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

**INCOME TAX**

**Rev. Rul. 2004–8, page 544.**

**Cost-share payments.** The Forest Land Enhancement Program (FLEP) is a small watershed program administered by the Secretary of Agriculture that is substantially similar to the type of programs described in section 126(a)(1) through (8) of the Code within the meaning of section 126(a)(9). All or a portion of cost-share payments received under the FLEP is eligible for exclusion from gross income to the extent permitted by section 126. Rental payments and incentive payments are not cost-share payments and are not excludable from gross income.


**REITs; parking facilities.** This ruling identifies circumstances in which a real estate investment trust’s (REIT’s) income from providing parking facilities at its rental real properties qualifies as rents from real property under section 856(d) of the Code.


This procedure provides guidance to individuals who fail to meet the eligibility requirements of section 911(d)(1) of the Code because adverse conditions in a foreign country preclude the individual from meeting those requirements. A current list of countries and the dates those countries are subject to the section 911(d)(4) waiver is provided. Rev. Proc. 2003–26 supplemented.

**EMPLOYEE PLANS**


**Section 412(i) plans; deductibility; listed transactions.** This ruling gives an example where a qualified pension plan cannot be a section 412(i) plan if the plan holds life insurance contracts and annuity contracts for the benefit of a participant that provide for benefits at normal retirement age in excess of the participant’s benefits at normal retirement age under the terms of the plan. The ruling also addresses when certain employer contributions to purchase life insurance coverage for a participant in a defined benefit plan are deductible and whether those transactions are “listed transactions.” Rev. Rul. 55–748 modified and superseded.

**Rev. Rul. 2004–21, page 544.**

**Nondiscrimination; section 412(i) plan.** This ruling provides an example where a plan that is funded, in whole or in part, with life insurance contracts may not satisfy the requirements of Code section 401(a)(4) prohibiting discrimination in favor of highly compensated employees.

**Rev. Rul. 2004–22, page 553.**

**COBRA and Medicare entitlement.** The COBRA continuation coverage period can be expanded from 18 to 36 months if a second qualifying event occurs. Medicare entitlement of a covered employee is one of the listed events that can be a second qualifying event. This ruling holds that Medicare entitlement is not a second qualifying event unless (ignoring the first qualifying event) it would result in a loss of coverage under the group health plan.

(Continued on the next page)
Proposed regulations under section 402 of the Code provide rules regarding the amount includible in a participant’s income when a life insurance contract is distributed from a qualified plan, and provide rules under sections 79 and 83 imposing similar valuation requirements for those other employer-provided life insurance arrangements. A public hearing is scheduled for June 9, 2004.

Fair market value; distributions; qualified retirement plans. This procedure provides interim guidance on how fair market value may be determined in the instance of distributions from a qualified retirement plan.

EMPLOYMENT TAX

REG–156421–03, page 571.
Proposed regulations under sections 3121(b)(10) and 3306(c)(10)(B) of the Code provide guidance on the Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) exceptions for student services. The proposed regulations provide guidance on whether an employer is considered a “school, college, or university,” and whether an employee is considered a “student” under these provisions. A public hearing is scheduled for June 16, 2004.

Notice 2004–12, page 556.
This notice contains a proposed revenue procedure that sets forth generally applicable standards for determining whether service in the employ of certain public or private nonprofit schools, colleges, universities, or affiliated organizations described in section 509(a)(3) of the Code performed by a student qualifies for the exception from Federal Insurance Contributions Act (FICA) tax provided under section 3121(b)(10). Rev. Proc. 98–16 suspended.

ADMINISTRATIVE

This procedure provides an elective safe harbor that the owner of an oil and gas property may use in determining the property’s recoverable reserves for purposes of computing cost depletion under section 611 of the Code.

This announcement provides information regarding changes to the reporting for certain 2002 forms by certain fiscal year pass-through entities affected by pending technical corrections to the qualified dividend rules. Partnerships, S corporations, and estates (including revocable trusts treated as part of an estate) with a fiscal year beginning in 2002 that received qualified dividends in 2003 must reflect the changes required by this announcement in their reporting for the tax year. Announcement 2003–56 modified.

March 8, 2004
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 tax laws 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 II.—Treaties and Tax Legislation. This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

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

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

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

The contents of this publication are not copyrighted and may be reprinted freely. A citation of the Internal Revenue Bulletin as the source would be appropriate.


* Beginning with Internal Revenue Bulletin 2003–43, we are publishing the index at the end of the month, rather than at the beginning.
Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 126.—Certain Cost-Sharing Payments

Cost-share payments. The Forest Land Enhancement Program (FLEP) is a small watershed program administered by the Secretary of Agriculture that is substantially similar to the type of programs described in section 126(a)(1) through (8) of the Code within the meaning of section 126(a)(9). All or a portion of cost-share payments received under the FLEP is eligible for exclusion from gross income to the extent permitted by section 126. Rental payments and incentive payments are not cost-share payments and are not excludable from gross income.

Rev. Rul. 2004–8

ISSUE

Is the Forest Land Enhancement Program (FLEP) substantially similar to the type of programs described in § 126(a)(1) through (8) of the Internal Revenue Code, so that the FLEP is within the scope of § 126(a)(9) and, thereby, cost-share payments received under the FLEP are eligible for exclusion from gross income to the extent permitted by § 126?

FACTS

The FLEP, authorized under the provisions of Title VIII of the Farm Security and Rural Investment Act of 2002, Pub. L. No. 107–171, 116 Stat. 134, which amended the Cooperative Forestry Assistance Act of 1978, Pub. L. No. 95–313, 92 Stat. 365, is a voluntary program for non-industrial private forest landowners that provides technical, educational, and cost-share assistance to encourage the long-term sustainability of non-industrial private forest land and related resources. The FLEP replaces the Stewardship Incentives Program (SIP), which was determined in Rev. Rul. 94–27, 1994–1 C.B. 26, to be within the scope of § 126(a)(9), and the Forestry Incentives Program (FIP), which is listed in § 126(a)(8). The SIP provided for the cost-sharing of a wide range of multiple resource management practices. The FIP provided for cost-sharing of timber stand improvements, site preparation for natural regeneration, and tree planting practices. The FLEP encompasses all of the cost-share practices authorized under both the SIP and the FIP.

A landowner who wishes to participate in the cost-share component of the FLEP must develop and implement, in cooperation with the state forester, another state official, or a professional resources manager, a management plan that addresses site specific activities and practices. The cost-share practices are limited to the treatment of 1,000 acres per year and must be implemented for a period of at least 10 years. The maximum cost-share payment for any practice may be up to 75 percent. The aggregate payment to any one landowner through 2007 may not exceed $100,000.

The Secretary of Agriculture has determined that cost-share payments under the FLEP are primarily for the purpose of conservation.

LAW AND ANALYSIS

Under § 126(a), gross income does not include the excludable portion of payments received under certain conservation programs set forth in § 126(a)(1) through (8). Under § 126(a)(9), a program affecting “small watersheds” that is administered by the Secretary of Agriculture also is eligible for § 126 treatment if the Commissioner determines that the program is substantially similar to the type of programs described in § 126(a)(1) through (8). See § 16A.126–1(d)(3) of the temporary Income Tax Regulations for the definition of “small watershed.”

Once the Commissioner has determined that a program is substantially similar to the types of programs described in § 126(a)(1) through (8), taxpayers receiving cost-share payments under that program must determine what portion of the cost-share payments is excludable from gross income under § 126.

HOLDING

The FLEP is substantially similar to the type of programs described in § 126(a)(1) through (8) within the meaning of § 126(a)(9). All or a portion of cost-share payments received under the FLEP is eligible for exclusion from gross income to the extent permitted by § 126. See § 126(b)(1) and § 16A.126–1 to determine what portion, if any, of the cost-share payments is excludable from gross income under § 126.

DRAFTING INFORMATION

The principal author of this revenue ruling is Nicole R. Cimino of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact Ms. Cimino at (202) 622–3120 (not a toll-free call).

Section 401.—Qualified Pension, Profit-Sharing, and Stock Bonus Plans

Rev. Rul. 2004–21

ISSUE

Does a plan that is funded, in whole or in part, with life insurance contracts satisfy the requirements of Code section 401(a)(4) prohibiting discrimination in favor of highly compensated employees.
the requirements of § 401(a)(4) of the Internal Revenue Code prohibiting discrimination in favor of highly compensated employees where: (1) highly compensated employees are permitted, prior to distribution of retirement benefits, to purchase life insurance contracts from the plan at cash surrender value; and (2) any rights under the plan for nonhighly compensated employees to purchase life insurance contracts from the plan prior to distribution of retirement benefits are not of inherently equal or greater value than the purchase rights of highly compensated employees?

FACTS

Employer M maintains Plan A, a retirement plan that is intended to be a qualified plan under § 401(a). Plan A provides an incidental death benefit within the meaning of § 1.401–1(b)(1)(i) of the Income Tax Regulations for each participant, and holds a life insurance contract on the life of each participant to fund that incidental death benefit. Before distributions to a participant under Plan A commence, each participant is offered the opportunity to purchase the life insurance contract under which the participant is insured from Plan A for its cash surrender value. It is assumed for purposes of this revenue ruling that Prohibited Transaction Exemption 92–6, 57 FR 5189 (February 12, 1992) applies to the purchase of a life insurance contract from Plan A and, thus, a participant’s purchase of a life insurance contract from Plan A is not a prohibited transaction under § 4975. Employer M has nonhighly compensated employees that are not excludable employees within the meaning of § 1.410(b)–6, and the features of the life insurance contracts covering the lives of highly compensated employees are different than the features of the life insurance contracts covering the lives of nonhighly compensated employees. In addition, because of these differences in the features of the contracts, the rights that the nonhighly compensated employees have to purchase the life insurance contracts under which they are insured from Plan A are not of inherently equal or greater value than the rights that highly compensated employees have to purchase the life insurance contracts under which they are insured.

LAW AND ANALYSIS

Section 401(a)(4) provides that, under a qualified retirement plan, contributions or benefits provided under the plan must not discriminate in favor of highly compensated employees. Section 410(b) provides minimum coverage requirements that are designed to ensure that a qualified plan provides sufficient benefits to a large enough proportion of participants who are nonhighly compensated employees.

Section 1.401(a)(4)–1(b)(3) provides that a plan satisfies the requirements of § 401(a)(4) only if all benefits, rights and features provided under the plan are made available under the plan in a nondiscriminatory manner. Under § 1.401(a)(4)–4(a), benefits, rights and features (i.e., optional forms of benefit, ancillary benefits, and other rights or features) are made available under the plan in a nondiscriminatory manner only if each benefit, right or feature satisfies the current availability requirement of § 1.401(a)(4)–4(b) and the effective availability requirement of § 1.401(a)(4)–4(c). In general, a benefit, right or feature satisfies the current availability requirement of § 1.401(a)(4)–4(b) for a plan year if the group of employees to whom the benefit, right or feature is currently available during the plan year satisfies § 410(b) (without regard to the average benefit percentage test of § 1.410(b)–5).

An other right or feature is any right or feature applicable to employees under the plan (other than a benefit formula, an optional form of benefit, or an ancillary benefit) that can be expected to have meaningful value. Under § 1.401(a)(4)–4(e)(3)(i), a distinct other right or feature exists if a right or feature is not available on substantially the same terms as another right or feature. Under § 1.401(a)(4)–4(e)(3)(iii)(C), the right to a particular form of investment, including, for example, a particular class or type of employer securities (taking into account, in determining whether different forms of investment exist, any differences in conversion, dividend, voting, liquidation preference, or other rights conferred under the security) is a distinct other right or feature. Similarly, differences in insurance contracts (e.g., differences in cash value growth terms or different exchange features) that may be purchased from a plan can create distinct other rights or features even if the terms under which the contracts are purchased from the plan are the same.

Under § 1.401(a)(4)–4(d)(4), an optional form of benefit, ancillary benefit, or other right or feature is permitted to be aggregated with another optional form of benefit, ancillary benefit, or other right or feature if one of the two is, in all cases, of inherently equal or greater value than the other, and the optional form of benefit, ancillary benefit, or other right or feature that is of inherently equal or greater value separately satisfies the current availability requirement of § 1.401(a)(4)–4(b) and the effective availability requirement of § 1.401(a)(4)–4(c). For this purpose, one benefit, right, or feature is of inherently equal or greater value than another benefit, right, or feature only if, at any time and under any conditions, it is impossible for any employee to receive a smaller amount or a less valuable right under the first benefit, right, or feature than under the second benefit, right, or feature.

To the extent the purchase from Plan A of a life insurance contract by a highly compensated employee is a distribution alternative with respect to benefits described in § 411(d)(6)(A), such a purchase right is an optional form of benefit under Plan A. Even in situations in which this purchase right is not an optional form of benefit, this purchase right is an other right or feature. The purchase rights for the highly compensated employees are distinct optional forms of benefit or other rights or features from the purchase rights for nonhighly compensated employees because of differences in the life insurance contracts (analogous to a conversion right applicable to a security). This purchase right for highly compensated employees does not satisfy the current availability requirement of § 1.401(a)(4)–4(b) because the right to purchase the contracts of a type available to the highly compensated employees is not available to any nonhighly compensated employees, and therefore is not available to a group that satisfies the requirements of § 410(b). Moreover, under the facts presented, this purchase right of highly compensated employees cannot satisfy the requirements of § 1.401(a)(4)–4 through aggregation with any other optional form of benefit, ancillary benefit, or other right or feature (such as the purchase right for nonhighly compensated employ-
ees) because no other optional form of benefit, ancillary benefit, or other right or feature under the plan that would enable the aggregated benefits to be available to a group that satisfies the requirements of § 410(b) is of inherently equal or greater value. Thus, Plan A fails to satisfy the nondiscrimination requirements of § 401(a)(4).

**HOLDING**

A plan that is funded, in whole or in part, with life insurance contracts does not satisfy the requirements of § 401(a)(4) prohibiting discrimination in favor of highly compensated employees where: (1) the plan permits highly compensated employees, prior to distribution of retirement benefits, to purchase those life insurance contracts prior to distribution; and (2) any rights under the plan for nonhighly compensated employees to purchase life insurance contracts from the plan prior to distribution of retirement benefits are not of inherently equal or greater value than the purchase rights of highly compensated employees.

**DRAFTING INFORMATION**

The principal authors of this revenue ruling are Larry Isaacs of Employee Plans, Tax Exempt and Government Entities Division, and Linda Marshall of the Office of the Division Counsel/Associate Chief Counsel, Tax Exempt and Government Entities. For further information regarding this revenue ruling, contact the Employee Plans taxpayer assistance telephone service between the hours of 8:00 a.m. and 6:30 p.m. Eastern Time, Monday through Friday, by calling (877) 829–5500 (a toll-free number). Mr. Isaacs may be reached at (202) 283–9710, and Ms. Marshall may be reached at (202) 622–6090 (not toll-free numbers).

Section 404.—Deduction for Contributions of an Employer to an Employees’ Trust or Annuity Plan and Compensation Under a Deferred-Payment Plan

(Also, §§ 401, 412, 6011, 6111, 6112; §§ 26 CFR 1.401–1, 1.412(i)–1, 1.6011–4, 301.6111–2, 301.6112–1)

Section 412(i) plans; deductibility; listed transactions. This ruling gives an example where a qualified pension plan cannot be a section 412(i) plan if the plan holds life insurance contracts and annuity contracts for the benefit of a participant that provide for benefits at normal retirement age in excess of the participant’s benefits at normal retirement age under the terms of the plan. The ruling also addresses when certain employer contributions to purchase life insurance coverage for a participant in a defined benefit plan are deductible and whether those transactions are “listed transactions.” Rev. Rul. 55–748 modified and superseded.

**Rev. Rul. 2004–20**

**ISSUES**

Issue 1: Can a qualified pension plan be a plan described in § 412(i) of the Internal Revenue Code if the plan holds life insurance contracts and annuity contracts for the benefit of a participant that provide for benefits at normal retirement age in excess of the participant’s benefits at normal retirement age under the terms of the plan?

Issue 2: If a qualified pension plan holds life insurance contracts providing for life insurance on a participant’s life in excess of the participant’s death benefit under the terms of the plan, are contributions for premiums for such excess life insurance coverage currently deductible by the employer?

**FACTS**

Situation 1

Employer M maintains Plan A, a defined benefit plan that is funded solely by life insurance contracts and annuities with level annual premiums for each participant commencing with the date the individual becomes a participant in the plan (or, in the case of an increase in benefits, commencing at the time the increase becomes effective) and ending with the individual’s attainment of normal retirement age. Plan A is intended to be a plan described in § 412(i). The amounts that will be accumulated under the insurance contracts and annuity contracts for the benefit of a participant at normal retirement age, assuming premiums are paid and determined by applying annuity purchase rates guaranteed under the contracts, will provide for benefits in excess of the participant’s benefits at normal retirement age under the terms of the plan.

Situation 2

Employer N maintains Plan B. With respect to Participant P, Plan B provides a death benefit that meets the definition of an incidental death benefit under § 1.401–1(b)(1)(i) of the Income Tax Regulations. The assets of Plan B include life insurance contracts on the life of Participant P with a face amount in excess of Participant P’s death benefit under Plan B. Premiums with respect to Participant P include an annual premium for the waiver of the entire premium payment if Participant P becomes disabled. Upon the death of a covered employee, the portion of the proceeds of the life insurance contract that exceeds the death benefit payable to Participant P’s beneficiary under the plan is applied to the payment of premiums under the plan with respect to other participants.

**LAW AND ANALYSIS**

Section 412 sets forth minimum funding requirements for qualified pension plans. Section 412(i) describes certain insurance contract plans that are exempt under § 412(h)(2) from the minimum funding requirements of § 412 (section 412(i) plans). Under § 411(b)(1)(F), a plan that is funded exclusively by the purchase of insurance contracts and satisfies the requirements of § 412(i)(2) and (3) satisfies the accrual requirements of § 411(b) if an employee’s accrued benefit as of any applicable date is not less than the cash surrender value his life insurance contracts would have on that applicable date if the requirements of § 412(i)(4) through (6) were satisfied.

A section 412(i) plan must be funded by the purchase of individual or group insurance contracts. Section 412(i)(2) re-
quires contracts held by a section 412(i) plan to provide for level annual premium payments to be paid commencing with the date the individual became a participant in the plan (or, in the case of an increase in benefits, commencing at the time the increase becomes effective) and extending not later than the retirement age for each individual participating in the plan. Section 412(i)(3) requires benefits provided under a section 412(i) plan to be equal to the benefits provided under each contract at normal retirement age under the plan.

Under § 1.412(i)–1(b)(2)(iii), the benefits for each participant provided under a section 412(i) plan that holds individual insurance contracts must be equal to the benefits provided under the participant’s individual contracts at the participant’s normal retirement age under the plan. Furthermore, under § 1.412(i)–1(b)(2)(iv), the benefits provided by the plan for each individual participant must be guaranteed by the life insurance company issuing the individual contracts to the extent premiums have been paid.

Section 404(a)(1)(A)(i) provides that the amount necessary to satisfy the minimum funding requirement under § 412 is deductible even if it is greater than the amount determined under § 404(a)(1)(A)(ii) or (iii), whichever is applicable with respect to the plan.

The alternative limit determined under § 404(a)(1)(A)(ii) is the amount necessary to provide the remaining unfunded cost of all participants’ past and current service credits as a level amount, or as a level percentage of compensation, over the remaining future service of each participant. However, if the remaining unfunded cost with respect to any three individuals is more than 50 percent of all remaining unfunded cost, the amount attributable to those individuals is distributed over a period of at least five years.

The alternative limit determined under § 404(a)(1)(A)(iii) is the normal cost of the plan plus, if past service or other supplementary pension or annuity credits are provided by the plan, the amount necessary to amortize the unfunded costs attributable to those credits in equal annual payments over 10 years. Under § 1.404(a)–6(a)(2) of the Income Tax Regulations, the normal cost for any year is defined as the amount actuarially determined which would be required as a contribution by the employer in such year to maintain the plan if the plan had been in effect from the beginning of service of each then included employee and if such costs for prior years had been paid and all assumptions as to interest, mortality, time of payment, etc., had been fulfilled.

Section 1.404(a)–3(b) provides that in no event shall the limitations under § 404(a)(1) for pension or annuity plans exceed costs based on assumptions and methods that are reasonable in view of the funding medium and reasonable expectations as to the effects of mortality, interest, and other pertinent factors.

Section 1.404(a)–14 provides rules for determining the deductible limits under § 404(a)(1)(A)(i), (ii), and (iii). The regulations provide in general that the limit on deductible amounts contributed for an employer’s taxable year is based on the amounts determined for purposes of § 412 for the applicable plan year or years.

Section 404(a)(1)(E) provides that an amount contributed to a plan that would otherwise be deductible, but that exceeds the limitations of § 404(a)(1), is deductible in future years to the extent of the difference between the amount contributed and the maximum amount deductible for each succeeding year under § 404(a)(1).

Section 4972 generally imposes a 10-percent excise tax on nondeductible contributions to a qualified plan, including nondeductible contributions carried over from preceding years.

Rev. Rul. 94–75, 1994–2 C.B. 59, discusses the tax consequences of converting a qualified defined benefit plan that is not a section 412(i) plan to a section 412(i) plan, and holds that the deductible limit under § 404(a)(1)(A)(ii) applies to a section 412(i) plan.

