community Renewal Tax Relief Act of 2000 eliminated this potential problem by changing the statutory definition of permissible beneficiaries to include an organization described in section 170(c)(1) that holds a contingent interest in the trust and is not a PCB. The final regulations, therefore, remove the provision regarding remote beneficiaries and the accompanying example.

Interests in Trust Acquired by Purchase

Two commentators requested clarification on whether a trust is eligible to be an ESBT if it acquires property in a part-gift, part-sale transaction, such as a gift of encumbered property or a net gift, in which the donor transfers property to a trust provided the trust pays the resulting gift tax. Section 1361(e)(1)(A)(ii) provides that a trust is eligible to be an ESBT only if "no interest in the trust was acquired by purchase." Section 1361(e)(1)(C) defines *purchase* as "any acquisition if the basis of the property acquired is determined under section 1012." The proposed regulations provide that if any portion of a beneficiary's basis in the beneficiary's interest is determined under section 1012, the beneficiary's interest was acquired by purchase. The final regulations clarify that the prohibition on purchases applies to purchases of a beneficiary's interest in the trust, not to

purchases of property by the trust. A net gift of a beneficial interest in a trust, where the donee pays the gift tax, would be treated as a purchase of a beneficial interest under these rules, while a net gift to the trust itself, where the trustee of the trust pays the gift tax, would not.

Grantor Trusts

Most commentators praised the position in the proposed regulations that a trust, all or a portion of which is treated as owned by an individual (deemed owner) under subpart E, part I, subchapter J, chapter 1 of the Code (grantor trust), may elect to be an ESBT. One commentator, however, suggested that grantor trusts should not be permitted to make ESBT elections. The final regulations continue to provide that a grantor trust may elect to be an ESBT.

The proposed regulations provide that if a grantor trust makes an ESBT election, the trust consists of a grantor portion, an S portion, and a non-S portion. The items of income, deduction, and credit attributable to the grantor portion are taxed to the deemed owner of that portion. The S portion is taxed under the special rules of section 641(c), while the non-S portion is subject to the normal trust taxation rules of subparts A through D of subchapter J.

Commentators made several suggestions regarding the taxation of a grantor trust that elects to be an ESBT. Some suggested that the taxation rules of section 641(c) should override the grantor trust rules of section 671, and thus all tax items attributable to the trust's shares in the S corporation should be taxed to the trust, not the deemed owner. Some suggested the grantor trust rules should not apply to any tax items of a trust that makes an ESBT election. According to these commentators, this approach would eliminate administrative complexity in determining what portion of the trust is treated as owned by the deemed owner. Others suggested that the trustee should be permitted to elect to have all items attributable to the S corporation taxed to the trust, not to the deemed owner. Others suggested that none of the S items should be taxed to the deemed owner but that ESBTs should be subject to additional reporting requirements to ensure the collection of the proper tax. Another suggested that the deemed owner should be taxed on the items from an ESBT only if the deemed owner is treated as owning the entire trust, not just a portion of the trust. Other commentators agreed with the taxation regime set forth in the proposed regulations.

The IRS and the Treasury Department believe that the qualification and taxation of ESBTs are two separate issues and that the proposed regulations take the correct position regarding the taxation of grantor trusts that make ESBT elections. Section 1361(e)(1) expands the permissible shareholders of an S corporation to include trusts that meet the definition of an ESBT. Grantor trusts are not excluded from the definition of an ESBT and, therefore, are permitted to make ESBT elections. Making an ESBT election, however, does not alter the long established treatment of tax items attributable to the portion of a trust treated as owned by the grantor or another. Section 671 requires that items of income, deduction, and credit attributable to the portion of the trust treated as owned by a grantor or another must be taken into account by that deemed owner. Only remaining items of the trust are subject to the provisions of subparts A through D of subchapter J. The special taxation rules for ESBTs are contained in subpart A and, therefore, only apply to any portion of the trust that is not treated as owned by the grantor or another under subpart E.

As pointed out by one of the commentators, the issue of determining what portion, if any, of a trust is treated as owned by the grantor or another has existed for years in a much broader context than in the application of the ESBT rules. The special taxation rules of section 641(c) would apply only to S items, while normal trust taxation rules clearly apply to non-S items. As a result, taxing all the S items to the trust would not eliminate the need to determine what portion of the trust is a grantor trust and the resulting administrative difficulties with respect to the non-S tax items of the trust.

Some commentators requested clarification of the effect of an ESBT election by a grantor trust. One commentator suggested that if a wholly-owned grantor trust makes an ESBT election, only the deemed owner should be treated as the shareholder of the S corporation. Another commentator made a similar suggestion where the grantor has retained the power to amend or revoke the trust or to make gifts from the trust. The IRS and the Treasury Department believe that the definitional and qualification requirements of section 1361(e) apply to any trust that makes an ESBT election irrespective of whether it is a grantor trust. Therefore, the final regulations continue to provide that the deemed owner is treated as a PCB along with others who meet the definition of a PCB.

Charitable Contributions

The proposed regulations provide that if an otherwise allowable deduction of the S portion is attributable to a charitable contribution paid by the S corporation, the contribution will be deemed to be paid by the S portion pursuant to the terms of the trust's governing instrument and will be deductible if the other requirements of section 642(c)(1) are met. Several commentators requested clarification concerning the other requirements of section 642(c)(1), the application of the limitations under section 681, and the election to treat charitable payments made after the close of a taxable year as made during the taxable year. One commentator suggested that the S portion should be entitled to a deduction for its share of any charitable contribution made by the S corporation because it is a separately stated item under section 1366 that the S portion takes into account under section 641(c)(2)(C)(i).

Section 641(c)(2)(C) specifies the items of income, loss, deduction, or credit that the S portion is required to take into account in determining its tax. These items include items required to be taken into account under section 1366, that is, the trust's *pro rata* share of the S corporation's items passed through to it as a shareholder. Both section 641(c)(2)(C) and section 1366(a) reference items that must be taken into account but do not themselves provide the authority to include in income, deduct from income, or claim a credit with respect to those items. That authority comes from other Code sections. A charitable contribution made by an S corporation is required to be a separately stated item under section 1366 because whether the item is deductible depends on the identity of the shareholder and the provisions of the Code

applicable to charitable contributions made by that type of shareholder. Thus, for an individual shareholder, the contribution is deductible only in accordance with the provisions of section 170, while for a trust or estate, the contribution is deductible only in accordance with the provisions of section 642(c).

The final regulations continue to provide that the S portion's share of a charitable contribution made by the S corporation is deductible only if it meets the requirements of section 642(c)(1). The final regulations clarify how those requirements apply to such a contribution. If a contribution is paid from the S corporation's gross income, the contribution will be deemed to be paid by the S portion pursuant to the terms of the trust's governing instrument. The limitations of section 681, regarding unrelated business income, apply to determine whether the contribution is deductible by the S portion. The final regulations also clarify that the charitable contribution is deductible by the S portion, if at all, only in the year that it is an item required to be taken into account by the trust under section 1366. The trustee may not make the election to treat a contribution made by the S corporation after the close of the taxable year as made during the taxable year. This election is available only for charitable payments actually made by the trust, not for the trust's share of contributions made by another entity.

One commentator suggested that if the trust contributes S corporation stock to a charitable organization, the S portion should be entitled to a charitable deduction with respect to the contribution. Deductions available to the S portion are limited by section 641(c)(2)(C) to S corporation items required to be taken into account under section 1366 and the S portion's share of state and local income taxes and administrative expenses. Charitable contributions by the trust are not items included in the list of items that may be taken into account by the S portion under section 641(c)(2)(C). Therefore, the final regulations do not change the rule that no deduction is available to either the S portion or the non-S portion with respect to a contribution of S corporation stock to charity.

Interest Paid on Loans to Acquire S Corporation Stock

The proposed regulations provide that interest expense incurred by the trust to purchase S corporation stock is allocated to the S portion but is not an administrative expense. Therefore, the interest is not an allowable deduction of the S portion under section 641(c)(2)(C)(iii). Several commentators suggested that the interest should be deductible. Some thought the interest should be allocated to the non-S portion and deducted under the investment interest limitations of section 163(d). Others thought the interest should be allocated to the S portion but should be considered a deductible administrative expense. One commentator suggested that if the shareholders are required to buy the stock of a departing shareholder pursuant to the terms of a stock purchase agreement, any interest expense incurred as a result of financing the stock purchase with a loan should be deductible when paid by an ESBT. Another commentator suggested that if interest paid on a loan to acquire S corporation stock is not deductible, it should be added to the basis of the acquired stock.

Because the purchase of S corporation stock increases the S portion, rather than the non-S portion, of the trust, interest expenses incurred in the purchase should be allocated to the S portion. These interest expenses would be deductible by the S portion only if they are "administrative expenses" under section 641(c)(2)(C)(iii). The IRS and the Treasury Department believe that, for purposes of section 641(c)(2)(C)(iii), "administrative expenses" include the traditional expenses necessary for the management and preservation of trust assets, but do not include expenses incurred to acquire additional assets. The final regulations, therefore, continue to provide that, in all cases, interest incurred to purchase S corporation stock is a nondeductible expense allocable to the S portion. Because there is no authority to permit nondeductible interest expenses to increase the basis of assets, the final regulations do not adopt this suggestion.

Tax Credit Carryovers

Section 641(c)(4) and the proposed regulations provide that if a trust is no longer an ESBT, any loss carryover or excess deductions of the S portion that are referred to in section 642(h) are taken into account by the entire trust or by the beneficiaries if the entire trust terminates. One commentator suggested that any tax credit carryovers of the S portion should receive similar treatment. Section 641(c)(4) permits the entire trust to take into account only those items specified in section 642(h), which does not include tax credit carryovers. The S portion's tax credit carryovers and any other items not listed in section 642(h) are forfeited once the trust is no longer an ESBT, just as they are upon the termination of a trust or estate. The final regulations, therefore, do not adopt the commentator's suggestion.

Distributions From the ESBT

One commentator suggested that the tax treatment of distributions to beneficiaries in the proposed regulations is inconsistent with section 641(c)(1)(A), which provides that the portion of an ESBT consisting of the S corporation stock is treated as a separate trust. The proposed regulations provide that distributions to beneficiaries from the S portion or the non-S portion, including distributions of the S corporation stock, are, to the extent of the distributable net income of the non-S portion, deductible under section 651 or 661 in determining the taxable income of the non-S portion, and are includible in the gross income of the beneficiaries under section 652 or 662. The commentator recommended that, because the S portion and the non-S portion are treated as separate trusts, the source of the distribution should determine its tax treatment.

The final regulations do not adopt the commentator's suggestion because section 641(c)(3) provides that section 641(c) does not affect the taxation of any distribution from the trust except for the exclusion of the S portion items from the distributable net income of the entire trust. Thus, the rules otherwise applicable to trust distributions apply to ESBTs.

ESBT Election

The proposed regulations provide that the ESBT election is filed with the service center where the trust files its income tax returns. The election to be a

qualified subchapter S trust (QSST) is filed with the service center where the S corporation files its income tax returns. The preamble to the proposed regulations requested comments on whether the rules for filing the QSST election should be changed so the election is filed with the service center where the trust files its returns. One commentator suggested there should be consistent filing locations for QSST elections, ESBT elections, and conversions from QSST to ESBT or ESBT to QSST. The commentator, therefore, suggested that all these documents be filed with the service center(s) where the trust and the S corporation file their returns.

The final regulations provide that the ESBT election and the election to convert from an ESBT to a QSST or from a QSST to an ESBT are all filed with the service center where the S corporation files its income tax returns. Thus, the rule in the final regulations will establish a consistent filing location for QSST and ESBT elections and conversions.

One commentator suggested that grantor trusts should be permitted to make protective ESBT elections in light of the uncertain status of some trusts that may be grantor trusts under section 674. The IRS and the Treasury Department continue to believe that a conditional ESBT election that only becomes effective in the event the trust is not a wholly-owned grantor trust should not be available. A conditional ESBT election should not be allowed because the ESBT election must have a fixed effective date. If, in the absence of a conditional ESBT election, the trust is an ineligible shareholder, relief under section 1362(f) may be available for an S corporation. In addition, a trust that qualifies as an ESBT may make an ESBT election notwithstanding that the trust is a wholly-owned grantor trust.

Expedited Section 1362(f) Relief

In several contexts, commentators requested some form of expedited relief if an S corporation's election is inadvertently ineffective or is inadvertently terminated. In all these situations, the S corporation may seek relief under section 1362(f). The facts and circumstances of a particular situation are considered in determining whether relief is available, and the procedures for obtaining this relief are well established.

Effect under Section 1377 of Change in Status of a Trust

A commentator suggested that a trust's conversion to an ESBT should result in a complete termination of the trust's interest in the S corporation for purposes of section 1377(a)(2) because the incidence of taxation with respect to S corporation items will change as a result of the ESBT election. The proposed regulations provide that the election would result in a termination only if, prior to the election, the trust was described in section 1361(c)(2)(A)(ii) or (iii). The commentator also recommended that the regulations address the conversion from an ESBT to another type of trust and the availability of an election under § 1.1368–1(g) to treat the S corporation's taxable year as two separate years in the case of a qualifying disposition.

The final regulations do not adopt the suggestion that all conversions of a trust to an ESBT should be treated as a complete termination of the trust's interest in the S corporation for purposes of section 1377(a)(2). The final regulations expand on the rule in the proposed regulations to cover all types of conversions. Under this rule, conversion of a trust to an ESBT or a QSST does not result in the prior trust terminating its entire interest in the S corporation, unless the prior trust was described in section 1361(c)(2)(A)(ii) or (iii). When a trust described in section 1361(c)(2)(A)(ii) or (iii) converts to an ESBT or a QSST, the shareholders of the S corporation under section 1361(c)(2)(B) change from the estate of the deemed owner or testator to the PCBs of the ESBT, or the current income beneficiary of the QSST. When a trust changes from a wholly-owned grantor trust or QSST to an ESBT or from an ESBT to a QSST, the individuals who are shareholders of the S corporation under section 1361(c)(2)(B) remain the same. The election to terminate the taxable year provided in section 1377(a)(2) applies to the termination of a *shareholder's* interest in the S corporation. Accordingly, it is appropriate to treat the conversion of a trust described in section 1361(c)(2)(A)(ii) or (iii) to an ESBT or QSST as a termination of the prior trust's interest in the S corporation, but not to treat other conversions to an ESBT or QSST as terminations. The election under § 1.1368–1(g) is also not available because the conversion of the trust is not a qualifying disposition.

Section 444 Elections

One commentator suggested that the final regulations permit an S corporation to retroactively reinstate a section 444 election that it had treated as terminated by operation of § 1.444–2T(a) (prior to the issuance of the temporary regulations) as a result of an ESBT or certain tax-exempt trusts becoming a shareholder of the corporation under the auspices of the 1996 Act. The commentator believes that failure to provide such relief would result in inequitable treatment of such S corporations because, under the rules of section 444, once their elections are terminated, they are precluded from again making a section 444 election.

The IRS and the Treasury Department believe that it is appropriate to allow S corporations under these circumstances to request that the IRS disregard the termination and permit the S corporation to continue to use the same fiscal year that it used previously under section 444. However, for reasons of administrative convenience, and in order to reduce the burden on taxpayers of having to file amended returns and make retroactive payments under section 7519, the prior termination will be disregarded only at the S corporation's request, and on a prospective basis.

The final regulations provide a procedure for such requests. To illustrate the procedure, assume that, prior to 1997, an S corporation had made a section 444 election to use a taxable year ending on September 30th. On January 1, 1997, an ESBT acquired a shareholder interest in the S corporation. The S corporation treated its 444 election as terminated under § 1.444–2T(a) as a result of the ESBT's shareholder interest. The S corporation changed to its required taxable year for the short period beginning October 1, 1996, and ending December 31, 1996, and filed Form 1120S, "*U.S. Income Tax Return for an S Corporation*," on the basis of a calendar year for all subsequent taxable years.

Under the final regulations, the S corporation may request that the IRS disregard the prior termination by filing Form

8716, *Election to Have a Tax Year Other Than a Required Tax Year,* with the appropriate Service Center by October 15, 2002, and by designating on the form "CONTINUATION OF SECTION 444 ELECTION UNDER § 1.444–4." The Form 8716 must indicate that under the S corporation's prior section 444 election, it used a taxable year ending September 30th. The request will be effective for the taxable year beginning January 1, 2002. No amended returns, no retroactive payments under section 7519, and no returns under § 1.7519–2T(a) for previous years in which the S corporation used its required year are required as a result of the request. Moreover, the S corporation need not make a required payment under section 7519 for its taxable year ending September 30, 2002; its first required payment for the taxable year beginning October 1, 2002, is due on May 15, 2003. The S corporation will be required to file a return under § 1.7519–2T for each taxable year beginning on or after January 1, 2002.

Effective Dates

The portion of the regulations involving the taxation of the grantor, S, and non-S portions of an ESBT was proposed to be applicable for taxable years of ESBTs that end on or after December 29, 2000, the date that the proposed regulations were published in the **Federal Register**. The remainder of the regulations involving ESBTs was proposed to be applicable on or after the date that final regulations are published in the **Federal Register**. Several commentators expressed concerns about the proposed applicability with regard to the taxation of the grantor portion of an ESBT. One commentator suggested that the proposed effective date discriminated against trusts with a situs in Guam. Others suggested that the rules regarding taxation of the grantor portion should not be applicable before the date the final regulations are published. One commentator suggested that these rules should only apply either to trusts created after the final regulations are published or after a substantial transition period.

The IRS and the Treasury Department believe that the applicable date for the rules concerning the taxation of an ESBT with a grantor portion is reasonable and appropriate. These rules do not discriminate against trusts with a particular situs because they apply to all trusts wherever situated. In the case of a grantor trust that made an ESBT election, the tax treatment of the grantor portion set forth in the proposed regulations may be different from the tax treatment that the trust and the grantor had thought was available. The proposed regulations, however, were published before the end of the 2000 taxable year and before income from that taxable year was required to be included on any person's income tax return. Thus, prior to the filing of income tax returns for 2000, it was known that the income from the grantor portion of the trust was to be taken into account by the deemed owner, not by the trust. In some situations, the trust, rather than the deemed owner, may have made estimated tax payments. Recognizing that the payment of estimated tax by the trust might subject the deemed owner to a penalty for underpayment of estimated taxes, the IRS and the Treasury Department provided relief by issuing Notice 2001–25, 2001–1 C.B. 941. That Notice provides procedures for a trust to elect to have its estimated tax payments credited to the account of the deemed owner and provides that, for purposes of calculating any underpayment of estimated tax, income attributable to the S corporation was to be taken into account on the last day of the deemed owner's 2000 taxable year.

Some commentators were concerned that existing ESBTs with currently exercisable, broad powers of appointments have resulted in S corporations exceeding the shareholder limit and have caused the termination of the S corporations' elections. The regulations regarding the definition of PCBs are applicable only for taxable years of ESBTs that begin on or after May 14, 2002. Therefore, persons who may receive a distribution from an ESBT pursuant to a currently exercisable power of appointment will not be considered PCBs of the ESBT until the first day of the ESBT's first taxable year that begins on or after May 14, 2002, and the S corporation's election will not terminate before that date. In addition, under section 1361(e)(2) if the trust disposes of all its stock in the S corporation within 60 days after that date, the persons, who would first meet the definition of PCBs on that date, will not be PCBs and the corporation's S status will not be affected.

One commentator was concerned by the applicability date of the regulations involving the deductibility of state and local income taxes and administrative expenses. Section 641(c)(2)(C)(iii) provides that the S portion may take into account its allocable share of state and local income taxes and administrative expenses, but only to the extent provided in the regulations. The commentator noted that before final regulations are issued there is no authority for an ESBT to deduct any of these items. Therefore, the commentator requested that trusts be allowed to rely on the regulatory provisions regarding these items for taxable years beginning after December 31, 1996. The effective date provisions have been modified based on this suggestion.

Additional Provisions

The final regulations clarify that the basis of S corporation stock in the S portion must be adjusted in accordance with section 1367 and the regulations thereunder. If the ESBT owns stock in more than one S corporation, the adjustments to the basis in the S corporation stock of each S corporation must be determined separately.

Effect on other documents

The following documents are superseded for taxable years of ESBTs beginning on and after May 14, 2002.

Notice 97–12 (1997–1 C.B. 385).

Notice 97–49 (1997–2 C.B. 304).

Rev. Proc. 98–23 (1998–1 C.B. 662).

Special Analysis

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 has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collections of information in the regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that (1) the estimated average

burden per trust in complying with the collections of information in § 1.1361–1(m) is 1 hour, and (2) the requirement for S corporations to comply with § 1.444–4(c) will affect very few taxpayers and the associated burden is minimal. Therefore, 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 Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on the regulations' impact on small business.

Drafting Information

The principal authors of these regulations are Bradford Poston and James A. Quinn of the Office of Associate Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and the Treasury Department participated in their development.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART I—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 1.444–4 is also issued under 26 U.S.C. 444(g). * * *

Par. 2. Section 1.444–4 is added to read as follows:

§ 1.444–4 Tiered structure.

(a) *Electing small business trusts*. For purposes of § 1.444–2T, solely with respect to an S corporation shareholder, the term *deferral entity* does not include a trust that is treated as an electing small business trust under section 1361(e). An S corporation with an electing small business trust as a shareholder may make an election under section 444. This paragraph is applicable to taxable years beginning on and after December 29, 2000; however, taxpayers may voluntarily apply it to taxable years of S corporations beginning after December 31, 1996.

(b) *Certain tax-exempt trusts*. For purposes of § 1.444–2T, solely with respect to an S corporation shareholder, the term *deferral entity* does not include a trust that is described in section 401(a) or 501(c)(3), and is exempt from taxation under section 501(a). An S corporation with a trust as a shareholder that is described in section 401(a) or section 501(c)(3), and is exempt from taxation under section 501(a) may make an election under section 444. This paragraph is applicable to taxable years beginning on and after December 29, 2000; however taxpayers may voluntarily apply it to taxable years of S corporations beginning after December 31, 1997.

(c) *Certain terminations disregarded*—(1) *In general*. An S corporation that is described in this paragraph (c)(1) may request that a termination of its election under section 444 be disregarded, and that the S corporation be permitted to resume use of the year it previously elected under section 444, by following the procedures of paragraph (c)(2) of this section. An S corporation is described in this paragraph if the S corporation is otherwise qualified to make a section 444 election, and its previous election was terminated under § 1.444–2T(a) solely because —

(i) In the case of a taxable year beginning after December 31, 1996, a trust that is treated as an electing small business trust became a shareholder of such S corporation; or

(ii) In the case of a taxable year beginning after December 31, 1997, a trust that is described in section 401(a) or 501(c)(3), and is exempt from taxation under section 501(a) became a shareholder of such S corporation.

(2) *Procedure*—(i) *In general*. An S corporation described in paragraph (c)(1) of this section that wishes to make the request described in paragraph (c)(1) of this section must do so by filing Form 8716, *Election To Have a Tax Year Other Than a Required Tax Year*, and typing or printing legibly at the top of such form — "CONTINUATION OF SECTION 444 ELECTION UNDER § 1.444–4." In order to assist the Internal Revenue Service in updating the S corporation's account, on Line 5 the Box "Changing to" should be checked. Additionally, the election month indicated must be the last month of the S corporation's previously elected section 444 election year, and the effective year indicated must end in 2002.

(ii) *Time and place for filing Form 8716*. Such form must be filed on or before October 15, 2002, with the service center where the S corporation's returns of tax (Forms 1120S) are filed. In addition, a copy of the Form 8716 should be attached to the S corporation's short period Federal income tax return for the first election year beginning on or after January 1, 2002.

(3) *Effect of request*—(i) *Taxable years beginning on or after January 1, 2002*. An S corporation described in paragraph (c)(1) of this section that requests, in accordance with this paragraph, that a termination of its election under section 444 be disregarded will be permitted to resume use of the year it previously elected under section 444, commencing with its first taxable year beginning on or after January 1, 2002. Such S corporation will be required to file a return under § 1.7519–2T for each taxable year beginning on or after January 1, 2002. No payment under section 7519 will be due with respect to the first taxable year beginning on or after January 1, 2002. However, a required payment will be due on or before May 15, 2003, with respect to such S corporation's second continued section 444 election year that begins in calendar year 2002.

(ii) *Taxable years beginning prior to January 1, 2002*. An S corporation described in paragraph (c)(1) of this section that requests, in accordance with this paragraph, that a termination of its election under section 444 be disregarded will not be required to amend any prior Federal income tax returns, make any required payments under section 7519, or file any returns under § 1.7519–2T, with respect to taxable years beginning on or after the date the termination of its section 444 election was effective and prior to January 1, 2002.

(iii) *Section 7519: required payments and returns*. The Internal Revenue Service waives any requirement for an S corporation described in paragraph (c)(1) of this section to file the federal tax returns and make any required payments under section 7519 for years prior to the taxable

year of continuation as described in paragraph (c)(3)(i) of this section, if for such years the S corporation filed its Federal income tax returns on the basis of its required taxable year.

§ 1.444–4T [Removed]

Par. 3. Section 1.444–4T is removed.

Par. 4. Sections 1.641(c)–0 and 1.641(c)–1 are added to read as follows:

§ 1.641(c)–0 Table of contents.

This section lists the major captions contained in § 1.641(c)–1.

§ 1.641(c)–1 Electing small business trust.

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(d) Taxation of S portion.
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(1) Income tax rate.
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(i) Treatment of distributions from the trust.
(j) Termination or revocation of ESBT election.
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§ 1.641(c)–1 Electing small business trust.

(a) *In general*. An electing small business trust (ESBT) within the meaning of section 1361(e) is treated as two separate trusts for purposes of chapter 1 of the Internal Revenue Code. The portion of an ESBT that consists of stock in one or more S corporations is treated as one trust. The portion of an ESBT that consists of all the other assets in the trust is treated as a separate trust. The grantor or another person may be treated as the owner of all or a portion of either or both such trusts under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code. The ESBT is treated as a single trust for administrative purposes, such as having one taxpayer identification number and filing one tax return. See § 1.1361–1(m).

(b) *Definitions*—(1) *Grantor portion*. The grantor portion of an ESBT is the portion of the trust that is treated as owned by the grantor or another person under subpart E.

(2) *S portion*. The S portion of an ESBT is the portion of the trust that consists of S corporation stock and that is not treated as owned by the grantor or another person under subpart E.

(3) *Non-S portion*. The non-S portion of an ESBT is the portion of the trust that consists of all assets other than S corporation stock and that is not treated as owned by the grantor or another person under subpart E.

(c) *Taxation of grantor portion*. The grantor or another person who is treated as the owner of a portion of the ESBT includes in computing taxable income items of income, deductions, and credits against tax attributable to that portion of the ESBT under section 671.

(d) *Taxation of S portion*—(1) *In general*. The taxable income of the S portion is determined by taking into account only the items of income, loss, deduction, or credit specified in paragraphs (d)(2), (3), and (4) of this section, to the extent not attributable to the grantor portion.

(2) *Section 1366 amounts*—(i) *In general*. The S portion takes into account the items of income, loss, deduction, or credit that are taken into account by an S corporation shareholder pursuant to section 1366 and the regulations thereunder. Rules otherwise applicable to trusts apply in determining the extent to which any loss, deduction, or credit may be taken into account in determining the taxable income of the S portion. See § 1.1361–1(m)(3)(iv) for allocation of those items in the taxable year of the S corporation in which the trust is an ESBT for part of the year and an eligible shareholder under section 1361(a)(2)(A)(i) through (iv) for the rest of the year.

(ii) *Special rule for charitable contributions*. If a deduction described in paragraph (d)(2)(i) of this section is attributable to an amount of the S corporation's gross income that is paid by the S corporation for a charitable purpose specified in section 170(c) (without regard to section 170(c)(2)(A)), the contribution will be deemed to be paid by the S portion pursuant to the terms of the trust' governing instrument within the meaning of section 642(c)(1) . The limitations of section 681, regarding unrelated business income, apply in determining whether the contribution is deductible in computing the taxable income of the S portion.

(iii) *Multiple S corporations*. If an ESBT owns stock in more than one S corporation, items of income, loss, deduction, or credit from all the S corporations are aggregated for purposes of determining the S portion's taxable income.

(3) *Gains and losses on disposition of S stock*—(i) *In general*. The S portion takes into account any gain or loss from the disposition of S corporation stock. No deduction is allowed under section 1211(b)(1) and (2) for capital losses that exceed capital gains.

(ii) *Installment method*. If income from the sale or disposition of stock in an S corporation is reported by the trust on the installment method, the income recognized under this method is taken into account by the S portion. See paragraph (g)(3) of this section for the treatment of interest on the installment obligation. See § 1.1361–1(m)(5)(ii) regarding treatment of a trust as an ESBT upon the sale of all S corporation stock using the installment method.

(iii) *Distributions in excess of basis*. Gain recognized under section 1368(b)(2) from distributions in excess of the ESBT's basis in its S corporation stock is taken into account by the S portion.

(4) *State and local income taxes and administrative expenses*—(i) *In general*. State and local income taxes and administrative expenses directly related to the S portion and those allocated to that portion in accordance with paragraph (h) are taken into account by the S portion.

(ii) *Special rule for certain interest*. Interest paid by the trust on money borrowed by the trust to purchase stock in an S corporation is allocated to the S portion but is not a deductible administrative expense for purposes of determining the taxable income of the S portion.

(e) *Tax rates and exemption of S portion*—(1) *Income tax rate*. Except for capital gains, the highest marginal trust rate provided in section 1(e) is applied to the taxable income of the S portion. See section 1(h) for the rates that apply to the S portion's net capital gain.

(2) *Alternative minimum tax exemption*. The exemption amount of the S portion under section 55(d) is zero.

(f) *Adjustments to basis of stock in the S portion under section 1367*. The basis of S corporation stock in the S portion must be adjusted in accordance with section 1367 and the regulations thereunder. If the ESBT owns stock in more than one S corporation, the adjustments to the basis in the S corporation stock of each S corporation must be determined separately with respect to each S corporation. Accordingly, items of income, loss, deduction, or credit of an S corporation that are taken into account by the ESBT under section 1366 can only result in an adjustment to the basis of the stock of that S corporation and cannot affect the basis in the stock of the other S corporations held by the ESBT.

(g) *Taxation of non-S portion*—(1) *In general*. The taxable income of the non-S portion is determined by taking into account all items of income, deduction, and credit to the extent not taken into account by either the grantor portion or the S portion. The items attributable to the non-S portion are taxed under subparts A through D of part I, subchapter J, chapter 1 of the Internal Revenue Code. The non-S portion may consist of more than one share pursuant to section 663(c).

(2) *Dividend income under section 1368(c)(2)*. Any dividend income within the meaning of section 1368(c)(2) is includible in the gross income of the non-S portion.

(3) *Interest on installment obligations*. If income from the sale or disposition of stock in an S corporation is reported by the trust on the installment method, the interest on the installment obligation is includible in the gross income of the non-S portion. See paragraph (d)(3)(ii) of this section for the treatment of income from such a sale or disposition.

(4) *Charitable deduction.* For purposes of applying section 642(c)(1) to payments made by the trust for a charitable purpose, the amount of gross income of the trust is limited to the gross income of the non-S portion. See paragraph (d)(2)(ii) of this section for special rules concerning charitable contributions paid by the S corporation that are deemed to be paid by the S portion.

(h) *Allocation of state and local income taxes and administration expenses*. Whenever state and local income taxes or administration expenses relate to more than one portion of an ESBT, they must be allocated between or among the portions to which they relate. These items may be allocated in any manner that is reasonable in light of all the circumstances, including the terms of the governing instrument, applicable local law, and the practice of the trustee with respect to the trust if it is reasonable and consistent. The taxes and expenses apportioned to each portion of the ESBT are taken into account by that portion.

(i) *Treatment of distributions from the trust*. Distributions to beneficiaries from the S portion or the non-S portion, including distributions of the S corporation stock, are deductible under section 651 or 661 in determining the taxable income of the non-S portion, and are includible in the gross income of the beneficiaries under section 652 or 662. However, the amount of the deduction or inclusion cannot exceed the amount of the distributable net income of the non-S portion. Items of income, loss, deduction, or credit taken into account by the grantor portion or the S portion are excluded for purposes of determining the distributable net income of the non-S portion of the trust.

(j) *Termination or revocation of ESBT election*. If the ESBT election of the trust terminates pursuant to § 1.1361–1(m)(5) or the ESBT election is revoked pursuant to § 1.1361–1(m)(6), the rules contained in this section are thereafter not applicable to the trust. If, upon termination or revocation, the S portion has a net operating loss under section 172; a capital loss carryover under section 1212; or deductions in excess of gross income; then any such loss, carryover, or excess deductions shall be allowed as a deduction, in accordance with the regulations under section 642(h), to the trust, or to the beneficiaries succeeding to the property of the trust if the entire trust terminates.

(k) *Effective date*. This section generally is applicable for taxable years of ESBTs beginning on and after May 14, 2002. However, paragraphs (a), (b), (c), and (l) *Example 1* of this section are applicable for taxable years of ESBTs that end on and after December 29, 2000. ESBTs may apply paragraphs (d)(4) and (h) of this section for taxable years of ESBTs beginning after December 31, 1996.

(l) *Examples*. The following examples illustrate the rules of this section:

Example 1. Comprehensive example. (i) Trust has a valid ESBT election in effect. Under section 678, *B* is treated as the owner of a portion of Trust consisting of a 10% undivided fractional interest in Trust. No other person is treated as the owner of any other portion of Trust under subpart E. Trust owns stock in *X*, an S corporation, and in *Y*, a C corporation. During 2000, Trust receives a distribution from *X* of $5,100, of which $5,000 is applied against Trust's adjusted basis in the *X* stock in accordance with section 1368(c)(1) and $100 is a dividend under section 1368(c)(2). Trust makes no distributions to its beneficiaries during the year.

(ii) For 2000, Trust has the following items of income and deduction:

Ordinary income attributable to *X* under section 1366Y	$5,000
Dividend income from *Y*	$900
Dividend from *X* representing C corporation earnings and profits	$100
Total trust income	$6,000
Charitable contributions attributable to *X* under section 1366	$300
Trustee fees	$200
State and local income taxes	$100

(iii) Trust's items of income and deduction are divided into a grantor portion, an S portion, and a non-S portion for purposes of determining the taxation of those items. Income is allocated to each portion as follows:

B must take into account the items of income attributable to the grantor portion, that is, 10% of each item, as follows:

Ordinary income from *X*	$500
Dividend income from *Y*	$90
Dividend income from *X*	$10
Total grantor portion income	$600

The total income of the S portion is $4,500, determined as follows:

Ordinary income from *X*	$5,000
Less: Grantor portion	($500)
Total S portion income	$4,500

The total income of the non-S portion is $900 determined as follows:

Dividend income from *Y* (less grantor portion)	$810
Dividend income from *X* (less grantor portion)	$90
Total non-S portion income	$900

(iv) The administrative expenses and the state and local income taxes relate to all three portions and under state law would be allocated ratably to the $6,000 of trust income. Thus, these items would be allocated 10% (600/6000) to the grantor portion, 75% (4500/6000) to the S portion and 15% (900/6000) to the non-S portion.

(v) *B* must take into account the following deductions attributable to the grantor portion of the trust:

Charitable contributions from *X*	$30
Trustee fees	$20
State and local income taxes	$10

(vi) The taxable income of the S portion is $4,005, determined as follows:

Ordinary income from *X*	$4,500
Less: Charitable contributions from X (less grantor portion)	($270)
75% of trustee fees	($150)
75% of state and local income taxes	($75)
Taxable income of S portion	$4,005

(vii) The taxable income of the non-S portion is $755, determined as follows:

Dividend income from *Y*	$810
Dividend income from *X*	$90
Total non-S portion income	$900
Less: 15% of trustee fees	($30)
15% state and local income taxes	$15)
Personal exemption	($100)
Taxable income of non-S portion	$755

Example 2. Sale of S stock. Trust has a valid ESBT election in effect and owns stock in *X*, an S corporation. No person is treated as the owner of any portion of Trust under subpart E. In 2003, Trust sells all of its stock in *X* to a person who is unrelated to Trust and its beneficiaries and realizes a capital gain of $5,000. This gain is taken into account by the S portion and is taxed using the appropriate capital gain rate found in section 1(h).

Example 3. (i) *Sale of S stock for an installment note.* Assume the same facts as in *Example 2*, except that Trust sells its stock in *X* for a $400,000 installment note payable with stated interest over ten years. After the sale, Trust does not own any S corporation stock.

(ii) *Loss on installment sale.* Assume Trust's basis in its *X* stock was $500,000. Therefore, Trust sustains a capital loss of $100,000 on the sale. Upon the sale, the S portion terminates and the excess loss, after being netted against the other items taken into account by the S portion, is made available to the entire trust as provided in section 641(c)(4).

(iii) *Gain on installment sale.* Assume Trust's basis in its *X* stock was $300,000 and that the $100,000 gain will be recognized under the installment method of section 453. Interest income will be recognized annually as part of the installment payments. The portion of the $100,000 gain recognized annually is taken into account by the S portion. However, the annual interest income is includible in the gross income of the non-S portion.

Example 4. Charitable lead annuity trust. Trust is a charitable lead annuity trust which is not treated as owned by the grantor or another person under subpart E. Trust acquires stock in *X*, an S corporation, and elects to be an ESBT. During the taxable year, pursuant to its terms, Trust pays $10,000 to a charitable organization described in section 170(c)(2). The non-S portion of Trust receives an income tax deduction for the charitable contribution under section 642(c) only to the extent the amount is paid out of the gross income of the non-S portion. To the extent the amount is paid from the S portion by distributing S corporation stock, no charitable deduction is available to the S portion.

Example 5. ESBT distributions. (i) As of January 1, 2002, Trust owns stock in *X*, a C corporation. No portion of Trust is treated as owned by the grantor or another person under subpart E. *X* elects to be an S corporation effective January 1, 2003, and Trust elects to be an ESBT effective January 1, 2003. On February 1, 2003, *X* makes an $8,000 distribution to Trust, of which $3,000 is treated as a dividend from accumulated earnings and profits under section 1368(c)(2) and the remainder is applied against Trust's basis in the *X* stock under section 1368(b). The trustee of Trust makes a distribution of $4,000 to Beneficiary during 2003. For 2003, Trust's share of *X*'s section 1366 items is $5,000 of ordinary income. For the year, Trust has no other income and no expenses or state or local taxes.

(ii) For 2003, Trust has $5,000 of taxable income in the S portion. This income is taxed to Trust at the maximum rate provided in section 1(e). Trust also has $3,000 of distributable net income (DNI) in the non-S portion. The non-S portion of Trust receives a distribution deduction under section 661(a) of $3,000, which represents the amount distributed to Beneficiary during the year ($4,000), not to exceed the amount of DNI ($3,000). Beneficiary must include this amount in gross income under section 662(a). As a result, the non-S portion has no taxable income.

Par. 5. Section 1.1361–0 is amended by adding entries for § 1.1361–1(j)(12) and (m) to read as follows:

§ 1.1361–0 Table of contents.

* * * * *

§ 1.1361–1 S corporation defined.

* * * * *

(j) * * *

(12) Converting a QSST to an ESBT.

* * * * *

(m) Electing small business trust (ESBT).

(1) Definition.

(2) ESBT election.

(3) Effect of ESBT election.

(4) Potential current beneficiaries.

(5) ESBT terminations.

(6) Revocation of ESBT election.

(7) Converting an ESBT to a QSST.

(8) Examples.

(9) Effective date.

* * * * *

Par. 6. Section 1.1361–1 is amended by:

1. Adding paragraphs (h)(1)(vi) and (h)(3)(i)(F).
2. Adding a sentence to the beginning of paragraph (h)(3)(ii) introductory text.
3. Adding paragraph (j)(12).
4. Adding a sentence to the end of paragraph (k)(2)(i).
5. Adding paragraph (m).

The additions read as follows:

§ 1.1361–1 S corporation defined.

* * * * *

(h) * * * (1) * * *

(vi) *Electing small business trusts*. An electing small business trust (ESBT) under section 1361(e). See paragraph (m) of this section for rules concerning ESBTs including the manner of making the election to be an ESBT under section 1361(e)(3).

* * * * *

(3) * * * (i) * * *

(F) If S corporation stock is held by an ESBT, each potential current beneficiary is treated as a shareholder. However, if for any period there is no potential current beneficiary of the ESBT, the ESBT is treated as the shareholder during such period. See paragraph (m)(4) of this section for the definition of potential current beneficiary.

(ii) * * * See § 1.641(c)–1 for the rules for the taxation of an ESBT. * * *

* * * * *

(j) * * *

(12) *Converting a QSST to an ESBT*. For a trust that seeks to convert from a QSST to an ESBT, the consent of the Commissioner is hereby granted to revoke the QSST election as of the effective date of the ESBT election, if all the following requirements are met:

(i) The trust meets all of the requirements to be an ESBT under paragraph (m)(1) of this section except for the requirement under paragraph (m)(1)(iv)(A) of this section that the trust not have a QSST election in effect.

(ii) The trustee and the current income beneficiary of the trust sign the ESBT election. The ESBT election must be filed with the service center where the S corporation files its income tax return. This ESBT election must state at the top of the document "ATTENTION ENTITY CONTROL—CONVERSION OF A QSST TO AN ESBT PURSUANT TO SECTION 1.1361–1(j)" and include all information otherwise required for an ESBT election under paragraph (m)(2) of this section. A separate election must be made with respect to the stock of each S corporation held by the trust.

(iii) The trust has not converted from an ESBT to a QSST within the 36-month period preceding the effective date of the new ESBT election.

(iv) The date on which the ESBT election is to be effective cannot be more than 15 days and two months prior to the date on which the election is filed and cannot be more than 12 months after the date on which the election is filed. If an election specifies an effective date more than 15 days and two months prior to the date on which the election is filed, it will be effective on the day that is 15 days and two months prior to the date on which it is filed. If an election specifies an effective date more than 12 months after the date on which the election is filed, it will be effective on the day that is 12 months after the date it is filed.

(k) * * *

(2) * * * (i) * * * Paragraphs (h)(1)(vi), (h)(3)(i)(F), (h)(3)(ii), and (j)(12) of this section are applicable for taxable years beginning on and after May 14, 2002.

* * * * *

(m) *Electing small business trust (ESBT)*—(1) *Definition*—(i) *General rule*. An electing small business trust (ESBT) means any trust if it meets the following requirements: the trust does not have as a beneficiary any person other than an individual, an estate, an organization described in section 170(c)(2) through (5), or an organization described in section 170(c)(1) that holds a contingent interest in such trust and is not a potential current beneficiary; no interest in the trust has been acquired by purchase; and the trustee of the trust makes a timely ESBT election for the trust.

(ii) *Qualified beneficiaries*—(A) *In general*. For purposes of this section, a beneficiary includes a person who has a present, remainder, or reversionary interest in the trust.

(B) *Distributee trusts*. A distributee trust is the beneficiary of the ESBT only if the distributee trust is an organization described in section 170(c)(2) or (3). In all other situations, any person who has a beneficial interest in a distributee trust is a beneficiary of the ESBT. A distributee trust is a trust that receives or may receive a distribution from an ESBT, whether the rights to receive the distribution are fixed or contingent, or immediate or deferred.

(C) *Powers of appointment*. A person in whose favor a power of appointment could be exercised is not a beneficiary of an ESBT until the holder of the power of appointment actually exercises the power in favor of such person.

(D) *Nonresident aliens*. A nonresident alien as defined in section 7701(b)(1)(B) is an eligible beneficiary of an ESBT. However, see paragraph (m)(4)(i) and (m)(5)(iii) of this section if the nonresident alien is a potential current beneficiary of the ESBT (which would result in an ineligible shareholder and termination of the S corporation election).

(iii) *Interests acquired by purchase*. A trust does not qualify as an ESBT if any interest in the trust has been acquired by purchase. Generally, if a person acquires an interest in the trust and thereby becomes a beneficiary of the trust as defined in paragraph (m)(1)(ii)(A), and any portion of the basis in the acquired interest in the trust is determined under section 1012, such interest has been acquired by purchase. This includes a net gift of a beneficial interest in the trust, in which the person acquiring the beneficial interest pays the gift tax. The trust itself may acquire S corporation stock or other

property by purchase or in a part-gift, part-sale transaction.

(iv) *Ineligible trusts*. An ESBT does not include—

(A) Any qualified subchapter S trust (as defined in section 1361(d)(3)) if an election under section 1361(d)(2) applies with respect to any corporation the stock of which is held by the trust;

(B) Any trust exempt from tax or not subject to tax under subtitle A; or

(C) Any charitable remainder annuity trust or charitable remainder unitrust (as defined in section 664(d)).

(2) *ESBT election*—(i) *In general*. The trustee of the trust must make the ESBT election by signing and filing, with the service center where the S corporation files its income tax return, a statement that meets the requirements of paragraph (m)(2)(ii) of this section. If there is more than one trustee, the trustee or trustees with authority to legally bind the trust must sign the election statement. If any one of several trustees can legally bind the trust, only one trustee needs to sign the election statement. Generally, only one ESBT election is made for the trust, regardless of the number of S corporations whose stock is held by the ESBT. However, if the ESBT holds stock in multiple S corporations that file in different service centers, the ESBT election must be filed with all the relevant service centers where the corporations file their income tax returns. This requirement applies only at the time of the initial ESBT election; if the ESBT later acquires stock in an S corporation which files its income tax return at a different service center, a new ESBT election is not required.

(ii) *Election statement*. The election statement must include—

(A) The name, address, and taxpayer identification number of the trust, the potential current beneficiaries, and the S corporations in which the trust currently owns stock;

(B) An identification of the election as an ESBT election made under section 1361(e)(3);

(C) The first date on which the trust owned stock in each S corporation;

(D) The date on which the election is to become effective (not earlier than 15 days and two months before the date on which the election is filed); and

(E) Representations signed by the trustee stating that—

(*1*) The trust meets the definitional requirements of section 1361(e)(1); and

(*2*) All potential current beneficiaries of the trust meet the shareholder requirements of section 1361(b)(1).

(iii) *Due date for ESBT election*. The ESBT election must be filed within the time requirements prescribed in paragraph (j)(6)(iii) of this section for filing a qualified subchapter S trust (QSST) election.

(iv) *Election by a trust described in section 1361(c)(2)(A)(ii) or (iii)*. A trust that is a qualified S corporation shareholder under section 1361(c)(2)(A)(ii) or (iii) may elect ESBT treatment at any time during the 2-year period described in those sections or the 16-day-and-2-month period beginning on the date after the end of the 2-year period. If the trust makes an ineffective ESBT election, the trust will continue nevertheless to qualify as an eligible S corporation shareholder for the remainder of the period described in section 1361(c)(2)(A)(ii) or (iii).

(v) *No protective election*. A trust cannot make a conditional ESBT election that would be effective only in the event the trust fails to meet the requirements for an eligible trust described in section 1361(c)(2)(A)(i) through (iv). If a trust attempts to make such a conditional ESBT election and it fails to qualify as an eligible S corporation shareholder under section 1361(c)(2)(A)(i) through (iv), the S corporation election will be ineffective or will terminate because the corporation will have an ineligible shareholder. Relief may be available under section 1362(f) for an inadvertent ineffective S corporation election or an inadvertent S corporation election termination. In addition, a trust that qualifies as an ESBT may make an ESBT election notwithstanding that the trust is a wholly-owned grantor trust.

(3) *Effect of ESBT election*—(i) *General rule*. If a trust makes a valid ESBT election, the trust will be treated as an ESBT for purposes of chapter 1 of the Internal Revenue Code as of the effective date of the ESBT election.

(ii) *Employer Identification Number*. An ESBT has only one employer identification number (EIN). If an existing trust makes an ESBT election, the trust continues to use the EIN it currently uses.

(iii) *Taxable year*. If an ESBT election is effective on a day other than the first day of the trust's taxable year, the ESBT election does not cause the trust's taxable year to close. The termination of the ESBT election (including a termination caused by a conversion of the ESBT to a QSST) other than on the last day of the trust's taxable year also does not cause the trust's taxable year to close. In either case, the trust files one tax return for the taxable year.

(iv) *Allocation of S corporation items*. If, during the taxable year of an S corporation, a trust is an ESBT for part of the year and an eligible shareholder under section 1361(c)(2)(A)(i) through (iv) for the rest of the year, the S corporation items are allocated between the two types of trusts under section 1377(a). See § 1.1377–1(a)(2)(iii).

(v) *Estimated taxes*. If an ESBT election is effective on a day other than the first day of the trust's taxable year, the trust is considered one trust for purposes of estimated taxes under section 6654.

(4) *Potential current beneficiaries*—(i) *In general*. For purposes of determining whether a corporation is a small business corporation within the meaning of section 1361(b)(1), each potential current beneficiary of an ESBT generally is treated as a shareholder of the corporation. Subject to the provisions of this paragraph (m)(4), a potential current beneficiary generally is, with respect to any period, any person who at any time during such period is entitled to, or in the discretion of any person may receive, a distribution from the principal or income of the trust. A person is treated as a shareholder of the S corporation at any moment in time when that person is entitled to, or in the discretion of any person may, receive a distribution of principal or income of the trust. No person is treated as a potential current beneficiary solely because that person holds any future interest in the trust.

(ii) *Grantor trusts*. If all or a portion of an ESBT is treated as owned by a person under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code, such owner is a potential current beneficiary in addition to persons described in paragraph (m)(4)(i) of this section.

(iii) *Special rule for dispositions of stock*. Notwithstanding the provisions of paragraph (m)(4)(i) of this section, if a

trust disposes of all of its S corporation stock, any person who first met the definition of a potential current beneficiary during the 60-day period ending on the date of such disposition is not a potential current beneficiary and thus is not a shareholder of that corporation.

(iv) *Distributee trusts*—(A) *In general*. This paragraph (m)(4)(iv) contains the rules for determining who are the potential current beneficiaries of an ESBT if a distributee trust becomes entitled to, or at the discretion of any person, may receive a distribution from principal or income of an ESBT. A distributee trust does not include a trust that is not currently in existence. For this purpose, a trust is not currently in existence if the trust has no assets and no items of income, loss, deduction, or credit. Thus, if a trust instrument provides for a trust to be funded at some future time, the future trust is not currently a distributee trust.

(B) If the distributee trust is not a trust described in section 1361(c)(2)(A), then the distributee trust is the potential current beneficiary of the ESBT and the corporation's S corporation election terminates.

(C) If the distributee trust is a trust described in section 1361(c)(2)(A), the persons who would be its potential current beneficiaries (as defined in paragraphs (m)(4)(i) and (ii) of this section) if the distributee trust were an ESBT are treated as the potential current beneficiaries of the ESBT. Notwithstanding the preceding sentence, however, if the distributee trust is a trust described in section 1361(c)(2)(A)(ii) or (iii), the estate described in section 1361(c)(2)(B)(ii) or (iii) is treated as the potential current beneficiary of the ESBT for the 2-year period during which such trust would be permitted as a shareholder.

(D) For the purposes of paragraph (m)(4)(iv)(C) of this section, a trust will be deemed to be described in section 1361(c)(2)(A) if such trust would qualify for a QSST election under section 1361(d) or an ESBT election under section 1361(e) if it owned S corporation stock.

(v) *Contingent distributions*. A person who is entitled to receive a distribution only after a specified time or upon the occurrence of a specified event (such as the death of the holder of a power of appointment) is not a potential current beneficiary until such time or the occurrence of such event.

(vi) *Currently exercisable powers of appointment*—(A) *In general*. A person to whom a distribution is or may be made during a period pursuant to a power of appointment is a potential current beneficiary. Thus, if any person has a lifetime power of appointment that would permit distributions from the trust to be made to more than 75 persons, the corporation's S corporation election will terminate because the number of potential current beneficiaries will exceed the 75-shareholder limit of section 1361(b)(1)(A). Also, the S corporation election will terminate if the currently exercisable power of appointment allows distributions to be made to an ineligible shareholder as defined in section 1361(b)(1)(B) and (C).

(B) *Waiver or release*. If the holder of a power of appointment permanently releases the power in a manner that is valid under applicable local law, the persons that would be potential current beneficiaries solely because of the power will not be potential current beneficiaries after the effective date of the release. An attempt to temporarily waive, release, or limit a currently exercisable power of appointment will be ignored in determining who are potential current beneficiaries of the trust.

(vii) *Number of shareholders*. Each potential current beneficiary of the ESBT, as defined in paragraphs (m)(4)(i) through (vi) of this section, is counted as a shareholder of any S corporation whose stock is owned by the ESBT. During any period in which the ESBT has no potential current beneficiaries, the ESBT is counted as the shareholder. A person is counted as only one shareholder of an S corporation even though that person may be treated as a shareholder of the S corporation by direct ownership and through one or more eligible trusts described in section 1361(c)(2)(A). Thus, for example, if a person owns stock in an S corporation and is a potential current beneficiary of an ESBT that owns stock in the same S corporation, that person is counted as one shareholder of the S corporation. Similarly, if a husband owns stock in an S corporation and his wife is a potential current beneficiary of an ESBT that owns stock in the same S corporation, the husband and wife will be counted as one shareholder of the S corporation.

(viii) *Miscellaneous*. Payments made by an ESBT to a third party on behalf of a beneficiary are considered to be payments made directly to the beneficiary. The right of a beneficiary to assign the beneficiary's interest to a third party does not result in the third party being a potential current beneficiary until that interest is actually assigned.

(5) *ESBT terminations*—(i) *Ceasing to meet ESBT requirements*. A trust ceases to be an ESBT on the first day the trust fails to meet the definition of an ESBT under section 1361(e). The last day the trust is treated as an ESBT is the day before the date on which the trust fails to meet the definition of an ESBT.

(ii) *Disposition of S stock*. In general, a trust ceases to be an ESBT on the first day following the day the trust disposes of all S corporation stock. However, if the trust is using the installment method to report income from the sale or disposition of its stock in an S corporation, the trust ceases to be an ESBT on the day following the earlier of the day the last installment payment is received by the trust or the day the trust disposes of the installment obligation.

(iii) *Potential current beneficiaries that are ineligible shareholders*. If a potential current beneficiary of an ESBT is not an eligible shareholder of a small business corporation within the meaning of section 1361(b)(1), the S corporation election terminates. For example, the S corporation election will terminate if a nonresident alien becomes a potential current beneficiary of an ESBT. Such a potential current beneficiary is treated as an ineligible shareholder beginning on the day such person becomes a potential current beneficiary, and the S corporation election terminates on that date. However, see the special rule of paragraph (m)(4)(iii) of this section. If the S corporation election terminates, relief may be available under section 1362(f).

(6) *Revocation of ESBT election*. An ESBT election may be revoked only with the consent of the Commissioner. The application for consent to revoke the election must be submitted to the Internal Revenue Service in the form of a letter

ruling request under the appropriate revenue procedure.

(7) *Converting an ESBT to a QSST*. For a trust that seeks to convert from an ESBT to a QSST, the consent of the Commissioner is hereby granted to revoke the ESBT election as of the effective date of the QSST election, if all the following requirements are met:

(i) The trust meets all of the requirements to be a QSST under section 1361(d).

(ii) The trustee and the current income beneficiary of the trust sign the QSST election. The QSST election must be filed with the service center where the S corporation files its income tax return. This QSST election must state at the top of the document "ATTENTION ENTITY CONTROL—CONVERSION OF AN ESBT TO A QSST PURSUANT TO SECTION 1.1361–1(m)" and include all information otherwise required for a QSST election under § 1.1361–1(j)(6). A separate QSST election must be made with respect to the stock of each S corporation held by the trust.

(iii) The trust has not converted from a QSST to an ESBT within the 36-month period preceding the effective date of the new QSST election.

(iv) The date on which the QSST election is to be effective cannot be more than 15 days and two months prior to the date on which the election is filed and cannot be more than 12 months after the date on which the election is filed. If an election specifies an effective date more than 15 days and two months prior to the date on which the election is filed, it will be effective on the day that is 15 days and two months prior to the date on which it is filed. If an election specifies an effective date more than 12 months after the date on which the election is filed, it will be effective on the day that is 12 months after the date it is filed.

(8) *Examples*. The provisions of this paragraph (m) are illustrated by the following examples in which it is assumed, unless otherwise specified, that all noncorporate persons are citizens or residents of the United States:

Example 1. (i) *ESBT election with section 663(c) separate shares*. On January 1, 2003, *M* contributes S corporation stock to Trust for the benefit of *M*'s three children *A*, *B*, and *C*. Pursuant to section 663(c), each of Trust's separate shares for *A*, *B*, and *C* will be treated as separate trusts for purposes of determining the amount of distributable net income (DNI) in the application of sections 661 and 662. On January 15, 2003, the trustee of Trust files a valid ESBT election for Trust effective January 1, 2003. Trust will be treated as a single ESBT and will have a single S portion taxable under section 641(c).

(ii) *ESBT acquires stock of an additional S corporation*. On February 15, 2003, Trust acquires stock of an additional S corporation. Because Trust is already an ESBT, Trust does not need to make an additional ESBT election.