Rev. Rul. 55–748, 1955–2 C.B. 234, discusses the deductibility of contributions to a qualified plan that are used to pay life insurance premiums attributable to the life insurance benefits of retirement income contracts purchased with respect to employees by the trust, the proceeds of which, upon the death of an employee, are payable to the trustee and are held by the trustee for application to payment of subsequent premiums on similar contracts on behalf of other employees. Rev. Rul. 55–748 holds that the part of the employer’s contribution attributable to the purchase of life insurance benefits, which, when they become payable, are applicable to the reduction of subsequent employer contributions to the plan are not considered as a cost of the pension plan for the purpose of determining the limitation on deductions under § 404(a)(1)(A), (B), and (C) of the Code (the predecessor provisions to current §§ 404(a)(1)(A)(i), (ii), and (iii)) for the year in which such contributions are paid, and cannot be deducted as such. Rev. Rul. 55–748 further provides that contributions attributable to such insurance benefits, not otherwise determined, may be determined by applying the rates provided in Rev. Rul. 55–747, 1955–2 C.B. 228, to the amounts of insurance that would revert to the trust in the event of death of the insured employee in the year for which the premiums are paid. In later years, if an employer for any reason, such as the receipt by the trustee of life insurance proceeds under a retirement income contract because of the death of an employee, which proceeds were applied to the payment of premiums on similar contracts for the benefit of other employees, contributes to the trust a sum less than the maximum deduction permitted for that year under § 404(a)(1)(A), (B), or (C), Rev. Rul. 55–748 provides that the employer may deduct in that year, in addition to this current contribution, the contributions made in prior years and not then deductible because they were attributable to that part of the retirement income contracts that would provide life insurance payable to the trustee, to the extent of the difference between his current contribution and his maximum deduction permitted under § 404(a)(1)(A), (B), or (C).

Rev. Rul. 55–747 provided a table to be used in computing the premiums to be included in the income of an employee on account of current life insurance protection provided for the employee under a life or endowment insurance contract held by an employees’ trust qualified under § 401(a).

Rev. Rul. 66–110, 1966–1 C.B. 12, provided that the current published premium rates charged by an insurer for individual 1-year term life insurance available to all standard risks may be used for determining the cost of insurance in connection with individual policies issued by the same insurer and held by an employees’ trust qualified under § 401(a). In addition, Rev. Rul. 66–110 extended the table of premiums set forth in Rev. Rul. 55–747 to cover additional ages.
Rev. Rul. 67–154, 1967–1 C.B. 11, amplified Rev. Rul. 66–110 and held that, where an insurer published one-year term insurance rates lower than those set forth in Rev. Rul. 55–747, but those rates were applicable only under a dividend option whereby term insurance may be purchased with dividends on existing policies and were lower than the insurer’s published rates for initial insurance available to all standard risks, those rates could not be used in place of the rates set forth in Rev. Rul. 55–747 in determining the cost of insurance under a trust described in § 401(a).

Notice 2001–10, 2001–1 C.B. 459, revoked Rev. Rul. 55–747, and provided a new table (Table 2001) to be used in valuing term life insurance coverage provided to an employee. Under Notice 2001–10, taxpayers could continue to use the rates set forth in Rev. Rul. 55–747 for purposes of determining the value of current life insurance protection provided under a qualified retirement plan for taxable years ending on or before December 31, 2001. In addition, Notice 2001–10 provided generally that taxpayers could continue to determine the value of current life insurance protection by using the insurer’s lower published rates available to standard risks as provided in Rev. Rul. 66–110. However, for periods after December 31, 2003, Notice 2001–10 sets forth certain additional conditions on the use of the insurer’s published rates.


Section 1.401–1(b)(1)(i) provides that a pension plan within the meaning of § 401(a) is a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to employees over a period of years, usually for life, after retirement. A pension plan may also provide for the payment of incidental death benefits through insurance or otherwise.

Rev. Rul. 74–307, 1974–2 C.B. 126, holds that preretirement death benefits under a qualified pension plan are considered incidental death benefits within the meaning of § 1.401–1(b)(1)(i) if less than 50 percent of the employer contribution credited to each participant’s account is used to purchase ordinary life insurance policies on the participant’s life, or if the death benefit before normal retirement date does not exceed the greater of (a) the proceeds of ordinary life insurance policies providing a death benefit of 100 times the anticipated monthly normal retirement benefit, or (b) the sum of (i) the reserve under the ordinary life insurance policies plus (ii) the participant’s account in the auxiliary fund. See also Rev. Rul. 68–453, 1968–2 C.B. 163.

Rev. Rul. 81–162, 1981–1 C.B. 169, holds that a plan established by an employer that provides employees only such benefits as are afforded through the purchase of ordinary life insurance contracts (other than retirement income contracts), which are converted to life annuities at normal retirement age, does not constitute a pension plan within the meaning of § 401(a). Rev. Rul. 81–162 provides that the primary purpose of such a life insurance contract is to provide life insurance protection, and the reserve accumulated thereon is a result of premium payments being made on a level basis. Rev. Rul. 81–162 reasons that such reserve will provide a relatively small retirement annuity in comparison with the annuity that a retirement income contract of the same face amount will provide. Therefore, Rev. Rul. 81–162 concludes that a plan providing only for the purchase of ordinary life insurance contracts (other than retirement income contracts) is not primarily for the payment of benefits to employees over a period of years after retirement. This analysis would not apply, however, if the death benefit payable to the beneficiary under the plan were limited to an incidental death benefit, with the remaining benefit payable to the plan.

In Situation 1, Plan A is not a plan described in § 412(i) because the participant’s benefit under Plan A payable at normal retirement age is not equal to the amount provided at normal retirement age with respect to the contracts held on behalf of the participant, and thus, Plan A fails to satisfy the requirements of § 412(i)(3). Accordingly, Plan A is subject to the requirements of § 412, with charges and credits to the funding standard account determined using the reasonable funding method selected for the plan under generally applicable rules, and using reasonable actuarial assumptions. Such reasonable funding method and such reasonable actuarial assumptions are also used to determine the deductible amount of contributions under the generally applicable rules of § 404(a). In addition, the exception from the accrual rules that applies to § 412(i) plans under § 411(b)(1)(F) does not apply to Plan A.

In Situation 2, the fact that the life insurance contracts on the life of Participant P provide for death benefits in excess of the death benefits under the plan would not cause Plan B to fail to satisfy the requirements to be a plan described in § 412(i), if Plan B otherwise met those requirements. Similarly, the fact that the life insurance contracts on the life of Participant P provide for death benefits that would fail to satisfy the incidental benefit rule of § 1.401–1(b)(1)(i) if payable to Participant P’s beneficiary under the plan does not cause Plan B to fail to satisfy the incidental death benefit rule of § 1.401–1(b)(1)(i) because those excess death benefits under the life insurance contracts are not payable to Participant P’s
beneficiary under the plan. However, a portion of Employer N’s contributions under Plan B is attributable to the purchase of life insurance coverage held by Plan B that is in excess of the incidental death benefit payable under Plan B. Under Rev. Rul. 55–748, the portion of Employer N’s contributions that is attributable to such excess life insurance coverage does not constitute normal cost, and is not deductible as part of normal cost for the taxable year in which contributed. Rather, that portion of Employer N’s contributions is used to provide a source of funds to pay future premiums on other participants (i.e., premiums on other participants) that will come due after the death of Participant P. Accordingly, the nondeductible portion of Employer N’s contributions under Plan B that is paid for life insurance protection for Participant P is carried over pursuant to the rules of § 404(a)(1)(E) to be treated as contributions under the rules of § 404(a)(1)(E) in later years and deductible when the employer contributions are less than the maximum deductible limit (e.g., in years in which excess death benefits under Plan B are used to satisfy Employer N’s obligation to pay future premiums on other participants). Similarly, Employer N’s contributions to pay premiums for the disability waiver for Participant P do not constitute normal cost, and are not deductible as part of normal cost for the taxable year in which contributed. Rather, that portion of Employer N’s contributions is used to provide a source of funds to pay future premiums that will come due after Participant P becomes disabled. Accordingly, the nondeductible portion of Employer N’s contributions under Plan B that is paid for the disability waiver for Participant P is carried over pursuant to the rules of § 404(a)(1)(E) to be treated as contributions under the rules of § 404(a)(1)(E) in later years and deductible when the employer contributions are less than the maximum deductible limit (e.g., if and when Participant P becomes disabled).

In general, the premiums for excess life insurance coverage that are not currently part of normal cost under § 404(a)(1)(A) are determined in a manner consistent with total premiums under the contract (i.e., must be spread in a level manner over the premium payment period). However, if the premiums for the life insurance contracts covering a participant are level annual premiums payable beginning with the participant’s participation in the plan and ending at the participant’s normal retirement age, this excess amount can be determined by applying the appropriate term cost factors to the excess term coverage. Nondeductible contributions are subject to the excise tax of § 4972 as provided thereunder. In determining the amount of premiums for excess life insurance coverage, Table 2001 is applicable for taxable years ending after December 31, 2001, and the table set forth in Rev. Rul. 55–747 is used for earlier periods. In addition, the current published premium rates charged by an insurer for individual 1-year term life insurance available to all standard risks as described in Rev. Rul. 66–110, as amplified by Rev. Rul. 67–154, can be used for taxable years ending on or before December 31, 2003. For arrangements entered into on or before January 28, 2002, such current published premium rates can continue to be used for periods ending after December 31, 2003. However, for arrangements entered into after January 28, 2002, such current published premium rates can continue to be used for periods ending after December 31, 2003, only if the additional requirements of Notice 2002–8 are satisfied.

HOLDING

A qualified pension plan cannot be a section 412(i) plan if the plan holds life insurance contracts and annuity contracts for the benefit of a participant that provide for benefits at normal retirement age in excess of the participant’s benefits at normal retirement age under the terms of the plan.

Employer contributions under a qualified defined benefit plan that are used to purchase life insurance coverage for a participant in excess of the participant’s death benefit provided under the plan are not fully deductible when contributed, but are carried over to be treated as contributions in future years and deductible in future years when other contributions to the plan that are taken into account for the taxable year are less than the maximum amount deductible for the year pursuant to the limits of § 404.

LISTED TRANSACTIONS

Transactions that are the same as, or substantially similar to, the transaction described in Situation 2 of this revenue ruling are identified as “listed transactions” for purposes of § 1.6011–4(b)(2) of the Income Tax Regulations and § 301.6111–2(b)(2) and § 301.6112–1(b)(2) of the regulations, arrangements that are the same as, or substantially similar to, the arrangements described in this notice may already be subject to the disclosure requirements of § 6011 of the Code, the tax shelter registration requirements of § 6111, or the list maintenance requirements of § 6112 (§§ 1.6011–4, 301.6111–1T, 301.6111–2, and 301.6112–1).

Persons who are required to satisfy the registration requirement of § 6111 of the Code with respect to the arrangements described in this notice and who fail to do so may be subject to the penalty under § 6707(a). Persons who are required to satisfy the list-keeping requirement of § 6112 with respect to the arrangements and who fail to do so may be subject to the penalty under § 6708(a). In addition, the Service may impose penalties on participants in these arrangements or substantially similar arrangements, including the accuracy-related penalty under § 6662.

EFFECT ON OTHER RULINGS

Rev. Rul. 55–748 is modified and superseded.

DRAFTING INFORMATION

The principal authors of this revenue ruling are Larry Isaacs of the Employee Plans, Tax Exempt and Government Entities Division, and Linda Marshall of the Office of the Division Counsel/Associate Chief Counsel, Tax Exempt and Government Entities. For further information regarding this revenue procedure, please contact the Employee Plans’ taxpayer assistance telephone service at...
Section 412.—Minimum Funding Standards

26 CFR 1.412(i)–1: Certain insurance contract plans.

Whether a plan is a section 412(i) plan. See Rev. Rul. 2004-20, page 546.

How for purposes of § 402 of the Code the fair market value of a life insurance contract may be determined when it is distributed from a qualified plan. See Rev. Proc. 2004-16, page 559.

Section 611.—Allowance of Deduction for Depletion

26 CFR 1.611–2: Rules applicable to mines, oil and gas wells, and other natural deposits.

If a taxpayer owns an oil and gas producing property, may the taxpayer elect to treat 105 percent of the property’s proved reserves as the property’s total recoverable units for purposes of computing cost depletion under section 611 of the Internal Revenue Code. See Rev. Proc. 2004-19, page 563.

Section 856.—Definition of Real Estate Investment Trust

26 CFR 1.856–4: Rents from real property.

REITs; parking facilities. This ruling identifies circumstances in which a real estate investment trust’s (REIT’s) income from providing parking facilities at its rental real properties qualifies as rents from real property under section 856(d) of the Code.

Rev. Rul. 2004–24

ISSUE

If a real estate investment trust (REIT) provides parking facilities at its rental real properties, under what circumstances do amounts received by the REIT for providing the parking facilities qualify as rents from real property under § 856(d) of the Internal Revenue Code?

FACTS

Situation 1

Corporation R has elected to be a REIT as defined in § 856. R owns commercial real properties such as office buildings, shopping centers, and residential apartment complexes. Each property includes one or more buildings containing space that R rents out for office, retail, or multi-family residential use. Each property also includes parking facilities for the use of the tenants of the buildings and their guests, customers, and subtenants. Each parking facility is located in or adjacent to a building occupied by tenants of R and is appropriate in size for the number of tenants and their guests, customers, and subtenants who are expected to use the facility.

The parking facilities do not have parking attendants. R maintains, repairs, and lights the parking facilities. As needed to manage the REIT itself, R also performs fiduciary functions, such as dealing with taxes and insurance, as permitted by § 1.856–4(b)(5)(ii) of the Income Tax Regulations. No other activities are performed in connection with the parking facilities.

Situation 2

The facts are the same as in Situation 1 except as follows. At some of R’s parking facilities, parking spaces are reserved for use by particular tenants. R assigns and marks the reserved spaces in connection with leasing space in the buildings to the tenants. Any recurring functions unique to the reserved spaces (such as enforcement) are provided by an independent contractor as defined in § 856(d)(3) from whom R does not derive or receive any income within the meaning of §§ 856(d)(7)(C)(i) and 1.856–4(b)(5)(i).

Situation 3

The facts are the same as in Situations 1 and 2 except as follows.

Although each parking facility is appropriate in size for the expected number of tenants and their guests, customers, and subtenants, some of the parking facilities are available for use not only by those parties, but also by the general public. In addition, the parking facilities have parking attendants. R performs the same activities it performs in Situations 1 and 2, but corporation S manages and operates the parking facilities under a management contract with R. S is an independent contractor as defined in § 856(d)(3). Although S typically remits to R parking fees from those using the parking facilities, S receives arm’s-length compensation under the terms of its management contract with R, and R does not derive or receive any income from S within the meaning of §§ 856(d)(7)(C)(i) and 1.856–4(b)(5)(i). S employs all of the individuals who manage and operate the parking facilities, including the parking attendants. S is directly responsible for providing all salary, wages, benefits, administration, and supervision of its employees.

In addition to collecting parking fees from those using the parking facilities, the parking attendants may park cars in order to achieve the maximum capacity of the parking facility or for reasons of safety or security. No separate fee is charged for an attendant to park a car. Occasionally, when necessary, an attendant may provide minor, incidental, emergency service at a parking facility, such as charging a battery or changing a flat tire. No other services are provided at the parking facilities.

LAW

To qualify as a REIT, an entity must derive at least 95 percent of its gross income from sources listed in § 856(c)(2) and at least 75 percent of its gross income from sources listed in § 856(c)(3). “Rents from real property” are among the sources listed in both of those sections. Section 856(d)(1) defines rents from real property to include (subject to the exclusions in § 856(d)(2)) the amounts described in § 856(d)(1)(A), (B), and (C). Section 856(d)(1)(B) refers to “charges for services customarily furnished or rendered in connection with the rental of real property, whether or not such charges are separately stated.” Section 856(d)(2)(C) excludes “impermissible tenant service income” from the definition of rents from real property. Thus, to qualify as rents from real property, charges for services must be for services customarily furnished or rendered in connection with the rental of real property and must not be impermissible tenant service income.
Section 1.856–4(b)(1) provides the following guidance on determining whether services are customarily furnished or rendered in connection with the rental of real property:

... Services furnished to the tenants of a particular building will be considered as customarily furnished if they are furnished to the tenants of buildings which are of a similar class (such as luxury apartment buildings) and are customarily provided with the service. ... To qualify as a service customarily furnished, the service must be furnished or rendered to the tenants of the real estate investment trust or, primarily for the convenience or benefit of the tenant, to the guests, customers, or subtenants of the tenant. ... Thus, to qualify as a service described in § 856(d)(1)(B), a service furnished at a REIT’s property must be customarily provided to tenants of properties of a similar class in that particular geographic market (the geographic market test). Section 1.856–4(b)(1) also mentions the furnishing of parking facilities as an example of a service that is customarily furnished to tenants of a particular class of buildings in many geographic markets. Reflecting the statutory requirement of “connection with the rental of real property,” § 1.856–4(b)(1) also provides that to qualify as a service described in § 856(d)(1)(B), the service must be furnished to the REIT’s tenants or their guests, customers, or subtenants.

Section 1.856–4(b)(5)(ii) discusses the fiduciary functions of a REIT’s trustees or directors, as follows:

The trustees or directors of the real estate investment trust are not required to delegate or contract out their fiduciary duty to manage the trust itself, as distinguished from rendering or furnishing services to the tenants of its property or managing or operating the property. Thus, the trustees or directors may do all those things necessary, in their fiduciary capacities, to manage and conduct the affairs of the trust itself. For example, the trustees or directors may establish rental terms, choose tenants, enter into and renew leases, and deal with taxes, interest, and insurance, relating to the trust’s property. The trustees or directors may also make capital expenditures with respect to the trust’s property (as defined in section 263) and may make decisions as to repairs of the trust’s property (of the type which would be deductible under section 162), the cost of which may be borne by the trust. Thus, § 1.856–4(b)(5)(ii) permits the trustees or directors of a REIT to perform activities needed to manage the REIT itself, as distinguished from rendering services to tenants of the REIT’s property or managing or operating the REIT’s property.

As noted above, § 856(d)(2)(C) excludes impermissible tenant service income from the definition of rents from real property. Pursuant to § 856(d)(7)(A), impermissible tenant service income means, with respect to any real property, any amount received or accrued directly or indirectly by a REIT for furnishing services to the tenants of the property or managing or operating the property. Section 856(d)(7)(C)(i), however, provides that services rendered or management or operation provided is not treated as furnished by the REIT for this purpose if furnished through an independent contractor (as defined in § 856(d)(3)) from whom the REIT does not derive or receive any income. Thus, amounts received by a REIT for services furnished to its tenants, or for property management or operation, do not constitute impermissible tenant service income if the services or management or operation furnished is not treated as furnished by the REIT.

Moreover, pursuant to § 856(d)(7)(C)(ii), an amount is not treated as impermissible tenant service income if the amount would be excluded from unrelated business taxable income under § 512(b)(3) if received by an organization described in § 511(a)(2) (referred to, for purposes of this revenue ruling, as an exempt organization). Thus, services provided directly by a REIT do not give rise to impermissible tenant service income if the charges for those services would be excluded from unrelated business taxable income if received by an exempt organization.

Section 512(b)(3)(A)(i) excludes rents from real property from unrelated business taxable income. Section 1.512(b)(3)(C)(i) provides, however, that payments for the use of space where services are also rendered to the occupant are not rents from real property. That section mentions space in parking lots as an example of space where services are also rendered to the occupant. Thus, payments for the use of parking space are not excluded from unrelated business taxable income under § 512(b)(3) if received by an exempt organization.

The conference report underlying the 1986 revision of § 856(d) (the 1986 conference report) provides the following guidance on services performed directly by REITs:

The conferees wish to make certain clarifications regarding those services that a REIT may provide under the conference agreement without using an independent contractor, which services would not cause the rents derived from the property in connection with which the services were rendered to fail to qualify as rents from real property (within the meaning of section 856(d)). The conferees intend, for example, that a REIT may provide customary services in connection with the operation of parking facilities for the convenience of tenants of an office or apartment building, or shopping center, provided that the parking facilities are made available on an unreserved basis without charge to the tenants and their guests or customers. On the other hand, the conferees intend that income derived from the rental of parking spaces on a reserved basis to tenants, or income derived from the rental of parking spaces to the general public, would not be considered to be rents from real property unless all services are performed by an independent contractor. Nevertheless, the conferees intend that the income from the rental of parking facilities properly would be considered to be rents from real property (and not merely income from services) in such circumstances if services are performed by an independent contractor.

2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II–220 (1986), 1986–3 (Vol. 4) C.B. 220. Thus, the 1986 conference report indicates that, in some circumstances, REITs may directly perform activities in connection with parking facilities without causing charges for providing the parking facilities to fail to qualify as rents from real property under § 856(d).
The difference between this congressional intent and the treatment of exempt organizations under § 512(b)(3) reflects differences between §§ 856(d) and 512(b)(3), as well as differences between the regulations interpreting those sections. The definition of rents from real property in § 856(d), which applies to REITs, differs significantly in scope and structure from the definition of rents from real property under § 512(b)(3), which applies to exempt organizations. For example, unlike § 512(b)(3), § 856(d)(7)(C)(i) treats services provided by an independent contractor as not provided by the REIT. The definition of rents from real property under § 512(b)(3) does not have a comparable provision.

ANALYSIS

Situation 1

In Situation 1, R provides unattended parking facilities at its rental real properties. R maintains, repairs, and lights the unattended parking facilities and performs fiduciary functions permitted by § 1.856–4(b)(5)(ii). These activities are customarily performed at parking facilities located at rental real properties in all geographic markets. No other activities are performed in connection with R's unattended parking facilities. Therefore, the furnishing of R's unattended parking facilities will be treated as meeting the geographic market test of § 1.856–4(b)(1).

R's unattended parking facilities are part of R's rental real properties and are provided for the use of R's tenants and their guests, customers, and subtenants. Each parking facility is located in or adjacent to a building occupied by tenants of R and is appropriate in size for the number of tenants and their guests, customers, and subtenants who are expected to use the facility. Therefore, the furnishing of R's unattended parking facilities meets the requirement of § 1.856–4(b)(1) that services be furnished to the REIT's tenants or their guests, customers, or subtenants. Because it meets both that requirement and the geographic market test, the furnishing of R's unattended parking facilities is a service customarily furnished or rendered in connection with the rental of real property under § 856(d)(1)(B).

The 1986 conference report indicates that the activities performed by R at its unattended parking facilities described in Situation 1 should not cause charges for providing those parking facilities to fail to qualify as rents from real property under § 856(d). Therefore, although in Situation 1 payments for the use of parking space are not excluded from unrelated business taxable income under § 512(b)(3) if received by an exempt organization, the furnishing of R's unattended parking facilities will be treated as not giving rise to impermissible tenant service income under § 856(d)(2)(C) and (d)(7). Accordingly, because the furnishing of R's unattended parking facilities will be treated as not giving rise to impermissible tenant service income, amounts received by R for furnishing these parking facilities qualify as rents from real property under § 856(d).

Situation 2

In Situation 2, the facts are the same as in Situation 1 except that at some of R's unattended parking facilities, parking is available to tenants on a reserved basis. The furnishing of these parking facilities qualifies as a service described in § 856(d)(1)(B) for the reasons discussed above with respect to Situation 1.

The 1986 conference report indicates that income from reserved parking should qualify as rents from real property only if services are performed by an independent contractor. In Situation 2, any recurring functions unique to the reserved parking spaces (such as enforcement) are performed by an independent contractor. R assigns and marks the reserved spaces in connection with leasing space to its tenants and provides maintenance, repair, lighting, and fiduciary functions permitted by § 1.856–4(b)(5)(ii). These basic activities performed by R are not services to tenants that the conferees intended to prevent REITs from performing directly at parking facilities. Section 1.856–4(b)(5)(ii) permits the trustees or directors of a REIT to perform activities needed to manage the REIT itself, as distinguished from rendering services to tenants of the REIT's property or managing or operating the property. Therefore, although in Situation 2 payments for the use of parking space are not excluded from unrelated business taxable income under § 512(b)(3) if received by an exempt organization, the furnishing of R's unattended, reserved parking facilities will be treated as not giving rise to impermissible tenant service income under § 856(d)(2)(C) and (d)(7). Accordingly, because the furnishing of R's unattended, reserved parking facilities qualifies as a service described in § 856(d)(1)(B) and does not give rise to impermissible tenant service income, amounts received by R for furnishing these parking facilities qualify as rents from real property under § 856(d).

Situation 3

In Situation 3, R provides attended parking facilities at its rental real properties. R performs the same activities it performs in Situations 1 and 2, and S manages and operates the attended parking facilities. Attendants at these facilities generally collect parking fees. Attendants may also park cars in order to achieve the maximum capacity of the parking facility or for reasons of safety or security, and no separate fee is charged for an attendant to park a car. Occasionally, when necessary, an attendant may provide minor, incidental, emergency service at a parking facility. These services typically are provided at attended parking facilities at rental real properties in all geographic markets. No other services are provided at R's attended parking facilities. Therefore, the furnishing of R's attended parking facilities will be treated as meeting the geographic market test of § 1.856–4(b)(1).

Some of R's attended parking facilities are available for use only by R's tenants and their guests, customers, and subtenants, but also by the general public. However, the 1986 conference report indicates that tenant parking facilities also available to the general public should not be included from qualifying under § 856(d)(1)(B). R's attended parking facilities are part of R's rental real properties, and each parking facility is located in or adjacent to a building occupied by tenants of R and is appropriate in size for the number of tenants and their guests, customers, and subtenants who are expected to use the facility. Because of this proximity to the tenants and appropriate size, the attended parking facilities that also are available to the general public can reasonably be expected to be used predomi-
nanty by R’s tenants and their guests, customers, and subtenants. For these reasons, the furnishing of R’s attended parking facilities will be treated as meeting the requirement of § 856–4(b)(1) that services be furnished to the REIT’s tenants or their guests, customers, or subtenants. Because it meets both that requirement and the geographic market test, the furnishing of R’s attended parking facilities is a service customarily furnished or rendered in connection with the rental of real property under § 856(d)(1)(B).

The 1986 conference report indicates that income from parking that is reserved or available to the general public should qualify as rents from real property only if services are performed by an independent contractor. The only activities that R performs in connection with its attended parking facilities are maintenance, repair, lighting, fiduciary functions, and assigning and marking reserved spaces. As noted above, these basic activities are not services to tenants that the conference intended to prevent REITs from performing directly at parking facilities. All of the other activities involved in furnishing R’s attended parking facilities are performed by S, an independent contractor as defined in § 856(d)(3). Although S typically collects parking fees and remits the fees to R, R receives arm’s-length compensation under the terms of its management contract with R, and R does not derive or receive any income from S within the meaning of §§ 856(d)(7)(C)(i) and 1.856–4(b)(5)(i). S employs all of the individuals who manage and operate the attended parking facilities and is directly responsible for providing all their salary, wages, benefits, administration, and supervision. Therefore, although in Situation 3 payments for the use of parking space are not excluded from unrelated business taxable income under § 512(b)(3) if received by an exempt organization, the furnishing of R’s attended parking facilities will be treated as not giving rise to impermissible tenant service income under § 856(d)(2)(C) and (d)(7). Accordingly, because the furnishing of R’s attended parking facilities qualifies as a service described in § 856(d)(1)(B) and does not give rise to impermissible tenant service income, amounts received by R for furnishing these parking facilities qualify as rents from real property under § 856(d).

HOLDING

Amounts received by R for furnishing unattended parking facilities, under the circumstances described in Situations 1 and 2, and for furnishing attended parking facilities, under the circumstances described in Situation 3, qualify as rents from real property under § 856(d).

DRAFTING INFORMATION

The principal author of this revenue ruling is Jonathan D. Silver of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling, contact Mr. Silver at (202) 622–3920 (not a toll-free call).

Section 3121.—Definitions

26 CFR 31.3121(b)(10)–2: Services performed by certain students in the employ of a school, college, or university, or of a nonprofit organization auxiliary to a school, college, or university.

A notice describes a safe harbor that certain institutions of higher education can use in applying the exception from Federal Insurance Contributions Act taxes for services performed by a student under section 3121(b)(10) of the Code. See Notice 2004-12, page 556.

Section 4980B.—Failure to Satisfy Continuation Coverage Requirements of Group Health Plans

26 CFR 54.4980B–7: Duration of COBRA continuation coverage. (Also 26 CFR 54.4980B–4)

COBRA and Medicare entitlement. The COBRA continuation coverage period can be expanded from 18 to 36 months if a second qualifying event occurs. Medicare entitlement of a covered employee is one of the listed events that can be a second qualifying event. This ruling holds that Medicare entitlement is not a second qualifying event unless (ignoring the first qualifying event) it would result in a loss of coverage under the group health plan.

Rev. Rul. 2004–22

ISSUE

For purposes of the COBRA continuation coverage requirements of section 4980B of the Internal Revenue Code, is the Medicare entitlement of a covered employee a second qualifying event for a qualified beneficiary if the Medicare entitlement would not have resulted in a loss of coverage for the qualified beneficiary under the group health plan that is providing the COBRA continuation coverage?

FACTS

Employee E and E’s spouse are covered under a group health plan subject to the COBRA continuation coverage requirements of section 4980B of the Internal Revenue Code. E is not entitled to Medicare benefits. E terminates employment (but not by reason of gross misconduct). E and E’s spouse lose coverage under the plan as a result of E’s termination of employment. The plan offers them the right to elect COBRA continuation coverage for a period of up to 18 months. E’s spouse elects and pays for COBRA continuation coverage timely. Before the 18-month period has expired, E becomes entitled to Medicare benefits by reason of the attainment of age 65. E’s spouse is still receiving COBRA continuation coverage under the plan at the time E becomes entitled to Medicare benefits. E’s spouse notifies the plan of E’s becoming entitled to Medicare benefits within 60 days after E became so entitled. Employees and their spouses receiving coverage under the plan by virtue of an employee’s current employment status are not treated differently under the plan on account of their being age 65 or older, nor on account of
their being entitled to Medicare benefits by reason of the attainment of age 65.1

LAW AND ANALYSIS

Section 4980B of the Code requires certain group health plans to make continuation coverage available to certain individuals who would otherwise lose their coverage under the plan as a result of certain occurrences (the COBRA continuation coverage requirements). Section 4980B imposes an excise tax if a plan subject to the COBRA continuation coverage requirements fails to comply with them.

Under section 4980B, the obligation of a plan to make COBRA continuation coverage available arises in connection with a qualifying event. The individuals to whom COBRA continuation coverage must be made available are qualified beneficiaries.

Under Q&A–1 of § 54.4980B–3 of the Miscellaneous Excise Tax Regulations, a qualified beneficiary is any individual who is covered under a group health plan on the day before a qualifying event by virtue of being on that day a covered employee or the spouse or a dependent child of a covered employee. However, a covered employee can be a qualified beneficiary only in connection with a qualifying event that is a termination (or reduction of hours) of the covered employee’s employment or that is the bankruptcy of the employer. Under Q&A–2 of § 54.4980B–3, a covered employee is generally any individual who is or was provided coverage under a group health plan by virtue of the performance of services for the employer maintaining the plan or by virtue of membership in the employee organization maintaining the plan. Under Q&A–1(f) of § 54.4980B–3, an individual ceases to be a qualified beneficiary if the individual does not elect COBRA continuation coverage by the end of the election period; an individual also ceases to be a qualified beneficiary when the plan no longer has an obligation to make COBRA continuation coverage available to the individual under the rules prescribing how long COBRA continuation coverage must be made available.

Section 4980B(f)(3) of the Code lists six categories of events and defines them as qualifying events if, but for the COBRA continuation coverage required to be provided, they would result in a loss of coverage of a qualified beneficiary. The categories of qualifying events include the termination (other than by reason of gross misconduct), or reduction of hours, of a covered employee’s employment and the covered employee’s becoming entitled to Medicare benefits under title XVIII of the Social Security Act. Q&A–1(c) of § 54.4980B–4 defines what is a loss of coverage for purposes of determining if a listed event is a qualifying event, requiring that the listed event cause the covered employee or the covered employee’s spouse or dependent child to cease to be covered under the same terms and conditions as in effect immediately before the event.

Q&A–1(c) of § 54.4980B–4 clarifies that a loss of coverage need not occur immediately after the event so long as it occurs before the end of the maximum coverage period.

Q&A–4 of § 54.4980B–7 describes the end of the maximum coverage period. In the case of a qualifying event that is a termination (or reduction of hours) of employment, the maximum coverage period generally ends 18 months after the qualifying event (29 months if a disability extension applies). In the case of a qualifying event that is a covered employee’s becoming entitled to Medicare benefits, the maximum coverage period generally ends 36 months after the date of the qualifying event. (Nothing in the statute or regulations prohibits a group health plan from providing coverage that continues beyond the end of the maximum coverage period.)

Q&A–6(b) of § 54.4980B–7 describes the circumstances under which a second qualifying event can expand the maximum coverage period of an earlier qualifying event. If a qualifying event that is a termination (or reduction of hours) of employment is followed within the 18-month maximum coverage period (or within the 29-month maximum coverage period in a case in which a disability extension applies) by a qualifying event that gives rise to a 36-month maximum coverage period, then the 18-month (or 29-month) period is expanded to 36 months (measured from the date of the first qualifying event). The expanded period applies only for those individuals who were qualified beneficiaries in connection with the first qualifying event and who are still qualified beneficiaries at the time of the second qualifying event.

The expanded maximum coverage period of Q&A–6 of § 54.4980B–7 applies only when the 36-month qualifying event follows the qualifying event that is a termination (or reduction of hours) of employment. (However, Q&A–4(d) of § 54.4980B–7 provides a special rule for the measurement of the maximum coverage period in a case where the covered employee’s becoming entitled to Medicare benefits precedes the termination (or reduction of hours) of employment; this special rule applies regardless of whether the Medicare entitlement is a qualifying event.) Because a covered employee is not a qualified beneficiary with respect to any 36-month qualifying event, the expanded period that applies in connection with a second qualifying event will not apply to a covered employee but only to the spouse or a dependent child of a covered employee.

Based on the statute and regulations, for a spouse or dependent child of a covered employee to be entitled to the expanded maximum coverage period when

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1 The Medicare Secondary Payer (MSP) provisions of the Social Security Act that apply with respect to individuals entitled to Medicare based on the attainment of age 65 — generally referred to as the “working aged” MSP provisions (section 1862(b)(1)(A), 42 U.S.C. 1395y(b)(1)(A)) — include two restrictions on most group health plans that are subject to the COBRA continuation coverage requirements. (The working aged MSP provisions and the COBRA continuation coverage requirements both include an exception for plans maintained by an employer with fewer than 20 employees. However, they differ in how the 20 employees are counted, creating the possibility that a plan exempt under one law will be subject to the other law.)

First, the working aged MSP provisions prohibit a group health plan from taking into account that an individual (or the individual’s spouse) who is covered under the plan by virtue of the individual’s current employment status with an employer is entitled to Medicare based on disability. (42 U.S.C. 1395y(b)(1)(B).)

The MSP provisions also prohibit a large group health plan (a plan of an employer that employs at least 20 employees) from taking into account that an individual or a member of an individual’s family who is covered under the plan by virtue of the individual’s current employment status with an employer is entitled to Medicare based on disability. (42 U.S.C. 1395y(b)(1)(B).)

In addition, the MSP provisions generally prohibit a plan from taking into account that an individual is eligible for or entitled to Medicare benefits based on end stage renal disease during a coordination period of 3 months. (42 U.S.C. 1395y(b)(1)(C)).
a second qualifying event occurs, the following three conditions must be satisfied:  

1. The spouse or dependent child must be a qualified beneficiary in connection with a termination (or reduction of hours) of employment;

2. The spouse or dependent child must still be a qualified beneficiary at the time that the 36-month event occurs; and

3. The 36-month event must be a qualifying event.

For a 36-month event to be a qualifying event, it must — but for the required COBRA continuation coverage — result in a loss of coverage for the qualified beneficiary under the plan within the maximum coverage period. In the context of determining if a 36-month event is a second qualifying event, it is necessary to ignore the COBRA continuation coverage provided in connection with the qualifying event that is the termination (or reduction of hours) of the covered employee’s employment. The inquiry is whether, in the absence of the first qualifying event, the 36-month event would result in a loss of coverage for the qualified beneficiary under the plan within the maximum coverage period. This determination is made by applying the terms of the plan to the qualified beneficiary as if the covered employee had not experienced the termination (or reduction of hours) of employment and determining if the occurrence of the 36-month event in this hypothetical scenario would result in a loss of coverage for the qualified beneficiary under the plan within 36 months after, generally, the covered employee’s actual termination (or reduction of hours) of employment.

In the facts described, the first two conditions for E’s Medicare entitlement to be a second qualifying event for E’s spouse are satisfied: E’s spouse is a qualified beneficiary in connection with E’s termination of employment, and E’s spouse is still a qualified beneficiary at the time that E becomes entitled to Medicare benefits. Thus, whether E’s spouse is entitled to a period of 36 months of COBRA continuation coverage (measured from the date of E’s termination of employment) depends on whether E’s Medicare entitlement is a qualifying event. The group health plan described complies with the Social Security Act by not treating a current employee or the employee’s spouse differently because either of them has attained age 65 or is entitled to Medicare benefits by reason of the attainment of age 65. Thus, applying the terms of the plan to E’s spouse as if E’s spouse were receiving coverage under the plan in absence of E’s termination of employment, E’s becoming entitled to Medicare benefits in the hypothetical scenario of E’s not having experienced a termination of employment would not result in a loss of coverage for E’s spouse within 36 months after the actual termination of employment. Consequently, E’s spouse is not entitled to an expansion of the maximum coverage period by reason of E’s Medicare entitlement, and the plan is not required to make COBRA continuation coverage available to E’s spouse beyond the end of the 18-month maximum coverage period.

HOLDING

The Medicare entitlement of a covered employee is not a second qualifying event for a qualified beneficiary unless the Medicare entitlement would have resulted (if COBRA continuation coverage, including COBRA continuation coverage due to the first qualifying event, is disregarded) in a loss of coverage for the qualified beneficiary under the group health plan that is providing the COBRA continuation coverage.

DRAFTING INFORMATION

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

Section 6011.—General Requirement of Return, Statement, or List


Whether certain transactions involving a pension plan that holds life insurance contracts and annuity contracts for the benefit of a participant which provide for benefits at normal retirement age in excess of the participant’s benefits at normal retirement age under the terms of the plan are “listed transactions.” See Rev. Rul. 2004-20, page 546.

Section 6111.—Registration of Tax Shelters

26 CFR 301.6111–2: Confidential corporate tax shelters.

Whether transactions involving a pension plan that holds life insurance contracts and annuity contracts for the benefit of a participant which provide for benefits at normal retirement age in excess of the participant’s benefits at normal retirement age under the terms of the plan are transactions that must be registered. See Rev. Rul. 2004-20, page 546.

Section 6112.—Organizers and Sellers of Potentially Abusive Tax Shelters Must Keep Lists of Investors

26 CFR 301.6112–1: Requirement to prepare, maintain, and furnish lists with respect to potentially abusive tax shelters.

Whether a list must be maintained with respect to transactions involving a pension plan that holds life insurance contracts and annuity contracts for the benefit of a participant which provide for benefits at normal retirement age in excess of the participant’s benefits at normal retirement age under the terms of the plan. See Rev. Rul. 2004-20, page 546.

2 This revenue ruling does not address any COBRA notice requirement that a qualified beneficiary may have to satisfy in order to be entitled to the expanded maximum coverage period in connection with a second qualifying event.

3 Q&A–4(b) of § 54.4980B–7 of the regulations allows a plan to elect to measure the maximum coverage period from the date of a later loss of coverage rather than from the date of the qualifying event.

4 E’s spouse also provided notice to the plan of E’s Medicare entitlement within 60 days after E became so entitled. This is relevant in determining whether E’s spouse has satisfied any COBRA notice requirement that may apply for E’s spouse to be entitled to the expanded maximum coverage period in connection with the occurrence of a second qualifying event.
Part III. Administrative, Procedural, and Miscellaneous

Proposed Revenue Procedure Regarding Services That Qualify for the Student FICA Exception

Notice 2004–12

I. Overview and Purpose

This notice contains a proposed revenue procedure providing a safe harbor that certain institutions of higher education, and certain affiliated organizations can use in applying the exception for services performed by a student provided under § 3121(b)(10) of the Internal Revenue Code (student FICA exception). A previous version of this safe harbor was issued in Rev. Proc. 98–16, 1998–1 C.B. 403. However, the Service has recently proposed amendments to the Employment Tax Regulations interpreting § 3121(b)(10) in order to clarify specific issues that have arisen with taxpayers and in litigation (see proposed regulations § 31.3121(b)(10)–2(c), (d), and (e) published in the Federal Register on February 25, 2004 (REG–156421–03, 2004–10 I.R.B. 571 [69 F.R. 8604]). In order to provide guidance that is consistent with the proposed regulations in all respects, the Service is suspending Rev. Proc. 98–16 and proposing to replace it with the revenue procedure contained in this notice.

The proposed revenue procedure updates the safe harbor of Rev. Proc. 98–16 in several respects that align it with the proposed regulations. First, the proposed revenue procedure adds a primary function requirement to the definition of an institution of higher education. Section 3121(b)(10) applies only to services performed in the employ of a school, college, or university, or an affiliated § 509(a)(3) organization. Under the proposed regulations and the new safe harbor, an organization can be a school, college, or university only if its primary function is to conduct educational activities. Thus, in order to take advantage of the safe harbor in the revenue procedure, an institution must satisfy not only the Department of Education’s regulations at 34 C.F.R. § 600.4 and satisfy the accreditation requirements of 34 C.F.R. § 600.2, as was required in Rev. Proc. 98–16, but also must have education and instruction as its primary function. The primary function requirement may make the exception under § 3121(b)(10) unavailable to certain institutions of higher education that are embedded within a larger organization like a hospital or museum.

Second, the proposed revenue procedure does not permit an institution to apply the student FICA exception to services performed by an employee who regularly works 40 or more hours per week. Under the existing regulations, services fall within the student FICA exception only if they are performed incident to and for the purpose of pursuing a course of study. The proposed regulations clarify that an individual who regularly works forty or more hours per week has the status of a career employee, and, accordingly, is not performing services incident to and for the purpose of pursuing a course of study. The proposed revenue procedure follows the proposed regulations. The student FICA exception generally, and the safe harbor provided by the proposed revenue procedure specifically, are still available for services performed by an employee who on occasion works 40 or more hours per week and otherwise meets the requirements of the safe harbor.

Third, the proposed revenue procedure provides that an individual has career employee status if the individual is a “professional employee.” The proposed regulations provide that a professional employee for purposes of the student FICA exception is an employee whose primary duty consists of the performance of services requiring knowledge of an advanced type in a field of science or learning, whose work requires the consistent exercise of discretion and judgment in its performance, and whose work is predominantly intellectual and varied in character. The proposed revenue procedure follows the proposed regulations.

Fourth, the proposed revenue procedure expands the terms of employment that result in status as a career employee. Rev. Proc. 98–16 provided that an individual was to be considered a career employee if the employee was eligible to participate in one of several types of retirement plans, eligible for reduced tuition (with certain exceptions), or otherwise classified by the institution of higher education as a career employee. The proposed regulations adopt the same criteria for identifying individuals who have the status of a career employee and adds to the list eligibility for a number of other benefits. The proposed revenue procedure follows the proposed regulations, adding the additional criteria that cause an individual to have career employee status and fall outside the scope of the safe harbor. Employees considered as having the status of a career employee per se cannot have the status of a student for purposes of the student FICA exception.

Fifth, and finally, the proposed revenue procedure provides that an employee has career employee status if the individual is required to be licensed under state or local law in order to perform the services the individual provides to the school, college, or university. The proposed revenue procedure follows the proposed regulation.