(iii) *Section 663(c) shares of ESBT convert to separate QSSTs*. Effective January 1, 2004, *A*, *B*, *C*, and Trust's trustee elect to convert each separate share of Trust into a separate QSST pursuant to paragraph (m)(7) of this section. For each separate share, they file a separate election for each S corporation whose stock is held by Trust. Each separate share will be treated as a separate QSST.

Example 2. (i) *Invalid potential current beneficiary*. Effective January 1, 2003, Trust makes a valid ESBT election. On January 1, 2004, *A*, a nonresident alien, becomes a potential current beneficiary of Trust. Trust does not dispose of all of its S corporation stock within 60 days after January 1, 2004. As of January 1, 2004, *A* is a potential current beneficiary of Trust and therefore is treated as a shareholder of the S corporation. Because *A* is not an eligible shareholder of an S corporation under section 1361(b)(1), the S corporation election of any corporation in which Trust holds stock terminates effective January 1, 2004. Relief may be available under section 1362(f).

(ii) *Invalid potential current beneficiary and disposition of S stock*. Assume the same facts as in *Example 2* (i) except that within 60 days after January 1, 2004, trustee of Trust disposes of all Trust's S corporation stock. *A* is not considered a potential current beneficiary of Trust and therefore is not treated as a shareholder of any S corporation in which Trust previously held stock.

Example 3. Subpart E trust. M transfers stock in *X*, an S corporation, and other assets to Trust for the benefit of *B* and *B*'s siblings. *M* retains no powers or interest in Trust. Under section 678(a), *B* is treated as the owner of a portion of Trust that includes a portion of the *X* stock. No beneficiary has acquired any portion of his or her interest in Trust by purchase, and Trust is not an ineligible trust under paragraph (m)(1)(iv) of this section. Trust is eligible to make an ESBT election.

Example 4. Subpart E trust continuing after grantor's death. On January 1, 2003, *M* transfers stock in *X*, an S corporation, and other assets to Trust. Under the terms of Trust, the trustee of Trust has complete discretion to distribute the income or principal to *M* during *M*'s lifetime and to *M*'s children upon *M*'s death. During *M*'s life, *M* is treated as the owner of Trust under section 677. The trustee of Trust makes a valid election to treat Trust as an ESBT effective January 1, 2003. On March 28, 2004, *M* dies. Under applicable local law, Trust does not terminate on *M*'s death. Trust continues to be an ESBT after *M*'s death, and no additional ESBT election needs to be filed for Trust after *M*'s death.

Example 5. Potential current beneficiaries and distributee trust holding S corporation stock. Trust-1 has a valid ESBT election in effect. The trustee of Trust-1 has the power to make distributions to *A* directly or to any trust created for the benefit of *A*. On January 1, 2003, *M* creates Trust-2 for the benefit of *A*. Also on January 1, 2003, the trustee of Trust-1 distributes some S corporation stock to Trust-2. *A*, as the current income beneficiary of Trust-2, makes a timely and effective election to treat Trust-2 as a QSST. Because Trust-2 is a valid S corporation shareholder, the distribution to Trust-2 does not terminate the ESBT election of Trust-1. Trust-2 itself will not be counted toward the 75-shareholder limit of section 1361(b)(1)(A). Additionally, because *A* is already counted as an S corporation shareholder because of *A*'s status as a potential current income beneficiary of Trust-1, *A* is not counted again by reason of *A*'s status as the deemed owner of Trust-2.

Example 6. Potential current beneficiaries and distributee trust not holding S corporation stock. (i) *Distributee trust that would itself qualify as an ESBT*. Trust-1 holds stock in *X*, an S corporation, and has a valid ESBT election in effect. Under the terms of Trust-1, the trustee has discretion to make distributions to *A*, *B*, and Trust-2, a trust for the benefit of *C*, *D*, and *E*. Trust-2 would qualify to be an ESBT, but it owns no S corporation stock and has made no ESBT election. Under paragraph (m)(4)(iv) of this section, Trust-2's potential current beneficiaries are treated as the potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1). Thus, *A*, *B*, *C*, *D*, and *E* are potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1). Trust-2 itself will not be counted as a shareholder of Trust-1 for purposes of section 1361(b)(1).

(ii) *Distributee trust that would not qualify as an ESBT or a QSST*. Assume the same facts as in paragraph (i) of this *Example 6* except that *D* is a nonresident alien. Trust-2 would not be eligible to make an ESBT or QSST election if it owned S corporation stock and therefore Trust-2 is a potential current beneficiary of Trust-1. Since Trust-2 is not an eligible shareholder, *X*'s S corporation election terminates.

(iii) *Distributee trust that is a section 1361(c)(2)(A)(ii) trust*. Assume the same facts as in paragraph (i) of this *Example 6* except that Trust-2 is a trust treated as owned by *A* under section 676 because *A* has the power to revoke Trust-2 at any time prior to *A*'s death. On January 1, 2003, *A* dies. Because Trust-2 is a trust described in section 1361(c)(2)(A)(ii) during the 2-year period beginning on the day of *A*'s death, under paragraph (m)(4)(iv)(C) of this section, Trust-2's only potential current beneficiary is the person listed in section 1361(c)(2)(B)(ii), *A*'s estate. Thus, *B* and *A*'s estate are potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1).

Example 7. Potential current beneficiaries and powers of appointment. *M* creates Trust for the benefit of *A*. *A* also has a currently exercisable power to appoint income or principal to anyone except *A*, *A*'s creditors, *A*'s estate, and the creditors of *A*'s estate. The potential current beneficiaries of Trust will be *A* and all other persons except for *A*'s creditors, *A*'s estate, and the creditors of *A*'s estate. This number will exceed the 75-shareholder limit of section 1361(b)(1)(A). If Trust holds S corporation stock, the corporation's S election will terminate.

(9) *Effective date*. This paragraph (m) is applicable for taxable years of ESBTs beginning on and after May 14, 2002.

Par. 7. Section 1.1362–6 is amended by revising paragraph (b)(2)(iv) to read as follows:

§ 1.1362–6 Election and consents.

* * * * *

(b) * * *

(2) * * *

(iv) *Trusts*. In the case of a trust described in section 1361(c)(2)(A) (including a trust treated under section 1361(d)(1)(A) as a trust described in section 1361(c)(2)(A)(i) and excepting an electing small business trust described in section 1361(c)(2)(A)(v) (ESBT)), only the person treated as the shareholder for purposes of section 1361(b)(1) must consent to the election. When stock of the corporation is held by a trust, both husband and wife must consent to any election if the husband and wife have a community interest in the trust property. See paragraph (b)(2)(i) of this section for rules concerning community interests in S corporation stock. In the case of an ESBT, the trustee and the owner of any portion of the trust that consists of the stock in one or more S corporations under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code must consent to the S corporation election. If there is more than one trustee, the trustee or trustees with authority to legally bind the trust must consent to the S corporation election.

* * * * *

Par. 8. Section 1.1362–7 is amended by:

1. Revising the section heading.

2. Adding a sentence to the end of paragraph (a).

The revision and addition read as follows:

§ 1.1362–7 Effective dates.

(a) * * * Section 1.1362–6(b)(2)(iv) is applicable for taxable years beginning on and after May 14, 2002.

* * * * *

Par. 9. Section 1.1377–0 is amended by adding an entry for § 1.1377–1(a)(2)(iii) to read as follows:

§ 1.1377–0 Table of contents.

* * * * *

§ 1.1377–1 Pro rata share.

(a) * * * (2) * * *

(iii) Shareholder trust conversions.

* * * * *

Par. 10. Section 1.1377–1 is amended by:

1. Adding paragraph (a)(2)(iii).

2. Adding *Example 3* to paragraph (c).

The additions read as follows:

§ 1.1377–1 Pro rata share.

(a) * * *

(2) * * *

(iii) *Shareholder trust conversions*. If, during the taxable year of an S corporation, a trust that is an eligible shareholder of the S corporation converts from a trust described in section 1361(c)(2)(A)(i), (ii), (iii), or (v) for the first part of the year to a trust described in a different subpart of section 1361(c)(2)(A)(i), (ii), or (v) for the remainder of the year, the trust's share of the S corporation items is allocated between the two types of trusts. The first day that a qualified subchapter S trust (QSST) or an electing small business trust (ESBT) is treated as an S corporation shareholder is the effective date of the QSST or ESBT election. Upon the conversion, the trust is not treated as terminating its entire interest in the S corporation for purposes of paragraph (b) of this section, unless the trust was a trust described in section 1361(c)(2)(A)(ii) or (iii) before the conversion.

* * * * *

(c) * * *

Example 3. Effect of conversion of a qualified subchapter S trust (QSST) to an electing small business trust (ESBT). (i) On January 1, 2003, Trust receives stock of S corporation. Trust's current income beneficiary makes a timely QSST election under section 1361(d)(2), effective January 1, 2003. Subsequently, the trustee and current income beneficiary of Trust elect, pursuant to § 1.1361–1(j)(12), to terminate the QSST election and convert to an ESBT, effective July 1, 2004. The taxable year of S corporation is the calendar year. In 2004, Trust's *pro rata* share of S corporation's nonseparately computed income is $100,000.

(ii) For purposes of computing the income allocable to the QSST and to the ESBT, Trust is treated as a QSST through June 30, 2004, and Trust is treated as an ESBT beginning July 1, 2004. Pursuant to section 1377(a)(1), the *pro rata* share of S corporation income allocated to the QSST is $49,727 ($100,000 x 182 days/366 days), and the *pro rata* share of S corporation income allocated to the ESBT is $50,273 ($100,000 x 184 days/366 days).

Par. 11. Section 1.1377–3 is revised to read as follows:

§ 1.1377–3 Effective dates.

Section 1.1377–1 and 1.1377–2 apply to taxable years of an S corporation beginning after December 31, 1996, except that § 1.1377–1(a)(2)(iii), and (c) *Example 3* are applicable for taxable years beginning on and after May 14, 2002.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 12. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 13. In § 602.101, paragraph (b) is amended by adding an entry for 1.444–4 and revising the entry for 1.1361–1 in numerical order to the table to read as follows:

§ 602.101 OMB Control numbers

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.444–4	1545–1591
* * * * *	
1.1361–1	1545–0731 1545–1591
* * * * *	

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved May 3, 2002.

Pamela F. Olson,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on May 13, 2002, 8:45 a.m., and published in the issue of the Federal Register for May 14, 2002, 67 F.R. 34388)

Part III. Administrative, Procedural, and Miscellaneous

Partnership Transactions Involving Long-term Contracts

Notice 2002–37

The Internal Revenue Service (IRS) and the Treasury Department (Treasury) intend to publish regulations addressing partnership transactions involving contracts accounted for under a long-term contract method of accounting.

BACKGROUND

Concurrently with this Notice, the IRS and Treasury are issuing final regulations under § 460 of the Internal Revenue Code to address a mid-contract change in taxpayer engaged in completing a contract accounted for under a long-term contract method of accounting. In general, the regulations divide the rules regarding a mid-contract change in taxpayer engaged in completing this type of contract into two categories—constructive completion transactions and step-in-the-shoes transactions. The regulations provide that a transfer described in § 721(a) of a long-term contract to a partnership and a transfer of a partnership interest are step-in-the-shoes transactions. The IRS and Treasury intend to publish regulations addressing these and other partnership transactions involving contracts accounted for under a long-term contract method of accounting. This Notice describes the special rules that will apply to such transactions.

DESCRIPTION OF REGULATIONS RELATING TO PARTNERSHIPS

The IRS and Treasury believe that step-in-the-shoes treatment generally is appropriate for contributions of contracts to partnerships in transactions subject to § 721(a). Accordingly, the contribution of a contract accounted for under a long-term contract method of accounting to a partnership in a transaction subject to § 721(a) is a step-in-the-shoes transaction.

The regulations will require a partner that contributes a contract accounted for under a long-term contract method of accounting to a partnership to increase the basis of the partnership interest by the amount of gross receipts that the partner has recognized with respect to the contract, and reduce the basis of the partnership interest by the amount of gross receipts the partner has received or reasonably expects to receive under the contract. However, the partner may not reduce the basis of the partnership interest below zero, but must recognize income to the extent that the basis of the partnership interest would be reduced below zero. The regulations will provide that, in applying a long-term contract method of accounting to the contributed contract, the partnership must reduce its total contract price (or gross contract price) by the amount of income recognized by the contributing partner. These rules follow provisions in the final mid-contract change in taxpayer regulations regarding transfers of long-term contracts in certain corporate transactions qualifying for step-in-the-shoes treatment.

Section 704(c) generally provides that income, gain, loss, or deduction attributable to property that is contributed to a partnership must be allocated to the contributing partner. The purpose of § 704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss. The regulations will apply § 704(c) principles to income or loss attributable to a contributed contract accounted for under a long-term contract method of accounting. The amount of income or loss subject to § 704(c) will be (i) the amount that would be taken into account (under the constructive completion rules) if, immediately before the contribution of the contract to the partnership, the partner disposed of the contract for its fair market value in a fully taxable transaction, reduced by (ii) the amount of income, if any, that the partner is required to recognize as a result of the contribution. The regulations will provide additional guidance on the manner of applying § 704(c) to income or loss from a contributed contract. The regulations will provide that for periods prior to the date that the regulations are published, taxpayers must apply § 704(c) to such income or loss in any manner that reasonably accounts for the § 704(c) income or loss over the life of the contract.

Section 741 provides that gain or loss recognized on the sale or exchange of an interest in a partnership shall be considered as gain or loss from a capital asset, except as provided in § 751. Section 751(a) provides that the amount of any money, or the fair market value of any property, received by a transferor partner in exchange for all or any part of the partner's interest in the partnership attributable to unrealized receivables (as defined in § 751(c)) or inventory items (as defined in § 751(d)) of the partnership shall be considered as an amount realized from the sale or exchange of property other than a capital asset. In Rev. Rul. 79–51, 1979–1 C.B. 225, the IRS ruled that where a partner sold the partner's entire interest in a partnership, amounts received in exchange for the partner's interest attributable to the value at the time of sale of the partnership's partially completed contracts, the income from which was being accounted for on the completed contract method, were taxed under § 751(a).

The transfer of an interest in a partnership engaged in a contract accounted for under a long-term contract method of accounting is a step-in-the-shoes transaction. The regulations will provide that contracts accounted for under a long-term contract method of accounting are unrealized receivables within the meaning of § 751(c). The amount of ordinary income or loss attributable to a contract under the regulations will be the amount of income or loss that the partnership would take into account (under the constructive completion rules) if, at the time of a transfer of a partnership interest or a distribution to a partner (as the case may be), the partnership disposed of the contract for its fair market value in a fully taxable transaction.

The IRS and the Treasury do not believe that step-in-the-shoes treatment is appropriate for distributions of long-term contracts by a partnership to a partner in a transaction subject to § 731(a). In these transactions, a step-in-the-shoes rule may not produce appropriate results if the partner's basis in the contract (including the

uncompleted property, if applicable) that is distributed by a partnership is not equal to the partnership's basis in the contract (including the uncompleted property, if applicable). The regulations will provide that a distribution of a contract accounted for under a long-term contract method of accounting by a partnership to a partner is a constructive completion transaction. In determining the partnership's income on the constructive completion transaction under § 1.460–4(k)(2), the fair market value of the contract will be treated as the amount paid for the contract.

Section 751(b)(1) provides that to the extent a partner receives in a distribution — (A) partnership property which is (i) unrealized receivables or (ii) inventory items which have appreciated substantially in value, in exchange for all or a part of the partner's interest in other partnership property (including money), or (B) partnership property (including money) other than property described in § 751(b)(1)(A)(i) or (ii) in exchange for all or part of the partner's interest in partnership property described in § 751 (b)(1)(A)(i) or (ii), the transaction shall be considered a sale or exchange of the property between the distributee partner and the partnership. Because the distribution of a contract accounted for under a long-term contract method of accounting is treated as a constructive completion transaction, a distribution of the contract causes the partnership to recognize all of the ordinary income or loss attributable to the contract. Although no income or loss remains in the contract after the constructive completion, the partnership may hold other assets that may cause § 751(b) to apply. Therefore, the regulations will require a partnership that distributes a contract accounted for under a long-term contract method of accounting to apply the constructive completion rules before applying the rules of § 751(b) to the distribution.

Where a partnership that holds a contract accounted for under a long-term contract method of accounting makes a distribution to a partner that has the effect of reducing that partner's share of ordinary income or loss from the contract, the regulations generally will not require a constructive completion of the entire contract. However, consistent with the general principles of subchapter K, § 751(b) may apply to such a transaction.

Section 732 determines the basis of property (other than money) distributed by a partnership to a partner. Section 734(b) provides for an adjustment to the basis of partnership property as a result of certain distributions from partnerships that have a § 754 election in effect. The regulations will provide that if a contract accounted for under a long-term contract method of accounting is distributed to a partner, then for purposes of determining the partner's basis in the contract (including the uncompleted property, if applicable) under § 732, and the amount of any basis adjustment under § 734(b), the partnership's basis in the contract (including the uncompleted property, if applicable) immediately prior to the distribution will be the partnership's allocable contract costs (including transaction costs), increased (or decreased) by the amount of income (or loss) recognized by the partnership on the contract through the date of the distribution (including amounts recognized as a result of the constructive completion), and decreased by the amounts that the partnership has received or reasonably expects to receive under the contract.

In addition, the regulations will provide that if a contract accounted for under a long-term contract method of accounting is distributed to a partner, then, in computing the total contract price for the new contract under § 1.460–4(k)(2)(iii), the partner's basis in the contract (including the uncompleted property, if applicable) after the distribution (as determined under § 732) will be deemed to be the consideration paid by the partner for the contract. Thus, the total contract price of the new contract will be reduced by the partner's basis in the contract (including the uncompleted property, if applicable) immediately after the distribution.

EFFECTIVE DATES

The regulations will be effective for contributions of long-term contracts to partnerships, distributions by partnerships engaged in long-term contracts, and transfers of interests in partnerships that are engaged in long-term contracts occurring on or after May 15, 2002.

REQUEST FOR PUBLIC COMMENT

Comments are requested on the scope and substance of the regulations. Direct all written comments to Internal Revenue Service, Attn: CC:ITA:RU (NT 2002–37), Room 5226, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, comments may be hand delivered Monday through Friday between the hours of 8:00 a.m. and 5:00 p.m. to: CC:ITA:RU (NT 2002–37), Courier's desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or submitted electronically to: *Notice.Comments@m1.irs.counsel.treas.gov*. Please submit all comments by August 12, 2002. All submissions will be open to public inspection.

DRAFTING INFORMATION

The principal author of this Notice is Richard T. Probst of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from Treasury and the IRS participated in its development. For further information regarding this Notice, contact Mr. Probst at (202) 622–3060 (not a toll-free call).

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26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.
(Also Part I, § 172.)

Rev. Proc. 2002–40

SECTION 1. PURPOSE

.01 The Job Creation and Worker Assistance Act of 2002 (the Act) added § 172(b)(1)(H) to the Internal Revenue Code to provide a 5-year carryback period for net operating losses (NOLs) for any taxable year ending during 2001 and 2002. Pub. L. No. 107–147, § 102(a), 116 Stat. 21 (March 9, 2002). Consistent with the intent of Congress as reflected in correspondence to the Treasury Department subsequent to the Act's enactment, this revenue procedure provides qualifying taxpayers who filed returns for a taxable year ending during 2001 and 2002 without taking advantage of the new 5-year carryback with a limited opportunity to

do so and to apply for a tentative carryback adjustment if they act on or before October 31, 2002.

.02 Specifically, this revenue procedure allows taxpayers that incurred an NOL in a taxable year ending during 2001 or 2002 and elected under § 172(b)(3) to forgo the NOL carryback period to revoke their elections in order to apply the 5-year carryback period. This revenue procedure also allows such taxpayers, as well as taxpayers who used a 2-year carryback period for an NOL in a taxable year ending during 2001 or 2002, to file an application for a tentative carryback adjustment under § 6411(a) based on a 5-year NOL carryback period even if the 12-month period for filing such an application has expired. A revocation and/or application for tentative carryback adjustment under this revenue procedure must be made on or before October 31, 2002. Finally, this revenue procedure allows taxpayers that filed returns for a taxable year ending in 2001 or 2002, and who neither elected to forgo the carryback period, nor used the 2-year carryback period, to elect to relinquish the 5-year carryback period (and thereby retain the ability to use the 2-year carryback period) if they act on or before October 31, 2002.

.03 In connection with these rules allowing taxpayers to reevaluate options regarding the carryback period, the Internal Revenue Service and Treasury Department intend to provide relief for consolidated groups that failed to waive the portion of the carryback period for consolidated net operating losses attributable to certain acquired members for which such members were members of another group. The scope of such relief will be announced shortly in separate guidance.

SECTION 2. BACKGROUND

.01 Section 172(b)(1)(A)(i) generally provides that an NOL for any taxable year must be carried back to each of the 2 years preceding the taxable year of such NOL. Section 172(b)(3) provides that any taxpayer entitled to a carryback period under § 172(b)(1) may elect to relinquish the carryback period with respect to an NOL for any taxable year.

.02 Section 102 of the Act amended § 172 of the Code in two respects. First, § 172(b)(1)(H) was added to allow a 5-year carryback period for NOLs for any taxable year ending during 2001 and 2002. Second, § 172(j) was added to allow any taxpayer entitled to the 5-year carryback under § 172(b)(1)(H) from any loss year to elect to relinquish that carryback period with respect to an NOL for any taxable year. A taxpayer making this election generally must apply the 2-year carryback period set forth in § 172(b)(1)(A)(i).

.03 An election to relinquish either the NOL carryback period in general under § 172(b)(3), or just the 5-year carryback period under § 172(j), must be made by the due date (including extensions) for filing the taxpayer's return for the taxable year of the NOL and in the manner prescribed by the Secretary.

.04 Section 6411(a) provides that a taxpayer may file an application for a tentative carryback adjustment of the tax for the prior taxable year affected by an NOL carryback from any taxable year. Section 6411(a) also provides that the application must be filed on or after the date of filing for the return for the taxable year of the NOL from which the carryback results and within a period of 12 months after such taxable year or, with respect to any portion of a business credit carryback attributable to an NOL from a subsequent taxable year, within a period of 12 months from the end of such subsequent taxable year. Section 6411(b) provides a 90-day period during which the Service will make a limited examination of the application to discover omissions and errors of computation and determine the amount of the decrease in tax attributable to the carryback. The Service may disallow, without further action, any application that contains errors of computation that cannot be corrected within the 90-day period or that contains material omissions. The decrease in tax attributable to the carryback will be applied against unpaid amounts of tax. Any remainder of the decrease will, within the 90-day period, be credited or refunded.

.05 It has been brought to the attention of the Service and Treasury Department that some taxpayers that incurred an NOL in a taxable year ending during 2001 filed returns before the Act became law and either elected under § 172(b)(3) to relinquish the NOL carryback period in general or applied the 2-year carryback period. In some cases, these taxpayers might have wished to take advantage of the 5-year carryback period, had they been aware of its availability, and apply for a tentative carryback adjustment. The Chairmen and Ranking Members of both the House Ways and Means Committee and the Senate Finance Committee have advised the Treasury Department of their intent that qualifying taxpayers be allowed to take advantage of the 5-year NOL carryback period to the maximum extent possible, and that they intend to pursue technical corrections legislation that will clarify this intent. Specifically, the technical corrections legislation will allow the Service to issue guidance to allow taxpayers to reconsider a previous election under § 172(b)(3) to relinquish the NOL carryback period in general, and to file an application for a tentative carryback adjustment under § 6411(a), to take advantage of the 5-year carryback period, on or before October 31, 2002. When enacted, this legislation will be effective as if originally included in the Act. This revenue procedure describes how the Service is taking into account Congressional intent in administering the provision.

SECTION 3. SCOPE

This revenue procedure applies to taxpayers that incurred an NOL for any taxable year ending in 2001 or 2002.

SECTION 4. TAXPAYERS THAT ELECTED TO FORGO THE CARRYBACK PERIOD

.01 In order to give effect to the intent of Congress to allow taxpayers a 5-year NOL carryback period, any taxpayer that previously elected under § 172(b)(3) to forgo the carryback period for an NOL for any taxable year ending in 2001 or 2002 may revoke such election in order to apply the 5-year carryback period by following the procedures of section 7 of this revenue procedure on or before October 31, 2002. Any revocation of the election to forgo the NOL carryback period will also apply to a carryback of any alternative tax NOL for the same taxable year.

.02 If a taxpayer that previously elected under § 172(b)(3) to forgo the carryback period for an NOL incurred in a taxable year ending in 2001 or 2002 does

not want to revoke that election in order to use the 5-year carryback period provided by § 172(b)(1)(H), the taxpayer need not file any additional form or statement. Unless the taxpayer follows the procedures set forth in section 7 of this revenue procedure, the taxpayer's previous election applies as well to forgo the 5-year carryback period.

SECTION 5. TAXPAYERS THAT APPLIED THE 2-YEAR CARRYBACK PERIOD

.01 If a taxpayer that previously filed an application for a tentative carryback adjustment (whether or not the Service has acted upon such application) or an amended return using a 2-year carryback period for an NOL incurred in a taxable year ending in 2001 or 2002, and that did not elect to forgo the 5-year carryback period under § 172(j), wants to use the 5-year carryback provided under § 172 (b)(1)(H), the taxpayer may do so by following the procedures of section 7 of this revenue procedure on or before October 31, 2002. Any amendment of a prior refund claim will also apply to a carryback of any alternative tax NOL for the same taxable year. In the case of an amended application for a tentative carryback adjustment, the 90-day period described in § 6411(b) will begin on the date the amended declaration is filed.

.02 If a taxpayer that previously filed an application for a tentative carryback adjustment or an amended return using a 2-year carryback period for an NOL incurred in a taxable year ending in 2001 or 2002 prefers to apply the 2-year carryback period, rather than the 5-year carryback period provided under § 172(b)(1)(H), the taxpayer need not file any form or statement in order to satisfy the requirements for an election under § 172 (j) to forgo the 5-year carryback period. Unless the taxpayer follows the procedures of section 7 of this revenue procedure, the taxpayer will be considered to have made an election under § 172(j) to forgo the 5-year carryback period in favor of the 2-year carryback period.

SECTION 6. TAXPAYERS THAT NEITHER ELECTED TO FORGO THE CARRYBACK PERIOD NOR APPLIED THE 2-YEAR CARRYBACK PERIOD

.01 Any taxpayer that:

(1) filed a federal income tax return for a taxable year ending in 2001 or 2002;

(2) did not elect under § 172(b)(3) to forgo the carryback period in general for an NOL incurred in such taxable year; and

(3) did not previously file an application for a tentative carryback adjustment or an amended return using a 2-year carryback period for such NOL, may apply the 2-year carryback period, in lieu of the 5-year carryback period, by following the procedures of section 7 of this revenue procedure on or before October 31, 2002.

.02 For any taxpayer described in section 6.01 of this revenue procedure that does not follow the procedures of section 7 of this revenue procedure to apply the 2-year carryback period, the 5-year carryback period will apply by operation of law. In that event, the period of limitations provided in § 6511 will apply in the case of any claim for refund on an amended return, and the period provided in § 6411(a) will apply in the case of any tentative carryback adjustment, that is based on the 5-year carryback period.

SECTION 7. PROCEDURES

.01 *What to File*. A taxpayer described in section 4 or 5 of this revenue procedure that wants to use the 5-year carryback period must file the appropriate form(s) using a 5-year carryback period. A taxpayer described in section 6 of this revenue procedure that wants to relinquish the 5-year carryback period (and thus retain its ability to use the 2-year carryback period) must file the appropriate form(s) using a 2-year carryback period, even if no refund or change in tax liability is shown on the form(s). The appropriate form(s) are:

(1) for corporations, a Form 1139, *Corporation Application for Tentative Refund*, or Form 1120X, *Amended U.S. Corporation Income Tax Return*;

(2) for individuals, a Form 1045, *Application for Tentative Refund*, or Form 1040X, *Amended U.S. Individual Income Tax Return*; and

(3) for estates or trusts, a Form 1045, or amended Form 1041, *U.S. Income Tax Return for Estates and Trusts*.

.02 *Labels*. Taxpayers described in section 4.01 of this revenue procedure should type or print across the top of the appropriate form "Revocation of NOL carryback waiver pursuant to Rev. Proc. 2002–40." Taxpayers described in section 5.01 of this revenue procedure should type or print across the top of the appropriate form "Amended refund claim pursuant to Rev. Proc. 2002–40."

.03 *When to File*. Any form filed pursuant to this revenue procedure must be filed on or before October 31, 2002.