II. Request for Comments

Comments are requested on the proposed revenue procedure. Comments may be submitted on or before May 25, 2004, to Internal Revenue Service, PO Box 7604, Washington, DC 20044, Attn: CC:PA:LPD:PR (Notice 2004–12), Room 5203. Submissions may also be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to the Courier’s Desk at 1111 Constitution Avenue, NW, Washington, DC 20224, Attn: CC:PA:LPD:PR (Notice 2004–12), Room 5203. Submissions may also be sent electronically via the internet to the following email address: Notice.comments@irs法律顾问.treas.gov. Include the notice number (Notice 2004–12) in the subject line.

III. Effect on Other Documents


IV. Effective Date

The Service intends to issue a final revenue procedure at the same time that the
proposed regulations under § 3121(b)(10) are finalized. Until a final version of the proposed revenue procedure is issued, taxpayers may rely on the proposed revenue procedure with respect to services performed on or after February 25, 2004 (the date prop. Reg. § 31.3121(b)(10)–2(c)–(f) (69 F.R. 8604) was published in the Federal Register).

V. Proposed Revenue Procedure

SECTION 1. PURPOSE

This revenue procedure sets forth generally applicable standards for determining whether service in the employ of certain public or private nonprofit schools, colleges, universities, or affiliated organizations described in § 509(a)(3) of the Internal Revenue Code (the Code) performed by a student qualifies for the exception from Federal Insurance Contributions Act (FICA) tax provided under § 3121(b)(10) of the Code (Student FICA exception). These standards are intended to provide objective and administrable guidelines for determining employment tax liability.

SECTION 2. SCOPE

.01 Institutions of higher education typically distinguish between career employees and student employees. Sections 5 and 6 of this revenue procedure contain generally applicable standards for determining whether or not services performed by employees of certain institutions of higher education are eligible for the Student FICA exception.

.02 The standards contained in this revenue procedure do not apply to employees who are postdoctoral students, postdoctoral fellows, medical residents, or medical interns because the services performed by these employees cannot be assumed to be incident to and for the purpose of pursuing a course of study. The employment activities of these individuals overlaps with the activities comprising the course of study, and thus it is not appropriate to apply the standards of this revenue procedure to these individuals.

.03 The standards contained in this revenue procedure may not constitute the exclusive method for determining whether the Student FICA exception applies. If the standard for qualifying for the exclusion described in section 6 of this revenue procedure (providing generally that an employee enrolled at least half-time at an institution of higher education has the status of student) is not met, whether or not service in the employ of a school, college, university, or affiliated organization described in § 509(a)(3) of the Code will qualify for the Student FICA exception will depend on consideration of all the facts and circumstances.

SECTION 3. BACKGROUND

.01 Sections 3101 and 3111 of the Code impose social security and Medicare taxes (FICA taxes) on employees and employers, respectively, equal to a percentage of the wages received by an individual with respect to employment.

.02 Section 3121(a) of the Code defines “wages” for purposes of FICA taxes as all remuneration for employment, with certain exceptions. Section 3121(b) of the Code defines “employment” as services performed by an employee for an employer, with certain exceptions.

.03 Section 3121(b)(10) of the Code excepts from the definition of employment services performed in the employ of a school, college, or university (whether or not that organization is exempt from income tax), or an affiliated organization described in § 509(a)(3) of the Code, if the services are performed by a student who is enrolled and regularly attending classes at that school, college, or university. Remuneration for services excluded from the definition of employment under § 3121(b)(10) of the Code is not subject to FICA taxes.

.04 Section 31.3121(b)(10)–2 of the Employment Tax Regulations provides that whether an employee has the status of a student is determined on the basis of the employee’s relationship with the school, college, or university for which the services are being performed. An employee who performs services in the employ of a school, college, or university as an incident to and for the purpose of pursuing a course of study at the school, college, or university has the status of a student in the performance of those services. Services that are not incident to and for the purpose of pursuing a course of study do not qualify for the exception. If the employee performs services as an incident to and for the purpose of pursuing a course of study and, therefore, has the status of a student, the amount of remuneration for services performed by the employee, the type of services performed by the employee, and the place where the services are performed are immaterial for purposes of the Student FICA exception.

.05 Section 218 of the Social Security Act (the Act), 42 U.S.C. section 418, allows states to provide Social Security coverage for services performed by students for the public school the student is attending under agreements established with the Social Security Administration. If a state has exercised its option under § 218 of the Act to provide for coverage of student services, § 3121(b)(10) of the Code provides that those services will not qualify for the Student FICA exception.

SECTION 4. CERTAIN INSTITUTIONS OF HIGHER EDUCATION

.01 The standards contained in this revenue procedure apply to “institutions of higher education” meeting the requirements of § 31.3121(b)(10)–2(c) of the proposed Employment Tax Regulations. For purposes of this revenue procedure, the term “institution of higher education” includes any public or private nonprofit school, college, or university within the meaning of prop. Reg. § 31.3121(b)(10)–2(c), or affiliated organization described in § 509(a)(3) of the Code, that meets the requirements set forth in Department of Education regulations at 34 C.F.R. § 600.4, as amended from time to time, and that is accredited or preaccredited by a nationally recognized accrediting agency as defined in the Department of Education regulations at 34 C.F.R. § 600.2.

.02 Services for other institutions may also be eligible for the Student FICA exception. Thus, for example, services performed by a student for a secondary school may be eligible for the Student FICA exception. Whether or not services for other institutions, such as secondary schools, qualify for the Student FICA exception is determined based on the facts and circumstances of each case.
SECTION 5. STUDENT FICA EXCEPTION NOT AVAILABLE FOR EMPLOYEES WITH CAREER EMPLOYEE STATUS

.01 Services performed by individuals with career employee status are not eligible for the Student FICA exception under the standard in section 6 of this revenue procedure because their services are not incident to and for the purpose of pursuing a course of study. See prop. Reg. § 31.3121(b)(10)–2(d)(3)(ii).

.02 Career employee status. Services of an employee with career employee status are not incident to and for the purpose of pursuing a course of study. An employee may be considered to have career employee status based on the employee’s hours worked, whether the employee is a “professional employee,” the employee’s terms of employment, or whether the employee is licensed under state or local law to work in the field in which the employee performs services. These standards are set forth in prop. Reg. § 31.3121(b)(10)–2(d)(3)(ii). An employee has career employee status if the employee is described in paragraph (1), (2), (3), or (4) of this section.

(1) Hours worked. An employee has the status of a career employee if the employee regularly performs services 40 hours or more per week.

(2) Professional employee. An employee has the status of a career employee if the employee is a professional employee. A professional employee is an employee—

(a) Whose primary duty consists of the performance of work requiring knowledge of an advanced type in a field of science or learning customarily acquired by a prolonged course of specialized intellectual instruction and study, as distinguished from a general academic education, from an apprenticeship, and from training in the performance of routine mental, manual, or physical processes.

(b) Whose work requires the consistent exercise of discretion and judgment in its performance; and

(c) Whose work is predominantly intellectual and varied in character (as opposed to routine mental, manual, mechanical, or physical work) and is of such character that the output produced or the result accomplished cannot be standardized in relation to a given period of time.

(3) Terms of employment. An employee’s terms of employment may indicate that the employee has career employee status. An employee with career employee status includes any employee who is—

(a) Eligible to receive vacation, sick leave, or paid holiday benefits;

(b) Eligible to participate in any retirement plan described in § 401(a) of the Code that is established or maintained by the employer; or would be eligible to participate if age and service requirements were met;

(c) Eligible to participate in an arrangement described in § 403(b) of the Code, or would be eligible to participate if age and service requirements were met;

(d) Eligible to participate in a plan described under § 457(a), or would be eligible to participate if age and service requirements were met;

(e) Eligible for reduced tuition (other than qualified tuition reduction under § 117(d)(5) of the Code provided to a teaching or research assistant who is a graduate student) because of the individual’s employment relationship with the institution;

(f) Eligible to receive employee benefits described under § 79 (life insurance), 127 (qualified educational assistance), 129 (dependent care assistance programs), or 137 (adoption assistance); or

(g) Classified by the employer as a career employee.

(4) Licensure. An employee is a career employee if the employee is required to be licensed under state or local law to work in the field in which the employee performs services.

.03 If an individual performs services in multiple job positions, the individual will be deemed to have career employee status with respect to all of the positions if the individual has career employee status in any one or more of the job positions.

SECTION 6. STANDARDS APPLICABLE TO UNDERGRADUATE AND GRADUATE STUDENTS

.01 An individual who is a half-time undergraduate student or a half-time graduate or professional student and who does not have the status of a career employee will qualify for the Student FICA exception under this revenue procedure with respect to services performed at or for an institution of higher education described in section 4 of this revenue procedure in which they are enrolled or at affiliated organizations described in § 509(a)(3) of the Code. Services performed by a student for any other employer are not covered by the standards of this revenue procedure.

.02 An individual is deemed to be a half-time undergraduate or half-time graduate or professional student if the individual does not have the status of a career employee status and is an undergraduate or graduate student who is in the last semester, trimester, or quarter of a course of study requiring at least two semesters, trimesters, or quarters to complete and is enrolled in the number of credit or unit hours needed to complete the requirements for obtaining a degree, certificate, or other recognized educational credential offered by that institution of higher education even if enrolled in less than half the number required of full-time students.

.03 The determination of student status should be made at the end of the drop-add period and may be adjusted thereafter at the institution of higher education’s option. The determination of student status for payroll periods ending before the end of the drop-add period may be based on the number of semester, trimester, or quarter hours being taken at the end of the registration period for that semester, trimester, or quarter.

.04 If an individual is described in section 6.01 or 6.02 of this revenue procedure, services performed by the individual are eligible for the Student FICA exception with respect to all services performed during all payroll periods of a month or less that fall wholly or partially within the academic term.

.05 The Student FICA exception does not apply to services performed by an individual who is not enrolled in classes during school breaks of more than five weeks (including summer breaks of more than five weeks), other than services described in section 6.04. See Rev. Rul. 72–142, 1972–1 C.B. 317, and Rev. Rul. 74–109, 1974–1 C.B. 288. However, the Student FICA exception applies to employment which continues during normal school breaks of 5 weeks or less during which the individual is not eligible for
the Student FICA exception pursuant to section 6.01 of this revenue procedure provided that the individual qualifies for the Student FICA exception pursuant to section 6.01 of this revenue procedure on the last day of classes or examinations preceding the break and is eligible to enroll in classes for the first academic period following the break.

.06 If the standards of this revenue procedure are met (and section 8 does not apply), the amount of remuneration for services performed by the employee, the type of services performed by the employee, and the place where the services are performed are immaterial. If the services performed by a student otherwise described in section 6.01 or 6.02 are covered under an agreement pursuant to section 218 of the Act, the Student FICA exception does not apply.

.07 For provisions relating to domestic service performed by a student in a local college club, or local chapter of a college fraternity or sorority, see § 31.3121(b)(2)–1.

SECTION 7. DEFINITIONS

For purposes of the standard contained in section 6 of this revenue procedure, the following definitions must be used. For purposes of the following definitions, the term “institution of higher education” means an institution of higher education as defined in section 4 of this revenue procedure.

.01 Undergraduate student. The term “undergraduate student” has the meaning attributed to that term in the Department of Education regulations at 34 C.F.R. section 674.2.

.02 Half-time undergraduate student. The term “half-time undergraduate student” has the meaning attributed to that term in the Department of Education regulations at 34 C.F.R. section 674.2.

.03 Graduate or professional student. The term “graduate or professional student” means a student who—

(1) is enrolled at an institution of higher education for the purpose of obtaining a degree, certificate, or other recognized educational credential above the baccalaureate level or is enrolled in a program leading to a professional degree;

(2) has completed the equivalent of at least three years of full-time study at an institution of higher education, either prior to entrance into the program or as part of the program itself; and

(3) is not a postdoctoral student, postdoctoral fellow, medical resident, or medical intern.

.04 Half-time graduate or professional student. The term “half-time graduate or professional student” means an enrolled graduate or professional student, as defined in section 7.03 of this revenue procedure, who is carrying at least a half-time academic workload at an institution of higher education as determined by that institution according to its own standards and practices.

SECTION 8. ANTI-ABUSE RULE

The standards in this revenue procedure must be applied in a reasonable manner, consistent with the purpose of excluding from employment only services that are performed as an incident to and for the purpose of pursuing a course of study at an institution of higher education as defined in section 4 of this revenue procedure. If the standards are inappropriately applied in a manner that conflicts with this underlying purpose so as to manipulate or mischaracterize the nature of the relationship between an employee and an institution of higher education, resulting in the improper avoidance of payment of FICA taxes, then whether the Student FICA exception applies will be determined on the basis of all the facts and circumstances, rather than on the basis of the specific standards set forth in section 6 of this revenue procedure. For example, the standards would be inappropriately applied through the manipulation of the relationship between employees and the institution of higher education if a university claimed that the Student FICA exception applied to research laboratory workers, who had been career employees, but were converted to non-career status and required to enroll in a certificate program granting six credit hours per semester for work experience in the laboratory. As another example, if an individual who was not a student worked for a university on a full-time basis for many years, in a job generally performed by non-students (but nonetheless failed to meet the literal definition of career employee), and then enrolled at the university for six credit hours of course work per semester while continuing the full-time work in the same job, it may not be appropriate to apply the standards of this revenue procedure to conclude that the individual’s work has become incident to and for the purpose of pursuing a course of study solely because the individual enrolled for this course work. In both of these examples, whether the work is performed incident to and for the purpose of pursuing a course of study must be determined on the basis of all the relevant facts and circumstances.

SECTION 9. EFFECTIVE DATE

This revenue procedure is effective for services performed on or after February 25, 2004 (the date prop. Reg. § 31.3121(b)(10)–2(c)–(f) (69 FR 8604) was published in the Federal Register).

The principal author of this notice is Stephen D. Suetterlein of the Office of Associate Chief Counsel (Tax Exempt & Government Entities). However, other personnel from the Service and Treasury Department participated in the development of this notice. For further information regarding this notice, contact Mr. Suetterlein at (202) 622–6040 (not a toll-free call).

26 CFR 601.201: Rulings and determination letters. (Also, Part I, § 402: § 1.402(a)–1.)

Rev. Proc. 2004–16

SECTION 1. PURPOSE

This revenue procedure is issued in connection with the issuance of proposed regulations under § 402(a) of the Internal Revenue Code regarding the valuation of life insurance contracts upon distribution from a qualified retirement plan and proposed regulations under §§ 79 and 83 regarding the valuation of life insurance contracts under those sections (REG–126967–03, 2004–10 I.R.B. 566). The preamble to the proposed regulations states that it is not appropriate in some cases to use either the net surrender value of a distributed life insurance contract (i.e., the contract’s cash value after reduction for any surrender charges) or the contract’s reserves as the contract’s fair
market value upon distribution of an insurance contract from a qualified plan but the preamble provides limited guidance as to what value may be used instead. Similarly, the proposed regulations under §§ 79 and 83 clarify that the amount includible in income under those sections is based upon the fair market value of the insurance contract rather than its cash value but these proposed regulations do not provide any guidance as what constitutes fair market value. The regulations are generally proposed to apply beginning on the date the proposed regulations are filed in the Federal Register. The preamble to the proposed regulations also requests public comments regarding appropriate methods for valuing life insurance contracts when distributed from qualified retirement plans and for purposes of §§ 79 and 83. Until further guidance is issued, this revenue procedure provides interim rules under which the cash value (without reduction for surrender charges) of a life insurance contract may be treated as the contract’s fair market value when the contract is distributed from a qualified plan under § 402 and for purposes of §§ 79 and 83.

SECTION 2. BACKGROUND

.01 Section 402(a) provides generally that any amount actually distributed to any distributee by any employees’ trust described in § 401(a) which is exempt from tax under § 501(a) shall be taxable to the distributee, in the taxable year of the distributee in which distributed, under § 72.

.02 Section 1.402(a)(1)(a)(1)(iii) of the current regulations provides, in general, that a distribution of property by a § 401(a) plan shall be taken into account by the distributee at its “fair market value.” Section 1.402(a)(1)(a)(2) of the current regulations provides, in general, that upon distribution of an annuity or life insurance contract, the “entire cash value” must be included in the distributee’s income. The current regulations do not define “fair market value” or “entire cash value” and questions have arisen regarding the interaction between these two provisions.

.03 The proposed regulations would clarify that the requirement that a distribution of property must be included in the distributee’s income at fair market value is controlling in those situations where the existing regulations provide for the inclusion of the entire cash value. Thus, the proposed regulations provide that, in those cases where a qualified plan distributes a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, the fair market value of such a contract is generally included in the distributee’s income rather than the entire cash value of the contract. For this purpose, the policy cash value and all other rights under the contract (including any supplemental agreements thereto and whether or not guaranteed) are included in determining the fair market value of such a contract. The proposed regulations provide a similar rule for purposes of the valuation of such contracts under §§ 79 and 83.

.04 In Rev. Rul. 59–195, 1959–1 C.B. 18, the Service ruled that in situations similar to those where an employer purchases and pays the premiums on an insurance policy on the life of one of its employees and subsequently sells such policy, on which further premiums must be paid, the value of such policy, for computing taxable gain in the year of purchase, should be determined under the method of valuation prescribed in § 25.2512–6 of the Gift Tax Regulations. Under this method, the value of such a policy is not its cash surrender value but the interpolated terminal reserve at the date of sale plus the proportionate part of any premium paid by the employer prior to the date of the sale which is applicable to a period subsequent to the date of the sale. Section 25.2512–6 also provides that if “because of the unusual nature of the contract such approximation is not reasonably close to the full value, this method may not be used.” Thus, this method may not be used to determine the fair market value of an insurance policy where the reserve does not reflect the value of all of the relevant features of the policy.

.05 In Q&A–10 of Notice 89–25, 1989–1 C.B. 662, the IRS addressed the question of what amount is includible in income under § 402(a) when a participant receives a distribution from a qualified plan that includes a life insurance policy with a value substantially higher than the cash surrender value stated in the policy. The notice noted the practice of using cash surrender value as fair market value for these purposes and concluded that this practice is not appropriate where the total policy reserves, including life insurance reserves (if any) computed under § 807(d), together with any reserves for advance premiums, dividend accumulations, etc., represent a much more accurate approximation of the policy’s fair market value.

.06 Since Notice 89–25 was issued, life insurance contracts have been marketed that are structured in a manner which results in a temporary period during which neither a contract’s reserves nor its cash surrender value represent the fair market value of the contract. For example, some life insurance contracts may provide for large surrender charges and other charges that are not expected to be eliminated or reversed in the future (under the contract or under another contract for which the first contract is exchanged), but this future elimination or reversal is not always reflected in the calculation of the contract’s reserve. If such a contract is distributed prior to the elimination or reversal of those charges, both the cash surrender value and the reserve under the contract could significantly understate the fair market value of the contract. Thus, the preamble to the proposed regulations states that, in some cases, it would not be appropriate to use either the net surrender value (i.e. the contract’s cash value after reduction for any surrender charges) or, because of the unusual nature of the contract, the contract’s reserves to determine the fair market value of the contract. Accordingly, Q&A–10 of Notice 89–25 should not be interpreted to provide that a contract’s reserves (including life insurance reserves (if any) computed under § 807(d), together with any reserves for advance premiums, dividend accumulations, etc.) are always an accurate representation of the contract’s fair market value.

.07 As stated in the preamble to the proposed regulations, the amount of any distribution determined under § 402 also applies for purposes of determining the qualified status of any plan. For example, the fair market value of a distributed life insurance contract, determined in accordance with the proposed regulations and this revenue procedure, must be considered in determining whether the insured participant has received benefits in excess of the limits imposed by § 415.
.08 Section 79 generally requires that the cost of group-term life insurance coverage on the life of an employee that is in excess of $50,000 of coverage be included in the income of the employee. Pursuant to § 1.79–1(b) of the Income Tax Regulations, under specified circumstances group-term life insurance may be combined with other benefits, referred to as permanent benefits.

.09 Permanent benefits provided to an employee are subject to taxation under rules described in § 1.79–1(d). Under those rules, the cost of the permanent benefits, reduced by the amount paid for those benefits by the employee, is included in the employee’s income. The cost of the benefits can be no less than an amount determined under a formula provided in the regulations. The formula is based in part on the increase in the employee’s deemed death benefit during the year. One of the factors used for determining the deemed death benefit is “the net level premium reserve at the end of that policy year for all benefits provided to the employee by the policy or, if greater, the cash value of the policy at the end of that policy year.”

.10 The proposed regulations would amend § 1.79–1(l) to delete the term cash value from the formula for determining the cost of permanent benefits and substitute the term fair market value. The purpose of the change is to clarify that, unless specifically excepted from the definition of permanent benefits, the value of all features of a life insurance policy providing an economic benefit to an employee (including, for example, the value of a springing cash value feature) must be included in the employee’s income.

.11 Section 83(a) provides that when property is transferred to any person in connection with the performance of services, the service provider must include in gross income (as compensation income) the excess of the fair market value of the property, determined without regard to lapse restrictions (such as life insurance contract surrender charges), and determined at the first time that the transferee’s rights in the property are either transferable or not subject to a substantial risk of forfeiture (i.e., when those rights become “substantially vested”), over the amount (if any) paid for the property. Section 1.83–3(e) provides that in the case of a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, only the cash surrender value of the contract is considered to be property. The proposed regulations generally would amend § 1.83–3(e) to provide that in the case of a transfer of an insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, the policy cash value and all other rights under the contract (including any supplemental agreements, whether or not guaranteed), other than current insurance protection, are treated as property for purposes of this section. However, in the case of the transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, which was part of a split-dollar arrangement (as defined in § 1.61–22(j)) entered into on or before September 17, 2003, and which is not materially modified (as defined in § 1.61–22(j)(2)) after September 17, 2003, only the cash surrender value of the contract is considered to be property.

SECTION 3. INTERIM GUIDANCE FOR DETERMINING FAIR MARKET VALUE

.01 The Service and the Treasury recognize that many taxpayers could have difficulty determining the fair market value of an insurance contract after the issuance of the proposed regulations under §§ 79 and 83 and the clarification in the preamble to the proposed regulations under § 402 that Notice 89–25 should not be interpreted to provide that a contract’s reserves (including life insurance reserves (if any) computed under § 807(d), together with any reserves for advance premiums, dividend accumulations, etc.) are always an accurate representation of the contract’s fair market value. Accordingly, in connection with the proposed regulations, this revenue procedure provides interim rules under which the cash value (without reduction for surrender charges) of a life insurance contract distributed from a qualified plan may be treated as the fair market value of a contract as of a determination date provided such cash value is at least as large as the aggregate of: (1) the premiums paid from the date of issue through the date of determination, plus (2) any amounts credited (or otherwise made available) to the policyholder with respect to those premiums, including interest, dividends, and similar income items (whether under the contract or otherwise), minus (3) reasonable mortality charges and reasonable charges (other than mortality charges), but only if those charges are actually charged on or before the date of determination and are expected to be paid.

.02 Cash value (without reduction for surrender charges) may be treated as the fair market value of a contract as of a determination date provided such cash value is at least as large as the aggregate of: (1) the premiums paid from the date of issue through the date of determination, plus (2) any amounts credited (or otherwise made available) to the policyholder with respect to those premiums, including interest, dividends, and similar income items (whether under the contract or otherwise), minus (3) reasonable mortality charges and reasonable charges (other than mortality charges), but only if those charges are actually charged on or before the date of determination and are expected to be paid.

.03 In those cases where the contract is a variable contract (as defined in § 817(d)) cash value (without reduction for surrender charges) may be treated as the fair market value of the contract provided such cash value is at least as large as the aggregate of: (1) the premiums paid from the date of issue through the date of determination, plus (2) all adjustments made with respect to those premiums during that period (whether under the contract or otherwise) that reflect investment return and the current market value of segregated asset accounts, minus (3) reasonable mortality charges and reasonable charges (other than mortality charges), but only if those charges are actually charged on or before the date of determination and are expected to be paid.

.04 The date of determination in the case of a distribution of a contract from a qualified plan is the date of that distribution. The date of determination in the case of the provision of permanent benefits subject to § 79 is the date those benefits are provided. The date of determination in the case of a transfer of an insurance contract subject to § 83 is the date on which fair market value must be determined under the rules of § 83.

SECTION 4. EFFECTIVE DATE

This revenue procedure is effective on February 13, 2004.

DRAFTING INFORMATION

The principal authors of this revenue procedure are Robert Walsh and Larry Isaacs of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding
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this revenue procedure as it pertains to § 402, please contact the Employee Plans’ taxpayer assistance telephone service at 1–877–829–5500 (a toll-free number) between the hours of 8:00 a.m. and 6:30 p.m. Eastern Time, Monday through Friday. For further information regarding this revenue procedure as it pertains to § 79, please contact Betty Clary of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) at (202) 622–6030 (not a toll-free number). For further information regarding this revenue procedure as it pertains to § 83, please contact Robert Misner of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) at (202) 622–6030 (not a toll-free number). Mr. Walsh and Mr. Isaacs may be reached at (202) 283–9888 (not a toll-free number).

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability. (Also, Part I, § 911, 1.911–1.)

Rev. Proc. 2004–17

SECTION 1. PURPOSE

.01 This revenue procedure provides information to any individual who failed to meet the eligibility requirements of § 911(d)(1) of the Internal Revenue Code because adverse conditions in a foreign country precluded the individual from meeting those requirements for taxable year 2003.


SECTION 2. BACKGROUND

.01 Section 911(a) of the Code allows a “qualified individual,” as defined in § 911(d)(1), to exclude foreign earned income and housing cost amounts from gross income. Section 911(c)(3) of the Code allows a qualified individual to deduct housing cost amounts from gross income.

.02 Section 911(d)(1) of the Code defines the term “qualified individual” as an individual whose tax home is in a foreign country and who is (A) a citizen of the United States and establishes to the satisfaction of the Secretary of the Treasury that the individual has been a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire taxable year, or (B) a citizen or resident of the United States who, during any period of 12 consecutive months, is present in a foreign country or countries during at least 330 full days.

.03 Section 911(d)(4) of the Code provides an exception to the eligibility requirements of § 911(d)(1). An individual will be treated as a qualified individual with respect to a period in which the individual was a bona fide resident of, or was present in, a foreign country if the individual left the country during a period for which the Secretary of the Treasury, after consultation with the Secretary of State, determines that individuals were required to leave because of war, civil unrest, or similar adverse conditions that precluded the normal conduct of business. An individual must establish that but for those conditions the individual could reasonably have been expected to meet the eligibility requirements.

.04 For 2003, the Secretary of the Treasury in consultation with the Secretary of State has determined that war, civil unrest, or similar adverse conditions that precluded the normal conduct of business existed in the following countries beginning on the specified date:

<table>
<thead>
<tr>
<th>Country</th>
<th>Date of Departure</th>
<th>On or after</th>
</tr>
</thead>
<tbody>
<tr>
<td>Burundi</td>
<td></td>
<td>July 13, 2003</td>
</tr>
<tr>
<td>Israel</td>
<td></td>
<td>March 16, 2003</td>
</tr>
<tr>
<td>Kuwait</td>
<td></td>
<td>March 16, 2003</td>
</tr>
<tr>
<td>Liberia</td>
<td></td>
<td>June 6, 2003</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td></td>
<td>May 13, 2003</td>
</tr>
<tr>
<td>Syria</td>
<td></td>
<td>March 16, 2003</td>
</tr>
</tbody>
</table>

.05 Accordingly, for purposes of § 911 of the Code, an individual who left one of the foregoing countries on or after the specified departure date shall be treated as a qualified individual with respect to the period during which that individual was present in, or was a bona fide resident of, such foreign country, if the individual establishes a reasonable expectation of meeting the requirements of § 911(d) but for those conditions.

.06 To qualify for relief under § 911(d)(4) of the Code, an individual must have established residency, or have been physically present, in the foreign country on or prior to the date that the Secretary of the Treasury determines that individuals were required to leave the foreign country. Individuals who establish residency, or are first physically present, in the foreign country after the date that the Secretary prescribes shall not be treated as qualified individuals under § 911(d)(4) of the Code. For example, individuals who are first physically present in Kuwait after March 16, 2003, are not eligible to qualify for the exception provided in § 911(d)(4) of the Code for taxable year 2003.
In order to assist those individuals who are filing prior year or amended tax returns, the Internal Revenue Service is re-publishing the countries listed for tax years 2000, 2001, and 2002 for which the eligibility requirements of § 911(d)(1) of the Code are waived under § 911(d)(4):

<table>
<thead>
<tr>
<th>Tax Year 2000—</th>
<th>Date of Departure</th>
<th>On or after</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eritrea</td>
<td>May 19, 2000</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Tax Year 2001—</th>
<th>Date of Departure</th>
<th>On or after</th>
</tr>
</thead>
<tbody>
<tr>
<td>Macedonia</td>
<td>July 27, 2001</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Tax Year 2002—</th>
<th>Date of Departure</th>
<th>On or after</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central African Republic</td>
<td>October 31, 2002</td>
<td></td>
</tr>
<tr>
<td>Côte d’Ivoire</td>
<td>October 18, 2002</td>
<td></td>
</tr>
<tr>
<td>Indonesia</td>
<td>October 13, 2002</td>
<td></td>
</tr>
<tr>
<td>Madagascar</td>
<td>April 13, 2002</td>
<td></td>
</tr>
<tr>
<td>Pakistan</td>
<td>March 22, 2002</td>
<td></td>
</tr>
<tr>
<td>Venezuela</td>
<td>December 20, 2002</td>
<td></td>
</tr>
</tbody>
</table>

SECTION 3. INQUIRIES

A taxpayer who needs assistance on how to claim this exclusion, or on how to file an amended return, should contact a local IRS Office or, for a taxpayer residing or traveling outside the United States, the nearest overseas IRS office.

SECTION 4. EFFECT ON OTHER DOCUMENTS


DRAFTING INFORMATION

The principal author of this revenue procedure is Kate Y. Hwa of the Office of Associate Chief Counsel (International). For further information regarding this revenue procedure, contact Ms. Hwa at (202) 622–3840 (not a toll-free call).

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability. (Also Part I, §§ 611; 1.611–2.)

Rev. Proc. 2004–19

SECTION 1. PURPOSE

This revenue procedure provides an elective safe harbor that the owner of an oil and gas property may use in determining the property’s recoverable reserves for purposes of computing cost depletion under § 611 of the Internal Revenue Code.

SECTION 2. BACKGROUND

.01 In General. Section 611(a) and the regulations thereunder allow as a deduction in computing taxable income a reasonable allowance for depletion in the case of oil and gas wells according to the peculiar conditions in each case.

.02 Computation of Cost Depletion. Under § 1.611–2(a) of the Income Tax Regulations, a taxpayer claiming the deduction for cost depletion computes the amount allowed with respect to each oil and gas property by reference to both the total number of recoverable units that the property is estimated to contain and the number of units sold from the property during the taxable year.

.03 Depletion Accounts. A taxpayer is required under § 1.611–2(b) to keep accounts for the depletion of each property and to adjust those accounts annually for units sold and for depletion claimed.

.04 Reserve Estimates. Section 1.611–2(c)(1) contains the rules for estimating the total recoverable units of mineral products reasonably known, or on good evidence believed, to exist with respect to each property. The estimate or determination must be made according to the method current in the industry and

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generally requires the reporting of only proved reserves for financial purposes. Second, the revision of a reserve estimate for purposes of the depletion allowance is permitted under fewer circumstances than is the revision of a reserve estimate for financial reporting purposes. While the SEC may require or permit the revision of a reserve estimate in the case of changes in the price of the mineral or the cost of its extraction, such circumstances are not sufficient basis for revision of a reserve estimate for purposes of the depletion allowance.

.07 Probable or Prospective Reserves. The appropriate quantity of probable or prospective reserves to be included in an oil and gas property’s total recoverable units for purposes of computing cost depletion has been a source of controversy between taxpayers and the Service. When present, the issue has been resolved through the examinations which are costly for both parties in the dispute. This revenue procedure provides a safe harbor which is intended to remove this source of controversy from the examinations of taxpayers who elect it.

SECTION 3. SCOPE

.01 In General. A taxpayer’s estimate of an oil and gas property’s probable or prospective reserves determined under the circumstances permitted under § 1.611–2(c)(2) as intended to remedy mistakes of geological fact: situations where the actual size of the mineral deposit in place, as originally estimated, is later determined on the basis of more exploratory studies, for example, to be greater or less than earlier information indicated. The court distinguished situations where revisions are made under the statute and regulations from those in which the mineral property has experienced a mere diminution in value or even a retreat into worthlessness.

.06 Differences between Tax and Financial Accounting for Reserves. Generally, accounting for reserves for purposes of the depletion allowance differs from accounting for reserves for financial purposes in two important respects. First, while the regulations require the inclusion of probable or prospective reserves in addition to proved reserves for purposes of the depletion allowance, the United States Securities and Exchange Commission (SEC)

(1) The total recoverable units under § 1.611–2(c)(1) that each of the taxpayer’s domestic oil and gas producing properties is estimated to contain as of a specific date will be treated as being equal to 105 percent of the property’s “proved reserves” (both developed and undeveloped) as defined in 17 C.F.R. § 210.4–10(a) of Regulation S-X, as of that date;

(2) The total recoverable units under § 1.611–2(c)(2) that each of the taxpayer’s domestic oil and gas producing properties is estimated, on a revised basis, to contain as of a taxable year will be deemed to be equal to 105 percent of the property’s “proved reserves” (both developed and undeveloped) as defined in Regulation S-X, as of that taxable year.

.02 Nothing in this revenue procedure precludes the examination and adjustment, if appropriate, of the estimate of proved reserves, as defined in Regulation S-X, in order to ensure that this revenue procedure is properly administered. Except as provided in section 5.02 of this revenue procedure, a taxpayer’s estimate of a property’s remaining recoverable units may be revised only under the circumstances permitted under § 1.611–2(c)(2).

SECTION 5. METHOD OF ELECTION AND REVOCATION

.01 In General. To elect the safe harbor provided in this revenue procedure for taxable years ending on or after March 8, 2004, a taxpayer must attach a statement to its timely filed (including extensions) original federal income tax return for the first taxable year for which the safe harbor is elected. The statement must indicate that the taxpayer is electing the safe harbor provided by Rev. Proc. 2004–19, and include the taxpayer’s name, address, taxpayer identification number, and contact name and telephone number. A copy of the statement must be sent to the Industry Director, Large and Mid-Size Business, Natural Resources, 1919 Smith Street, Houston, Texas 77002. Once a taxpayer files a first return electing the safe harbor for a taxable year, the taxpayer may not revoke the election for the taxable year. The election is effective for the taxable year of election and all subsequent taxable years until revoked and applies to all of the

.01 If a taxpayer makes an election in accordance with section 5 of this revenue procedure, then, for purposes of computing cost depletion:

...
taxpayer’s domestic oil and gas producing properties.

(2) Revocation. To revoke a safe harbor election, a taxpayer must attach a statement to its timely filed (including extensions) original federal income tax return for the first taxable year for which the safe harbor is revoked. The statement must indicate that the taxpayer is revoking the safe harbor provided by Rev. Proc. 2004–19, and include the taxpayer’s name, address, taxpayer identification number, and contact name and telephone number. A copy of the statement must be sent to the Industry Director, Large and Mid-Size Business, Natural Resources, 1919 Smith Street, HOU 1000, Houston, Texas 77002. If a taxpayer revokes its election, the taxpayer may not re-elect the safe harbor for the next five taxable years following the taxable year of revocation.

.02 Election of Safe Harbor for Taxable Year Beginning Before January 1, 2005. If the first taxable year for which a taxpayer elects the safe harbor provided in this revenue procedure begins before January 1, 2005, the taxpayer may, for the taxable year of election, revise the estimate of remaining recoverable units for any of the taxpayer’s domestic oil and gas producing properties whether or not there has been a change in geological fact indicating that the remaining recoverable units as of the taxable year for any given property is materially greater or less than the number remaining from the prior estimate. The taxpayer must use the economic and operating conditions (such as prices and costs) applicable to the taxable year of election in determining the estimate of total recoverable units.

.03 Election of Safe Harbor for Taxable Year Beginning After December 31, 2004. If the first taxable year for which a taxpayer elects the safe harbor provided in this revenue procedure begins after December 31, 2004, the taxpayer must determine, for each domestic oil and gas producing property, the last taxable year preceding the taxable year of election as of which the taxpayer revised an oil and gas property’s total recoverable units (the year of last revision) pursuant to § 1.611–2(c)(2). The taxpayer determines the property’s remaining recoverable units for the year of last revision using the safe harbor rules set forth in section 4 of this revenue procedure. The taxpayer then applies the rules set forth in § 1.611–2(b) for all subsequent taxable years to determine the property’s remaining recoverable units for the taxable year of election. Similar procedures apply if the taxpayer’s estimate of the property’s remaining recoverable units is based on the taxpayer’s original estimate of its total recoverable units under § 1.611–2(c)(1). The taxpayer may not, for the taxable year of election, revise the estimate of remaining recoverable units for any of the taxpayer’s domestic oil and gas producing properties unless there has been a change in geological fact indicating that the remaining recoverable units as of the taxable year for any given property is materially greater or less than the number remaining from the prior estimate.

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective for taxable years ending on or after March 8, 2004.

SECTION 7. PAPERWORK REDUCTION ACT

The collection of information contained in this revenue procedure 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 1545–1861.

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

The collection of information in this revenue procedure is in section 5. The information in section 5 is required to be submitted to the applicable service center in order to elect (or revoke) the safe harbor. This information will be used to determine whether a taxpayer estimated the total recoverable units for each of its domestic oil and gas producing properties under the safe harbor. The likely respondents are businesses or other for-profit institutions.

The estimated total annual reporting burden is 50 hours.

The estimated annual burden per respondent varies from .25 hours to .75 hours, depending on individual circumstances, with an estimated average burden of .5 hours to complete the statement. The estimated number of respondents is 100.

The estimated annual frequency of responses is on occasion.

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 under 26 U.S.C. § 6103.

SECTION 8. DRAFTING INFORMATION

The principal author of this revenue procedure is Jolene J. Shiraishi of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue procedure, contact Ms. Shiraishi at (202) 622–3120 (not a toll-free call).

March 8, 2004

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2004-10 I.R.B.
Notice of Proposed Rulemaking and Notice of Public Hearing

Value of Life Insurance Contracts When Distributed From a Qualified Retirement Plan

REG–126967–03

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed amendments to the regulations under section 402(a) of the Internal Revenue Code regarding the amount includible in a distributee’s income when life insurance contracts are distributed by a qualified retirement plan and the treatment of property sold by a qualified retirement plan to a plan participant or beneficiary for less than fair market value. This document also contains proposed amendments to the regulations under sections 79 and 83 conforming the language in those regulations to the language in the proposed amendments to the section 402(a) regulations. These regulations will affect administrators of, participants in, and beneficiaries of qualified employer plans. These regulations also provide guidance to employers who provide group-term life insurance to their employees that is includible in the gross income of the employees and to employers who transfer life insurance contracts to persons in connection with the performance of services. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by May 13, 2004. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for June 9, 2004, at 10 a.m., must be received by May 19, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–126967–03), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG–126967–03), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington D.C. 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 Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, D.C.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed amendments to the section 79 regulations, Betty Clary at (202) 622–6080; concerning the proposed amendments to the section 83 regulations, Robert Misner at (202) 622–6030; concerning the proposed amendments to the 402 regulations, Linda Marshall at (202) 622–6090; concerning submissions and the hearing and/or to be placed on the building access list to attend the hearing, Robin Jones at (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR Part 1) under section 402(a) of the Internal Revenue Code (Code) relating to the amount includible in a distributee’s income when a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection is distributed by a retirement plan qualified under section 401(a) of the Code and to the sale of property by a retirement plan to a plan participant or beneficiary for less than the fair market value of the property. This document also contains proposed amendments to the regulations under sections 79 and 83 relating, respectively, to employer-provided group-term life insurance and life insurance contracts transferred in connection with the performance of services.

Section 402(a) provides generally that any amount actually distributed to any distributee by any employees’ trust described in section 401(a) which is exempt from tax under section 501(a) shall be taxable to the distributee, in the taxable year of the distributee in which distributed, under section 72.

Section 1.402(a)–1(a)(1)(ii) of the current regulations provides, in general, that a distribution of property by a section 401(a) plan shall be taken into account by the distributee at its “fair market value.” Section 1.402(a)–1(a)(2) of the regulations provides, in general, that upon the distribution of an annuity or life insurance contract, the “entire cash value” of the contract must be included in the distributee’s income. The current regulations do not define “fair market value” or “entire cash value” and questions have arisen regarding the interaction between these two provisions and whether “entire cash value” includes a reduction for surrender charges.

Prohibited Transaction Exemption (PTE) 77–8 (1977–2 C.B. 425), subsequently amended and redesignated as Prohibited Transaction Exemption 92–6, was jointly issued in 1977 by the Department of Labor and the Internal Revenue Service. PTE 77–8 permits an employee benefit plan to sell individual life insurance contracts and annuities to (1) a plan participant insured under such policies, (2) a relative of such insured participant who is the beneficiary under the contract, (3) an employer any of whose employees are covered by the plan, or (4) another employee benefit plan, for the cash surrender value of the contracts, provided the conditions set forth in the exemption are met.

The preamble to PTE 77–8 (citing Rev. Rul. 59–195; 1959–1 C.B. 18) notes that, for Federal income tax purposes, the value of an insurance policy is not the same as, and may exceed, its cash surrender value, and that a purchase of an insurance policy at its cash surrender value may therefore be a purchase of property for less than its fair market value. The regulations under section 402 do not address the consequences of a sale of property by a section 401(a) plan to a plan participant or beneficiary for less than the fair market value of
that property. In this regard, the preamble to PTE 77–8 states that the Federal income tax consequences of such a bargain purchase must be determined in accordance with generally applicable Federal income tax rules but that any income realized by a participant or relative of such participant upon such a purchase under the conditions of PTE 77–8 will not be deemed a distribution from the plan to such participant for purposes of subchapter D of chapter 1 of the Internal Revenue Code (i.e., sections 401 to 424 of the Code) relating to qualified pension, profit-sharing, and stock bonus plans.

Section 79 of the Code generally requires that the cost of group-term life insurance coverage provided by an employer on the life of an employee that is in excess of $50,000 of coverage be included in the income of the employee. Pursuant to §1.79–1(b) of the regulations, under specified circumstances, group-term life insurance may be combined with other benefits, referred to as permanent benefits. A permanent benefit is defined in §1.79–0 of the regulations as an economic value extending beyond one policy year (for example, a paid-up or cash surrender value) that is provided under a life insurance policy. The regulations further provide that certain features are not permanent benefits, including (a) a right to convert (or continue) life insurance after group life insurance coverage terminates, (b) any other feature that provides no economic benefit (other than current insurance protection) to the employee, and (c) a feature under which term life insurance is provided at a level premium for a period of five years or less.

Permanent benefits provided to an employee are subject to taxation under rules described in §1.79–1(d) of the regulations. Under those rules, the cost of the permanent benefits, reduced by the amount paid for those benefits by the employee, is included in the employee’s income. The regulations provide the cost of the permanent benefits can be no less than an amount determined under a formula set forth in the regulations. One of the factors used in this formula is “the net level premium reserve at the end of that policy year for all benefits provided to the employee by the policy or, if greater, the cash value of the policy at the end of that policy year.”

Section 83(a) provides that when property is transferred to any person in connection with the performance of services, the service provider must include in gross income (as compensation income) the excess of the fair market value of the property, determined without regard to lapse restrictions, and determined at the first time that the transferee’s rights in the property are either transferable or not subject to a substantial risk of forfeiture, over the amount (if any) paid for the property. Section 1.83–3(e) of the regulations generally provides that in the case of “a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, only the cash surrender value of the contract is considered to be property.”