SECTION 8. EFFECTIVE DATE

This revenue procedure is effective for NOLs arising in taxable years ending after December 31, 2000.

DRAFTING INFORMATION

The principal author of this revenue procedure is Martin Scully, Jr. of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Scully at (202) 622–4960 (not a toll-free call).

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26 CFR 1.62–2: Reimbursements and other expense allowance arrangements.
(Also Part I, § 62.)

Rev. Proc. 2002–41

The purpose of this revenue procedure is to provide an optional expense substantiation rule so that businesses in the pipeline construction industry can provide reimbursements under an accountable plan to employees who also furnish welding rigs or mechanics rigs as part of their performance of services as employees. This revenue procedure is not intended to suggest that all workers providing such services and equipment are employees. Rather, the method in this revenue procedure may be applied when businesses choose to use an accountable plan to reimburse individuals who are employees for rig-related expenses incurred as employees.

As part of the Industry Issue Resolution Pilot Program, announced in Notice 2000–65, representatives of the pipeline construction industry requested clarification of the proper treatment of amounts paid to employee welders and heavy equipment mechanics who provide heavy equipment in connection with the performance of services. At issue was whether the amounts should be treated as payments of rent, payments of wages, or as the reimbursement of expenses subject to the accountable plan requirements.

Employers in the pipeline construction industry encounter several challenges to reimbursing under an accountable plan the costs relating to employee-provided welding rigs and mechanics rigs, particularly in determining the proper amount of the expense incurred. Rig welders and heavy equipment mechanics work for multiple companies for relatively short periods. Therefore, the proper allocation of fixed costs related to the equipment among employers is unclear. Moreover, although the rigs are mobile, the existing mileage-based expense substantiation provision does not accurately reflect rig-related costs because rigs are used primarily while stationary. Further, these employees incur substantial expenses as employees in providing these rigs as a condition of employment. Due to these unique features, reimbursing employees for rig-related expenses under the existing accountable plan requirements is unworkable for this industry. In order to enable this industry to reimburse rig-related expenses to employees under an accountable plan, this revenue procedure provides an optional expense substantiation rule under which rig-related expenses may be treated as substantiated when reimbursing these expenses under an accountable plan.

Under this revenue procedure an employer may pay certain welders and heavy equipment mechanics an amount of up to $13 per hour for rig-related expenses that is deemed substantiated under an accountable plan when paid in accord with this revenue procedure (up to $8 per hour if the employer provides fuel or otherwise reimburses fuel expenses). This revenue procedure provides for an annual inflation adjustment to these amounts after 2003, if necessary and is effective for payments made on or after January 1, 2003. The rules are provided in Questions and Answers below.

The Service recognizes that employers in other industries may similarly provide payments to employees for the costs of providing equipment as employees used in the performance of services as employees. To the extent that the unique features of other industries creates similar challenges to implementing accountable plans, the Service welcomes comments regarding the appropriateness and design of similar relief. We specifically request comments concerning other categories of qualified nonpersonal use vehicles owned by employees and used by the employees in the course of providing services as employees, especially where the nature of an industry results in employees working for multiple employers during each year, for which a deemed substantiation rule would be appropriate.

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SECTION 1. PURPOSE AND SCOPE

Q-1. Must an employer use this revenue procedure to reimburse employees for rig-related expenses?

A-1. No. Use of the rule described in this revenue procedure is not mandatory, and an employer may, outside the scope of this revenue procedure, reimburse actual expenses under an arrangement that meets the accountable plan requirements of § 62(c) of the Internal Revenue Code (Code) and regulations thereunder. Alternatively, an employer may reimburse employee business expenses under a nonaccountable plan (defined in Answer 6), or may choose not to reimburse employee business expenses.

Q-2. What is the tax treatment of amounts deemed substantiated under this revenue procedure?

A-2. If the other requirements described in Answer 5 are satisfied, the amounts substantiated in accordance with this revenue procedure are treated as paid under an accountable plan. Thus, the amounts are not reported as wages on Form W–2 and are exempt from the withholding and payment of income and employment taxes. Also, no return of information (*e.g.*, Form 1099) is required for payments made under an accountable plan. § 1.6041–3(h)(1).

Q-3. Which employers may use the deemed substantiation rule provided in this revenue procedure?

A-3. This substantiation rule may be used by any "eligible employer." An eligible employer is any employer that hires employee rig welders or heavy equipment mechanics and requires, as a condition of employment, that the rig welders and heavy equipment mechanics provide a welding rig or mechanics rig and use the rig in performing services as an employee employed in the construction, repair, or maintenance of transportation mainline pipeline. The business of transportation mainline pipeline construction or repair includes the construction, maintenance, or repair of transportation mainline pipeline up to the first metering station or connection. This includes mainline pipeline whether it transports coal, gas, water, or other transportable materials, vapors, or liquids. The first metering station or connection means the point where a valve, consumer connection, or town border station divides mainline transmission lines or higher pressure lateral and branch lines from lower pressure distribution systems.

Q-4. For which vehicles and equipment may eligible employers use the deemed substantiation rule provided in this revenue procedure?

A-4. Eligible employers may use the deemed substantiation rule in this revenue procedure only to reimburse employees for expenses related to the use of welding rigs and mechanics rigs described in Answer 9.

SECTION 2. BACKGROUND

Q-5. What provisions of the tax law apply when an employer reimburses an employee for employee business expenses?

A-5. The tax rules that apply when an employer reimburses an employee for employee business expenses depend upon whether the reimbursement is made under an accountable plan or nonaccountable plan. An accountable plan is a reimbursement or other expense allowance arrangement that meets three requirements under § 1.62–2: business connection, substantiation, and return of amounts in excess of substantiated expenses. The business connection requirement is satisfied if the arrangement provides advances, allowances or reimbursements only for business expenses allowable as deductions under §§ 161–198 that are paid or incurred by an employee (or that the employer reasonably expects the employee to incur) in connection with the performance of services as an employee. The substantiation requirement is satisfied if the arrangement requires each business expense to be substantiated to the employer within a reasonable period of time. The return of excess requirement is satisfied if the arrangement requires the employee to return to the payor within a reasonable period of time any amount paid under the arrangement in excess of the expenses substantiated. A nonaccountable plan is a reimbursement or other expenses allowance arrangement that does not satisfy one or more of the three requirements.

Q-6. What are the tax consequences to an employee when an employer reimburses expenses under a nonaccountable plan?

A-6. Generally, § 162(a) allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including the trade or business of being an employee. Under § 1.62–2(c)(5), amounts treated as paid under a nonaccountable plan are included in the employee's gross income, must be reported as wages on the employee's Form W–2, and are subject to withholding and payment of income and employment taxes (Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA), and income tax withholding). *See also* Employment Tax Regulations §§ 31.3121(a)–3 (FICA); 31.3306(b)–2 (FUTA); 31.3401(a)–4 (income tax withholding); and Income Tax Regulation § 1.6041–3(h)(1) (return of information exemption) (for exemption from reporting requirements for payments made under an accountable plan before January 1, 2001, see § 1.6041–3(i)(1)). The employee may still deduct the expenses. However, those deductions may

only be claimed as miscellaneous itemized deductions, which are limited by § 67 to the amount exceeding 2 percent of adjusted gross income.

Q-7. What are the tax consequences to an employee when an employer reimburses expenses under an accountable plan?

A-7. Section 1.62–2(c)(4) provides that amounts treated as paid under an accountable plan are excluded from the employee's gross income, are not reported as wages or other compensation on the employee's Form W–2, and are exempt from the withholding and payment of income and employment taxes.

SECTION 3. DEEMED SUBSTANTIATION FOR RIG-RELATED EXPENSES

Q-8. What is the amount of rig-related expenses that can be deemed substantiated under this revenue procedure?

A-8. If an eligible employer either provides fuel or separately reimburses fuel expenses, expenses of up to $8 per hour for welding rigs or mechanics rigs may be deemed substantiated if the other requirements in this revenue procedure are met. If an eligible employer does not provide fuel or separately reimburse fuel expenses, rig-related expenses of up to $13 per hour for welding or mechanics rigs may be deemed substantiated if the other requirements in this revenue procedure are met.

Q-9. For what types of vehicles may rig-related expenses be deemed substantiated?

A-9. Under this revenue procedure, rig-related expenses may be deemed substantiated only with respect to welding rigs and mechanics rigs. For purposes of this revenue procedure, welding rigs are ¾ ton or heavier trucks equipped with a welding machine and other necessary equipment, such as tanks and generators. For purposes of this revenue procedure, mechanics rigs are heavy trucks equipped with a permanently installed mechanics bed and other necessary equipment that is used to repair and maintain heavy machinery on a job site. As explained in Answer 11, mechanics rigs and welding rigs are qualified nonpersonal use vehicles. The rule in this revenue procedure is not available for any other vehicles.

Q-10. May expenses be deemed substantiated for pickup trucks under this revenue procedure?

A-10. No. Expenses for pickup trucks may not be deemed substantiated as rig-related expenses under this revenue procedure unless the pickup truck is part of a welding rig as described in Answer 9. (See Rev. Proc. 2001–54 for rules under which the amount of ordinary and necessary expenses of local travel or transportation incurred by an employee will be deemed substantiated under § 1.274–5 when an employer provides a mileage allowance under an accountable plan.)

Q-11. Are welding rigs and mechanics rigs qualified nonpersonal use vehicles?

A-11. Under the authority of § 1.274–5T(k)(2)(ii)(S), the Commissioner, solely for purposes of applying the deemed substantiation rule in this revenue procedure, designates the welding rigs and mechanics rigs as described in Answer 9 as qualified nonpersonal use vehicles.

Q-12. For which employees may an eligible employer deem rig-related expenses substantiated under this revenue procedure?

A-12. An eligible employer may deem rig-related expenses substantiated only for employee rig welders and heavy equipment mechanics who are required, as a condition of employment, to provide a welding or mechanics rig for use in providing personal services as an employee.

Q-13. Under what circumstances may an eligible employer anticipate that an employee would incur rig-related expenses while performing services as an employee for an eligible employer under the deemed substantiation rule?

A-13. An eligible employer's reimbursement will meet the business connection requirement of § 1.62–2(d) if the eligible employer reasonably anticipates that the employee will incur rig-related expenses in connection with the performance of services for the employer. It would not be reasonable for an eligible employer to anticipate that an employee would incur rig-related expenses for hours that it actually knew the employee's rig was not used (such as during a work stoppage for inclement weather).

Q-14. Will the amount deemed substantiated under this revenue procedure be adjusted for inflation?

A-14. Yes. For calendar years after 2003, the hourly rate will be adjusted annually for inflation under § 1(f)(3), except that the base year for such adjustment will be calendar year 2002 and no adjustment will be made unless the increase is at least one dollar. Any adjustment will be rounded to the nearest dollar. Any adjustment to the rates provided in this revenue procedure will be published annually.

Q-15. May an independent contractor determine deductible expenses under this revenue procedure?

A-15. No. Independent contractors engaged in the trade or business of providing welding services or services as heavy equipment mechanics may not use the deemed substantiation method in this revenue procedure to determine deductible expenses in their trade or business.

SECTION 4. EMPLOYEE TREATMENT OF RIG-RELATED EXPENSES

Q-16. May an employee exclude from income amounts reimbursed and deemed substantiated under this revenue procedure?

A-16. Yes. This is true even if the amounts reimbursed and deemed substantiated exceed the actual rig-related expenses. For example, assume an employee incurs $20,000 in rig-related expenses, and the employer reimburses $20,800 at the $13 per hour rate for welding rigs provided under this revenue procedure. Because the reimbursement was paid under an accountable plan, the entire reimbursement is excluded from the employee's income.

Q-17. May an employee claim deductions for rig-related expenses that exceed amounts reimbursed under an accountable plan or deemed substantiated under this revenue procedure?

A-17. Yes. To the extent employee business expenses exceed those reimbursed under an accountable plan, they may be claimed as miscellaneous itemized deductions on Schedule A. To do this, the employee must report all reimbursed amounts, including those deemed substantiated, and must offset expenses on Form 2106.

Q-18. May an employee treat payments made under a nonaccountable plan as if they were made under an accountable plan by voluntarily substantiating expenses and returning any excess to the employer?

A-18. No. An employee cannot create an accountable plan. Under § 1.62–2(c)(3), if an employer provides a nonaccountable plan, an employee who receives payments under the plan cannot compel the employer to treat the payments as paid under an accountable plan by voluntarily substantiating the expenses or returning any excess to the employer.

Q-19. May an employee deduct any rig-related expenses that exceed those reimbursed by an employer and deemed substantiated under this revenue procedure on Schedule C, Profit or Loss From Business?

A-19. No. Expenses incurred in connection with the trade or business of being an employee may not be deducted on Schedule C.

Q-20. May an employee deduct any rig-related expenses that exceed those reimbursed by an employer and deemed substantiated under this revenue procedure on Schedule E, Supplemental Income and Loss?

A-20. No. Expenses incurred in connection with the trade or business of being an employee may not be deducted on Schedule E.

Q-21. May an employee deduct expenses that an eligible employer has already reimbursed under an accountable plan?

A-21. No.

SECTION 5. SPECIAL RULES FOR EMPLOYERS

Q-22. May an eligible employer establish an accountable plan to reimburse rig welders or heavy equipment mechanics for non-rig-related business expenses?

A-22. Yes. An employer may establish a separate accountable plan to reimburse non-rig-related employee business expenses incurred by rig welders or heavy equipment mechanics in addition to the arrangement provided under this revenue procedure. For example, Rev. Proc. 2001–47 provides rules under which an employer may establish an accountable plan for 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 will be deemed substantiated under § 1.274–54.

Q-23. May an eligible employer substitute a rig-related reimbursement for a portion of wages otherwise payable to an employee?

A-23. This revenue procedure is not intended to permit the recharacterization of wages otherwise payable to an employee. For example, if an employer normally pays an employee $35 per hour in wages and does not provide a rig reimbursement in the event of inclement weather, the employer may not recharacterize a portion of the $35 hourly wage into rig reimbursement during inclement weather. If an employer's reimbursement or other expenses allowance arrangement evidences a pattern of abuse of the accountable plan rules, then all payments made under the arrangement will be treated as paid under a nonaccountable plan.

Q-24. What are the tax consequences if an employer that uses the deemed substantiation rule in this revenue procedure provides an additional reimbursement of rig-related expenses?

A-24. If an employer that uses the deemed substantiation rule separately reimburses an employee for any rig-related expenses, the additional payment is treated as paid under a nonaccountable plan. Thus, the additional payment is reported as wages or other compensation of the employee's Form W–2, and is subject to withholding and payment of income and employment taxes.

For example, employee *A* is reimbursed for rig-related expenses deemed substantiated under this revenue procedure, and *A* incurs expenses for cleaning the rig and an oil change. The employer pays employee *A* an additional $25 per week to cover cleaning and the oil change. Because the employer also pays a rig reimbursement under this revenue procedure, the $25 paid by the employer is treated as paid under a nonaccountable plan. Thus, the additional payment is reported as wages or other compensation of the employee's Form W–2, and is subject to withholding and payment of income and employment taxes.

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective for payments made on or after January 1, 2003.

SECTION 7. REQUEST FOR COMMENTS

We welcome comments regarding this revenue procedure. We specifically request comments concerning other categories of qualified nonpersonal use vehicles owned by employees and used by the employees in the course of providing services as employees, especially where the nature of an industry results in employees working for multiple employers during each year, for which a deemed substantiation rule would be appropriate.

Comments regarding this revenue procedure should be sent by September 9, 2002 in writing, and should reference Rev. Proc. 2002–41. Comments can be addressed to:

CC:ITA:RU (Rev. Proc. 2002–41),
room 5226
Internal Revenue Service
POB 7604, Ben Franklin Station
Washington, DC 20044

Comments also may be hand delivered between the hours of 8 a.m. and 5 p.m. to:

CC:ITA:RU (Rev. Proc. 2002–41)
Courier's Desk
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC.

Alternatively, taxpayers may transmit comments electronically via the following e-mail address:

Notice.Comments@irscounsel.treas.gov

SECTION 8. DRAFTING INFORMATION

The principal author of this revenue procedure is Joe Spires of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities), IRS. However, other personnel from the IRS and Treasury Department participated in its development. For further information regarding this revenue procedure, call Mr. Spires at (202) 622–6040 (not a toll-free number).

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Compensation Deferred Under Eligible Deferred Compensation Plans

REG–105885–99

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that would provide guidance on compensation deferred under eligible section 457(b) deferred compensation plans of state and local governmental and tax-exempt entities. The regulations reflect the changes made to section 457 by the Tax Reform Act of 1986, the Small Business Job Protection Act of 1996, the Taxpayer Relief Act of 1997, the Economic Growth and Tax Relief Reconciliation Act of 2001, the Job Creation and Worker Assistance Act of 2002, and other legislation. The regulations would also make various technical changes and clarifications to the existing final regulations on many discrete issues. These regulations provide the public with guidance necessary to comply with the law and will affect plan sponsors, administrators, participants, and beneficiaries. The document also provides a notice of public hearing on these proposed regulations.

DATES: Written and electronic comments must be received by August 7, 2002. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for August 28, 2002, must be received no later than August 7, 2002.

ADDRESSES: Send submissions to CC:ITA:RU (REG–105885–99), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:ITA:RU (REG–105885–99), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at *www.irs.gov/regs*. The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, please contact Cheryl Press, (202) 622–6060 (not a toll-free number). To be placed on the attendance list for the hearing, please contact LaNita Van Dyke at (202) 622–7180 (not a toll-free number.)

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information in this notice of proposed rulemaking has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1580.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to the collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

On September 23, 1982, final regulations (T.D. 7836, 1982–2 C.B. 91) under section 457 of the Internal Revenue Code of 1954 (Code) were published in the **Federal Register** (47 FR 42335) (September 27, 1982) (final regulations). The final regulations provide guidance for complying with the changes to the applicable tax law made by the Revenue Act of 1978 (92 Stat. 2779) relating to deferred compensation plans maintained by state and local governments and rural electric cooperatives. These proposed regulations would amend the final regulations to conform them to the many amendments made to section 457 by subsequent legislation, including section 1107 of the Tax Reform Act of 1986 (TRA '86) (100 Stat. 2494), section 1404 of the Small Business Job Protection Act of 1996 (SBJPA) (110 Stat. 1755) (1996), section 1071 of the Taxpayer Relief Act of 1997 (TRA '97) (111 Stat. 788) (1997), sections 615, 631, 632, 634, 635, 641, 647, 649, and other sections of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) (115 Stat. 38) (2001), and paragraphs (o)(8) and (p)(5) of section 411 of the Job Creation and Worker Assistance Act of 2002 (116 Stat. 21) (2002). These proposed regulations would also amend the final regulations to provide additional guidance on section 457 issues raised since the final regulations were published in 1982. This document also incorporates the guidance provided in Notice 98–8, 1998–1 C.B. 355, with respect to amendments made to section 457 by the SBJPA and TRA '97, including the section 457(g) trust requirement for eligible plans of state and local governments (eligible governmental plans).

Explanation of Provisions

Overview

The proposed regulations would provide broad guidance regarding the rules applicable to eligible deferred compensation plans described in section 457(b) (eligible plans) and, in particular, provide clear standards for the administration and operation of eligible plans. The proposed regulations would amend the existing final regulations to update them for changes in the law, including the many changes made by EGTRRA, and respond to the comments and inquiries received from state and local governments and tax-exempt employers that sponsor eligible plans, from participants and beneficiaries, and from service providers and other advisors.

The proposed regulations at §§ 1. 457–1 through 1.457–3 include a general overview of section 457, as applicable to

both eligible plans and ineligible plans that are subject to section 457(f), and general definitional provisions. Specific rules applicable to eligible plans are contained in proposed §§ 1.457–4 through 1.457–10, while rules applicable to those deferred compensation plans that fail to satisfy the requirements applicable to eligible plans (ineligible plans) are contained in proposed § 1.457–11.

1. *General provisions and establishment of eligible plans*

Section 457, as amended by TRA '86, applies to tax-exempt employers as well as to state and local governments. Eligible employers may maintain eligible plans, which must satisfy the requirements of section 457(b) in both form and operation, or may maintain ineligible plans. Benefits under eligible plans are excludable from income of plan participants until paid, in the case of an eligible governmental plan, or, in the case of an eligible plan of a tax-exempt employer, until paid or made available. Benefits under ineligible plans are, under section 457(f), includible in income when deferred or, if later, when rights to the benefits are not subject to a substantial risk of forfeiture. Certain types of plans of state and local government and tax-exempt entities are not subject to section 457. These types are listed in the definition of *plan* in proposed § 1.457–2.

The proposed regulations make clear that the requirements of section 457(b) for eligible plans apply to both elective contributions and to other types of contributions, such as mandatory contributions, nonelective employer contributions, and employer matching contributions. Thus, for example, proposed § 1.457–2(b) defines *annual deferrals* to include both elective salary reduction contributions and nonelective employer contributions. Annual deferrals also include compensation deferred under eligible plans that are defined benefit plans.

An eligible plan must satisfy the requirements of section 457(b) and related provisions both in form and in operation. Under the proposed regulations, an eligible plan must be established in writing, must include all of the material terms for benefits under the plan, and must be operated in compliance with the requirements reflected in the regulations. Of course, plan sponsors retain flexibility in determining whether to provide certain design options permitted under section 457. For example, although these proposed regulations permit certain in-service distributions of smaller account balances in accordance with section 457(e)(9), an eligible plan is not required to offer participants this distribution option. However, any optional features incorporated into an eligible plan must meet the requirements of section 457 and the regulations in both form and operation.

All amounts deferred under an eligible governmental plan are required to be set aside in a trust, custodial account, or annuity contract for the exclusive benefit of participants and their beneficiaries. However, under section 457(b)(6), all amounts deferred under an eligible plan of a tax-exempt employer are required to be unfunded. This requirement for an eligible plan of a tax-exempt employer does not alter any provision of Title I of the Employee Retirement Income Security Act of 1974 (ERISA). Accordingly, an eligible plan of a tax-exempt employer may be subject to certain of the requirements of Title I.. In the case of an eligible plan of a tax-exempt employer that is subject to Title I of ERISA, compliance with the exclusive purpose, trust, funding, and certain other rules will cause the plan to fail to satisfy section 457(b)(6). See Q&A-25 of Notice 87–13, 1987–1 C.B. 432.

The proposed regulations include certain basic rules regarding the taxation of contributions and benefits under ineligible plans, especially the relationship between deferred compensation under an ineligible plan and property transfers to which section 83 applies, but are not intended to provide complete or comprehensive guidance under section 457(f). Similarly, the proposed regulations refer to, but do not provide specific guidance on, certain arrangements that are not treated as plans providing deferred compensation, such as *bona fide* severance pay plans described in section 457(e)(11).

2. *Annual deferrals, deferral limitations, and deferral agreements under eligible plans*

a. Annual Deferrals

Proposed § 1.457–4 sets forth rules regarding deferrals under eligible plans under section 457(b). The proposed regulations would expand the rules contained in the final regulations. Examples have been included in order to illustrate the application of the rules to specific circumstances and to address common questions and situations encountered in the administration of eligible plans.

The proposed regulations use the term *annual deferrals* to describe all amounts contributed or deferred under an eligible plan, whether by voluntary salary reduction contribution or by other employer contribution, and all earnings thereon. If, as is typical, amounts contributed to the eligible plan are fully vested, the total of amounts contributed to the eligible plan during a taxable year is the same as the total of the annual deferrals for the taxable year.

The proposed regulations would also clarify that the rules concerning agreements for deferrals operate on a cash basis. Thus, under proposed § 1.457–4(b), an agreement to defer compensation is valid if it is made before the first day of the month in which compensation is paid or made available. In general, there is no requirement that the agreement be entered into prior to the time the services giving rise to the compensation are performed. However, compensation payable in the first month of employment may be deferred only if an agreement is entered into prior to the time a participant performs services for the employer. The proposed regulations provide explicitly that nonelective employer contributions are treated as being made under a valid agreement. In addition, Rev. Rul. 2000–33, 2000–2 C.B. 142, provides guidance concerning automatic enrollment under eligible plans. Contributions made under an automatic enrollment arrangement described in that Revenue Ruling may be treated as made under a valid agreement.

b. Deferral Limitations

The proposed regulations under § 1.457–4 explain the annual limits that apply to annual deferrals under eligible plans. These contribution limits are sometimes referred to as "plan ceilings." Generally, the basic annual limit or plan ceiling for a year cannot exceed a specified dollar amount for the year or, if less, 100 percent of a participant's "includible compensation." Under EGTRRA, the dollar amount is $11,000 for 2002; $12,000 for 2003; $13,000 for 2004; $14,000 for 2005; and $15,000 for 2006 and thereafter. After 2006, the $15,000 amount is adjusted for cost-of-living. As a result of the enactment of the Job Creation and Worker Assistance Act of 2002, Public Law 107–147 (116 Stat. 21) on March 9, 2002, the calculation of includible compensation is no longer reduced by the exclusions from gross income under sections 402(g), 125, 132(f), and 457. Thus, for years beginning after December 31, 2001, includible compensation is no longer reduced by elective deferrals to an eligible plan. If a participant's includible compensation is less than the applicable dollar limit, the dollar amount equal to 100 percent of includible compensation is the basic annual limit for the participant.

An eligible plan may also permit certain "catch-up" contributions. First, in accordance with section 414(v) as added to the Code by EGTRRA, a plan may allow a participant who attains age 50 by the end of the year to elect to have an additional deferral for the year. The additional amount permitted under this age 50 catch-up is $1,000 for 2002, $2,000 for 2003, $3,000 for 2004, $4,000 for 2005, and $5,000 for 2006. Proposed regulations (REG–142499–01, 2001–45 I.R.B. 476) under section 414(v) were published in the **Federal Register** on October 23, 2001 (66 FR 53555) as § 1.414(v)–1.

Second, an eligible plan may permit a larger catch-up amount in the last three years ending before the participant attains normal retirement age. The amount of this special section 457 catch-up is two times the basic annual limit (*e.g.*, an additional $15,000 for 2006), but only to the extent the participant has not previously deferred the maximum amount under an eligible plan or similar tax-deferred retirement plan (called the underutilized amount or underutilized limitation in the proposed regulations). Alternatively, the age 50 catch-up is available in the last three years ending before the participant attains normal retirement age if the age 50 catch-up amount is larger than the special section 457 catch-up amount. Under the proposed regulations, a participant may not elect to have the special section 457 catch-up apply more than once, unless the participant is covered by a plan of another employer. If a participant also or later participates in an eligible plan of a different employer and otherwise meets the requirements for limited catch-up, the participant may elect under the new plan to have the special section 457 catch-up apply.

For purposes of the special section 457 catch-up, the proposed regulations provide that the plan must designate a normal retirement age between the age at which participants have the right to receive immediate retirement benefits under the basic pension plan of the state or tax-exempt entity without actuarial or similar reduction and age 70 ½. Alternatively, a plan may provide that a participant is allowed to designate a normal retirement age within these ages. The proposed regulations provide a special rule for defining normal retirement age in eligible plans of qualified police or firefighters as defined under section 415(b)(2)(H)(ii)(I), taking into account that these participants are often eligible for retirement at a younger age than other workers.

The proposed regulations require an eligible plan to set forth the plan's normal retirement age. However, as discussed in this preamble under **Proposed Effective Date**, plan amendments to reflect this requirement are not required to be adopted until guidance is issued addressing when plan amendments must be adopted.

3. *Individual limitation for combined annual deferrals under eligible plans*

Before enactment of EGTRRA, a coordination limitation applied under which the basic annual limitation and the special section 457 catch-up limitation were reduced by amounts excluded from a participant's income for any taxable year by reason of a salary reduction or elective contribution under a section 401(k) plan or a section 403(b) contract. EGTRRA eliminated coordination with section 401(k) plans and section 403(b) contracts for 2002 and thereafter. However, coordination with these types of arrangements is still taken into account for purposes of determining the underutilized amount for years before 2002, so that these rules continue to be reflected in the proposed regulations for that sole purpose.

EGTRRA did not eliminate section 457(c) under which the maximum amount excludable under all eligible plans, including eligible governmental plans and eligible plans of a tax-exempt entity, cannot exceed applicable section 457 plan limitations. Thus, these limitations, including the basic limitation, the age 50 catch-up limitation, and the special section 457 catch-up limitation, apply not only on a plan basis, but also on an individual basis for cases in which an individual participates in more than one eligible plan during a taxable year. The proposed regulations include rules for how the applicable section 457 limitations apply on an individual basis. The rules for applying catch-up limits on an individual basis provide that the special section 457 catch-up available in the last three years prior to normal retirement age is taken into account only to the extent that an annual deferral is made for a participant under an eligible plan as a result of plan provisions permitted under the special section 457 catch-up and, if the applicable catch-up amount is not the same for each such eligible plan, the individual limit is applied using the catch-up amount under whichever plan that has the largest catch-up amount applicable to the participant. However, as discussed above, a participant may not elect to have the special section 457 catch-up apply more than once, unless the participant is covered by a plan of another employer.