In T.D. 9092, 2003–46 I.R.B. 1055 [68 FR 54336], published in the Federal Register on September 17, 2003, relating to split-dollar life insurance arrangements, §1.83–3(e) was amended to add the following sentence: “Notwithstanding the previous sentence, in the case of a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, or any undivided interest therein, that is part of a split-dollar life insurance arrangement (as defined in §1.61–22(b)(1) or (2)) that is entered into, or materially modified (within the meaning of §1.61–22(j)(2)), after September 17, 2003, the policy cash value and all other rights under such contract (including any supplemental agreements thereto and whether or not guaranteed), other than current life insurance protection, are treated as property for purposes of this section.”

Explanation of Provisions

A. Overview

These proposed amendments to the regulations under section 402(a) clarify that the requirement that a distribution of property must be included in the distributee’s income at fair market value is controlling in those situations where the existing regulations provide for the inclusion of the entire cash value. Thus, these proposed regulations provide that, in those cases where a qualified plan distributes a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, the fair market value of such a contract (i.e., the value of all rights under the contract, including any supplemental agreements thereto and whether or not guaranteed) is generally included in the distributee’s income and not merely the entire cash value of the contracts.

These proposed regulations also provide that if a qualified plan transfers property to a plan participant or beneficiary for consideration that is less than the fair market value of the property, the transfer will be treated as a distribution by the plan to the participant or beneficiary to the extent the fair market value of the distributed property exceeds the amount received in exchange. Thus, in contrast to the statement to the contrary in the preamble to PTE 77–8, any bargain element in the sale would be treated as a distribution under section 402(a). It is also intended that any bargain element would be treated as a distribution for other purposes of the Code, including the limitations on in-service distributions from certain qualified retirement plans and the limitations of section 415.

These proposed regulations also amend the current regulations under sections 79 and 83 to clarify that fair market value is also controlling with respect to life insurance contracts under those sections and, thus, that all of the rights under the contract (including any supplemental agreements thereto and whether or not guaranteed) must be considered in determining that fair market value. With respect to section 79, these proposed regulations would amend §1.79–1(d) to remove the term cash value from the formula for determining the cost of permanent benefits and substitute the term fair market value. With respect to section 83, these proposed regulations would amend §1.83–3(e) generally to apply the definition of property for new split-dollar life insurance arrangements to all situations involving the transfer of life insurance contracts. Section 83(a) requires that the excess of the fair market value of the property over the amount paid for the property be included in income. The current definition of property outside the context of a split-dollar life insurance arrangement may lead taxpayers to believe that it is appropriate upon receiving a transfer of a life insurance contract to include only its cash surrender value on the day of the transfer when, due to supplemental agreements, the fair market value of the transferred property is much greater. The pur-
pose of the changes to these regulations is to clarify that, unless specifically excepted from the definition of permanent benefits or fair market value, the value of all features of a life insurance policy providing an economic benefit to a service provider (including, for example, the value of a springing cash value feature) must be included in determining the employee’s income.

The proposed regulations will not affect the relief granted by the provisions of Section IV, paragraph 4 of Notice 2002–8, 2002–1 C.B. 398, to the parties to any insurance contract that is part of a pre-January 28, 2002, split-dollar life insurance arrangement. Also, consistent with the effective date of the final split-dollar life insurance regulations, §1.61–22, these proposed regulations will not apply to the transfer of a life insurance contract which is part of a split-dollar life insurance arrangement entered into on or before September 17, 2003, and not materially modified after that date. However, taxpayers are reminded that, in determining the fair market value of property transferred under section 83, lapse restrictions (such as life insurance contract surrender charges) are ignored.

B. Determination of Fair Market Value

As noted above, §1.402(a)–1(a)(1)(ii) does not define fair market value. In Rev. Rul. 59–195, the Service ruled that, in situations similar to those in which an employer purchases and pays the premiums on an insurance policy on the life of one of its employees and subsequently sells such policy, on which further premiums must be paid, the value of such policy for computing taxable gain in the year of purchase should be determined under the method of valuation prescribed in §25.2512–6 of the Gift Tax Regulations. Under this method, the value of such a policy is not its cash surrender value but the interpolated terminal reserve at the date of sale plus the proportionate part of any premium paid by the employer prior to the date of the sale which is applicable to a period subsequent to the date of the sale. Section 25.2512–6 of the Gift Tax Regulations also provides that if “because of the unusual nature of the contract such approximation is not reasonably close to the full value, this method may not be used.” Thus, this method may not be used to determine the fair market value of an insurance policy where the reserve does not reflect the value of all of the relevant features of the policy.

In Q&A–10 of Notice 89–25, 1989–1 C.B. 662, the IRS addressed the question of what amount is includible in income under section 402(a) when a participant receives a distribution from a qualified plan that includes a life insurance policy with a value substantially higher than the cash surrender value stated in the policy. The notice noted the practice of using cash surrender value as fair market value for these purposes and concluded that this practice is not appropriate where the total policy reserves, including life insurance reserves (if any) computed under section 807(d), together with any reserves for advance premiums, dividend accumulations, etc., represent a much more accurate approximation of the policy’s fair market value.

Since Notice 89–25 was issued, life insurance contracts have been marketed that are structured in a manner which results in a temporary period during which neither a contract’s reserves nor its cash surrender value represent the fair market value of the contract. For example, some life insurance contracts may provide for large surrender charges and other charges that are not expected to be paid because they are expected to be eliminated or reversed in the future (under the contract or under another contract for which the first contract is exchanged), but this future elimination or reversal is not always reflected in the calculation of the contract’s reserve. If such a contract is distributed prior to the elimination or reversal of those charges, both the cash surrender value and the reserve under the contract could significantly understate the fair market value of the contract. Thus, in some cases, it would not be appropriate to use either the net surrender value (i.e., the contract’s cash value after reduction for any surrender charges) or, because of the unusual nature of the contract, the contract’s reserves to determine the fair market value of the contract. Accordingly, Q&A–10 of Notice 89–25 should not be interpreted to provide that a contract’s reserves (including life insurance reserves if any) computed under section 807(d), together with any reserves for advance premiums, dividend accumulations, etc.) are always an accurate representation of the contract’s fair market value.

For example, it would not be appropriate to use a contract’s reserve or the net surrender value of the contract as fair market value at the time of distribution if under that contract those amounts are significantly less than the aggregate of: (1) the premiums paid from the date of issue through the date of distribution, plus (2) any amounts credited (or otherwise made available) to the policyholder with respect to those premiums (including interest, dividends, and similar income items), or, in the case of variable contracts, all adjustments made with respect to the premiums paid during that period that reflect investment return and the current market value of segregated asset accounts, minus (3) reasonable mortality charges and reasonable charges (other than mortality charges) actually charged from the date of issue to the date of distribution and expected to be paid.

The following example provides an illustration of a contract where it would not be appropriate to use a contract’s reserve or its net surrender value as its fair market value:

A participates in a plan intended to satisfy the requirements of section 401(a). In Year 1, the plan acquires a life insurance contract on A’s life that is not a variable contract and with a face amount of $1,400,000. In that year and for the next four years, the plan pays premiums of $100,000 per year on the contract. The contract provides for a surrender charge that is fixed for the first five years of the contract and decreases ratably to zero at the end of ten years. The contract also imposes reasonable mortality and other charges as defined by section 7702(c)(3)(B)(i) and (ii) of the Code.

The contract provides a stated cash surrender value for each of the first ten years (the first five years are guaranteed), as set forth in the table below. The reserves under the contract, including life insurance reserves and reserves for advance premiums, dividend accumulations, etc. (calculated using the rules in section 807(d) of the Code) at the end of the fifth year are $150,000.
At the end of Year 5, A retired and received a distribution of the insurance contract that was purchased on his life.

These regulations clarify that the contract is included in A’s income at its fair market value rather than the $100,000 cash surrender value. Furthermore, A could not treat the $150,000 reserve as of the end of the fifth year as the fair market value, because this amount is less than the amount a willing buyer would pay a willing seller for such a contract, with neither party being under a compulsion to buy and sell and both having reasonable knowledge of the relevant facts.

**Proposed Effective Dates**

The amendments to §1.402(a)–1(a)(2) of the regulations are proposed to be applicable to any distribution of a transferable retirement income, endowment, or other life insurance contract occurring on or after February 13, 2004. The amendment to §1.79–1 is proposed to be applicable to permanent benefits provided on or after February 13, 2004. The amendment to §1.83–3(e) is proposed to be applicable to any transfer occurring on or after February 13, 2004. The amendments to §1.402(a)–1(a)(1)(iii) of the regulations are proposed to be applicable to any transfer of property by a plan to a plan participant or beneficiary for less than fair market value where the transfer occurs on or after the date of publication in the Federal Register of the final regulations adopting these amendments. Taxpayers may rely upon these proposed regulations for guidance pending the issuance of final regulations.

**Interim Guidance for Determining Fair Market Value**

The IRS and the Treasury recognize that taxpayers could have difficulty determining the fair market value of a life insurance contract after the clarification in this preamble that Notice 89–25 should not be interpreted to provide that a contract’s reserves (including life insurance reserves (if any) computed under section 807(d), together with any reserves for advance premiums, dividend accumulations, etc.) are always an accurate representation of the contract’s fair market value. Accordingly, in connection with this guidance, the IRS has issued Rev. Proc. 2004–16, 2004–10 I.R.B. 559, which provides interim rules under which the cash value (without reduction for surrender charges) of a life insurance contract distributed from a qualified plan may be treated as the fair market value of that contract. The interim rules in Rev. Proc. 2004–16, permit the use of values that should be readily available from insurance companies, because the cash value (without reduction for surrender charges) is an amount that, in the case of a flexible insurance contract (including a variable contract), is generally reported in policyholder annual statements, and in the case of traditional insurance contracts, is fixed at issue and provided in the insurance contract.

Under those interim rules, a plan may treat the cash value (without reduction for surrender charges) as the fair market value of a contract at the time of distribution provided such cash value is at least as large as the aggregate of: (1) the premiums paid from the date of issue through the date of distribution, plus (2) any amounts credited (or otherwise made available) to the policyholder with respect to those premiums, including interest, dividends, and similar income items (whether under the contract or otherwise), minus (3) reasonable mortality charges and reasonable charges (other than mortality charges), but only if those charges are actually charged on or before the date of distribution.

In those cases where the contract is a variable contract (as defined in section 807(d)) a plan may treat the cash value (without reduction for surrender charges) as the fair market value of the contract at the time of distribution provided such cash value is at least as large as the aggregate of: (1) the premiums paid from the date of issue through the date of distribution, plus (2) all adjustments made with respect to those premiums during that period (whether under the contract or otherwise) that reflect investment return and the current market value of segregated asset accounts, minus (3) reasonable mortality charges and reasonable charges (other than mortality charges), but only if those charges are actually charged on or before the date of distribution and are expected to be paid.

Applying those interim rules to the example above, A could treat the cash value (without reduction for surrender charges) of $450,000 as the fair market value of the contract as of the end of the fifth year, because, in this example, that amount exceeds the aggregate of the five $100,000 premiums ($500,000), plus the amounts credited to A with respect to those premiums, minus the reasonable mortality and other charges actually imposed and expected to be paid.

<table>
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<tr>
<th>Year</th>
<th>Premium</th>
<th>Net Surrender Value</th>
<th>Cash Value Determined without Reduction for Surrender Charges</th>
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</table>
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 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, 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 Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department specifically request comments on the clarity of the proposed regulations and how they may be made easier to understand. In addition, the Treasury Department and the IRS specifically request comments regarding the interim rules set forth in Rev. Proc. 2004–16 and proposals for appropriate permanent methods for valuing life insurance contracts when distributed from qualified retirement plans and for valuing such contracts for purposes of sections 79 and 83, including appropriate discounts which take into account the probability that contracts will be surrendered during the period during which surrender charges apply. The IRS and the Treasury are also reviewing other types of contracts, such as annuities, which have cash surrender value but where that cash surrender value may not reflect the fair market value of the contracts. Accordingly, the IRS and the Treasury also request comments regarding the valuation of these other contracts. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Wednesday, June 9, 2004, at 10 a.m. in the auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must use the main building entrance on Constitution Avenue. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For more information about having your name placed on the 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 (signed original and eight (8) copies) or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic by Wednesday, May 19, 2004. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these regulations are Robert M. Walsh, Employee Plans, Tax Exempt and Government Entities Division, and Linda Marshall, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury participated in the development of these regulations.

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

§1.79–1 Group-term life insurance—general rules.

(d) * * *

(3) Formula for determining deemed death benefit. The deemed death benefit (DDB) at the end of any policy year for any particular employee is equal to:

\[ R/Y \]

where—

R is the net level premium reserve at the end of that policy year for all benefits provided to the employee by the policy or, if greater, the fair market value of the policy at the end of that policy year; and

Y is the net single premium for insurance (the premium for one dollar of paid-up, whole life insurance) at the employee’s age at the end of that policy year.

* * * * *

Par. 3. In §1.83–3, paragraph (e), the last two sentences are revised to read as follows:

§1.83–3 Meaning and use of certain terms.

* * * * *

(e) * * * In the case of a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, or any undivided interest therein, the policy cash value and all other rights under such contract (including any supplemental agreements thereto and whether or not guaranteed), other than current life insurance protection, are treated as property for purposes of this section. However, in the case of the transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, which was part of a split-dollar arrangement (as defined in §1.61–22(b)) entered into (as defined in §1.61–22(j)) on or before September 17, 2003, and which is not materially modified (as defined in §1.61–22(j)(2)) after September 17, 2003, only the cash surrender value of the contract is considered to be property.

* * * * *

Par. 4. Section 1.402(a)–1 is amended by:

1. Revising paragraph (a)(1)(iii).

2. Revising the last two sentences of paragraph (a)(2).

The revisions read as follows:

2004-10 I.R.B. 570 March 8, 2004
§1.402(a)–1 Taxability of beneficiary under a trust which meets the requirements of section 401(a).

(a) * * * (1) * * *

(iii) Except as provided in paragraph (b) of this section, a distribution of property by a trust described in section 401(a) and exempt under section 501(a) shall be taken into account by the distributee at its fair market value. In the case of a distribution of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, or any interest therein, the policy cash value and all other rights under such contract (including any supplemental agreements thereto and whether or not guaranteed) are included in determining the fair market value of the contract. In addition, where a trust described in section 401(a) and exempt under section 501(a) transfers property to a plan participant or beneficiary in exchange for consideration and where the fair market value of the property transferred exceeds the amount received by the trust, then the excess of the fair market value of the property transferred by the trust over the amount received by the trust is treated as a distribution by the trust to the distributee.

* * * * *

(2) * * * If, however, the contract distributed by such exempt trust is a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, the fair market value of such contract at the time of distribution must be included in the distributee's income in accordance with the provisions of section 402(a), except to the extent that, within 60 days after the distribution of such contract, all or any portion of such value is irrevocably converted into a contract under which no part of any proceeds payable on death at any time would be excludable under section 101(a) (relating to life insurance proceeds). If the contract distributed by such trust is a transferable annuity contract, a life insurance contract, a retirement income contract, endowment contract, or other contract providing life insurance protection (whether or not transferable), then notwithstanding the preceding sentence, the fair market value of the contract is includible in the distributee's gross income, unless within such 60 days such contract is also made nontransferable.

* * * * *

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

(Filed by the Office of the Federal Register on February 13, 2004, 8:45 a.m., and published in the issue of the Federal Register for February 17, 2004, 69 F.R. 7384).

Notice of Proposed Rulemaking and Notice of Public Hearing

Student FICA Exception

REG–156421–03

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations that provide guidance regarding the meaning of “school, college, or university” and “student” for purposes of the student FICA exception under sections 3121(b)(10) and 3306(c)(10)(B) of the Internal Revenue Code (Code). In addition, this document contains proposed regulations that provide guidance on the meaning of “school, college, or university” for purposes of the FICA exception under section 3121(b)(2) for domestic service performed in a local college club, or local chapter of a college fraternity or sorority by a student. This document also provides a notice of public hearing on these proposed regulations.

DATES: Written and electronic comments must be received by May 25, 2004. Outlines of topics to be discussed at the public hearing scheduled for June 16, 2004, must be received by May 25, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–156421–03), room 5703, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG–156421–03), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically, via the IRS Internet site at: www.irs.gov/regs.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, John Richards of the Office of Associate Chief Counsel (Tax Exempt and Government Entities), (202) 622–6040; concerning submissions of comments, the hearing and/or to be placed on the building access list to attend the hearing, Treena Garret, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to 26 CFR part 31 under sections 3121(b)(10) and 3306(c)(10)(B) of the Internal Revenue Code. These sections except from “employment” for Federal Insurance Contributions Act (FICA) tax purposes and Federal Unemployment Tax Act (FUTA) purposes, respectively, service performed in the employ of a school, college, or university if such service is performed by a student who is enrolled and regularly attending classes at such school, college, or university. In addition, this document contains proposed amendments to 26 CFR part 31 under section 3121(b)(2). This section excepts from employment for FICA purposes domestic service performed in a local college club, or local chapter of a college fraternity or sorority, by a student who is enrolled and is regularly attending cases at a school, college, or university.

Explanation of Provisions

A. Current Law

Section 3121(b)(10) of the Code (the student FICA exception) excepts from the definition of employment for FICA purposes services performed in the employ of a school, college, or university (SCU) (whether or not that organization is exempt from income tax), or an affiliated organization that satisfies section 509(a)(3) of the Code in relation to the SCU (“related section 509(a)(3) organization”), if the service is performed by a student who
is enrolled and regularly attending classes at that SCU. Section 3306(c)(10)(B) contains a similar student exception. Thus, the student FICA exception applies to services only if both the “SCU status” and “student status” requirements are met. This regulation deals with both the SCU status and student status requirements.

To satisfy the SCU status requirement, the employer for whom the employee performs services (the common law employer) must be either a SCU or a related section 509(a)(3) organization. If a student is not employed by a SCU or a related section 509(a)(3) organization, then the student FICA exception is not available. See e.g., Rev. Rul. 69–519, 1969–2 C.B. 185 (holding that students attending an apprenticeship school established pursuant to an agreement between a union and a contractors’ association were employees of the participating contractors to whom the students were assigned.) Section 31.3121(b)(10)–2(d) of the Employment Tax Regulations provides that the term “SCU” for purposes of the student FICA exception is to be construed in its “commonly or generally accepted sense.”

To satisfy the student status requirement, the employee must meet three requirements. First, under section 3121(b)(10), the employee must be a student enrolled and regularly attending classes at the SCU employing the student. Second, the employee must be pursuing a course of study at the SCU employing the student. Third, the employee must be “[a]n employee who performs services in the employ of a [SCU] as an incident to and for the purpose of pursuing a course of study at such [SCU] . . . .” Reg. §31.3121(b)(10)–2(c). The IRS’s position has been that whether services are incident to and for the purpose of pursuing a course of study depends on two factors: the employee’s course workload and the nature of the employee’s employment relationship with the employer. See e.g., Rev. Proc. 98–16, 1998–1 C.B. 403; Rev. Rul. 78–17, 1978–1 C.B. 306.

B. Need for Regulations

Treasury and IRS have determined that it is necessary to provide additional clarification of the terms “SCU” and “student who is enrolled and regularly attending classes” as they are used in section 3121(b)(10). In recent years the question has arisen whether the performance of certain services that are in the nature of on the job training are excepted from employment under the student FICA exception. This issue was presented with respect to medical residents and interns in State of Minnesota v. Apfel, 151 F.3d 742 (8th Cir. 1998), which concluded that services performed by medical residents and interns are not employment for social security purposes. The question also applies to services performed by employees in other fields, particularly regulated fields, where on the job training is often required to gain licensure. Guidance is needed to address situations where the performance of services and pursuit of the course of study are not separate and distinct activities, but instead are to some extent intermingled.

Section 3121(a) defines “wages” as “all remuneration for employment . . . .” Under section 3121(b), “employment” means “any service . . . performed . . . by an employee for the person employing him.” The Social Security Act provides nearly identical definitions of “wages” and “employment.” 42 U.S.C. sections 409(a)(1)(J); 410(a). “The very words ‘any service . . . performed . . . for his employer,’ with the purpose of the Social Security Act in mind, import a breadth of coverage.” Social Security Board v. Nierotko, 327 U.S. 358, 365 (1946). The courts have generally found that the terms “wages” and “employment” as used in both the social security benefits and FICA tax provisions are to be interpreted broadly. State of New Mexico v. Weinberger, 517 F.2d 989, 993 (10th Cir. 1975); Mayberry v. United States, 151 F.3d 855, 860 (8th Cir. 1998); Moorhead v. United States, 774 F.2d 936, 941 (9th Cir. 1985); Abrahamsen v. United States, 228 F.3d 1360, 1364 (Fed. Cir. 2000).

The broad interpretation of these terms results from the underlying purpose of the Social Security Act, namely, “to provide funds through contributions by employer and employee for the decent support of elderly workmen who have ceased to labor.” Nierotko, 327 U.S. at 364. See also St. Luke’s Hospital v. United States, 333 F.2d 157, 164 (6th Cir. 1964) (“[I]n dealing with the beneficient purposes of the Social Security Act, this court generally favors that interpretation of statutory provisions which calls for coverage rather than exclusion.”).

Wage and employment questions affect both social security benefits entitlement and FICA taxes which fund the social security trust fund. Except in unusual circumstances, the Social Security Act, and the Internal Revenue FICA provisions, are to be read in pari materia. United States v. Cleveland Indians Baseball Co., 532 U.S. 200, 213 (2001). Thus, whether certain service is employment affects not just FICA taxation, but also social security benefits eligibility and level of benefits. Moreover, the integrity of the social security system requires symmetry between service that is considered employment for social security benefits purposes and employment for FICA taxation purposes.