The proposed regulations allow an eligible governmental plan to pay out an annual deferral to the extent the deferral exceeds the individual limit or to correct a deferral in excess of the plan's limit.

4. *Sick and vacation pay deferrals*

The proposed regulations would permit an eligible plan to provide that a participant may elect to defer accumulated sick pay, accumulated vacation pay, and

back pay if certain conditions are satisfied. In accordance with section 457(b)(4), the plan must provide that these amounts may be deferred for any calendar month only if an agreement providing for the deferral is entered into before the beginning of the month in which the amounts would otherwise be paid or made available to the participant. Thus, a participant is not permitted to elect to receive the value of accumulated sick and vacation pay on or after the date on which the employer makes that pay available to the participant in cash. Any deferrals under an eligible plan of sick and vacation pay or back pay are subject to the maximum deferral limitations of section 457 in the year of deferral. Thus, the total amount deferred for any year cannot exceed the plan ceiling for the year, taking into account the 100 percent of includible compensation limit.

5. *Excess deferrals*

The proposed regulations address the treatment of excess deferrals and the effect of excess deferrals on plan eligibility under section 457(b). The proposed regulations also provide that an eligible governmental plan may self correct excess deferrals and will not fail to satisfy the applicable requirements of the proposed regulations (including the distribution rules and the funding rules) solely by reason of a distribution of excess deferrals.

Under the proposed regulations, if an excess deferral arises under the maximum deferral limits of section 457(b) for a plan of a governmental employer, an eligible governmental plan is required to correct the failure by distributing the excess deferral to the participant, with allocable net income, as soon as administratively practicable after the plan determines that the amount would be an excess deferral. If excess deferrals of this type are not distributed, the plan will be an ineligible plan with respect to which benefits are taxed according to the rules of section 457(f). If an excess deferral arises under the maximum deferral limits of section 457(b) for a plan of a tax-exempt employer, the plan is not an eligible plan. For purposes of these rules, all plans under which an individual participates by virtue of his or her relationship with a single employer are treated as a single plan.

As stated previously, while EGTRRA repealed the coordination limitation under section 457(c), EGTRRA did not eliminate the requirement that the maximum amount excludable under all eligible plans under section 457(c) as revised by EGTRRA, including eligible governmental plans and eligible plans of a tax-exempt entity, cannot exceed the applicable section 457(b) limitations. Thus, an excess deferral that results from the application of the new individual limitation for multiple eligible plans under section 457(c) may also be, but is not required to be, distributed to the participant. However, consistent with the legislative history to section 457(c), the proposed regulations make clear that a plan will not lose its status as an eligible plan by failing to distribute those excess deferrals that result from the application of this requirement (although those amounts are currently includible in the participant's income).

Comments are specifically requested concerning record-keeping requirements with respect to excess deferrals that are not distributed and, in particular, concerning the maintenance of records adequate to keep track of any previously taxed excess deferrals that remain in an eligible plan. In addition, comments are also requested as to the proper income and payroll tax reporting of distributions of excess deferrals.

6. *Minimum distribution requirements*

EGTRRA eliminated the special minimum distribution rules that applied to eligible plans. Thus, the proposed regulations generally incorporate by reference the requirements of section 401(a)(9) and the regulations thereunder concerning minimum distributions to participants and beneficiaries. Final and temporary regulations (T.D. 8987, 2002–19 I.R.B. 852) under section 401(a)(9) were published in the **Federal Register** on April 17, 2002 (67 FR 18988). These regulations provide rules for defined benefit plans and defined contribution plans. Generally, the rules for defined contribution plans apply to eligible deferred compensation plans. Beginning in 2003, a simple uniform table generally applies to all employees to determine the minimum distribution required during their lifetime, including employees covered by an eligible deferred compensation plan.[1] The one exception to this rule for lifetime distributions is for an employee with a spouse designated as the employee's sole beneficiary and the spouse is more than 10 years younger than the employee. In that case the employee can use the employee and spouse's joint and last survivor expectancy to determine the minimum distribution required during the employee's lifetime.

7. *Loans*

Proposed § 1.457–6(f) sets forth rules governing loans from eligible plans. This proposal responds to the numerous inquiries received concerning the availability of loans from eligible plans maintained by state and local governments, the assets of which are held in trust pursuant to section 457(g).

While section 457(g) does not directly address the issue of whether, or under what circumstances, loans may be made available from trusteed eligible plans, the legislative history to the SBJPA indicates that the new statutory provisions should be interpreted as permitting participant loans from the eligible plan trust under the rules applicable to loans from qualified plans. H.R. Rep. 104–737, at 251. Commentators, some citing this legislative history and some citing pre-ERISA case law and rulings interpreting the exclusive benefit requirement of section 401(a), have urged the IRS to issue formal guidance concerning loans from eligible plans. These comments take the position that the availability of loans will make savings through eligible plans more attractive to participants and will decrease the disparity between eligible plans and the other tax-favored voluntary retirement savings plans.

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[1]Employees may use these new final regulations for distributions for 2002 or may use regulations proposed in 1987 or 2001.

The pre-ERISA requirements applicable to loans from qualified plans require a facts and circumstances analysis of the availability of the loan feature to all participants, the rate of return, the overall prudence of the investment of the trust corpus in the note of an individual participant, and the pattern of repayments. See, *e.g.*, *Central Motor Co. v. United States*, 583 F.2d 470, 488–491 (10th Cir. 1978); *Winger's Department Store v. Commissioner*, 82 T.C. 869 (1982); *Ma-Tran Corp. v. Commissioner*, 70 T.C. 158 (1978); and *Feroleto Steel Co. v. Commissioner*, 69 T.C. 97 (1977). See also Rev. Rul. 67–258 (1967–2 CB 68).

Under the proposed regulations, a loan from an unfunded eligible plan of a tax-exempt organization would be treated as an impermissible distribution, in violation of the requirements of section 457. However, for loans from an eligible governmental plan, the proposed regulations include a facts and circumstances general standard. This general standard is intended to apply to determine whether the loan is *bona fide* and for the exclusive purpose of benefitting participants and beneficiaries under section 457(g), as was required under pre-ERISA law for qualified plans. Among the facts and circumstances are whether the loan has a fixed repayment schedule and a reasonable interest rate, and whether there are repayment safeguards to which a prudent lender would adhere.[2] The proposed regulations require a loan to bear a reasonable rate of interest in order to satisfy the requirement that assets and income of an eligible governmental plan be held for the exclusive benefit of participants and their beneficiaries. The proposed regulations would also clarify that section 72(p) applies with respect to loans made under an eligible governmental plan. Regulations interpreting section 72(p)(2) are at § 1.72(p)–1.

If the proposed regulations are finalized in their current form, it is anticipated that the IRS will modify its current no-rule position regarding the issuance of private letter rulings to eligible plans that provide for loans.

8. *Distributions from eligible plans*

a. Eligible Governmental Plans

EGTRRA substantially altered the taxation of distributions from an eligible governmental plan by providing that amounts held under such an eligible plan are not included in a participant's or beneficiary's gross income until distributed. The proposed regulations would interpret this EGTRRA change as applying to all participants in an eligible governmental plan. Thus, an eligible governmental plan may permit participants who are currently entitled to be paid after 2001 to change their previously irrevocable payment elections.

Under EGTRRA, after 2001, the direct rollover rules applicable to qualified plans and section 403(b) contracts will apply to distributions from an eligible governmental plan. The direct rollover rules for qualified plans and section 403(b) contracts are generally explained at §§ 35.3405–1, 31.3405(c)–1, 1.401(a)(31)–1, 1.402(c)–2, and 1.402(f)–1. These direct rollover regulations have not been updated since EGTRRA to reflect that rollovers are permitted for distributions from eligible governmental plans (nor do those regulations reflect that amounts may be rolled over to eligible governmental plans after 2001).

b. Eligible Plans of Tax-Exempt Entities

Amounts deferred under an eligible plan of a tax-exempt entity continue to be taxable when paid or made available. The proposed regulations explain these rules, including the exceptions for amounts available in the event of unforeseeable emergency and distributions of smaller accounts (not in excess of $5,000).

9. *Plan terminations and plan-to-plan transfers*

The proposed regulations address the topic of plan terminations and plan-to-plan transfers. These topics have become increasingly important in light of the recent statutory changes that impose a trust requirement on eligible governmental plans. In particular, questions have been raised with respect to hospitals and other entities that change from government to private entities, whether or not tax-exempt. The direct rollovers that will be permitted by EGTRRA beginning in 2002 for eligible governmental plans provide participants affected by these types of events the ability to retain their retirement savings in a funded, tax-deferred savings vehicle by rollover to IRAs, qualified plan, or section 403(b) contracts. The proposed regulations provide a blueprint for the different plan termination and plan-to-plan transfer alternatives available to sponsors of eligible plans in these situations.

a. Plan Terminations

The proposed regulations would allow a plan to have provisions permitting plan termination whereupon amounts could be distributed without violating the distribution requirements of section 457. Under the proposed regulations, an eligible plan is terminated only if all amounts deferred under the plan are paid to participants as soon as administratively practicable. If the amounts deferred under the plan are not distributed, the plan is treated as a frozen plan and must continue to comply with all of the applicable statutory requirements necessary for plan eligibility. The proposed regulations generally follow the approach of Rev. Rul. 89–87, 1982–2 C.B. 81, which provides guidance on the termination of qualified plans. In that revenue ruling, a qualified plan under which benefit accruals have ceased is not terminated if assets of the plan remain in the plan's related trust rather than being distributed as soon as administratively feasible.

The proposed regulations also highlight the consequences to the plan in the case of an employer that ceases to be an eligible employer but fails to terminate the plan or to transfer its assets under the rules of the proposed regulations described below.

[2] See, for example, the standards in Rev. Rul. 69–494, 1969–2 C.B. 88, for determining when plan investments are primarily for the purpose of benefitting employees or their beneficiaries.

b. Plan-to-plan Transfers

The proposed regulations would clarify that transfers between certain types of eligible plans do not violate the requirements of section 457(b), including the distribution requirements of section 457(d), if certain conditions are satisfied. Thus, an eligible governmental plan may transfer its assets to another eligible governmental plan; likewise, an unfunded, tax-exempt plan may transfer amounts deferred to another unfunded, tax-exempt plan. However, in the same manner that rollovers are not permitted between unfunded plans of tax-exempt employers and funded governmental plans (and because of potential violations of the exclusive benefit rule applicable to eligible governmental plans), amounts cannot be transferred from an eligible plan of a tax-exempt employer to an eligible governmental plan or from an eligible governmental plan to an eligible plan of a tax-exempt employer.

Plan-to-plan transfers within similar types of eligible plans are permitted in two kinds of circumstances. First, it is contemplated that transfers may occur when a participant in the transferor plan terminates employment with the transferor employer and is employed by the transferee employer. Transfers with respect to individual participants are permitted if both plans agree to the transfer, the participant has terminated employment with the transferor, and the participant whose amounts deferred are being transferred will have an amount deferred immediately after the transfer at least equal to the amount deferred immediately before the transfer.

Second, the proposed regulations also contemplate certain asset transfers of all amounts deferred under the plan in the event an activity of a state or local government is privatized or otherwise ceases to be performed by a governmental entity. Thus, as an alternative to plan termination or a plan-to-plan transfer, the proposed regulations provide that a government employer that loses its eligible status may transfer the eligible plan to another eligible government employer within the same state. For example, a county hospital that maintains an eligible plan and that ceases to be a governmental entity could transfer the plan to the county for continued administration.

The proposed regulations also address transfers between eligible governmental plans and qualified defined benefit plans with respect to past service credit. Because the proposed regulations specifically state that a transfer for past service credit is not treated as a distribution for purposes of section 457, such a transfer could be made while the participant is still working.

10. *Qualified domestic relations orders*

The proposed regulations address the issue of qualified domestic relations orders (QDROs). The administration of QDROs has created difficulties for eligible employers and section 457 plan administrators and participants, and numerous inquiries and private letter ruling requests involving the application of judicial domestic relations orders to participants' accounts in eligible section 457(b) deferred compensation plans have been received. The proposed regulations provide that an eligible plan may honor the terms of a QDRO without jeopardizing its eligible status.

Under the proposed regulations, as provided under section 457 as amended by EGTRRA, an eligible plan does not become an ineligible plan described in section 457(f) solely because its administrator or sponsor complies with a QDRO described in section 414(p) (taking into account the special rule section 414(p)(11) for governmental and church plans), including a QDRO requiring the distribution of the benefits of a participant to an alternate payee in advance of the general rules for eligible plan distributions under § 1.457–6. In the case of an eligible governmental plan, amounts paid to the alternate payee who is the spouse or former spouse of a participant under the QDRO are taxable to the alternate payee when they are paid.

In the case of an eligible plan of a tax-exempt entity, amounts payable to the alternate payee who is the spouse or former spouse of a participant under the QDRO are taxable to the alternate payee when they are paid or made available to the alternate payee. In addition, amounts deferred under an eligible plan of a tax-exempt entity that are attributable to the alternate payee are treated as made available on the date the alternate payee is first able to receive a distribution.

11. *Rollovers to eligible plans*

EGTRRA now allows rollovers contributions to be accepted by an eligible governmental plan, but only if the receiving eligible governmental plan maintains the rollover amount in a separate account. The proposed regulations include such rollovers as part of the amount deferred under the receiving plan, but a rollover contribution is not taken into account as an annual deferral under the plan for purposes of the plan ceiling limit on annual deferrals. While EGTRRA does not require a separate account for each type of rollover contributions (*e.g.*, an account for rollovers from qualified plans which is separate from rollovers from section 403(b) contracts), comments are requested on whether there are any special characteristics applicable to qualified plans, section 403(b) contracts, or individual retirement arrangements (IRAs) under section 72(t) (imposing an additional income tax on early distributions from such plans, contracts, or arrangements) which could be lost if multiple types of separate accounts are not maintained.

12. *Correction program for section 457(b) eligible deferred compensation plans*

Employee Plans, within the Office of the Commissioner, Tax Exempt and Government Entities (TE/GE), has comprehensive correction programs for sponsors of retirement plans (qualified retirement plans, 403(b) plans, and Simplified Employee Pensions). These programs, including the Employee Plans Compliance Resolution System (EPCRS), Rev. Proc. 2001–17, 2001–1 C.B. 589, permit plan sponsors to correct plan defects and thereby continue to provide their employees retirement benefits on a tax-favored basis. Employee Plans intends to expand the provisions of EPCRS to include appropriate correction procedures for certain failures arising under eligible deferred compensation plans. The public is invited to submit comments to assist in the development of these procedures. Comments should be sent to:

Internal Revenue Service
Attention: T:EP:RA:VC
1111 Constitution Avenue, NW
Washington, D.C. 20224

Pending the update of EPCRS, submissions related to section 457 (b) eligible deferred compensation plan failures will be accepted by Employee Plans on a provisional basis outside of EPCRS.

13. *Ineligible plans*

The proposed regulations include guidance regarding ineligible plans under section 457(f). Section 457(f) was in section 457 when it was added to the Code in 1978 for governmental employees, and extended to employees of tax-exempt organizations (other than churches or certain church-controlled organizations) in 1986, because unfunded amounts held by a tax-exempt entity compound tax free like an eligible plan, a qualified plan, or a section 403(b) contract. Section 457(f) was viewed as essential in order to provide an incentive for employers that are not subject to income taxes to adopt an eligible plan, a qualified plan, or a section 403(b) contract.[3] Section 457(f) generally provides that, in the case of an agreement or arrangement for the deferral of compensation, the deferred compensation is included in gross income when deferred or, if later, when the rights to payment of the deferred compensation cease to be subject to a substantial risk of forfeiture. Section 457(f) does not apply to an eligible plan, a qualified plan, a section 403(b) contract, a section 403(c) contract, a transfer of property described in section 83, a trust to which section 402(b) applies, or a qualified governmental excess benefit arrangement described in section 415(m).

The proposed regulations reflect the statutory changes in section 457(f) that have been made since 1982—which is when the current outstanding regulations were issued—and clarify the interaction between sections 457(f) and 83 (relating to the transfer of property in connection with the performance of services). Under the proposed regulations, section 457(f) does not apply to a transfer of property if section 83 applies to the transfer. Further, section 457(f) does not apply if the date on which there is no substantial risk of forfeiture with respect to the compensation is on or after the date on which there is a transfer of property to which section 83 applies. However, section 457(f) applies if the date on which there is no substantial risk of forfeiture with respect to the compensation deferred precedes the date on which there is a transfer of property to which section 83 applies. The proposed regulations include several examples, including an example illustrating that section 457(f) does not fail to apply merely because benefits are subsequently paid by a transfer of property. Comments are requested on the coordination of section 457(f) and section 83 under these proposed regulations.

In 2000, the IRS issued Announcement 2000–1, 2000–1 C.B. 294, in which it provided interim guidance on certain broad-based, nonelective plans of a state or local government that were in existence before 1999. Comments are requested on whether similar guidance should be included in the final regulations, and, if so, how the guidance should apply to arrangements, such as those maintained by certain state or local governmental educational institutions, under which supplemental compensation is payable as an incentive to terminate employment, or as an incentive to retain retirement-eligible employees, to ensure an appropriate workforce during periods in which a temporary surplus or deficit in workforce is anticipated.

Proposed Effective Date

It is proposed that these regulations apply generally for taxable years beginning after December 31, 2001. This is the general applicability date of the changes made in section 457 by EGTRRA. Special effective date provisions apply to provisions relating to coordination of sections 457(f) and 83 and for qualified domestic relations orders. Plan amendments to reflect EGTRRA, and any other requirement under these regulations, are not required to be adopted until the later of when guidance is issued addressing when plan amendments must be adopted or the date final regulations are issued. However, employers may rely on these proposed regulations in taxable years beginning after August 20, 1996 (which is the earliest applicability date for requirements applicable to eligible plans under the SBJPA). Comments are requested on whether an applicability date later than taxable years beginning after December 31, 2001, should apply when the regulations are issued in final form.

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

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written or electronic comments (a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and Treasury specifically request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for August 28, 2002, beginning at 10 a.m. in the IRS Auditorium of the 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

[3]See generally the *Report to the Congress on the Tax Treatment of Deferred Compensation under Section 457*, Department of the Treasury, January 1992 (available from the Office of Tax Policy, Room 5315, Treasury Department, 1500 Pennsylvania Avenue, NW, Washington DC 20220).

beyond the immediate entrance more than 30 minutes before the hearing starts. 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 August 7, 2002. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the schedule of 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 Cheryl Press, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

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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 continues to read in part as follows:

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

Par. 2. Sections 1.457–1, 1.457–2, 1.457–3, and 1.457–4 are revised to read as follows:

§ 1.457–1 General overview of section 457.

Section 457 provides rules for nonqualified deferred compensation plans established by eligible employers as defined under § 1.457–2(d). Eligible employers can establish either deferred compensation plans that are eligible plans and that meet the requirements of section 457(b) and §§ 1.457–3 through 1.457–10, or deferred compensation plans or arrangements that do not meet the requirements of section 457(b) and §§ 1.457–3 through 1.457–10 and that are subject to tax treatment under section 457(f) and § 1.457–11.

§ 1.457–2 Definitions.

This section sets forth the definitions that are used under §§ 1.457–1 through 1.457–11.

(a) *Amount(s) deferred*. *Amount(s) deferred* means the total annual deferrals under an eligible plan in the current and prior years, adjusted for gain or loss. Except as otherwise specifically indicated, *amount(s) deferred* includes any rollover amount held by an eligible plan as provided under § 1.457–10(e).

(b) *Annual deferral(s)*—(1) *Annual deferral(s)* means, with respect to a taxable year, the amount of compensation deferred under an eligible plan, whether by salary reduction or by nonelective employer contribution. The amount of compensation deferred under an eligible plan is taken into account as an annual deferral in the taxable year of the participant in which deferred, or, if later, the year in which the amount of compensation deferred is no longer subject to a substantial risk of forfeiture.

(2) If the amount of compensation deferred under the plan during a taxable year is not subject to a substantial risk of forfeiture, the amount taken into account as an annual deferral is not adjusted to reflect gain or loss allocable to the compensation deferred. If, however, the amount of compensation deferred under the plan during the taxable year is subject to a substantial risk of forfeiture, the amount of compensation deferred that is taken into account as an annual deferral in the taxable year in which the substantial risk of forfeiture lapses must be adjusted to reflect gain or loss allocable to the compensation deferred until the substantial risk of forfeiture lapses.

(3) If the eligible plan is a defined benefit plan within the meaning of section 414(j), the annual deferral for a taxable year is the present value of the increase during the taxable year of the participant's accrued benefit that is not subject to a substantial risk of forfeiture (disregarding any such increase attributable to prior annual deferrals). For this purpose, present value must be determined using actuarial assumptions and methods that are reasonable (both individually and in the aggregate), as determined by the Commissioner.

(c) *Beneficiary*. *Beneficiary* means a beneficiary of a participant, a participant's estate, or any other person whose interest in the plan is derived from the participant, including an alternate payee as described in § 1.457–10(c).

(d) *Catch-up*. *Catch-up* amount or *catch-up* limitation for a participant for a taxable year means the annual deferral permitted under section 414(v) (as described in § 1.457–4(c)(2)) or section 457(b)(3) (as described in § 1.457–4(c)(3)) to the extent the amount of the annual deferral for the participant for the taxable year is permitted to exceed the plan ceiling applicable under section 457(b)(2) (as described in § 1.457–4(c)(1)).

(e) *Eligible employer*. *Eligible employer* means an entity that is a state as defined in paragraph (l) of this section that establishes a plan or a tax-exempt entity as defined in paragraph (m) of this section that establishes a plan. The performance of services as an independent contractor for a state or local government or a tax-exempt entity is treated as the performance of services for an eligible employer. The term *eligible employer* does not include a church as defined in section 3121(w)(3)(A), a qualified church-controlled organization as defined in section 3121(w)(3)(B), or the Federal government or any agency or instrumentality thereof.

(f) *Eligible plan*. An *eligible plan* is a plan that meets the requirements of §§ 1.457–3 through 1.457–10 that is established and maintained by an eligible employer. An *eligible governmental plan* is an eligible plan that is established and maintained by an eligible employer as defined in paragraph (l) of this section. An arrangement does not fail to constitute a single eligible governmental plan merely because the arrangement is funded through more than one trustee, custodian, or insurance carrier. An *eligible plan of a tax-exempt entity* is an eligible plan that is established and maintained by an eligible employer as defined in paragraph (m) of this section.

(g) *Includible compensation. Includible compensation* of a participant means, with respect to a taxable year, the participant's compensation, as defined in section 415(c)(3), for services performed for the eligible employer. The amount of includible compensation is determined without regard to any community property laws.

(h) *Ineligible plan. Ineligible plan* means a plan established and maintained by an eligible employer that is not maintained in accordance with §§ 1.457–3 through 1.457–10. A plan that is not established by an eligible employer as defined in paragraph (e) of this section is neither an eligible nor an ineligible plan.

(i) *Nonelective employer contribution.* A *nonelective employer contribution* is a contribution made by an eligible employer for the participant with respect to which the participant does not have the choice to receive the contribution in cash or property. Solely for purposes of section 457 and §§ 1.457–2 through 1.457–11, the term *nonelective employer contribution* includes employer contributions that would be described in section 401(m) if they were contributions to a qualified plan.

(j) *Participant. Participant* in an eligible plan means an individual who is currently deferring compensation, or who has previously deferred compensation under the plan by salary reduction or by nonelective employer contribution and who has not received a distribution of his or her entire benefit under the eligible plan. Only individuals who perform services for the eligible employer, either as an employee or as an independent contractor, may defer compensation under the eligible plan.

(k) *Plan. Plan* includes any agreement or arrangement between an eligible employer and a participant or participants under which the payment of compensation is deferred (whether by salary reduction or by nonelective employer contribution). The following types of plan are not treated as agreements or arrangement under which compensation is deferred: a *bona fide* vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plan described in section 457(e)(11)(A)(i) and any plan paying length of service awards to *bona fide* volunteers (and their beneficiaries) on account of qualified services performed by such volunteers as described in section 457(e)(11)(A)(ii). Further, the term *plan* does not include any of the following (and section 457 and §§ 1.457–2 through 1.457–11 do not apply to any of the following)—

(1) Any nonelective deferred compensation under which all individuals (other than those who have not satisfied any applicable initial service requirement) with the same relationship with the eligible employer are covered under the same plan with no individual variations or options under the plan as described in section 457(e)(12), but only to the extent the compensation is attributable to services performed as an independent contractor;

(2) An agreement or arrangement described in § 1.457–11(b);

(3) Any plan satisfying the conditions in section 1107(c)(4) of the Tax Reform Act of 1986 (TRA '86) (relating to certain plans for state judges); and

(4) Any of the following plans or arrangements (to which specific transitional statutory exclusions apply)—

(i) A plan or arrangement of a tax-exempt entity in existence prior to January 1, 1987, if the conditions of section 1107(c)(3)(B) of the TRA '86, as amended by section 1011(e)(6) of Technical and Miscellaneous Revenue Act of 1988 (TAMRA), are satisfied;

(ii) A collectively bargained nonelective deferred compensation plan in effect on December 31, 1987, if the conditions of section 6064(d)(2) of TAMRA are satisfied;

(iii) Amounts described in section 6064(d)(3) of TAMRA (relating to certain nonelective deferred compensation arrangements in effect before 1989); and

(iv) Any plan satisfying the conditions in section 1107(c)(4) or (5) of TRA '86 (relating to certain plans for certain individuals with respect to which the Service issued guidance before 1977).

(l) *State. State* includes the 50 States of the United States, the District of Columbia, a political subdivision of a state or the District of Columbia, or any agency or instrumentality of a state or the District of Columbia.

(m) *Tax-exempt entity. Tax-exempt entity* includes any organization (other than a governmental unit) exempt from tax under subtitle A of the Internal Revenue Code.

(n) *Trust. Trust* means a trust described under section 457(g) and § 1.457–8. Custodial accounts and contracts described in section 401(f) are treated as trusts under the rules described in § 1.457–8(a)(2).

§ 1.457–3 General introduction to eligible plans.

(a) *Compliance in form and operation.* An eligible plan is a written plan established and maintained by an eligible employer that is maintained, in both form and operation, in accordance with the requirements of §§ 1.457–4 through 1.457–10. An eligible plan must contain all the material terms and conditions for benefits under the plan. An eligible plan may contain certain optional features not required for plan eligibility under section 457(b), such as distributions for unforeseeable emergencies, loans, plan-to-plan transfers, additional deferral elections, acceptance of rollovers to the plan, and distributions of smaller accounts to eligible participants. However, except as otherwise specifically provided in §§ 1.457–4 through 1.457–10, if an eligible plan contains any optional provisions, the optional provisions must meet, in both form and operation, the relevant requirements under section 457 and §§ 1.457–2 through 1.457–10.

(b) *Treatment as single plan.* In any case in which multiple plans are used to avoid or evade the requirements of §§ 1.457–4 through 1.457–10, the Commissioner may apply the rules under §§ 1.457–4 through 1.457–10 as if the plans were a single plan.

§ 1.457–4 Annual deferrals, deferral limitations, and deferral agreements under eligible plans.

(a) *Taxation of annual deferrals.* Annual deferrals that satisfy the requirements of paragraphs (b) and (c) of this section are excluded from the gross income of a participant in the year deferred or contributed and are not includible in gross income until paid to the participant in the case of an eligible

governmental plan, or until paid or otherwise made available to the participant in the case of an eligible plan of a tax-exempt entity. See § 1.457–7.

(b) *Agreement for deferral*. In order to be an eligible plan, the plan must provide that compensation may be deferred for any calendar month by salary reduction only if an agreement providing for the deferral has been entered into before the first day of the month in which the compensation is paid or made available. A new employee may defer compensation payable in the calendar month during which the participant first becomes an employee if an agreement providing for the deferral is entered into on or before the first day on which the participant performs services for the eligible employer. An eligible plan may provide that if a participant enters into an agreement providing for deferral by salary reduction under the plan, the agreement will remain in effect until the participant revokes or alters the terms of the agreement. Nonelective employer contributions are treated as being made under an agreement entered into before the first day of the calendar month.

(c) *Maximum deferral limitations*—(1) *Basic annual limitation*. (i) Except as described in paragraphs (c)(2) and (3) of this section, in order to be an eligible plan, the plan must provide that the annual deferral amount for a taxable year (the plan ceiling) may not exceed the lesser of—

(A) The applicable annual dollar amount specified in section 457(e)(15): $11,000 for 2002; $12,000 for 2003; $13,000 for 2004; $14,000 for 2005; and $15,000 for 2006 and thereafter. After 2006, the $15,000 amount is adjusted for cost-of-living in the manner described in paragraph (c)(4) of this section; or

(B) 100 percent of the participant's includible compensation for the taxable year.

(ii) The amount of annual deferrals permitted by the 100 percent of includible compensation limitation under paragraph (c)(1)(i)(B) of this section is determined under section 457(e)(5) and § 1.457–2(g).

(iii) For purposes of determining the plan ceiling under this paragraph (c), the annual deferral amount does not include any rollover amounts received by the eligible plan under § 1.457–10(e).

(iv) The provisions of this paragraph (c)(1) are illustrated by the following examples:

Example 1. (i) *Facts*. Participant A, who earns $14,000 a year, enters into a salary reduction agreement in 2006 with A's eligible employer and elects to defer $13,000 of A's compensation for that year. Participant A is not eligible for the catch-up described in paragraph (c)(2) or (3) of this section, participates in no other retirement plan, and has no other income exclusions taken into account in computing includible compensation.

(ii) *Conclusion*. The annual deferral limit for A in 2006 is the lesser of $15,000 or 100 percent of includible compensation, $14,000. A's annual deferral of $13,000 is permitted under the plan because it is not in excess of $14,000 and thus does not exceed 100 percent of A's includible compensation.

Example 2. (i) *Facts*. Assume the same facts as in *Example 1*, except that A's eligible employer provides an immediately vested, matching employer contribution under the plan for participants who make salary reduction deferrals under A's eligible plan. The matching contribution is equal to 100 percent of elective contributions, but not in excess of 10 percent of compensation (in A's case, $1,400).

(ii) *Conclusion*. Participant A's annual deferral exceeds the limitations of this paragraph (c)(1). A's maximum deferral limitation in 2006 is $14,000. A's salary reduction deferral of $13,000 combined with A's eligible employer's nonelective employer contribution of $1,400 exceeds the basic annual limitation of this paragraph (c)(1) because A's annual deferrals total $14,400. A has an excess deferral for the taxable year of $400, the amount exceeding A's permitted annual deferral limitation. The $400 excess deferral is treated as described in paragraph (e) of this section.

Example 3. (i) *Facts*. Beginning in year 2002, Eligible Employer X contributes $3,000 per year for five years to Participant B's eligible plan account. B's interest in the account vests in 2006. B has annual compensation of $50,000 in each of the five years 2002 through 2006. Participant B is 41 years old. B is not eligible for the catch-up described in paragraph (c)(2) or (3) of this section, participates in no other retirement plan, and has no other income exclusions taken into account in computing includible compensation. Adjusted for gain or loss, the value of B's benefit when B's interest in the account vests in 2006 is $17,000.

(ii) *Conclusion*. Under this vesting schedule, $17,000 is taken into account as an annual deferral in 2006. B's annual deferrals under the plan are limited to a maximum of $15,000 in 2006. Thus, the aggregate of the amounts deferred, $17,000, is in excess of the B's maximum deferral limitation by $2,000. The $2,000 is treated as an excess deferral described in paragraph (e) of this section.

(2) *Age 50 catch-up*—(i) *In general*. In accordance with section 414(v) and the regulations thereunder, an eligible governmental plan may provide for catch-up contributions for a participant who is age 50 by the end of the year, provided that such age 50 catch-up contributions do not exceed the catch-up limit under section 414(v)(2) for the taxable year. The maximum amount of age 50 catch-up contributions for a taxable year under section 414(v) is as follows: $1,000 for 2002; $2,000 for 2003; $3,000 for 2004; $4,000 for 2005; and $5,000 for 2006 and thereafter. After 2006, the $5,000 amount is adjusted for cost-of-living. For additional guidance, see regulations under section 414(v).

(ii) *Coordination with special section 457 catch-up*. In accordance with sections 414(v)(6)(C) and 457(e)(18), the age 50 catch-up described in this paragraph (c)(2) does not apply for any taxable year for which a higher limitation applies under the special section 457 catch-up under paragraph (c)(3) of this section. Thus, for purposes of this paragraph (c)(2)(ii) and paragraph (c)(3) of this section, the special section 457 catch-up under paragraph (c)(3) of this section applies for any taxable year if and only if the plan ceiling taking into account paragraph (c)(1) and (3) of this section (and disregarding the age 50 catch-up described in this paragraph (c)(2)) is larger than the plan ceiling taking into account paragraph (c)(1) of this section and the age 50 catch-up described in this paragraph (c)(2) (and disregarding paragraph (c)(3) of this section). Thus, a participant who is eligible for the age 50 catch-up for a year and for whom the year is also one of the participant's last three taxable years ending before the participant attains normal retirement age is entitled to the larger of—

(A) The plan ceiling under paragraph (c)(1) of this section and the age 50 catch-up described in this paragraph (c)(2) (and disregarding paragraph (c)(3) of this section) or

(B) The plan ceiling under paragraphs (c)(1) and (3) of this section (and disregarding the age 50 catch-up described in this paragraph (c)(2)).

(iii) *Examples*. The provisions of this paragraph (c)(2) are illustrated by the following examples:

Example 1. (i) *Facts*. Participant C, who is 55, is eligible to participate in an eligible governmental plan in 2006. The plan provides a normal retirement age of 65. The plan provides limitations on annual deferrals up to the maximum permitted under paragraphs (c)(1) and (3) of this section and the age 50 catch-up described in this paragraph (c)(2). For 2006, C will receive compensation of $40,000 from the eligible employer. C desires to defer the maximum amount possible in 2006. The applicable basic dollar limit of paragraph (c)(1)(i)(A) of this section

is $15,000 for 2006 and the additional dollar amount permitted under the age 50 catch-up is $5,000 for 2006.

(ii) *Conclusion*. C is eligible for the age 50 catch-up in 2006 because C is 55 in 2006. However, C is not eligible for the special section 457 catch-up under paragraph (c)(3) of this section in 2006 because 2006 is not one of the last three taxable years ending before C attains normal retirement age. Accordingly, the maximum that C may defer for 2006 is $20,000.

Example 2. (i) *Facts*. The facts are the same as in *Example 1*, except that, in 2006, C will attain age 62. The maximum amount that C can elect under the special section 457 catch-up under paragraph (c)(3) of this section is $2,000 for 2006.

(ii) *Conclusion*. The maximum that C may defer for 2006 is $20,000. This is the sum of the basic plan ceiling under paragraph (c)(1) of this section equal to $15,000 and the age 50 catch-up equal to $5,000. The special section 457 catch-up under paragraph (c)(3) of this section is not applicable since it provides a smaller plan ceiling.

Example 3. (i) *Facts*. The facts are the same as in *Example 2*, except that the maximum additional amount that C can elect under the special section 457 catch-up under paragraph (c)(3) of this section is $7,000 for 2006.

(ii) *Conclusion*. The maximum that C may defer for 2006 is $22,000. This is the sum of the basic plan ceiling under paragraph (c)(1) of this section equal to $15,000, plus the additional special section 457 catch-up under paragraph (c)(3) of this section equal to $7,000. The additional dollar amount permitted under the age 50 catch-up is not applicable to C for 2006 because it provides a smaller plan ceiling.

(3) *Special section 457 catch-up*—(i) *In general*. Except as provided in paragraph (c)(2)(ii) of this section, an eligible plan may provide that, for one or more of the participant's last three taxable years ending before the participant attains "normal retirement age," the plan ceiling is an amount not in excess of the lesser of—

(A) Twice the dollar amount in effect under paragraph (c)(1)(i)(A) of this section; or

(B) The underutilized limitation determined under paragraph (c)(3)(ii) of this section.

(ii) *Underutilized limitation*. The underutilized amount determined under this paragraph (c)(3)(ii) is the sum of—

(A) The plan ceiling established under paragraph (c)(1) of this section for the taxable year; plus

(B) The plan ceiling established under paragraph (c)(1) of this section (or under section 457(b)(2) for any year before the applicability date of this section) for any prior taxable year or years, less the amount of annual deferrals under the plan for such prior taxable year or years (disregarding any annual deferrals under the plan permitted under the age 50 catch-up under paragraph (c)(2) of this section).

(iii) *Determining underutilized limitation under paragraph (c)(3)(ii)(B) of this section*. In determining the includible compensation of a participant under § 1.457–2(g) for purposes of calculating the amount described in paragraph (c)(3)(ii)(A) of this section, includible compensation is not reduced by contributions of amounts described in paragraph (c)(3)(ii)(B) of this section. In addition, a prior taxable year is taken into account under paragraph (c)(3)(ii)(B) of this section only if it is a year beginning after December 31, 1978, in which the participant was eligible to participate in the plan, and in which compensation deferred (if any) under the plan during the year was subject to a plan ceiling established under paragraph (c)(1) of this section.

(iv) *Special rules concerning application of the coordination limit for years prior to 2002 for purposes of determining the underutilized limitation*—(A) *General rule*. For purposes of determining the underutilized limitation for years prior to 2002, participants remain subject to the rules in effect prior to the repeal of the coordination limitation under section 457(c)(2). Thus, the applicable basic annual limitation under paragraph (c)(1) of this section and the special section 457 catch-up under this paragraph (c)(3) for years in effect prior to 2002 are reduced, for purposes of determining a participant's underutilized amount under a plan, by amounts excluded from the participant's income for any prior taxable year by reason of a salary reduction or elective contribution under any other eligible section 457(b) plan, section 401(k) qualified cash or deferred arrangement, section 402(h)(1)(B) simplified employee pension (SARSEP), section 403(b) annuity contract, and section 408(p) simple retirement account, or under any plan for which a deduction is allowed because of a contribution to an organization described in section 501(c)(18) (pre–2002 coordination plans). Similarly, in applying the section 457(b)(2)(B) limitation for includible compensation for years prior to 2002, the limitation is 33 1/3 percent of the participant's compensation includible in gross income.

(B) *Coordination limitation applied to participant*. For purposes of determining the underutilized limitation for years prior to 2002, the coordination limitation applies to pre-2002 coordination plans of all employers for whom a participant has performed services, not only to those of the eligible employer. Thus, for purposes of determining the amount excluded from a participant's gross income in any prior taxable year under paragraph (c)(3)(ii)(B) of this section, the participant's annual deferral under an eligible plan, and salary reduction or elective deferrals under all other pre-2002 coordination plans, must be determined on an aggregate basis. To the extent that the combined deferral for years prior to 2002 exceeded the maximum deferral limitations, the amount is treated as an excess deferral under paragraph (e) of this section for those prior years.

(C) *Special rule where no annual deferrals under the eligible plan*. A participant who, although eligible, did not defer any compensation under the eligible plan in any given year before 2002 is not subject to the coordinated deferral limit, even though the participant may have deferred compensation under one of the other pre-2002 coordination plans. An individual is treated as not having deferred compensation under an eligible plan for a prior taxable year if all annual deferrals under the plan are distributed in accordance with paragraph (e) of this section. Thus, to the extent that a participant participated solely in one or more of the other pre-2002 coordination plans during a prior taxable year (and not the eligible plan), the participant is not subject to the coordinated limitation for that prior taxable year. However, the participant is treated as having deferred amounts in a prior taxable year for purposes of determining the underutilized limitation for that prior taxable year under this paragraph (c)(3)(iv)(C), but only to the extent that the participant's salary reduction contributions or elective deferrals under all pre-2002 coordination plans have not exceeded the maximum deferral limitations in effect under section 457(b) for that prior taxable year. To the extent an employer did not offer an eligible plan to an individual in a prior given year, no underutilized limitation is available to the individual for that prior year, even if the

employee subsequently becomes eligible to participate in an eligible plan of the employer.

(D) *Examples*. The provisions of this paragraph (c)(3)(iv) are illustrated by the following examples:

Example 1. (i) *Facts*. In 2001 and in years prior to 2001, Participant D earned $50,000 a year and was eligible to participate in both an eligible plan and a section 401(k) plan. However, D had always participated only in the section 401(k) plan and had always deferred the maximum amount possible. For each year before 2002, the maximum amount permitted under section 401(k) exceeded the limitation of paragraph (c)(3)(i) of this section. In 2002, D is in the 3-year period prior to D's attainment of the eligible plan's normal retirement age of 65, and D now wants to participate in the eligible plan and make annual deferrals of up to $30,000 under the plan's special section 457 catch-up provisions.

(ii) *Conclusion*. Participant D is treated as having no underutilized amount under paragraph (c)(3)(ii)(B) of this section for 2002 for purposes of the catch-up limitation under section 457(b)(3) and paragraph (c)(3) of this section because, in each of the years before 2002, D has deferred an amount in excess of the limitation of paragraph (c)(3)(i) of this section.

Example 2. (i) *Facts*. Assume the same facts as in *Example 1*, except that D only deferred $2,500 per year under the section 401(k) plan for one year before 2002.

(ii) *Conclusion*. D is treated as having an underutilized amount under paragraph (c)(3)(ii)(B) of this section for 2002 for purposes of the special section 457 catch-up limitation. This is because D has deferred an amount for prior years that is less than the limitation of paragraph (c)(1)(i) of this section.

Example 3. (i) *Facts*. Participant E, who earned $15,000 for 2000, entered into a salary reduction agreement in 2000 with E's eligible employer and elected to defer $3,000 for that year. For 2000, E's eligible employer provided an immediately vested, matching employer contribution under the plan for participants who make salary reduction deferrals under E's eligible plan. The matching contribution was equal to 100 percent of elective contributions, but not in excess of 10 percent of compensation before salary reduction deferrals (in E's case, $1,500). For 2000, E was not eligible for any catch-up contribution, participated in no other retirement plan, and had no other income exclusions taken into account in computing taxable compensation.

(ii) *Conclusion*. Participant E's annual deferral exceeded the limitations of section 457(b) for 2000. E's maximum deferral limitation in 2000 was $4,000 because E's includible compensation was $12,000 ($15,000 minus the deferral of $3,000) and the applicable limitation for 2000 was one-third of the individual's includible compensation (one-third of $12,000 equals $4,000). E's salary reduction deferral of $3,000 combined with E's eligible employer's matching contribution of $1,500 exceeded the limitation of section 457(b) for 2000 because E's annual deferrals totaled $4,500. E had an excess deferral for 2000 of $500, the amount exceeding E's permitted annual deferral limitation, and E's underutilized amount for 2000 is zero.

(v) *Normal retirement age*—(A) *General rule*. For purposes of the special section 457 catch-up in this paragraph (c)(3), a plan must specify the normal retirement age under the plan. A plan may define normal retirement age as any age that is on or after the earlier of age 65 or the age at which participants have the right to retire and receive, under the basic defined benefit pension plan of the state or tax-exempt entity, immediate retirement benefits without actuarial or similar reduction because of retirement before some later specified age, and that is not later than age 70 ½. Alternatively, a plan may provide that a participant is allowed to designate a normal retirement age within these ages. For purposes of the special section 457 catch-up in this paragraph (c)(3), an entity sponsoring more than one eligible plan may not permit a participant to have more than one normal retirement age under the eligible plans it sponsors.

(B) *Special rule for eligible plans of qualified police or firefighters*. An eligible plan with participants that include qualified police or firefighters as defined under section 415(b)(2)(H)(ii)(I) may designate a normal retirement age for such qualified police or firefighters that is earlier than the earliest normal retirement age designated under the general rule of paragraph (c)(3)(i)(A) of this section, but in no event may the normal retirement age be earlier than age 40. Alternatively, a plan may allow a qualified police or firefighter participant to designate a normal retirement age that is between age 40 and age 70 ½.

(vi) *Examples*. The provisions of this paragraph (c)(3) are illustrated by the following examples:

Example 1. (i) *Facts*. Participant *F*, who will turn 61 on April 1, 2006, becomes eligible to participate in an eligible plan on January 1, 2006. The plan provides a normal retirement age of 65. The plan provides limitations on annual deferrals up to the maximum permitted under paragraphs (c)(1) through (3) of this section. For 2006, F will receive compensation of $40,000 from the eligible employer. F desires to defer the maximum amount possible in 2006. The applicable basic dollar limit of paragraph (c)(1)(i)(A) of this section is $15,000 for 2006 and the additional dollar amount permitted under the age 50 catch-up in paragraph (c)(2) of this section for an individual who is at least age 50 is $5,000 for 2006.

(ii) *Conclusion*. F is not eligible for the special section 457 catch-up under paragraph (c)(3) of this section in 2006 because 2006 is not one of the last three taxable years ending before F attains normal retirement age. Accordingly, the maximum that F may defer for 2006 is $20,000. See also paragraph (c)(2)(iii) *Example 1* of this section.

Example 2. (i) *Facts*. The facts are the same as in *Example 1* except that, in 2006, F elects to defer only $2,000 under the plan (rather than the maximum permitted amount of $20,000). In addition, assume that the applicable basic dollar limit of paragraph (c)(1)(i)(A) of this section continues to be $15,000 for 2007 and the additional dollar amount permitted under the age 50 catch-up in paragraph (c)(2) of this section for an individual who is at least age 50 continues to be $5,000 for 2007. In F's taxable year 2007, which is one of the last three taxable years ending before F attains the plan's normal retirement age of 65, F again receives a salary of $40,000 and elects to defer the maximum amount permissible under the plan's catch-up provisions prescribed under paragraph (c) of this section.

(ii) *Conclusion*. For 2007, which is one of the last three taxable years ending before F attains the plan's normal retirement age of 65, the applicable limit on deferrals for F is the larger of the amount under the special section 457 catch-up or $20,000, which is the basic annual limitation ($15,000) and the age 50 catch-up limit of section 414(v) ($5,000). For 2007, F's special section 457 catch-up amount is the lesser of two times the basic annual limitation ($30,000) or the sum of the basic annual limitation ($15,000) plus the $13,000 underutilized limitation under paragraph (c)(3)(ii) of this section (the $15,000 plan ceiling in 2006, minus the $2,000 contributed for F in 2006), or $28,000. Thus, the maximum amount that F may defer in 2007 is $28,000.

Example 3. (i) *Facts*. The facts are the same as in *Examples 1* and *2*, except that F does not make any contributions to the plan before 2010. In addition, assume that the applicable basic dollar limitation of paragraph (c)(1)(i)(A) of this section continues to be $15,000 for 2010 and the additional dollar amount permitted under the age 50 catch-up in paragraph (c)(2) of this section for an individual who is at least age 50 continues to be $5,000 for 2010. In F's taxable year 2010, the year in which F attains age 65 (which is the normal retirement age under the plan), F desires to defer the maximum amount possible under the plan. F's compensation for 2010 is again $40,000.

(ii) *Conclusion*. For 2010, the maximum amount that F may defer is $20,000. The special section 457 catch-up provisions under paragraph (c)(3) of this section are not applicable because 2010 is not a taxable year ending before the year in which F attains normal retirement age.

(4) *Cost-of-living adjustment*. For years beginning after December 31, 2006, the $15,000 dollar limitation in paragraph (c)(1)(i)(A) of this section will be adjusted to take into account increases in the cost-of-living. The adjustment in the dollar limitation is made at the same time and in the same manner as under section 415(d) (relating to qualified plans under section 401(a)), except that the base period is the calendar quarter beginning July 1, 2005, and any increase which is

not a multiple of $500 will be rounded to the next lowest multiple of $500.

(d) *Deferral of sick, vacation, and back pay under an eligible plan*—(1) *In general*. An eligible plan may provide that a participant may elect to defer accumulated sick pay, accumulated vacation pay, and back pay under an eligible plan if certain conditions are satisfied. The plan must provide, in accordance with paragraph (b) of this section, that these amounts may be deferred for any calendar month only if an agreement providing for the deferral is entered into before the beginning of the month in which the amounts would otherwise be paid or made available and the participant is an employee in that month. Any deferrals made under this paragraph (d)(1) under an eligible plan are subject to the maximum deferral limitations of paragraph (c) of this section.

(2) *Examples*. The provisions of this paragraph (d) are illustrated by the following examples:

Example 1. (i) *Facts*. Participant G, age 62, is a participant in an eligible plan providing a normal retirement age of 65. Under the terms of G's employer's eligible plan and G's sick leave plan, G may, during November of 2003 (which is one of the three years prior to normal retirement age), make a one-time election to contribute amounts representing accumulated sick pay to the eligible plan in December of 2003 (within the maximum deferral limitations). Alternatively, such amounts may remain in the "bank" under the sick leave plan. No cash out of the sick pay is available at any time prior to termination of employment. The total value of G's accumulated sick pay (determined, in accordance with the terms of the sick leave plan, by reference to G's current salary) is $4,000 in December of 2003.

(ii) *Conclusion*. Under the terms of the eligible plan and sick leave plan, G may elect before December of 2003 to defer the $4,000 value of accumulated sick pay under the eligible plan, provided that G's other annual deferrals to the eligible plan for 2003, when added to the $4,000, do not exceed G's maximum deferral limitation for the year.

Example 2. (i) *Facts*. Employer X maintains an eligible plan and a vacation leave plan. Under the terms of the vacation leave plan, employees generally accrue three weeks of vacation per year. Up to one week's unused vacation may be carried over from one year to the next, so that in any single year an employee may have a maximum of four weeks vacation time. At the beginning of each calendar year, under the terms of the eligible plan (which constitutes an agreement providing for the deferral), the value of any unused vacation time from the prior year in excess of one week is automatically contributed to the eligible plan, to the extent of the employee's maximum deferral limitations. Amounts in excess of the maximum deferral limitations are forfeited.

(ii) *Conclusion*. The value of the unused vacation pay contributed to X's eligible plan pursuant to the terms of the plan and the terms of the vacation leave plan is treated as an annual deferral to the eligible plan in the calendar year the contribution is made. No amounts contributed to the eligible plan will be considered made available to a participant in X's eligible plan.

(e) *Excess deferrals under an eligible plan*—(1) *In general*. Any amount deferred under an eligible plan for the taxable year of a participant that exceeds the maximum deferral limitations set forth in paragraphs (c)(1) through (3) of this section, and any amount that exceeds the individual limitation under § 1.457–5, constitutes an excess deferral taxable in accordance with § 1.457–11 for that taxable year. Thus, an excess deferral is includible in gross income in the taxable year deferred or, if later, the first taxable year in which there is no substantial risk of forfeiture.

(2) *Excess deferrals under an eligible governmental plan other than as a result of the individual limitation*. In order to be an eligible governmental plan, the plan must provide that any excess deferrals resulting from a failure of a plan to apply the limitations of paragraphs (c)(1) through (3) of this section to amounts deferred under the eligible plan (computed without regard to the individual limitation under § 1.457–5) will be distributed to the participant, with allocable net income, as soon as administratively practicable after the plan determines that the amount is an excess deferral. For purposes of determining whether there is an excess deferral resulting from a failure of a plan to apply the limitations of paragraphs (c)(1) through (3) of this section, all plans under which an individual participates by virtue of his or her relationship with a single employer are treated as a single plan. An eligible governmental plan does not fail to satisfy the requirements of paragraphs (a) through (d) of this section or §§ 1.457–6 through 1.457–10 (including the distribution rules under § 1.457–6 and the funding rules under § 1.457–8) solely by reason of a distribution made under this paragraph (e)(2). If such excess deferrals are not corrected by distribution under this paragraph (e)(2), the plan will be an ineligible plan under which benefits are taxable in accordance with § 1.457–11.

(3) *Excess deferrals under an eligible plan of a tax-exempt employer other than as a result of the individual limitation*. If a plan of a tax-exempt employer fails to comply with the limitations of paragraphs (c)(1) through (3) of this section, the plan will be an ineligible plan under which benefits are taxable in accordance with § 1.457–11. For purposes of determining whether there is an excess deferral resulting from a failure of a plan to apply the limitations of paragraphs (c)(1) through (3) of this section, all plans under which an individual participates by virtue of his or her relationship with a single employer are treated as a single plan.

(4) *Excess deferrals arising from application of the individual limitation*. An eligible plan may provide that an excess deferral as a result of a failure to comply with the individual limitation under § 1.457–5 for a taxable year may be distributed to the participant, with allocable net income, as soon as administratively practicable after the plan determines that the amount is an excess deferral. An eligible plan does not fail to satisfy the requirements of paragraphs (a) through (d) of this section or §§ 1.457–6 through 1.457–10 (including the distribution rules under § 1.457–6 and the funding rules under § 1.457–8) solely by reason of a distribution made under this paragraph (e)(4). Although a plan will still maintain eligible status if excess deferrals are not distributed under this paragraph (e)(4), a participant must include the excess amounts in income as provided in paragraph (e)(1) of this section.

(5) *Examples*. The provisions of this paragraph (e) are illustrated by the following examples:

Example 1. (i) *Facts*. In 2006, the eligible plan of State Employer X in which Participant H participates permits a maximum deferral of the lesser of $15,000 or 100 percent of includible compensation. In 2006, H, who has compensation of $28,000, nevertheless defers $16,000 under the eligible plan. Participant H is age 45 and normal retirement age under the plan is age 65. For 2006, the applicable dollar limit under paragraph (c)(1)(i)(A) of this section is $15,000.

(ii) *Conclusion*. Participant H has deferred $1,000 in excess of the $15,000 limitation provided for under the plan for 2006. The $1,000 excess must be included by H into H's income for 2006. In order to correct the failure and still be an eligible plan, the plan must distribute the excess deferral, with allocable net income, as soon as administratively practicable after determining that the amount exceeds the plan deferral limitations. If the excess deferral is not distributed, the plan will be an ineligible plan

with respect to which benefits are taxable in accordance with § 1.457–11.

Example 2. (i) *Facts*. The facts are the same as in *Example 1*, except that H's deferral under the eligible plan is limited to $11,000 and H also makes a salary reduction contribution of $5,000 to an annuity contract under section 403(b) with the same Employer X.

(ii) *Conclusion*. H's deferrals are within the plan deferral limitations of Employer X. Because of the repeal of the application of the coordination limitation under former paragraph (2) of section 457(c), H's salary reduction deferrals under the annuity contract are no longer considered in determining H's applicable deferral limits under paragraphs (c)(1) through (3) of this section.

Example 3. (i) *Facts*. The facts are the same as in *Example 1*, except that H's deferral under the eligible governmental plan is limited to $14,000 and H also makes a deferral of $4,000 to an eligible governmental plan of a different employer. Participant H is age 45 and normal retirement age under both eligible plans is age 65.

(ii) *Conclusion*. Because of the application of the individual limitation under § 1.457–5, H has an excess deferral of $3,000 (the sum of $14,000 plus $4,000 equals $18,000, which is $3,000 in excess of the dollar limitation of $15,000). The $3,000 excess deferral, with allocable net income, may be distributed from either plan as soon as administratively practicable after determining that the combined amount exceeds the deferral limitations. If the $3,000 excess deferral is not distributed to H, each plan will continue to be an eligible plan, but the $3,000 must be included by H into H's income for 2006.

Example 4. (i) *Facts*. Assume the same facts as in *Example 3*, except that H's deferral under the eligible governmental plan is limited to $14,000 and H also makes a deferral of $4,000 to an eligible plan of Employer Y, a tax-exempt entity.

(ii) *Conclusion*. The results are the same as in *Example 3, i.e.*, because of the application of the individual limitation under § 1.457–5, H has an excess deferral of $3,000. If the $3,000 excess deferral is not distributed to H, each plan will continue to be an eligible plan, but the $3,000 must be included by H into H's income for 2006.

Par. 3. Sections 1.457–5 through 1.457–12 are added to read as follows:

§ 1.457–5 Individual limitation for combined annual deferrals under multiple eligible plans

(a) *General rule*. The individual limitation under section 457(c) and this section equals the basic annual deferral limitation under § 1.457–4(c)(1)(i)(A), the age 50 catch-up amount under § 1.457–4(c)(2), and the special section 457 catch-up amount under § 1.457–4(c)(3), applied by taking into account the combined annual deferral for the participant for any taxable year under all eligible plans. While an eligible plan may include provisions under which it will meet the individual limitation under section 457(c) and this section, annual deferrals by a participant that exceed the individual limit under section 457(c) and this section will not cause a plan to lose its eligible status. However, to the extent the combined annual deferrals for a participant for any taxable year exceed the individual limitation under section 457(c) and this section for that year, the amounts are treated as excess deferrals as described in § 1.457–4(e).