Resolution of this issue has significant social security benefits and FICA tax implications. The case of medical residents illustrates the possible effect on individuals and the social security system as a whole of excepting service in the nature of on the job training from employment for social security benefits and FICA tax purposes. The Social Security Administration (SSA) reported to the General Accounting Office (GAO) that “[b]ecause many residents are married and have children and work as residents for up to 8 years, an exemption from Social Security coverage could have a very significant effect on their potential disability benefits or their family’s survivor benefits.” Moreover, SSA reported that if medical residents were determined to be students for purposes of the student FICA exception, 270,000 medical residents would lose some coverage over the next ten years (2001 through 2010).1

This regulation addresses two issues: (1) whether an organization carrying on educational activities in connection with the performance of services is a SCU within the meaning of section 3121(b)(10), and (2) whether certain employees performing services in the nature of on the job training have the status of a student who is enrolled and regularly attending classes for purposes of section 3121(b)(10).

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C. Whether an Organization Carrying On Educational Activities Is a SCU

Organizations providing on the job training typically carry on both noneducational and educational activities. The issue is whether organizations carrying on both noneducational and educational activities are SCUs within the meaning of section 3121(b)(10). For example, organizations such as hospitals typically carry on both educational and noneducational activities. In United States v. Mayo Foundation, 282 F. Supp. 2d 997 (D. Minn. 2003), the United States argued, consistent with the position it has maintained administratively, that the primary purpose of an organization determines whether the organization is a SCU for purposes of the student FICA exception. The court rejected this argument, finding it inconsistent with the common sense standard. The court stated, “If the [IRS] had intended the term ‘SCU’ in §3121(b)(10) to have the same scope and meaning as ‘educational institution’ (found in §170(b)(1)(A)(ii) . . . ), it could have clearly and explicitly given the phrase such scope and meaning by cross-referencing those Code provisions and their implementing regulations.” Although Treasury and IRS disagree with the interpretation of the district court, the Secretary understands and is responding to the court’s view by more clearly incorporating the primary purpose standard in regulations.

This regulation provides that the character of an organization as a SCU or not as a SCU is determined by its primary function. The primary function standard is consistent with the language of section 3121(b)(10) and the existing regulations thereunder, and is consistent with the intended scope of the student FICA exception as reflected in the legislative history accompanying the Social Security Amendments of 1939 and 1950.

Section 170(b)(1)(A) of the Code defines various classes of organizations for charitable deduction purposes. All of the organizations have some combination of charitable, educational, religious and/or cultural purposes. The definitions distinguish them into categories based on various criteria. One such class defined in section 170(b)(1)(A)(ii) is for any “educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.”

Section 1.170A–9(b)(1) of the Income Tax Regulations provides:

An educational organization is described in section 170(b)(1)(A)(ii) if its primary function is the presentation of formal instruction and it normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The term includes institutions such as primary, secondary, preparatory, or high schools, and colleges and universities. It includes Federal, State, and other public-supported schools which otherwise come within the definition. It does not include organizations engaged in both educational and noneducational activities unless the latter are merely incidental to the educational activities. A recognized university which incidentally operates a museum or sponsors concerts is an educational organization within the meaning of section 170(b)(1)(A)(ii). However, the operation of a school by a museum does not necessarily qualify the museum as an educational organization within the meaning of this subparagraph.

Thus, in order to qualify as an educational organization under section 170(b)(1)(A)(ii), it is not enough that the organization carries on educational activities; instead, the organization’s primary function must be to carry on educational activities.

The section 170(b)(1)(A)(ii) standard applies to the organization as a whole, an approach that is consistent with §31.3121(b)(10)–2(b) of the regulations, which provides that one of “[t]he statutory tests [is] the character of the organization in the employ of which the services are performed as a [SCU] . . . .” Thus, the character of the organization determines whether it is a SCU, not merely whether the organization carries on some educational activities. Further, section 3121(b) provides that “the term ‘employment’ means any service . . . performed . . . by an employee for the person employing him,” and §31.3121(d)–2 of the regulations provides that “every person is an employer if he employs one or more employees.” Under section 7701(a)(1), the term “person” means any individual, trust, estate, association, or corporation. Thus, the character of the person employing the employee—the legal entity recognized for federal tax purposes—determines whether the SCU status requirement is met, not merely the character of a division or function of the employer.

In addition, the primary function standard reaches a result consistent with the “commonly or generally accepted sense” standard of the existing regulation (§31.3121(b)(10)–2(d)). In common parlance, the term “hospital” is used to describe an organization with the primary function of caring for patients. The term “museum” is used to describe an organization with the primary function of maintaining a collection and displaying it to the public in a way that will educate them about the collection and related concepts. A hospital or a museum may conduct educational activities, even classes or possibly even certificate or degree programs, but the activities which define them in the public mind are patient care and maintenance and display of a collection. An organization bears the label “school” when its primary function is the conduct of classes for an identified set of students leading to the awarding of a credential demonstrating mastery of some subject matter.

Finally, defining the term “SCU” to include institutions whose primary function is other than to carry on educational activities could lead to expansion of the student FICA exception beyond what Congress intended. When Congress enacted the student FICA exception in 1939, and amended it in 1950, it contemplated that the exception would be limited in scope. The House Report to the Social Security Amendments of 1939 states the following in describing the purpose of the student FICA and other exceptions:

In order to eliminate the nuisance of inconsequential tax payments, the bill excludes certain services performed for fraternal benefit societies and other nonprofit institutions exempt from income tax, and certain other groups. While the earnings of a substantial number of persons are excluded by this recommendation, the total amount of earnings involved is undoubtedly...
very small. . . . The intent of this amendment is to exclude those persons and those organizations in which the employment is part-time or intermittent and the total amount of earnings is only nominal, and the payment of tax is inconsequential and a nuisance. The benefit rights built up are also inconsequential. Many of those affected, such as students and the secretaries of lodges, will have other employment which will enable them to develop insurance benefits. This amendment, therefore, should simplify the administration for the worker, the employer, and the Government.


The House Report to the Social Security Amendments of 1950 continued to describe the exception as a matter of administrative convenience not meaningfully affecting social security benefits:

The bill would continue to exclude service performed for nominal amounts in the employ of tax-exempt nonprofit organizations, service performed by student nurses and internes [sic], and service performed by students in the employ of colleges and universities. These exclusions simplify administration without depriving any significant number of people of needed protection.

H. R. Rep. No. 1300, 81st Cong. 1st Sess. 12 (1949). The Senate Report contains similar language. S. Rep. No. 1669, 81st Cong. 2d Sess. 15 (1950). Defining “SCU” to include organizations whose primary purpose is not to carry on educational activities would create a broad exception contrary to what Congress intended. Accordingly, the term “SCU” should not be interpreted so broadly as to include organizations whose primary function is other than to carry on educational activities.

D. Whether Certain Employees Are Students

This regulation clarifies who is a student enrolled and regularly attending classes for purposes of section 3121(b)(10). The existing regulations at §31.3121(b)(10)–2(c) provide that an employee will have the status of student only if the services are performed “as an incident to and for the purpose of pursuing a course of study” at the SCU. Thus, to qualify for the exception, the individual’s predominant relationship with the SCU must be as a student, and only secondarily or incidentally as an employee.

Where an individual’s employment and educational activities are separate and distinct, the extent and nature of the respective activities determine whether the employment or student aspect of the relationship with the SCU is predominant. See Rev. Proc. 98–16. In the vast majority of cases the service and the course of study are separate and distinct activities; for example, the biology major’s service in the cafeteria is unrelated to his course of study. By contrast, some employees’ services are arguably part of a course of study; for example, the services of a medical resident are necessary to receive a certificate in a medical specialty. The standards in Rev. Proc. 98–16—whether the employee has at least a half-time course workload, and whether the employee is eligible to receive certain employee benefits—are inadequate to determine student status in such circumstances. Where the services performed by the individual for the SCU are also earning the individual credit toward an educational credential, the determination of whether the employment relationship is the predominant relationship with the SCU must be based on other factors. This regulation is intended to provide standards to determine student status in such cases.

This regulation is intended to further Congress’s intent regarding those eligible for the student FICA exception as reflected by the legislative history to the Social Security Amendments of 1939. Consistent with Congress’s intent, the student FICA exception covers individuals earning small amounts who are expected to accumulate social security benefits through future employment that will follow the completion of their education. Thus, in the typical case, a student will earn a modest amount while devoting his primary time and attention to classes and study.

This regulation provides clarification in three respects. First, it describes what the individual must be doing to be considered enrolled and regularly attending classes. In order to be a class, the activity must be more than an activity that gives the individual an opportunity to acquire new skills and knowledge. It must involve instructional activities, and be led by a knowledgeable faculty member following an established curriculum for identified students. Classes can include much more than traditional classroom-based instruction, but the faculty leadership, the set curriculum, and the prescribed time frame are essential.

Second, this regulation provides standards for determining whether an employee is pursuing a course of study. The regulation provides that one or more courses conducted by a SCU the completion of which fulfills the requirements to receive an educational credential granted by the SCU is a course of study.

Third, this regulation provides standards for determining whether an employee’s services are incident to and for the purpose of pursuing a course of study. The regulation provides in general that whether the employee’s services are incident to and for the purpose of pursuing a course of study depends on all the facts and circumstances. This determination is made by comparing the educational aspect of the relationship between the employer and the employee with the service aspect of the relationship. The regulation provides that the employee’s course workload is used to measure the scope of the educational aspect of the relationship. A relevant factor is the employee’s course workload relative to a full-time course workload. The regulation further provides that where an employee has the status of a career employee, the services performed by the employee are not incident to and for the purpose of pursuing a course of study.

This regulation specifies various aspects of an individual’s employment relationship with the SCU which cause conclusively the individual to have the status of a “career employee.”

This regulation provides that the criteria used to identify an employee as having the status of a career employee are (1) the

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2 The general exception from employment for services performed for non-profit organizations was repealed in 1983 by Public Law 98–21, section 102(b).

3 The Social Security Amendments of 1965 repealed the student intern exception under §3121(b)(13). See discussion infra.
reasonable interpretation of the legislative history. The IRS's use of an employee's terms of employment may also cause an employee to have the status of a career employee. A list of terms is provided, any one of which causes the employee to have the status of a career employee. On the list are terms of employment that provide for eligibility to receive certain employee benefits typically associated with career employment, such as eligibility to participate in certain types of retirement plans or tuition reduction arrangements. The notion of a career employee standard based on eligibility to receive certain fringe benefits was recommended by the higher education community for purposes of guidance that was issued in Rev. Proc. 98–16, and Treasury and IRS believe it is an appropriate standard to use for purposes of identifying employees whose services are not incident to and for the purpose of pursuing a course of study. Rev. Proc. 98–16 provides that career employee status precludes application of the safe harbor standard, but leaves the possibility that the employee could have the status of a student based on all the facts and circumstances. The House Report accompanying the legislation provides:

Paragraph 13 excepts service performed as a student nurse in the employ of a hospital or a nurse's training school by an individual who is enrolled and is regularly attending classes . . . ; and service performed as an intern (as distinguished from a resident doctor) in the employ of a hospital by an individual who has completed a 4 years' course in a medical school chartered or approved pursuant to State law." The House Report accompanying the legislation provides:

Finally, this regulation provides that an employee who must be licensed by a government entity in order to perform a certain function has the status of a career employee. An employee who is required to be licensed to perform the services must have received sufficient prior instruction and demonstrated sufficient mastery of the activity to receive the license. Furthermore, licensed workers typically earn more than a modest amount for their work to reflect their expertise. As discussed, the legislative history indicates that the student FICA exception is intended to cover individuals earning a small amount of wages prior to entry into meaningful post-education employment. The exception is not intended to cover an individual who has developed enough expertise to be working in a field where he or she is already licensed and has the capacity to earn substantial wages.

The IRS requests comments on the criteria used to identify an employee as having the status of a career employee. In particular, the IRS requests comments on the licensure criterion and whether this criterion should be further refined or clarified.

IRS and Treasury believe that Congress has shown the specific intent to provide social security coverage to individuals who work long hours, serve as highly skilled professionals, and typically share some or all of the terms of employment of career employees, particularly medical residents and interns. The Social Security Amendments of 1939 added section 1426(b)(13) to the Code (later redesignated section 3121(b)(13)), which provided an exception from social security coverage for "service performed as an intern in the employ of a hospital by an individual who has completed a 4 years' course in a medical school chartered or approved pursuant to State law."
tion 3121(b)(13). The refund claims were computed based upon the remuneration paid to medical school graduates in their second or subsequent year of clinical training. The court held that the services of medical residents were not excluded under the medical intern exception.

In 1965, one year after the St. Luke’s decision, Congress amended the Code to repeal the special exemption for medical interns. The legislative history underlying the Social Security Amendments of 1965 (Public Law 89–97) suggests that Congress intended that medical interns be covered by FICA just as medical residents already were. The House Report states:

Coverage would also be extended to services performed by medical and dental interns. The coverage of services as an intern would give young doctors an earlier start in building up social security protection and would help many of them to become insured under the program at the time when they need the family survivor and disability protection it provides. This protection is important for doctors of medicine who, like members of other professions, in the early years of their practice, may not otherwise have the means to provide adequate survivorship and disability protection for themselves and their families. Interns would be covered on the same basis as other employees working for the same employers, beginning on January 1, 1966.


The Senate Report states:

Section 3121(b)(13) of the Internal Revenue Code of 1954 excludes from the term ‘employment,’ and thus from coverage under the [FICA], services performed as an intern in the employ of a hospital by an individual who has completed a 4-year course in a medical school . . . . Section 311(b)(5) of the bill amends section 3121(b)(13) so as to remove this exclusion. The effect of this amendment is to extend coverage under the [FICA] to such interns unless their services are excluded under provisions other than section 3121(b)(13). Thus, the services of an intern are covered if he is employed by a hospital which is not exempt from income tax as an organization described in section 501(c)(3) of the Code.

S. Rep. No. 404, 89th Cong. 1st Sess. 237–38 (1965). The last sentence makes indirect reference to the exclusion from FICA for services performed for exempt organizations under section 3121(b)(8)(B) of the 1954 Code. That exclusion was repealed by the Social Security Amendments of 1983 (Public Law 98–21). Nothing in the legislative history indicates that Congress believed interns (or residents, who were even further along in their medical careers than interns) were eligible for the student FICA exception.

In addition to revoking the medical intern exception, section 311 of the Social Security Amendments of 1965, entitled, “Coverage for Doctors of Medicine,” changed the law in two other ways affecting medical doctors. First, section 1402(c)(5) of the 1954 Code was amended to eliminate the exception for physician services from the definition of “trade or business,” thus subjecting these services to self-employment tax. Second, section 3121(b)(6)(C)(iv) of the 1954 Code, which provided an exception from the definition of employment for “service performed in the employ of the United States if the service is performed by any individual as an employee included under § 5351(2) of title 5, [U.S.C.,] (relating to certain interns, student nurses, and other student employees of hospitals of the Federal Government),” was amended by adding, “other than as a medical or dental intern or a medical or dental resident in training.”

These provisions, taken together, indicate Congress’s intent to create a scheme under which all medical doctors are covered under the social security system, whether or not they are still in training, whether or not they are self-employed, or whether or not they work for the federal government.

E. Effect on Rev. Proc. 98–16

Several years ago, representatives of higher education asked the IRS and Treasury for guidance on the application of the student FICA exception. Colleges and universities were particularly interested in guidance relating to students who had on-campus jobs that were completely separate and distinct from their course work. In response, the IRS issued Rev. Proc. 98–16, which sets forth standards for determining whether services performed by students in the employ of certain institutions of higher education qualify for the exception from FICA tax provided under section 3121(b)(10). The revenue procedure provided answers to many longstanding questions.

The revenue procedure addresses different circumstances than those prompting the need for the clarifications provided in this proposed regulation. It provides a safe harbor that applies where the student’s course work and the student’s employment are separate activities, and are not intermingled. In clarifying the regulations interpreting section 3121(b)(10), the IRS and Treasury fully intend to retain the safe harbor in the revenue procedure. However, several discrete aspects of the safe harbor need to be updated to align with the proposed regulations. Thus, in conjunction with this notice of proposed rulemaking, the IRS is suspending Rev. Proc. 98–16 and proposing to replace it with a new revenue procedure that is revised in limited ways to align with the proposed regulations. See Notice 2004–12, to be published in I.R.B. 2004–10 (March 8, 2004). Taxpayers may rely on the proposed revenue procedure until final regulations and a final revenue procedure are issued. Also, the public is invited to comment on the proposed revenue procedure.

F. Related Proposed Amendments

Section 3306(c)(10)(B) of the Code excepts from "employment" for FUTA tax purposes services performed by a student who is enrolled and regularly attending classes at a SCU. This regulation provides that the standards that apply in determining whether an employer is a SCU and whether an employee is a student for purposes of section 3121(b)(10) also apply for purposes of section 3306(c)(10)(B). In addition, this regulation provides that the standards that apply for purposes of determining whether an employer is a SCU for purposes of section 3121(b)(10) also apply for purposes of section 3121(b)(2) (excluding from employment for FICA purposes domestic services performed for local college clubs, fraternities, and sororities by students who are enrolled and regularly attending classes).
G. Proposed Effective Date

It is proposed that these regulations apply to services performed on or after February 25, 2004.

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 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. In addition, because no collection of information is imposed on small entities, the provisions of the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on the 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 that are submitted timely to the IRS. The IRS and Treasury Department request comments on all aspects of the proposed regulations and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing is scheduled for June 16, 2004, beginning at 10 a.m. in room 2615 of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. All visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. 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 electronic or written comments by May 25, 2004, and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies). A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is John Richards of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). 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 31 is proposed to be amended as follows:

PART 31—EMPLOYMENT TAXES

Paragraph 1. The authority citation for part 31 continues to read in part, as follows:

Authority 26 U.S.C. 7805

Par. 2. In §31.3121(b)(2)–1, paragraph (d) is revised to read as follows:

§31.3121(b)(2)–1 Domestic service performed by students for certain college organizations.

* * * * *

(d) A school, college, or university is described in section 3121(b)(2) if its primary function is the presentation of formal instruction, it normally maintains a regular faculty and curriculum, and it normally has a regularly enrolled body of students in attendance at the place where its educational activities are regularly carried on. See section 170(b)(1)(A)(ii) and the regulations thereunder.

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Par. 3. Section 31.3121(b)(10)–2 is amended by:

1. Adding headings for paragraphs (a), (b).

2. Revising paragraphs (c) and (d).

3. Redesignating paragraph (e) as (g).

4. Adding paragraphs (e) and (f).

The revisions and additions read as follows:

§31.3121(b)(10)–2 Services performed by certain students in the employ of a school, college, or university, or of a nonprofit organization auxiliary to a school, college, or university.

(a) General rule. (1)* * *
(b) Statutory tests. * * *
(c) School, College, or University. A school, college, or university is described in section 3121(b)(10) if its primary function is the presentation of formal instruction, it normally maintains a regular faculty and curriculum, and it normally has a regularly enrolled body of students in attendance at the place where its educational activities are regularly carried on. See section 170(b)(1)(A)(ii) and the regulations thereunder.

(d) Student Status—general rule. Whether an employee has the status of a student performing the services shall be determined based on the relationship of the employee with the organization for which the services are performed. In order to have the status of a student, the employee must perform services in the employ of a school, college, or university described in paragraph (c) of this section at which the employee is enrolled and regularly attending classes in pursuit of a course of study within the meaning of paragraphs (d)(1) and (2) of this section. In addition, the employee’s services must be incident to and for the purpose of pursuing a course of study within the meaning of paragraph (d)(3) of this section at such school, college, or university. An employee who performs services in the employ of an affiliated organization described in paragraph (a)(2) of this section must be enrolled and regularly attending classes at the affiliated school, college, or university within the meaning of paragraph (c) of this section in pursuit of a course of study within the meaning of paragraphs (d)(1) and (2) of this section. In addition, the employee’s services must be incident to and for the purpose of pursuing a course of study within the meaning of paragraph (d)(3) of this section at such school, college, or university.
(1) Enrolled and regularly attending classes. An employee must be enrolled and regularly attending classes at a school, college, or university within the meaning of paragraph (c) of this section at which the employee is employed to have the status of a student within the meaning of section 3121(b)(10). An employee is enrolled within the meaning of section 3121(b)(10) if the employee is registered for a course or courses creditable toward an educational credential described in paragraph (d)(2) of this section. In addition, the employee must be regularly attending classes to have the status of a student. For purposes of this paragraph (d)(1), a class is an instructional activity led by a knowledgeable faculty member for identified students following an established curriculum. Traditional classroom activities are not the sole means of satisfying this requirement. For example, research activities under the supervision of a faculty advisor necessary to complete the requirements for a Ph.D. degree may constitute classes within the meaning of section 3121(b)(10). The frequency of events such as these determines whether the employee may be considered to be regularly attending classes.

(2) Course of study. An employee must be pursuing a course of study in order to have the status of a student. A course of study is one or more courses the completion of which fulfills the requirements necessary to receive an educational credential granted by a school, college, or university within the meaning of paragraph (c) of this section. For purposes of this paragraph, an educational credential is a degree, certificate, or other recognized educational credential granted by an organization described in paragraph (c) of this section. In addition, a course of study is one or more courses at a school, college or university within the meaning of paragraph (c) of this section the completion of which fulfills the requirements necessary for the employee to sit for an examination required to receive certification by a recognized organization in a field.

(3) Incident to and for the purpose of pursuing a course of study. An employee’s services must be incident to and for the purpose of pursuing a course of study in order for the employee to have the status of a student. Whether an employee’s services are incident to and for the purpose of pursuing a course of study shall be determined on the basis of the relationship of such employee with the organization for which such services are performed. The educational aspect of the relationship, as compared to the service aspect of the relationship, must be predominant in order for the employee’s services to be incident to and for the purpose of pursuing a course of study. The educational aspect of the relationship between the employer and the employee is established by the employee’s course workload. The service aspect of relationship is established by the facts and circumstances related to the employee’s employment. In the case of an employee with the status of a career employee within the meaning of paragraph (d)(3)(ii) of this section, the service aspect of the relationship with the employer is predominant. Standards applicable in determining whether an employee’s services are considered to be incident to and for the purpose of pursuing a course of study are provided in paragraphs (d)(3)(i) and (ii) of this section.

(i) Course workload. The educational aspect of an employee’s relationship with the employer is evaluated based on the employee’s course workload. Whether an employee’s course workload is sufficient in order for the employee’s employment to be incident to and for the purpose of pursuing a course of study generally depends on the particular facts and circumstances. A relevant factor in evaluating an employee’s course workload is the employee’s course workload relative to a full-time course workload at the school, college or university within the meaning of paragraph (c) of this section at which the employee is enrolled and regularly attending classes.

(ii) Career employee status. Services of an employee with the status of a career employee are not incident to and for the purpose of pursuing a course of study. An employee has the status of a career employee if the employee is described in paragraph (d)(3)(ii)(A), (B), (C) or (D) of this section.

(A) Hours worked. An employee has the status of a career employee if the employee regularly performs services 40 hours or more per week.

(B) Professional employee. An employee has the status of a career employee if the employee is a professional employee. A professional employee is an employee—

(1) Whose primary duty consists of the performance of work requiring knowledge of an advanced type in a field of science or learning customarily acquired by a prolonged course of specialized intellectual instruction and study, as distinguished from a general academic education, from an apprenticeship, and from training in the performance of routine mental, manual, or physical processes.

(2) Whose work requires the consistent exercise of discretion and judgment in its performance; and

(3) Whose work is predominantly intellectual and varied in character (as opposed to routine mental, manual, mechanical, or physical work) and is of such character that the output produced or the result accomplished cannot be standardized in relation to a given period of time.

(C) Terms of employment. An employee with the status of a career employee includes any employee who is—

(1) Eligible to receive vacation, sick leave, or paid holiday benefits;

(2) Eligible to participate in any retirement plan described in section 401(a) that is established or maintained by the employer, or would be eligible to participate if age and service requirements were met;

(3) Eligible to participate in an arrangement described in section 403(b), or would be eligible to participate if age and service requirements were met;

(4) Eligible to participate in a plan described under section 457(a), or would be eligible to participate if age and service requirements were met;

(5) Eligible for reduced tuition (other than qualified tuition reduction under section 117(d)(5) provided to a teaching or research assistant who is a graduate student) because of the individual’s employment relationship with the institution;

(6) Eligible to receive employee benefits described under sections 79 (life insurance), 127 (qualified educational assistance), 129 (dependent care assistance programs), or 137 (adoption assistance); or

(7) Classified by the employer as a career employee.

(D) Licensure status. An employee is a career employee if the employee is required to be licensed under state or local law to work in the field in which the employee performs services.
(e) Examples. The following examples illustrate the principles of paragraphs (c) and (d) of this section:

Example 1. (i) Employee C is employed by State University T to provide services as a clerk in T’s administrative offices, and is enrolled and regularly attending classes at T in pursuit of a B.S. degree in biology. C has a course workload which constitutes a full-time course workload at T. C performs services on average 20 hours per week, but from time to time works 40 hours or more during a week. C receives only hourly wages and no other pay or benefits. C is not required under state or local law to be licensed to perform the services for T.

(ii) In this example, C is employed by T, a school, college, or university within the meaning of paragraph (c) of this section. C is enrolled and regularly attending classes at T in pursuit of a course of study. C’s hours worked do not cause C to have the status of a career employee, even though C may occasionally work 40 hours or more during a week. C’s part-time employment relative to C’s full-time course workload indicates that C’s services are incident to and for the purpose of pursuing a course of study. C is not a professional employee, and C’s terms of employment and licensure status do not cause C to have the status of a career employee within the meaning of paragraph (d)(3)(ii) of this section. Thus, C has the status of a student. Accordingly, C’s services are excepted from employment under section 3121(b)(10).

Example 2. (i) Employee D is employed in the accounting department of University U, and is enrolled and regularly attending classes at U in pursuit of an M.B.A. degree. D has a course workload which constitutes a half-time course workload at U. D’s work does not require the consistent exercise of discretion and judgment, and is not predominantly intellectual and varied in character. D regularly performs services full-time (40 hours per week), and is eligible to participate in a retirement plan described in section 401(a) maintained by U.

(ii) In this example, D is employed by U, a school, college, or university within the meaning of paragraph (c) of this section. In addition, D is enrolled and regularly attending classes at U in pursuit of a course of study. However, D has the status of a career employee because D regularly works 40 hours per week, and is eligible to participate in U’s section 401(a) retirement plan. Because D has the status of a career employee within the meaning of paragraph (d)(3)(ii) of this section, D’s services are not incident to and for the purpose of pursuing a course of study. Accordingly, D’s services are not excepted from employment under section 3121(b)(10).

Example 3. (i) Employee E is employed by University V to provide patient care services at a teaching hospital that is an unincorporated division of V. These services are performed as part of a medical residency program in a medical specialty sponsored by V. The residency program in which E participates is accredited by the Accreditation Counsel for Graduate Medical Education. Upon completion of the program, E will receive a certificate of completion, and be eligible to sit for an examination required to be certified by a recognized organization in the medical specialty. E regularly performs services more than 40 hours per week. E’s patient care services require knowledge of an advanced type in the field of medicine, and are predominantly intellectual and varied in character. Further, although E is subject to supervision, E’s services require the consistent exercise of discretion and judgment regarding the treatment of patients. In addition, E receives vacation, sick leave, and paid holiday benefits; and salary deferral benefits under an arrangement described in section 403(b). E is a first-year resident, and thus is not eligible to be licensed to practice medicine under the laws of the state in which E performs services.

(ii) In this example, E is employed by V, a school, college, or university within the meaning of paragraph (c) of this section. However, because of E’s hours worked, professional employee status, and employee benefits, E has the status of a career employee within the meaning of paragraph (d)(3)(ii) of this section. Thus, E’s services are not incident to and for the purpose of pursuing a course of study. Accordingly, E’s services are not excepted from employment under section 3121(b)(10).

Example 4. (i) Employee F is employed in the facilities management department of University W. F has a B.S. degree in engineering, and is completing the work experience required to sit for an examination to become a professional engineer eligible for licensure under state or local law. F is not attending classes at W in pursuit of a course of study leading to an educational credential. F regularly performs services 40 hours or more per week. F receives certain employee benefits including vacation, sick leave, and paid holiday benefits. F also receives retirement benefits under an arrangement described in section 457.

(ii) In this example, F is employed by W, a school, college, or university within the meaning of paragraph (c) of this section. However, F is not enrolled and regularly attending classes at W in pursuit of a course of study. F’s work experience is not a course of study for purposes of paragraph (d)(2) of this section. In addition, because of F’s hours worked and employment benefits, F has the status of a career employee within the meaning of paragraph (d)(3)(ii) of this section. Thus, F’s services are not incident to and for the purpose of pursuing a course of study. Accordingly, F’s services are not excepted from employment under section 3121(b)(10).

Example 5. (i) Employee G is employed by Employer X as an apprentice in a skilled trade. X is a subcontractor providing services in the field in which G wishes to specialize. G is pursuing a certificate in the skilled trade from Community College C. G is performing services for X pursuant to an internship program sponsored by C under which its students gain experience, and receive credit toward a certificate in the trade.

(ii) In this example, G is employed by X. X is not a school, college or university within the meaning of paragraph (c) of this section. Thus, the exception from employment under section 3121(b)(10) is not available with respect to G’s services for X.

Example 6. (i) Employee H is employed by a cosmetology school Y at which H is enrolled and regularly attending classes in pursuit of a certificate of completion. Y’s primary function is to carry on educational activities to prepare its students to work in the field of cosmetology. Prior to issuing a certificate, Y requires that its students gain experience in cosmetology services by performing services for the general public on Y’s premises. H performs services less than 40 hours per week. H’s work does not require knowledge of an advanced type in a field of science or learning, nor is it predominantly intellectual and varied in character. H receives remuneration in the form of hourly compensation from Y for providing cosmetology services to clients of Y, and does not receive any other compensation or benefits. H is not required to be licensed in the state in which H performs services while participating in the training program.

(ii) In this example, H is employed by Y, a school, college or university within the meaning of paragraph (c) of this section, and is enrolled and regularly attending classes at Y in pursuit of a course of study. In addition, because H works less than 40 hours per week, H is not a professional employee, and H’s terms of employment, and licensure status do not indicate that H has the status of a career employee. H is not a career employee within the meaning of paragraph (d)(3)(ii) of this section. Thus, H’s services are incident to and for the purpose of pursuing a course of study. Accordingly, H’s services are excepted from employment under section 3121(b)(10).

Example 7. (i) Employee J is a teaching assistant at University Z. J is enrolled and regularly attending classes in pursuit of a graduate degree at Z. J has a course workload which constitutes a full-time course workload at Z. J performs services less than 40 hours per week. J’s duties include grading quizzes, providing class and laboratory instruction pursuant to a lesson plan developed by the professor, and preparing laboratory equipment for demonstrations. J receives no employee benefits. J receives a cash stipend and a qualified tuition reduction within the meaning of section 117(d)(5) for the credits earned for being a teaching assistant. J is not required under state or local law to be licensed to perform the activities of a teaching assistant.

(ii) In this example, J is employed as a teaching assistant by Z, a school, college, or university within the meaning of paragraph (c), and is enrolled and regularly attending classes at Z in pursuit of a course of study. J’s full-time course workload relative to J’s employment workload indicates that J’s services are incident to and for the purpose of pursuing a course of study. J is not a professional employee because J’s work does not require the consistent exercise of discretion and judgment in its performance. In addition, J’s terms of employment and licensure status do not cause J to have the status of a career employee within the meaning of paragraph (d)(3)(ii) of this section. Thus, J has the status of a student. Accordingly, J’s services are excepted from employment under section 3121(b)(10).

(f) Effective date. Paragraphs (c), (d), and (e) of this section apply to services performed on or after February 25, 2004.
§31.3306(c)(10)–2 Services of student in employ of a school, college, or university.

* * * * *

(c) General rule. (1) For purposes of this section, the tests are the character of the organization in the employ of which the services are performed and the status of the employee as a student enrolled and regularly attending classes at the school, college, or university described in paragraph (c)(2) of this section, in the employ of which he performs the services. The type of services performed by the employee, the place where the services are performed, and the amount of remuneration for services performed by the employee are not material.

(2) School, college, or university. A school, college, or university is described in section 3306(c)(10)(B) if its primary function is the presentation of formal instruction, and it normally maintains a regular faculty and curriculum, and it normally has a regularly enrolled body of students in attendance at the place where its educational activities are regularly carried on. See section 170(b)(1)(A)(ii) and the regulations thereunder.

(d) Student Status—general rule. Whether an employee has the status of a student within the meaning of section 3306(c)(10)(B) performing the services shall be determined based on the relationship of the employee with the organization for which the services are performed. In order to have the status of a student, the employee must perform services in the employ of a school, college, or university described in paragraph (c)(2) of this section at which the employee is enrolled and regularly attending classes in pursuit of a course of study within the meaning of paragraphs (d)(1) and (2) of this section. In addition, the employee’s services must be incident to and for the purpose of pursuing a course of study at such school, college, or university within the meaning of paragraph (d)(3) of this section.

(1) Enrolled and regularly attending classes. An employee must be enrolled and regularly attending classes at a school, college, or university within the meaning of paragraph (c)(2) of this section at which the employee is employed to have the status of a student within the meaning of section 3306(c)(10)(B). An employee is enrolled within the meaning of section 3306(c)(10)(B) if the employee is registered for a course or courses creditable toward an educational credential described in paragraph (d)(2) of this section. In addition, the employee must be regularly attending classes to have the status of a student. For purposes of this paragraph (d)(1), a class is a didactic activity in which a faculty member plays a leadership role in furthering the objectives of an established curriculum. Traditional classroom activities are not the sole means of satisfying this requirement. The frequency of events such as these determines whether the employee may be considered to be regularly attending classes.

(2) Course of study. An employee must be pursuing a course of study in order to have the status of a student within the meaning of section 3306(c)(10)(B). A course of study is one or more courses the completion of which fulfills the requirements necessary to receive an educational credential granted by a school, college, or university within the meaning of paragraph (c)(2) of this section. For purposes of this paragraph, an educational credential is a degree, certificate, or other recognized educational credential granted by an organization described in paragraph (c)(2) of this section. In addition, a course of study is one or more courses at a school, college, or university within the meaning of paragraph (c)(2) of this section the completion of which fulfills the requirements necessary for the employee to sit for an examination required to receive certification by a recognized organization in a field.

(3) Incident to and for the purpose of pursuing a course of study. An employee’s services must be incident to and for the purpose of pursuing a course of study in order for the employee to have the status of a student within the meaning of section 3306(c)(10)(B). Whether an employee’s services are incident to and for the purpose of pursuing a course of study shall be determined on the basis of the relationship of such employee with the organization for which such services are performed. The educational aspect of the relationship, as compared to the service aspect of the relationship, must be predominant in order for the employee’s services to be incident to and for the purpose of pursuing a course of study. The educational aspect of the relationship between the employee and the employer is established by the employee’s course workload. The service aspect of relationship is established by the facts and circumstances related to the employee’s employment. In the case of an employee with the status of a career employee, the service aspect of the relationship with the employer is predominant. Standards applicable in determining whether an employee’s services are considered to be incident to and for the purpose of pursuing a course of study are provided in paragraphs (d)(3)(i) and (ii) of this section.

(i) Course workload. The educational aspect of an employee’s relationship with the employer is evaluated based on the employee’s course workload. Whether an employee’s course workload is sufficient for the employee’s employment to be incident to and for the purpose of pursuing a course of study generally depends on the particular facts and circumstances. A relevant factor in evaluating the employee’s course workload is the employee’s course workload relative to a full-time course workload at the school, college or university within the meaning of paragraph (c)(2) of this section at which the employee is enrolled and regularly attending classes.

(ii) Career employee status. Services of an employee with the status of a career employee are not incident to and for the purpose of pursuing a course of study. An employee has the status of a career employee if the employee is described in paragraph (d)(3)(ii)(A), (B), (C), or (D) of this section.

(A) Hours worked. An employee has the status of a career employee if the employee regularly performs services 40 hours or more per week.

(B) Professional employee. An employee has the status of a career employee if the employee is a professional employee. A professional employee is an employee—

(1) Whose primary duty consists of the performance of work requiring knowledge of an advanced type in a field of science or learning customarily acquired by a prolonged course of specialized intellectual instruction and study, as distinguished from a general academic education, from an apprenticeship, and from training in the performance of routine mental, manual, or physical processes.

(2) Whose work requires the consistent exercise of discretion and judgment in its performance; and
Changes to Reporting Requirements for Certain 2002 Forms Because of Changes in the Tax Rates and Holding Period Rules for Qualified Dividends

Announcement 2004–11

BACKGROUND

Under current law, qualified dividends received after 2002 are taxed to individuals, estates, and trusts at the new lower capital gain tax rates (5% or 15%). The new rates do not apply to dividends passed through from fiscal year partnerships, S corporations, or estates for their fiscal year beginning in 2002, even if the dividends were received in 2003.

Also, to qualify for the lower rates under current law, you must hold a stock for at least 61 days of a 120-day period. That period begins 60 days before the day a stock trades without its dividend (the “ex-dividend date”), and ends 59 days after the ex-dividend date. In the case of dividends attributable to periods of more than 366 days that were received on preferred stock, you must hold the stock for at least 91 days of a 180-day period. That period begins 90 days before the ex-dividend date, and ends 89 days after the ex-dividend date.

TECHNICAL CORRECTION

Section 2 of the Tax Technical Corrections Act of 2003 (H.R. 3654, S. 1984), which has not yet been enacted, would amend current law to allow partnerships, S corporations, and estates (including revocable trusts treated as part of an estate) with fiscal years beginning in 2002 to pass through dividends received in 2003 from domestic corporations and qualified foreign corporations as qualified dividends to their partners, shareholders, and beneficiaries (to the extent otherwise permitted by law). In addition, the legislation would amend the holding period rules for qualified dividends by changing the 120-day period to a 121-day period and the 180-day period to a 181-day period. These periods would end one day later than under current law. Both amendments would be treated as if included in section 302 of the Jobs and Growth Tax Relief Reconciliation Act of 2003. The Commissioner of Internal Revenue has agreed to allow taxpayers to apply section 2 of the Tax Technical Corrections Act of 2003 as if the legislation were presently enacted.

As a result, there are changes in the reporting requirements for the following 2002 forms (these forms and their instructions do not reflect this legislation) filed by entities with 2002–2003 fiscal years:

• Schedules K and K–1 for partnerships and S corporations and

• Schedule K–1 for estates.

Also, the tax computation (for both the regular tax and the alternative minimum tax) for estates with 2002–2003 fiscal years and qualified dividends received in 2003 is affected by this change.

Note: Dividends received in a tax year beginning in 2002 and ending in 2003 are not qualified dividends for individuals with 2002–2003 fiscal years, even if the dividends are received during 2003.

The necessary changes are described in the following sections.


Estates with 2002–2003 fiscal years and qualified dividends received in 2003 must attach to their 2002 Form 1041 a computation similar to that shown in Part V of the 2003 Schedule D (Form 1041) or the Qualified Dividends Tax Worksheet on page 22 of the 2003 Instructions for Form 1041 and Schedules A, B, D, G, I, J, and K–1. These estates may use the 2003 Schedule D (Form 1041) or the Qualified Dividends Tax Worksheet to figure their 2002 tax. To do so, these filers must:

• Enter qualified dividends received in 2003 on line 20 of the 2003 Schedule D (Form 1041) or line 2 of the Qualified Dividends Tax Worksheet (whichever applies).

• Modify the computation in Part V of Schedule D (Form 1041) or the Qualified Dividends Tax Worksheet by using the 2002 Tax Rate Schedule instead of the 2003 Tax Rate Schedule.

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

(Filed by the Office of the Federal Register on February 24, 2004, 8:45 a.m., and published in the issue of the Federal Register for February 25, 2004, 69 FR 8604)
Substitute $1,850 for $1,900 on line 25 of the 2003 Schedule D (Form 1041) or line 6 of the Qualified Dividends Tax Worksheet.

**Note:** This change also affects the computation of the alternative minimum tax. Estates should attach a computation similar to that shown in Part IV, Schedule I, of the 2003 Form 1041.

Estates must continue to report each beneficiary’s share of ordinary dividends for the entire tax year on line 2 of the 2002 Schedule K–1. In addition, the estate must report each beneficiary’s share of qualified dividends received in 2003 on line 14 of the 2002 Schedule K–1.

Estates should advise beneficiaries filing Form 1040 to report qualified dividends on line 9b of the 2003 Form 1040.

**FISCAL YEAR PARTNERSHIPS AND S CORPORATIONS: REPORTING QUALIFIED DIVIDENDS FOR 2002–2003**

Partnerships and S corporations with 2002–2003 fiscal years must continue to report ordinary dividends for the entire tax year on the applicable lines shown below:

- Form 1065 (or 8865) filers: Schedule K, line 4b of the 2002 Form 1065 (or 8865) and each partner’s share on line 24 of Schedule K–1 (Form 1065 or 8865).
- Form 1065–B filers: Schedule K, line 16 of the 2002 Form 1065–B and each partner’s share on an attachment to Schedule K–1 (Form 1065–B).
- Form 1120S filers: Schedule K, line 21 of the 2002 Form 1120S and each shareholder’s share on line 23 of Schedule K–1 (Form 1065 or 8865).

Partnerships and S corporations should advise partners and shareholders filing Form 1040 to report qualified dividends on line 9b of the 2003 Form 1040.

**EFFECT ON OTHER DOCUMENTS**


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**Charitable Remainder Trusts; Application of Ordering Rule; Hearing Cancellation**

**Announcement 2004–14**

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

**Action:** Cancellation of notice of public hearing on proposed rulemaking.

**Summary:** This document provides notice of cancellation of a public hearing on the ordering of rules of section 664(b) for characterizing distributions from charitable remainder trusts.

**Dates:** The public hearing originally scheduled for March 9, 2004, at 10 a.m., is cancelled.

**For Further Information**

Contact: Robin R. Jones of the Publications and Regulations Branch, Legal Processing Division at (202) 622–7180 (not a toll-free number).

**Supplementary Information:**

A notice of proposed rulemaking and notice of public hearing (REG–110896–98, 2003–51 I.R.B. 1226) that appeared in the Federal Register on Thursday, November 20, 2003 (68 FR 65419), announced that a public hearing was scheduled for March 9, 2004, at 10 a.m., in the auditorium. The subject of the public hearing is proposed regulations under section 664 of the Internal Revenue Code. The public comment period for these regulations expired on February 17, 2004.

The notice of proposed rulemaking and notice of public hearing, instructed those interested in testifying at the public hearing to submit an outline of the topics to be addressed. As of Wednesday, February 18, 2004, no one has requested to speak. Therefore, the public hearing scheduled for March 9, 2004, is cancelled.

Cynthia E. Grigsby, Acting Chief, Publications and Regulations Branch, Legal Processing Division, Associate Chief Counsel (Procedure and Administration).

(Filed by the Office of the Federal Register on February 25, 2004, 8:45 a.m., and published in the issue of the Federal Register for February 26, 2004, 69 FR 8885)
Definition of Terms

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

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

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

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

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

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

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

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

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

Suspected 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.
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.
EO—Executive Order.
ER—Employer.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
FR—Federal Register.
FX—Foreign corporation.
G.C.M.—Chief Counsel’s Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
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.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
X—Corporation.
Y—Corporation.
Z—Corporation.

March 8, 2004
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