(b) *Limitation applied to participant*. The individual limitation in this section applies to eligible plans of all employers for whom a participant has performed services, including both eligible governmental plans and eligible plans of a tax-exempt entity and both eligible plans of the employer and eligible plans of other employers. Thus, for purposes of determining the amount excluded from a participant's gross income in any taxable year (including the underutilized limitation under § 1.457–4(c)(3)(ii)(B)), the participant's annual deferral under an eligible plan, and the participant's annual deferrals under all other eligible plans, must be determined on an aggregate basis. To the extent that the combined annual deferral amount exceeds the maximum deferral limitation applicable under § 1.457–4(c)(1)(i)(A), (c)(2), or (c)(3), the amount is treated as an excess deferral under § 1.457–4(e).

(c) *Special rules for catch-up amounts under multiple eligible plans*. For purposes of applying section 457(c) and this section, the special section 457 catch-up under § 1.457–4(c)(3) is taken into account only to the extent that an annual deferral is made for a participant under an eligible plan as a result of plan provisions permitted under § 1.457–4(c)(3). In addition, if a participant has annual deferrals under more than one eligible plan and the applicable catch-up amount under § 1.457–4(c)(2) or (3) is not the same for each such eligible plan for the taxable year, section 457(c) and this section are applied using the catch-up amount under whichever plan has the largest catch-up amount applicable to the participant.

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

Example 1. (i) *Facts*. Participant F is age 62 in 2006 and participates in two eligible plans during 2006, Plans J and K, which are each eligible plans of two different governmental entities. Each plan includes provisions allowing the maximum annual deferral permitted under § 1.457–4(c)(1) through (3). For 2006, the underutilized amount under § 1.457–4(c)(3)(ii)(B) is $20,000 under Plan J and is $40,000 under Plan K. Normal retirement age is age 65 under both plans. Participant F defers $15,000 under each plan. Participant F's includible compensation is in each case in excess of the deferral. Neither plan designates the $15,000 contribution as a catch-up permitted under each plan's special section 457 catch-up provisions.

(ii) *Conclusion*. For purposes of applying this section to Participant F for 2006, the maximum exclusion is $20,000. This is equal to the sum of $15,000 plus $5,000, which is the age 50 catch-up amount. Thus, F has an excess amount of $10,000 which is treated as an excess deferral for Participant F for 2006 under § 1.457–4(e).

Example 2. (i) *Facts*. Participant E, who will turn 63 on April 1, 2006, participates in four eligible plans during 2006: Plan W which is an eligible governmental plan; and Plans X, Y, and Z which are each eligible plans of three different tax-exempt entities. For 2006, the limitation under these plans that apply to Participant E under all four plans under § 1.457–4(c)(1)(i)(A) is $15,000. For 2006, the additional age 50 catch-up limitation that applies to Participant E under Plan W under § 1.457–4(c)(2) is $5,000. Further, for 2006, different limitations under §§ 1.457–4(c)(3) and (c)(3)(ii)(B) apply to Participant E under each of these plans, as follows: under Plan W, the underutilized limitation under § 1.457–4(c)(3)(ii)(B) is *$7,000*; under Plan X, the underutilized limitation under § 1.457–4(c)(3)(ii)(B) is *$2,000*; under Plan Y, the underutilized limitation under § 1.457–4(c)(3)(ii)(B) is *$8,000*; and under Plan Z, § 1.457–4(c)(3) is not applicable since normal retirement age is age 62 under Plan Z. Participant E's includible compensation is in each case in excess of any applicable deferral.

(ii) *Conclusion*. For purposes of applying this section to Participant E for 2006, Participant E could elect to defer $23,000 under Plan Y, which is the maximum deferral limitation under §§ 1.457–4(c)(1) through (3), and to defer no amount under Plans W, X, and Z. The $23,000 maximum amount is equal to the sum of $15,000 plus $8,000, which is the catch-up amount applicable to Participant E under Plan Y and which is the largest catch-up amount applicable to Participant E under any of the four plans for 2006. Alternatively, Participant E could instead elect to defer the following combination of amounts: $5,000 to Plan W and an aggregate total of $15,000 to Plans X, Y, and Z; $22,000 to Plan W and none to any of the other three plans; $17,000 to Plan X and none to any of the other three plans; or $15,000 to Plan Z and none to any of the other three plans.

(iii) If the underutilized amount under Plans W, X, and Y for 2006 were in each case zero (because E had always contributed the maximum amount or E was a new participant) or an amount not in excess of $5,000, the maximum exclusion under this section would be $20,000 for Participant E for 2006 ($15,000 plus the $5,000 age 50 catch-up amount), which Participant E could contribute to Plan W.

§ 1.457–6 Timing of distributions under eligible plans.

(a) *In general*. Except as provided in paragraph (c) of this section (relating to distributions on account of an unforeseeable emergency), paragraph (e) of this section (relating to distributions of small accounts), § 1.457–10(a) (relating to plan terminations), or § 1.457–10(c) (relating to domestic relations orders), amounts deferred under an eligible governmental plan may not be paid to a participant or beneficiary before the participant has a severance from employment with the eligible employer. For rules relating to loans, see paragraph (f) of this section.

(b) *Severance from employment*—(1) *Employees*. An employee has a severance from employment with the eligible employer if the employee dies, retires, or otherwise has a severance from employment with the eligible employer.

(2) *Independent contractors*—(i) *In general*. An independent contractor is considered to have a severance from employment with the eligible employer upon the expiration of the contract (or in the case of more than one contract, all contracts) under which services are performed for the eligible employer, if the expiration constitutes a good-faith and complete termination of the contractual relationship. An expiration does not constitute a good faith and complete termination of the contractual relationship if the eligible employer anticipates a renewal of a contractual relationship or the independent contractor becoming an employee. For this purpose, an eligible employer is considered to anticipate the renewal of the contractual relationship with an independent contractor if it intends to again contract for the services provided under the expired contract, and neither the eligible employer nor the independent contractor has eliminated the independent contractor as a possible provider of services under any such new contract. Further, an eligible employer is considered to intend to again contract for the services provided under an expired contract if the eligible employer's doing so is conditioned only upon incurring a need for the services, the availability of funds, or both.

(ii) *Special rule*. Notwithstanding paragraph (b)(2)(i) of this section, the plan is considered to satisfy the requirement described in paragraph (a) of this section that no amounts deferred under the plan be paid or made available to the participant before the participant has a severance from employment with the eligible employer, if, with respect to amounts payable to a participant who is an independent contractor, an eligible plan provides that—

(A) No amount will be paid to the participant before a date at least 12 months after the day on which the contract expires under which services are performed for the eligible employer (or, in the case of more than one contract, all such contracts expire); and

(B) No amount payable to the participant on that date will be paid to the participant if, after the expiration of the contract (or contracts) and before that date, the participant performs services for the eligible employer as an independent contractor or an employee.

(c) *Rules applicable to distributions for unforeseeable emergencies*—(1) *In general*. An eligible plan may permit a distribution to a participant or beneficiary faced with an unforeseeable emergency. The distribution must satisfy the requirement of paragraph (c)(2) of this section.

(2) *Requirements*—(i) *Unforeseeable emergency defined*. An unforeseeable emergency must be defined in the plan as a severe financial hardship of the participant or beneficiary resulting from an illness or accident of the participant or beneficiary, the participant's or beneficiary's spouse or the participant's or beneficiary's dependent (as defined in section 152(a)); loss of the participant's or beneficiary's property due to casualty; or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant or the beneficiary. For example, the imminent foreclosure of or eviction from the participant's or beneficiary's primary residence may constitute an unforeseeable emergency. In addition, the need to pay for medical expenses, including nonrefundable deductibles, as well as for the cost of prescription drug medication, may constitute an unforeseeable emergency. Finally, the need to pay for the funeral expenses of a family member may also constitute an unforeseeable emergency. Except in extraordinary circumstances, the purchase of a home and the payment of college tuition are not unforeseeable emergencies under this paragraph (c)(2).

(ii) *Unforeseeable emergency distribution standard*. Whether a participant or beneficiary is faced with an unforeseeable emergency permitting a distribution under this paragraph (c) is to be determined based on the relevant facts and circumstances of each case, but, in any case, a distribution on account of unforeseeable emergency may not be made to the extent that such emergency is or may be relieved through reimbursement or compensation from insurance or otherwise; by liquidation of the participant's assets, to the extent the liquidation of such assets would not itself cause severe financial hardship; or by cessation of deferrals under the plan.

(iii) *Distribution necessary to satisfy emergency need*. Distributions because of an unforeseeable emergency must be limited to the amount reasonably necessary to satisfy the emergency need (which may include any amounts necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution).

(d) Minimum required distributions for eligible plans. In order to be an eligible plan, a plan must meet the distribution requirements of section 457(d)(1) and (2). Under section 457(d)(2), a plan must meet the minimum distribution requirements of section 401(a)(9). See section 401(a)(9) and the regulations thereunder for these requirements. Section 401(a)(9) requires that a plan begin lifetime distributions to a participant no later than April 1 of the calendar year following the later of the calendar year in which the participant attains age 70 ½ or the calendar year in which the participant retires.

(e) *Distributions of smaller accounts*—(1) *In general*. An eligible plan may provide for a distribution of all or a portion of a dollar amount which is not attributable to rollover contributions (as defined in section 411(a)(11)(D)). In order to permit such a distribution, an eligible plan must provide that the amount of the distribution must not exceed the dollar limit under section 411(a)(11)(A) (which is $5,000 for 2002) and that the distribution is made only if no amount has been deferred under the plan by or for the participant during the two-year period ending on the date of the distribution and

there has been no prior distribution under the plan to the participant under this paragraph (e). An eligible plan is not required to permit distributions under this paragraph (e).

(2) *Alternative provisions possible*. Consistent with the provisions of paragraph (e)(1) of this section, a plan may provide that the total amount deferred for a participant or beneficiary, if not in excess of the applicable dollar limit of section 411(a)(11)(A), will be distributed automatically to the participant or beneficiary if the requirements of paragraph (e)(1) of this section are met. Alternatively, the plan may provide for the total amount deferred for a participant or beneficiary, if not in excess of the applicable dollar limit of section 411(a)(11)(A), to be distributed to the participant or beneficiary only if the participant or beneficiary so elects. The plan is permitted to substitute a specified dollar amount that is less than the applicable dollar limit of section 411(a)(11)(A) under either of these alternatives. In addition, these two alternatives can be combined; for example, a plan could provide for automatic distributions for account balances totaling an amount not in excess of the applicable dollar limit of section 411(a)(11)(A) but allow participants or beneficiary to elect a distribution if the total account balance is above $500 but not above the applicable dollar limit of section 411(a)(11)(A).

(f) *Loans from eligible plans*—(1) *Eligible plans of tax-exempt entities*. If a participant or beneficiary receives (directly or indirectly) any amount deferred as a loan from an eligible plan of a tax-exempt entity, that amount will be treated as having been paid or made available to the individual as a distribution under the plan, in violation of the distribution requirements of section 457(d).

(2) *Eligible governmental plans*. The determination of whether the availability of a loan, the making of a loan, or a failure to repay a loan made from a trustee (or a person treated as a trustee under section 457(g)) of an eligible governmental plan to a participant or beneficiary is treated as a distribution (directly or indirectly) for purposes of this section, and the determination of whether the availability of the loan, the making of the loan, or a failure to repay the loan is in any other respect a violation of the requirements of section 457(b) and the regulations, depends on the facts and circumstances. Thus, for example, a loan must bear a reasonable rate of interest in order to satisfy the exclusive benefit requirement of section 457(g)(1) and § 1.457–8(a)(1). See also § 1.457–7(b)(3) relating to the application of section 72(p) with respect to the taxation of a loan made under an eligible governmental plan, and § 1.72(p)–1 relating to section 72(p)(2).

(3) *Example*. The provisions of paragraph (f)(2) of this section are illustrated by the following example:

Example. (i) *Facts*. Eligible Plan X of State Y is funded through Trust Z. Plan X provides for an employee's account balance under Plan X to be paid in 5 annual installments (of 1/5th the account balance the first year, 1/4th the account balance the second year, etc.) beginning at severance from employment with State Y. Plan X includes a loan program under which any active employee with a vested account balance may receive a loan from Trust Z. Loans are made pursuant to plan provisions regarding loans that are set forth in the plan under which loans bear a reasonable rate of interest and are secured by the employee's account balance. In order to avoid taxation under § 1.457–7(b)(3) and section 72(p)(1), the plan provisions limit the amount of loans and require loans to be repaid in level installments as required under section 72(p)(2). Participant J's vested account balance under Plan X is $50,000. J receives a loan from Trust Z in the amount of $5,000 on December 1, 2003 to be repaid in level installments made quarterly over the 5-year period ending on November 30, 2008. Participant J makes the required repayments until J has a severance from employment from State Y in 2005 and subsequently fails to repay the outstanding loan balance of $2,250. The $2,250 loan balance is offset against J's $80,000 account balance benefit under Plan X, and J is paid one fifth of the remaining $77,750 in 2005.

(ii) *Conclusion*. The making of the loan to J will not be treated as a violation of the requirements of section 457(b) or the regulations. The cancellation of the loan at severance from employment does not cause Plan X to fail to satisfy the requirements for plan eligibility under section 457. In addition, because the loan satisfies the maximum amount and repayment requirements of section 72(p)(2), J is not required to include any amount in income as a result of the loan until 2005, when J has income of $2,250 as a result of the offset (which is a permissible distribution under this section) and income of $15,550 (one fifth of $77,750) as a result of the first annual installment payment.

§ 1.457–7 Taxation of distributions under eligible plans.

(a) *General rules for when amounts are included in gross income*. The rules for determining when an amount deferred under an eligible plan is includible in the gross income of a participant or beneficiary depend on whether the plan is an eligible governmental plan or an eligible plan of a tax-exempt entity. Paragraph (b) of this section sets forth the rules for an eligible governmental plan. Paragraph (c) of this section sets forth the rules for an eligible plan of a tax-exempt entity.

(b) *Amounts included in gross income under an eligible governmental plan*—(1) *Amounts included in gross income in year paid under an eligible governmental plan*. Except as provided in paragraphs (b)(2) and (3) of this section (or in § 1.457–10(c) relating to payments to a spouse or former spouse pursuant to a qualified domestic relations order), amounts deferred under an eligible governmental plan are includible in the gross income of a participant or beneficiary for the taxable year in which paid to the participant or beneficiary under the plan.

(2) *Rollovers to individual retirement arrangements and other eligible retirement plans*. A trustee-to-trustee transfer in accordance with section 401(a)(31) (generally referred to as a direct rollover) is not includible in gross income of a participant or beneficiary in the year transferred. In addition, any payment made in the form of an eligible rollover distribution (as defined in section 402(c)(4)) is not includible in gross income in the year paid to the extent the payment is transferred to an eligible retirement plan (as defined in section 402(c)(8)(B)) within 60 days, including the transfer to the eligible retirement plan of any property distributed from the eligible governmental plan. For this purpose, the rules of section 402(c)(2) through (7) and (9) apply. Any trustee-to-trustee transfer under this paragraph (b)(2) is a distribution that is subject to the distribution requirements of § 1.457–6.

(3) *Amounts taxable under section 72(p)(1)*. In accordance with section 72(p), the amount of any loan from an eligible governmental plan to a participant or beneficiary (including any pledge

or assignment treated as a loan under section 72(p)(1)(B)) is treated as having been received as a distribution from the plan under section 72(p)(1), except to the extent set forth in section 72(p)(2) (relating to loans that do not exceed a maximum amount and that are repayable in accordance with certain terms) and § 1.72(p)–1. Thus, except to the extent a loan satisfies section 72(p)(2), any amount loaned from an eligible governmental plan to a participant or beneficiary (including any pledge or assignment treated as a loan under section 72(p)(1)(B)) is includible in the gross income of the participant or beneficiary for the taxable year in which the loan is made. See generally § 1.72(p)–1.

(4) *Examples*. The provisions of this paragraph (b) are illustrated by the following examples:

Example 1. (i) *Facts*. Eligible Plan G of a governmental entity permits distribution of benefits in a single sum or in installments of up to 20 years, with such benefits to commence at any date that is after severance from employment (but not later than the plan's normal retirement age of 65). Effective for participants who have a severance from employment after December 31, 2001, Plan X allows an election—as to both the date on which payments are to begin and the form in which payments are to be made—to be made by the participant at any time that is before the commencement date selected. However, Plan X chooses to require elections to be filed at least 30 days before the commencement date selected in order for Plan X to have enough time to be able to effectuate the election.

(ii) *Conclusion*. No amounts are included in gross income before actual payments begin. If installment payments begin (and the installment payments are payable over at least 10 years so as not to be eligible rollover distributions), the amount included in gross income for any year is equal to the amount of the installment payment paid during the year.

Example 2. (i) *Facts*. Same facts as in *Example 1*, except that the same rules are extended to participants who had a severance from employment before January 1, 2002.

(ii) *Conclusion*. For all participants (*i.e.*, both those who have a severance from employment after December 31, 2001, and those who have a severance from employment before January 1, 2002 (including those whose benefit payments have commenced before January 1, 2002)), no amounts are included in gross income before actual payments begin. If installment payments begin (and the installment payments are payable over at least 10 years so as not to be eligible rollover distributions), the amount included in gross income for any year is equal to the amount of the installment payment paid during the year.

(c) *Amounts included in gross income under an eligible plan of a tax-exempt entity*—(1) *Amounts included in gross income in year paid or made available under an eligible plan of a tax-exempt entity*. Amounts deferred under an eligible plan of a tax-exempt entity are includible in the gross income of a participant or beneficiary for the taxable year in which paid or otherwise made available to the participant or beneficiary under the plan. Thus, amounts deferred under an eligible plan of a tax-exempt entity are includible in the gross income of the participant or beneficiary in the year the amounts are first made available under the terms of the plan, even if the plan has not distributed the amounts deferred. Amounts deferred under an eligible plan of a tax-exempt entity are not considered made available to the participant or beneficiary solely because the participant or beneficiary is permitted to choose among various investments under the plan.

(2) *When amounts deferred are considered to be made available under an eligible plan of a tax-exempt entity*—(i) *General rule*. Except as provided in paragraphs (c)(2)(ii) through (iv) of this section, amounts deferred under an eligible plan of a tax-exempt entity are considered made available (and, thus, are includible in the gross income of the participant or beneficiary under this paragraph (c)) at the earliest date, on or after severance from employment, on which the plan allows distributions to commence, but in no event later than the date on which distributions must commence pursuant to section 401(a)(9). For example, in the case of a plan that permits distribution to commence on the date that is 60 days after the close of the plan year in which the participant has a severance from employment with the eligible employer, amounts deferred are considered to be made available on that date. However, distributions deferred in accordance with paragraphs (c)(2)(ii) through (iv) of this section are not considered made available prior to the applicable date under paragraphs (c)(2)(ii) through (iv) of this section. In addition, no portion of a participant or beneficiary's account is treated as made available (and thus currently includible in income) under an eligible plan of a tax-exempt entity merely because the participant or beneficiary under the plan may elect to receive a distribution in any of the following circumstances:

(A) If the requirements of § 1.457–4(d) are met, a distribution of amounts representing accumulated sick and vacation pay solely because a participant was entitled to take paid sick or vacation leave in lieu of regular compensation or because the participant could have deferred these amounts under an eligible plan at an earlier date. However, to the extent that the participant is able to receive the value of accumulated sick and vacation pay in cash (in addition to regular compensation) at the time of the election to defer, these amounts are considered made available.

(B) If the requirements of § 1.457–6(c)(2) are met, a distribution in the event of an unforeseeable emergency.

(C) If the requirements of § 1.457–6(e)(1) are met, a distribution not in excess of the dollar limit under section 411(a)(11)(A) (which is $5,000 for 2002) either before or after the participant has a severance from employment with the employer.

(ii) *Initial election to defer commencement of distributions*—(A) *In general*. An eligible plan of a tax-exempt entity may provide a period for making an initial election during which the participant or beneficiary may elect, in accordance with the terms of the plan, to defer the payment of some or all of the amounts deferred to a fixed or determinable future time. The period for making this initial election must expire prior to the first time that any such amounts would be considered made available under the plan under paragraph (c)(2)(i) of this section.

(B) *Failure to make initial election to defer commencement of distributions*. Generally, if no initial election is made by a participant or beneficiary under this paragraph (c)(2)(ii), then the amounts deferred under an eligible plan of a tax-exempt entity are considered made available and taxable to the participant or beneficiary in accordance with paragraph (c)(2)(i) of this section at the earliest time, on or after severance from employment (but in no event later than the date on which distributions must commence pursuant to section 401(a)(9)), that distribution is permitted to commence under the terms of the plan. However, the plan may provide for a default payment schedule that applies if no election is made. If the plan provides for a default payment

schedule, the amounts deferred are includible in the gross income of the participant or beneficiary in the year the amounts deferred are first made available under the terms of the default payment schedule.

(iii) *Additional election to defer commencement of distribution*. An eligible plan of a tax-exempt entity is permitted to provide that a participant or beneficiary who has made an initial election under paragraph (c)(2)(ii)(A) of this section may make one additional election to defer (but not accelerate) commencement of distributions under the plan before distributions have commenced in accordance with the initial deferral election under paragraph (c)(2)(ii)(A) of this section. Amounts payable to a participant or beneficiary under an eligible plan of a tax-exempt entity are not treated as made available merely because the plan allows the participant to make an additional election under this paragraph (c)(2)(iii). A participant or beneficiary is not precluded from making an additional election to defer commencement of distributions merely because the participant or beneficiary has previously received a distribution under § 1.457–6(c) because of an unforeseeable emergency, has received a distribution of smaller amounts under § 1.457–6(e), has made (and revoked) other deferral or method of payment elections within the initial election period, or is subject to a default payment schedule under which the commencement of benefits is deferred (for example, until a participant is age 65).

(iv) *Election as to method of payment*. An eligible plan of a tax-exempt entity may provide that the election as to the method of payment under the plan may be made at any time prior to the time the amounts are distributed in accordance with the participant or beneficiary's initial or additional election to defer commencement of distributions under paragraph (c)(2)(ii) or (iii) of this section. Where no method of payment is elected, the entire amount deferred will be includible in the gross income of the participant or beneficiary when the amounts first become made available in accordance with a participant's initial or additional elections to defer under paragraphs (c)(2)(ii) and (iii) of this section, unless the eligible plan provides for a default method of payment (in which case amounts are considered made available and taxable when paid under the terms of the default payment schedule).

(3) *Examples*. The provisions of this paragraph (c) are illustrated by the following examples:

Example 1. (i) *Facts*. Eligible Plan X of a tax-exempt entity provides that a participant's total account balance, representing all amounts deferred under the plan, is payable to a participant in a single sum 60 days after severance from employment throughout these examples, unless, during a 30-day period immediately following the severance, the participant elects to receive the single sum payment at a later date (that is not later than the plan's normal retirement age of 65) or elects to receive distribution in 10 annual installments to begin 60 days after severance from employment (or at a later date, if so elected, that is not later than the plan's normal retirement age of 65). On November 13, 2002, participant K, a calendar year taxpayer, has a severance from employment with the eligible employer. K does not, within the 30-day window period, elect to postpone distributions to a later date or to receive payment in 10 fixed annual installments.

(ii) *Conclusion*. The single sum payment is payable to K 60 days after the date K has a severance from employment (January 12, 2003), and is includible in the gross income of K in 2003 under section 457(a).

Example 2. (i) *Facts*. The terms of eligible Plan X are the same as described in *Example 1*. Participant L participates in eligible Plan X. On November 11, 2002, participant L has a severance from the employment of the eligible employer. On November 24, 2002, L makes an initial deferral election not to receive the single sum payment payable 60 days after the severance, and instead elects to receive the amounts in 10 annual installments to begin 60 days after severance from employment.

(ii) *Conclusion*. No portion of L's account is considered made available in 2002 or 2003 before a payment is made and no amount is includible in the gross income of L until distributions commence. The annual installment payable in 2003 will be includible in L's gross income in 2003.

Example 3. (i) *Facts*. The facts are the same as in *Example 1*, except that eligible Plan X also provides that those participants who are receiving distributions in 10 annual installments may, at any time and without restriction, elect to receive a cash out of all remaining installments. Participant M elects to receive a distribution in 10 annual installments commencing in 2003.

(ii) *Conclusion*. M's total account balance, representing the total of the amounts deferred under the plan, is considered made available in, and is includible in M's gross income, in 2003.

Example 4. (i) *Facts*. The facts are the same as in *Example 3*, except that, instead of providing for an unrestricted cash out of remaining payments, the plan provides that participants or beneficiaries who are receiving distributions in 10 annual installments may accelerate the payment of the amount remaining payable to the participant upon the occurrence of an unforeseeable emergency as described in § 1.457–6(c)(1) in an amount not exceeding that described in § 1.457–6(c)(2).

(ii) *Conclusion*. No amount is considered made available to participant M on account of M's right to accelerate payments upon the occurrence of an unforeseeable emergency.

Example 5. (i) *Facts*. Eligible Plan Y of a tax-exempt entity provides that distributions will commence 60 days after a participant's severance from employment unless the participant elects, within a 30-day window period following severance from employment, to defer distributions to a later date (but no later than the year following the calendar year the participant attains age 70 ½). The plan provides that a participant who has elected to defer distributions to a later date may make an election as to form of distribution at any time prior to the 30th day before distributions are to commence.

(ii) *Conclusion*. No amount is considered made available prior to the date distributions are to commence by reason of a participant's right to defer or make an election as to the form of distribution.

Example 6. (i) *Facts*. The facts are the same as in *Example 1*, except that the plan also permits participants who have earlier made an election to defer distribution to make one additional deferral election at any time prior to the date distributions are scheduled to commence. Participant N has a severance from employment at age 50. The next day, during the 30-day period provided in the plan, N elects to receive distribution in the form of 10 annual installment payments beginning at age 55. Two weeks later, within the 30-day window period, N makes a new election permitted under the plan to receive 10 annual installment payments beginning at age 60 (instead of age 55). When N is age 59, N elects under the additional deferral election provisions, to defer distributions until age 65.

(ii) *Conclusion*. In this example, N's election to defer distributions until age 65 is a valid election. The two elections N makes during the 30-day window period are not additional deferral elections described in paragraph (c)(2)(iii) of this section because they are made before the first permissible payout date under the plan. Therefore, the plan is not precluded from allowing N to make the additional deferral election. However, N can make no further election to defer distributions beyond age 65 because this additional deferral election can only be made once.

§ 1.457–8 Funding rules for eligible plans.

(a) *Eligible governmental plans*—(1) *In general*. In order to be an eligible governmental plan, all amounts deferred under the plan, all property and rights purchased with such amounts, and all income attributable to such amounts, property, or rights, must be held in trust for the exclusive benefit of participants and their beneficiaries. A trust described in this paragraph (a) that also meets the requirements of §§ 1.457–3 through 1.457–10 is treated as an organization exempt from tax under section 501(a), and a participant's or beneficiary's interest in amounts in the trust is includible in

the gross income of the participants and beneficiaries only to the extent, and at the time, provided for in section 457(a) and §§ 1.457–4 through 1.457–10.

(2) *Trust requirement*. (i) A trust described in this paragraph (a) must be established pursuant to a written agreement that constitutes a valid trust under state law. The terms of the trust must make it impossible, prior to the satisfaction of all liabilities with respect to participants and their beneficiaries, for any part of the assets and income of the trust to be used for, or diverted to, purposes other than for the exclusive benefit of participants and their beneficiaries.

(ii) Amounts deferred under an eligible governmental plan must be transferred to a trust within a period that is not longer than is reasonable for the proper administration of the participant accounts (if any). For purposes of this requirement, the plan may provide for amounts deferred for a participant under the plan to be transferred to the trust within a specified period after the date the amounts would otherwise have been paid to the participant. For example, the plan could provide for amounts deferred under the plan to be contributed to the trust within 15 business days following the month in which these amounts would otherwise have been paid to the participant.

(3) *Custodial accounts and annuity contracts treated as trusts*—(i) *In general*. For purposes of the trust requirement of this paragraph (a), custodial accounts and annuity contracts described in section 401(f) that satisfy the requirements of this paragraph (a)(3) are treated as trusts under rules similar to the rules of section 401(f). Therefore, the provisions of § 1.401(f)–1(b) will generally apply to determine whether a custodial account or an annuity contract is treated as a trust. The use of a custodial account or annuity contract as part of an eligible governmental plan does not preclude the use of a trust or another custodial account or annuity contract as part of the same plan, provided that all such vehicles satisfy the requirements of section 457(g)(1) and (3) and paragraphs (a)(1) and (2) of this section and that all assets and income of the plan are held in such vehicles.

(ii) *Custodial accounts*—(A) *In general*. A custodial account is treated as a trust, for purposes of section 457(g)(1) and paragraph (a)(1) and (2) of this section, if the custodian is a bank, as described in section 408(n), or a person who meets the nonbank trustee requirements of paragraph (a)(3)(ii)(B) of this section, and the account meets the requirements of paragraphs (a)(1) and (2) of this section, other than the requirement that it be a trust.

(B) *Nonbank trustee status*. The custodian of a custodial account may be a person other than a bank only if the person demonstrates to the satisfaction of the Commissioner that the manner in which the person will administer the custodial account will be consistent with the requirements of section 457(g)(1) and (3). To do so, the person must demonstrate that the requirements of § 1.408–2(e)(2) through (6) (relating to nonbank trustees) are met. The written application must be sent to the address prescribed by the Commissioner in the same manner as prescribed under § 1.408–2(e). To the extent that a person has already demonstrated to the satisfaction of the Commissioner that the person satisfies the requirements of § 1.408–2(e) in connection with a qualified trust (or custodial account or annuity contract) under section 401(a), that person is deemed to satisfy the requirements of this paragraph (a)(3)(ii)(B).

(iii) *Annuity contracts*. An annuity contract is treated as a trust for purposes of section 457(g)(1) and paragraph (a)(1) of this section if the contract is an annuity contract, as defined in section 401(g), that has been issued by an insurance company qualified to do business in the State, and the contract meets the requirements of paragraphs (a)(1) and (2) of this section, other than the requirement that it be a trust. An annuity contract does not include a life, health or accident, property, casualty, or liability insurance contract.

(4) *Combining assets*. [Reserved]

(b) *Eligible plans maintained by tax-exempt entity*—(1) *General rule*. In order to be an eligible plan of a tax-exempt entity, the plan must be unfunded and plan assets must not be set aside for participants or their beneficiaries. Under section 457(b)(6) and this paragraph (b), an eligible plan of a tax-exempt entity must provide that all amounts deferred under the plan, all property and rights to property (including rights as a beneficiary of a contract providing life insurance protection) purchased with such amounts, and all income attributable to such amounts, property, or rights, must remain (until paid or made available to the participant or beneficiary) solely the property and rights of the eligible employer (without being restricted to the provision of benefits under the plan), subject only to the claims of the eligible employer's general creditors.

(2) *Additional requirements*. For purposes of paragraph (b)(1) of this section, the plan must be unfunded regardless of whether or not the amounts were deferred pursuant to a salary reduction agreement between the eligible employer and the participant. Any funding arrangement under an eligible plan of a tax-exempt entity that sets aside assets for the exclusive benefit of participants violates this requirement, and amounts deferred are generally immediately includible in the gross income of plan participants and beneficiaries. Nothing in this paragraph (b) prohibits an eligible plan from permitting participants and their beneficiaries to make an election among different investment options available under the plan, such as an election affecting the investment of the amounts described in paragraph (b)(1) of this section.

§ 1.457–9 Effect on eligible governmental plan when not administered in accordance with eligibility requirements.

A plan of a state ceases to be an eligible governmental plan on the first day of the first plan year beginning more than 180 days after the date on which the Commissioner notifies the state in writing that the plan is being administered in a manner that is inconsistent with one or more of the requirements of §§ 1.457–3 through 1.457–8, or 1.457–10. However, the plan may correct the plan inconsistencies specified in the written notification before the first day of that plan year and continue to maintain plan eligibility. If a plan ceases to be an eligible governmental plan, amounts subsequently deferred by participants will be includible in income when deferred, or, if later, when the amounts deferred cease to be subject to a substantial risk of forfeiture, as provided at § 1.457–11. Amounts deferred before the date on which the plan ceases to be an eligible governmental plan, and

any earnings thereon, will be treated as if the plan continues to be an eligible governmental plan and will not be includible in participant's or beneficiary's gross income until paid to the participant or beneficiary.

§ 1.457–10 Miscellaneous provisions.

(a) *Plan terminations and frozen plans*—(1) *In general*. An eligible employer may amend its plan to eliminate future deferrals for existing participants or to limit participation to existing participants and employees. An eligible plan may also contain provisions that permit plan termination and permit amounts deferred to be distributed on termination. In order for a plan to be considered terminated, amounts deferred under an eligible plan must be distributed to all plan participants and beneficiaries as soon as administratively practicable after termination of the eligible plan. The mere provision for, and making of, distributions to participants or beneficiaries upon a plan termination will not cause an eligible plan to cease to satisfy the requirements of section 457(b) or the regulations.

(2) *Employers that cease to be eligible employers*—(i) *Plan not terminated*. An eligible employer that ceases to be an eligible employer may no longer maintain an eligible plan. If the employer was a tax-exempt entity and the plan is not terminated as permitted under paragraph (a)(2)(ii) of this section, the tax consequences to participants and beneficiaries in the previously eligible (unfunded) plan of an ineligible employer will be determined in accordance with either section 451 if the employer becomes an entity other than a state or §1.457–11 if the employer becomes a state. If the employer was a state and the plan is neither terminated as permitted under paragraph (a)(2)(ii) of this section nor transferred to another eligible plan of that state as permitted under paragraph (b) of this section, the tax consequences to participants in the previously eligible governmental plan of an ineligible employer, the assets of which are held in trust pursuant to § 1.457–8(a), will be determined in accordance with section 402(b) (section 403(c) in the case of an annuity contract) and the trust will no longer be treated as a trust that is exempt from tax under section 501(a).

(ii) *Plan termination*. As an alternative to determining the tax consequences to the plan and participants under paragraph (a)(2)(i) of this section, the employer may terminate the plan and distribute the amounts deferred (and all plan assets) to all plan participants as soon as administratively practicable in accordance with paragraph (a)(1) of this section. Such distribution may include eligible rollover distributions in the case of a plan that was an eligible governmental plan. In addition, if the employer is a state, another alternative to determining the tax consequences under paragraph (a)(2)(i) of this section is to transfer the assets of the eligible governmental plan to an eligible governmental plan of another eligible employer within the same state under the plan-to-plan transfer rules of paragraph (b) of this section.

(3) *Examples*. The provisions of this paragraph (a) are illustrated by the following examples:

Example 1. (i) *Facts*. Employer Y, a corporation that owns a state hospital, sponsors an eligible governmental plan funded through a trust. Employer Y is acquired by a for-profit hospital and Employer Y ceases to be an eligible employer under section 457(e)(1) or § 1.457–2(e). Employer Y terminates the plan and, during the next 6 months, distributes to participants and beneficiaries all amounts deferred that were under the plan.

(ii) *Conclusion*. The termination and distribution does not cause the plan to fail to be an eligible governmental plan. Amounts that are distributed as eligible rollover distributions may be rolled over to an eligible retirement plan described in section 402(c)(8)(B).

Example 2. (i) *Facts*. The facts are the same as in *Example 1*, except that Employer Y decides to continue to maintain the plan.

(ii) *Conclusion*. If Employer Y continues to maintains the plan, the tax consequences to participants and beneficiaries with respect to compensation deferred thereafter will be determined in accordance with either section 402(b) if the compensation deferred is funded through a trust, section 403(c) if the compensation deferred is funded through annuity contracts, or § 1.457–11 if the compensation deferred is not funded through a trust or annuity contract. In addition, if Employer Y continues to maintain the plan, the trust (including amounts deferred before the date on which the plan ceases to be an eligible governmental plan and any earnings thereon) will no longer be treated as exempt from tax under section 501(a).

Example 3. (i) *Facts*. Employer Z, a corporation that owns a tax-exempt hospital, sponsors an unfunded eligible plan. Employer Z is acquired by a for-profit hospital and is no longer an eligible employer under section 457(e)(1) or § 1.457–2(e). Employer Z terminates the plan and distributes all amounts deferred under the eligible plan to participants and beneficiaries within a one-year period.

(ii) *Conclusion*. Distributions under the plan are treated as made under an eligible plan of a tax-exempt entity and the distributions of the amounts deferred are includible in the gross income of the participant or beneficiary in the year distributed.

Example 4. (i) *Facts*. The facts are the same as in *Example 3*, except that Employer Z decides to maintain instead of terminate the plan.

(ii) *Conclusion*. If Employer Z maintains the plan, the tax consequences to participants and beneficiaries in the plan will thereafter be determined in accordance with section 451.

(b) *Plan-to-plan transfers*—(1) *General rule*. An eligible governmental plan may provide for the transfer of amounts deferred by a participant or beneficiary to another eligible governmental plan, and an eligible plan of a tax-exempt entity may provide for transfers of amounts deferred by a participant to another eligible plan of a tax-exempt entity, if the conditions in paragraph (b)(2) of this section are met. An eligible governmental plan may accept transfers from another eligible governmental plan as described in the preceding sentence, and an eligible plan of a tax-exempt entity may accept transfers from another eligible plan of a tax-exempt entity as described in the preceding sentence. However, a state may not transfer the assets of its eligible governmental plan to a tax-exempt entity's eligible plan and the plan of a tax-exempt entity may not accept such a transfer. Similarly, a tax-exempt entity may not transfer the assets of its eligible plan to an eligible governmental plan and an eligible governmental plan may not accept such a transfer. In addition, if the conditions in paragraph (b)(4) of this section (relating to permissive past service credit and repayments under section 415) are met, an eligible governmental plan of a state may provide for the transfer of amounts deferred by a participant or beneficiary to a qualified plan (under section 401(a)) maintained by a state. However, a qualified plan may not transfer assets to an eligible governmental plan or to an eligible plan of a tax-exempt entity, and an eligible governmental plan or the plan of a tax-exempt entity may not accept such a transfer.

(2) *Requirements for plan-to-plan transfers among eligible plans*. A transfer under paragraph (b)(1) of this section from an eligible governmental plan to another eligible governmental plan is permitted only if the following conditions are met —

(i) The transferor plan provides for transfers;

(ii) The receiving plan provides for the receipt of transfers;

(iii) The participant or beneficiary whose amounts deferred are being transferred will have an amount deferred immediately after the transfer at least equal to the amount deferred with respect to that participant or beneficiary immediately before the transfer; and

(iv) The participant or beneficiary whose amounts deferred are being transferred has had a severance from employment with the transferring employer and is performing services for the entity maintaining the receiving plan. However, this paragraph (b)(2)(iv) is not required to be satisfied if—

(A) All of the assets held by the eligible governmental plan are transferred;

(B) The transfer is to another eligible governmental plan maintained by an eligible employer that is a state entity within the same state; and

(C) The participants whose deferred amounts are being transferred are not eligible for additional annual deferrals in the receiving plan unless they are performing services for the entity maintaining the receiving plan.

(3) *Examples*. The provisions of paragraphs (b)(1) and (2) of this section are illustrated by the following examples:

Example 1. (i) *Facts*. Participant A, the president of City X's hospital, has accepted a position with another hospital which is a tax-exempt entity. A participates in the eligible governmental plan of City X. A would like to transfer the amounts deferred under City X's eligible governmental plan to the eligible plan of the tax-exempt hospital.

(ii) *Conclusion*. City X's plan may not transfer A's amounts deferred to the tax-exempt employer's eligible plan. In addition, because the amounts deferred would no longer be held in trust for the exclusive benefit of participants and their beneficiaries, the transfer would violate the exclusive benefit rule of section 457(g) and § 1.457–8(a).

Example 2. (i) *Facts*. County M, located in State S, operates several health clinics and maintains an eligible governmental plan for employees of those clinics. One of the clinics operated by County M is being acquired by a hospital operated by State S, and employees of that clinic will become employees of State S. County M permits those employees to transfer their balances under County M's eligible governmental plan to the eligible governmental plan of State S.

(ii) *Conclusion*. If the eligible governmental plans of County M and State S provide for the transfer and acceptance of the transfer (and the other requirements of paragraph (b)(1) of this section are satisfied), the transfer will not cause either plan to violate the requirements of section 457 or these regulations.

Example 3. (i) *Facts*. City Employer Z, a hospital, sponsors an eligible governmental plan. City Employer Z is located in State B. All of the assets of City Employer Z are being acquired by a tax-exempt hospital. City Employer Z, in accordance with the plan-to-plan transfer rules of paragraph (b) of this section, would like to transfer the total amount of assets deferred under City Employer Z's eligible governmental plan to the acquiring tax-exempt entity's eligible plan.

(ii) *Conclusion*. City Employer Z may not permit participants to transfer the amounts to the eligible plan of the tax-exempt entity. In addition, because the amounts deferred would no longer be held in trust for the exclusive benefit of participants and their beneficiaries, the transfer would violate the exclusive benefit rule of section 457(g) and § 1.457–8(a).

Example 4. (i) *Facts*. The facts are the same as in *Example 3*, except that City Employer Z, prior to the transfer of all of its assets to the eligible plan of the tax-exempt entity, decides to transfer all of the amounts deferred under City Z's eligible governmental plan to the eligible governmental plan of the related state government entity, State B.

(ii) *Conclusion*. If City Employer Z's (transferor) eligible governmental plan provides for such transfer and the eligible governmental plan of the State B permits the acceptance of such a transfer (and the other requirements of paragraph (b)(1) of this section are satisfied), City Employer Z may transfer the total amounts deferred under its eligible governmental plan, prior to termination of that plan, to the eligible governmental plan maintained by State B. However, the participants of City Employer Z whose deferred amounts are being transferred are not eligible to participate in the eligible governmental plan of State B, the receiving plan, unless they are performing services for State B.

(4) *Purchase of permissive past service credit by plan-to-plan transfers from an eligible governmental plan to a qualified plan*—(i) *General rule*. An eligible governmental plan of a state may provide for the transfer of amounts deferred by a participant or beneficiary to a defined benefit governmental plan (as defined in section 414(d)) of that state, and no amount shall be includible in gross income by reason of the transfer, if the conditions in paragraph (b)(4)(ii) of this section are met. A transfer under this paragraph (b)(4) is not treated as a distribution for purposes of § 1.457–6. Therefore, such a transfer may be made before severance from employment.

(ii) *Conditions for plan-to-plan transfers from an eligible governmental plan to a qualified plan*. A transfer may be made under this paragraph (b)(4) only if the transfer is either—

(A) For the purchase of permissive past service credit (as defined in section 415(n)(3)(A)) under the receiving defined benefit governmental plan; or

(B) A repayment to which section 415 does not apply by reason of section 415(k)(3).

(iii) *Example*. The provisions of this paragraph (b)(4) are illustrated by the following example:

Example. (i) *Facts*. Plan X is an eligible governmental plan maintained by County Y for its employees. Plan X provides for distributions only in the event of death, an unforeseeable emergency, or severance from employment with Y (including retirement from Y). Plan S is a qualified defined benefit plan maintained by State T for its employees. County Y is within State T. Employee A is an employee of Y and is a participant in Plan X. Employee A previously was an employee of T and is still entitled to benefits under Plan S. Plan S includes provisions allowing participants in certain plans, including Plan X, to transfer assets to Plan S for the purchase past service credit under Plan S not in excess of the credit permitted under section 415(n) and does not permit the amount transferred to exceed the amount necessary to fund the benefit resulting from the past service credit. Although not required to do so, Plan X allows A to transfer assets to Plan T to provide a past service benefit under Plan T.

(ii) *Conclusion*. Assuming that the special rules at section 415(n)(3) are satisfied with respect to the transfer, the transfer is permitted under this paragraph (b)(4).

(c) *Qualified domestic relations orders under eligible plans*—(1) *General rule*. An eligible plan does not become an ineligible plan described in section 457(f) solely because its administrator or sponsor complies with a qualified domestic relations order as defined in section 414(p), including an order requiring the distribution of the benefits of a participant to an alternate payee in advance of the general rules for eligible plan distributions under § 1.457–6. If a distribution or payment is made from an eligible plan to an alternate payee pursuant to a qualified domestic relations order, rules similar to the rules of section 402(e)(1)(A) shall apply to the distribution or payment.

(2) *Examples*. The provisions of this paragraph (c) are illustrated by the following examples:

Example 1. (i) *Facts*. Participant C and C's spouse D are divorcing. C is employed by State S and is a participant in an eligible plan maintained by S. C has an account valued at $100,000 under the plan. Pursuant to the divorce, a court issues a qualified domestic relations order on September 1, 2003, that allocates 50 percent of C's $100,000 plan

account to D and specifically provides for an immediate distribution to D of D's share within 6 months of the order. Payment is made to D in January of 2004.

(ii) *Conclusion*. S's eligible plan does not become an ineligible plan described in section 457(f) and § 1.457–11 solely because its administrator or sponsor complies with the qualified domestic relations order requiring the immediate distribution to D in advance of the general rules for eligible plan distributions under § 1.457–6. In accordance with section 402(e)(1)(A), D (not C) must include the distribution in gross income. The distribution is includible in D's gross income in 2004. If the qualified domestic relations order were to provide for distribution to D at a future date, amounts deferred attributable to D's share will be includible in D's gross income when paid to D.

Example 2. (i) *Facts*. The facts are the same as in *Example 1*, except that S is a tax-exempt entity, instead of a state.

(ii) *Conclusion*. S's eligible plan does not become an ineligible plan described in section 457(f) and § 1.457–11 solely because its administrator or sponsor complies with the qualified domestic relations order requiring the immediate distribution to D in advance of the general rules for eligible plan distributions under § 1.457–6. In accordance with section 402(e)(1)(A), D (not C) must include the distribution in gross income. The distribution is includible in D's gross income in 2004, assuming that the plan did not make the distribution available to D in 2003. If the qualified domestic relations order were to provide for distribution to D at a future date, amounts deferred attributable to D's share would be includible in D's gross income when paid or made available to D.

(d) *Death benefits and life insurance proceeds*. A death benefit plan under section 457(e)(11) is not an eligible plan. In addition, no amount paid or made available under an eligible plan as death benefits or life insurance proceeds is excludable from gross income under section 101.

(e) *Rollovers to eligible governmental plans*—(1) *General rule*. An eligible governmental plan may accept contributions that are eligible rollover distributions (as defined in section 402(c)(4)) made from another eligible retirement plan (as defined in section 402(c)(8)(B)) if the conditions in paragraph (e)(2) of this section are met. Amounts contributed to an eligible governmental plan as eligible rollover distributions are not taken into account for purposes of the annual limit on annual deferrals by a participant in § 1.457–4(c) or §1.457–5, but are otherwise treated in the same manner as amounts deferred under section 457 for purposes of §§ 1.457–3 through 1.457–9 and this section.

(2) *Conditions for rollovers to an eligible governmental plan*. An eligible governmental plan that permits eligible rollover distributions made from another eligible retirement plan to be paid into the eligible governmental plan is required under this paragraph (e)(2) to provide that it will separately account for any eligible rollover distributions it receives.

(3) *Example*. The provisions of this paragraph (e) are illustrated by the following example:

Example. (i) *Facts*. Plan T is an eligible governmental plan that provides that employees who are eligible to participate in Plan T may make rollover contributions to Plan T from amounts distributed to an employee from an eligible retirement plan. An eligible retirement plan is defined in Plan T as another eligible governmental plan, a qualified section 401(a) or 403(a) plan, or a section 403(b) contract, or an individual retirement arrangement (IRA) that holds such amounts. Plan T requires rollover contributions to be paid by the eligible retirement plan directly to Plan T (a direct rollover) or to be paid by the participant within 60 days after the date on which the participant received the amount from the other eligible retirement plan. Plan T does not take rollover contributions into account for purposes of the plan's limits on amounts deferred that conform to § 1.457–4(c). Rollover contributions paid to Plan T are invested in the trust in the same manner as amounts deferred under Plan T and rollover contributions (and earnings thereon) are available for distribution to the participant at the same time and in the same manner as amounts deferred under Plan T. In addition, Plan T provides that, for each participant who makes a rollover contribution to Plan T, the Plan T recordkeeper is to establish a separate account for the participant's rollover contributions. The recordkeeper calculates earnings and losses for investments held in the rollover account separately from earnings and losses on other amounts held under the plan and calculates disbursements from and payments made to the rollover account separately from disbursements from and payments made to other amounts held under the plan.

(ii) *Conclusion*. Plan T does not lose its status as an eligible governmental plan as a result of the receipt of rollover contributions.

(f) *Deemed IRAs under eligible governmental plans*. [Reserved]

§ 1.457–11 Tax treatment of participants if plan is not an eligible plan.

(a) *In general*. Under section 457(f), if an eligible employer provides for a deferral of compensation under any agreement or arrangement that is an ineligible plan—

(1) Compensation deferred under the agreement or arrangement is includible in the gross income of the participant or beneficiary for the first taxable year in which there is no substantial risk of forfeiture (within the meaning of section 457(f)(3)(B)) of the rights to such compensation;

(2) If the compensation deferred is subject to a substantial risk of forfeiture, the amount includible in gross income for the first taxable year in which there is no substantial risk of forfeiture includes earnings thereon to the date on which there is no substantial risk of forfeiture;

(3) Earnings credited on the compensation deferred under the agreement or arrangement that are not includible in gross income under paragraph (a)(2) of this section are includible in the gross income of the participant or beneficiary only when paid or made available to the participant or beneficiary, provided that the interest of the participant or beneficiary in any assets (including amounts deferred under the plan) of the entity sponsoring the agreement or arrangement is not senior to the entity's general creditors; and

(4) Amounts paid or made available to a participant or beneficiary under the agreement or arrangement are includible in the gross income of the participant or beneficiary under section 72, relating to annuities.

(b) *Exceptions*. Paragraph (a) of this section does not apply with respect to—

(1) A plan described in section 401(a) which includes a trust exempt from tax under section 501(a);

(2) An annuity plan or contract described in section 403;

(3) That portion of any plan which consists of a transfer of property described in section 83;

(4) That portion of any plan which consists of a trust to which section 402(b) applies; or

(5) A qualified governmental excess benefit arrangement described in section 415(m).

(c) *Coordination of section 457(f) with section 83*—(1) *Transfer of property described in section 83*. Under paragraph (b)(3) of this section, section 457(f) and paragraph (a) of this section do not apply to that portion of any plan which consists of a transfer of property described in section 83. For this purpose, a transfer of property described in section 83 means a transfer of property to which section 83 applies. Section 457(f) and paragraph (a) of this section do not apply if the date on

which there is no substantial risk of forfeiture with respect to compensation deferred under an agreement or arrangement that is not an eligible plan is on or after the date on which there is a transfer of property to which section 83 applies. However, section 457(f) and paragraph (a) of this section apply if the date on which there is no substantial risk of forfeiture with respect to compensation deferred under an agreement or arrangement that is not an eligible plan precedes the date on which there is a transfer of property to which section 83 applies. If deferred compensation payable in property is includible in gross income under section 457(f), then, as provided in section 72, the amount includible in gross income when that property is later transferred or made available to the service provider is the excess of the value of the property at that time over the amount previously included in gross income under section 457(f).

(2) *Examples*. The provisions of this paragraph (c) are illustrated in the following examples:

Example 1. (i) *Facts*. As part of an arrangement for the deferral of compensation, an eligible employer agrees on December 1, 2002, to pay an individual rendering services for the eligible employer a specified dollar amount on January 15, 2005. The arrangement provides for the payment to be made in the form of property having a fair market value equal to the specified dollar amount. The individual's rights to the payment are not subject to a substantial risk of forfeiture (within the meaning of section 457(f)(3)(B)).

(ii) *Conclusion*. In this example, because there is no substantial risk of forfeiture with respect to the agreement to transfer property in 2005, the present value (as of December 1, 2002) of the payment is includible in the individual's gross income for 2002. Under paragraph (a)(4) of this section, when the payment is made on January 15, 2005, the amount includible in the individual's gross income is equal to the excess of the fair market value of the property when paid, over the amount that was includible in gross income for 2002 (which is the basis allocable to that payment).

Example 2. (i) *Facts*. As part of an arrangement for the deferral of compensation, individuals A and B rendering services for a tax-exempt entity each receive in 2010 property that is subject to a substantial risk of forfeiture (within the meaning of section 457(f)(3)(B) and within the meaning of section 83(c)(1)). Individual A makes an election to include the fair market value of the property in gross income under section 83(b) and individual B does not make this election. The substantial risk of forfeiture for the property transferred to individual A lapses in 2012 and the substantial risk of forfeiture for the property transferred to individual B also lapses in 2012. Thus, the property transferred to individual A is included in A's gross income for 2010 when A makes a section 83(b) election and the property transferred to individual B is included in B's gross income for 2012 when the substantial risk of forfeiture for the property lapses.

(ii) *Conclusion*. In this example *2*, in each case, the compensation deferred is not subject to section 457(f) or this section because section 83 applies to the transfer of property on or before the date on which there is no substantial risk of forfeiture with respect to compensation deferred under the arrangement.

Example 3. (i) *Facts*. In 2010, X, a tax-exempt entity, agrees to pay deferred compensation to employee C. The amount payable is $100,000 to be paid 10 years later in 2020. The commitment to make the $100,000 payment is not subject to a substantial risk of forfeiture. In 2010, the present value of the $100,000 is $50,000. In 2018, X transfers to C property having a fair market value (for purposes of section 83) equal to $70,000. The transfer is in partial settlement of the commitment made in 2010 and, at the time of the transfer in 2018, the present value of the commitment is $80,000. In 2020, X pays C the $12,500 that remains due.

(ii) *Conclusion*. In this example *3*, C has income of $50,000 in 2010. In 2018, C has income of $30,000, which is the amount transferred in 2018, minus the allocable portion of the basis that results from the $50,000 of income in 2010. (Under section 72(e)(2)(B), income is allocated first. The income is equal to $30,000 ($80,000 minus the $50,000 basis), with the result that the allocable portion of the basis is equal to $40,000 ($70,000 minus the $30,000 of income).) In 2020, C has income of $2,500 ($12,500 minus $10,000, which is the excess of the original $50,000 basis over the $40,000 basis allocated to the transfer made in 2018).

§ 1.457–12 Effective dates.

Sections 1.457–1 through 1.457–11 apply for taxable years beginning after December 31, 2001, except that § 1.457–11(c) does not apply with respect to an option without a readily ascertainable fair market value (within the meaning of section 83(e)(3)) that was granted on or before May 8, 2002, and, § 1.457–10(c) (relating to qualified domestic relations orders) applies for transfers, distributions, and payments made after December 31, 2001.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on May 7, 2002, 8:45 a.m., and published in the issue of the Federal Register for May 8, 2002, 67 F.R. 30826)

Hedging Transactions; Corrections

Announcement 2002–55

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correcting amendment.

SUMMARY: This document contains corrections to final regulations (T.D. 8985, 2002–14 I.R.B. 707) that were published in the **Federal Register** on Wednesday, March 20, 2002 (67 FR 12863), relating to the character of gain or loss from hedging transactions.

DATES: This correction is effective March 20, 2002.

FOR FURTHER INFORMATION CONTACT: Elizabeth Handler (202) 622–3930 or Viva Hammer (202) 622–0869 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

The final regulations that are the subject of these corrections are under section 1221 of the Internal Revenue Code.

Need for Correction

As published, the final regulations contain errors that may prove to be misleading and are in need of clarification.

Correction of Publication

Accordingly, 26 CFR Part 1 is corrected by making the following correcting amendments:

PART 1 — INCOME TAXES

1. The authority citation for part 1 continues to read in part as follows:

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

§ 1.446–4 [Corrected]

2. Section 1.446–4, paragraph (d)(3) is amended by removing the language "§ 1.1221–2(a)(4)(i)" from the last sentence and adding the language "§ 1.1221–2(a)(4)" in its place.

§ 1.1256(e)–1 [Corrected]

3. Section 1.1256(e)–1, paragraph (c) is amended by removing the language "(f)(1)(ii)" from the second sentence and adding the language "(g)(1)(ii)" in its place.

New Revision of Publication 597, *Information on the U.S. – Canada Income Tax Treaty*

Announcement 2002–56

Publication 597, revised May 2002, is now available from the Internal Revenue Service. It replaces the May 1998 revision.

This publication discusses a number of the treaty provisions that often apply to U.S. citizens or residents who may be liable for Canadian tax.

You can get a copy of this publication by calling 1–800–TAX-FORM (1–800–829–3676). You can also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address. The publication is also available on the IRS web site at *www.irs.gov*.

New Revision of Publication 1544, *Reporting Cash Payments of Over $10,000* (and Publication 1544SP, *Informe de Pagos en Efectivo en Exceso de $10,000*)

Announcement 2002–57

Publication 1544, revised March 2002, is now available from the Internal Revenue Service. It replaces the August 1997 revision. The publication is also available in Spanish as Publication 1544SP.

The publication explains why, when, and how to report large cash payments. It also discusses the substantial penalties for not reporting them.

You can get either version of this publication by calling 1–800–TAX-FORM (1–800–829–3676). You can also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address. Both versions are also available on the IRS web site at *www.irs.gov*.

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 law 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 the 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.—Intemal 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.—Statements 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.

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