Internal Revenue
bulletin

Bulletin No. 1999–9
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HIGHLIGHTS OF THIS ISSUE

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

INCOME TAX

T.D. 8807, page 33.
REG–115433–98, page 54.
Temporary and final regulations relate to timely mailing treated as timely filing and paying under section 7502 of the Code.

T.D. 8813, page 34.
Final regulations under section 7701 of the Code provide guidance regarding the definition of a trust as a United States person (domestic trust) or a foreign trust.

EMPLOYEE PLANS

REG–245562–96, page 45.
This amendment to the proposed regulations under section 401 of the Code provides guidance on the qualification of retirement plans which accept rollover contributions from employees.

EMPLOYMENT TAX

T.D. 8814, page 4.
Final regulations under section 3121(v)(2) of the Code provide guidance as to when amounts deferred under or paid from a nonqualified deferred compensation plan are taken into account as wages for purposes of the employment taxes imposed by the federal Insurance Contribution Act (FICA).

T.D. 8815, page 31.
Final regulations under section 3306(r)(2) of the Code provide guidance as to when amounts deferred under or paid from a nonqualified deferred compensation plan are taken into account as wages for purposes of the employment taxes imposed by the Federal Unemployment Tax Act (FUTA).

EXCISE TAX

REG–118620–97, page 46.
Proposed regulations under section 4251 of the Code provide rules for the application of the communications excise tax to prepaid telephone cards (PTCs). A public hearing will be held on May 5, 1999.

ADMINISTRATIVE

REG–106219–98, page 51.
Proposed regulations under section 1502 of the Code provide specific rules that apply to the acquisition of the stock of an S corporation by an affiliated group of corporations that joins in the filing of a consolidated return. A public hearing on the proposed regulations will be held on March 31, 1999.

Notice 99–12, page 44.
Electronic funds transfer; failure to deposit penalty. This notice provides guidance relating to the waiver of the failure to deposit penalty under section 6656 of the Code for certain taxpayers first required to make federal tax deposits by electronic funds transfers beginning on or after July 1, 1996.

Announcement 99–17, page 59.
The Announcement Relating to Court Decisions in 1999–4 I.R.B. 4 is corrected.

Finding Lists begin on page 61.
Index for January and February begins on page 63.

Department of the Treasury
Internal Revenue Service

Mission of the Service

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 of a permanent nature are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

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

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

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

The Bulletin is divided into four parts as follows:

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

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions, and 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.
With the exception of the Notice of Proposed Rulemaking and the disbarment and suspension list included in this part, none of these announcements are consolidated in the Cumulative Bulletins.

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

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

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

Section 3121.—Definitions

26 CFR 31.3121(v)(20–1: Treatment of amounts deferred under certain nonqualified deferred compensation plans.

T.D. 8814

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 31 and 602

Federal Insurance Contributions Act (FICA) Taxation of Amounts Under Employee Benefit Plans

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations under section 3121(v)(2) of the Internal Revenue Code (Code) that provide guidance as to when amounts deferred under or paid from a nonqualified deferred compensation plan are taken into account as wages for purposes of the employment taxes imposed by the Federal Insurance Contributions Act (FICA). Section 3121(v)(2), relating to treatment of certain nonqualified deferred compensation, was added to the Code by section 324 of the Social Security Amendments of 1983. These regulations provide guidance to employers who maintain nonqualified deferred compensation plans and to participants in those plans.

DATES: *Effective Date:* These regulations are effective January 29, 1999.

Applicability Date: These regulations are applicable on and after January 1, 2000. In addition, these regulations provide certain transition rules for amounts deferred and benefits paid before January 1, 2000, including allowing employers to use a reasonable, good faith interpretation of section 3121(v)(2).

FOR FURTHER INFORMATION CONTACT: Janine Cook, Linda E. Alsalihi, or Margaret A. Owens, (202) 622-6040 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this final rule has been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget (OMB) under 44 U.S.C. 3507 and assigned control number 1545–1643.

The collection of information in this regulation is in §31.3121(v)(2)–1(b)(2). This information is required to implement Code section 3121(v). This information will be used to identify the material terms of a plan. The collection of information is required to obtain a benefit. The likely recordkeepers are business or other for-profit institutions.

Comments on the collection of information should be sent to the **Office of Management and Budget,** Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service** Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224. Comments on the collection of information should be received by March 30, 1999. Comments are specifically requested concerning:

Whether the collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the collection of information (see below);

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

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

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

The estimated total annual recordkeeping burden for §31.3121(v)(2)–1(b)(2) is 12,500 hours. The annual estimated burden per recordkeeper varies from 2 hours to 10 hours, depending on the individual circumstances, with an estimated average of 5 hours. The estimated number of recordkeepers is 2,500.

Estimates of the reporting burden in §31.3121(v)(2)–1(f) and (g) are reflected in the burden estimates of Form 941, Employer's Quarterly Federal Tax Return, Form 941c, Supporting Statement To Correct Information, Form W-2, Wage and Tax Statement, and Form W-2c, Corrected Wage and Tax Statement.

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

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

Background

These regulations amend the Employment Tax Regulations (26 CFR part 31) under section 3121(v)(2). Section 3121(v)(2) was added to the Internal Revenue Code (Code) by section 324 of the Social Security Amendments of 1983 (1983 Amendments). Section 2662(f)(2) of the Deficit Reduction Act of 1984 (DEFRA) amended section 324 of the 1983 Amendments.

Notice 94–96 (1994–2 C.B. 564) provides that until final regulations are issued, the IRS will not challenge an employer's determination of FICA tax liability with respect to a nonqualified deferred compensation plan for periods before the effective date of any final regulations if the determination is based on a reasonable, good faith interpretation of section 3121(v)(2). On January 25, 1996, a notice of proposed rulemaking (EE–142–87) under section 3121(v)(2) was published in the **Federal Register** (61 F.R. 2194), providing guidance related to the Federal Insurance Contributions Act

(FICA) tax treatment of amounts deferred under or paid from certain nonqualified deferred compensation plans. On December 24, 1997, a notice of proposed rulemaking (REG–209484–87 and REG–209807–95) under section 3121(v)(2) extending the proposed general effective date of the regulations to January 1, 1998, was published in the **Federal Register** (62 F.R. 67304).

Comments regarding the 1996 proposed regulations were received from the public, and on June 24, 1996, the IRS held a public hearing concerning the proposed amendments. After consideration of the public comments received and the statements made at the public hearing, the proposed regulations are adopted as revised by this Treasury decision.

Explanation of Provisions

Sections 3101 and 3111 impose FICA tax on employees and employers, respectively. FICA tax consists of the Old-Age, Survivors, and Disability Insurance (OASDI) tax and the Hospital Insurance (HI) tax. Generally, FICA tax is computed as a percentage of wages (as defined in section 3121(a)) with respect to employment. Subject to specific exceptions, section 3121(a) defines wages as all remuneration for employment. Section 31.3121(a)–2(a) provides that FICA tax is imposed at the time the remuneration is actually or constructively paid.

1983 Amendments

Prior to the 1983 Amendments, benefits under a nonqualified deferred compensation plan generally were wages subject to FICA tax at the time they were actually or constructively paid, unless certain retirement-related exclusions applied. These exclusions (former section 3121(a)(2)(A), (a)(3), and (a)(13)(A)(iii)) were repealed by the 1983 Amendments. Thus, under the 1983 Amendments, which generally apply to remuneration paid after December 31, 1983, retirement payments are no longer excluded from wages. Instead, the 1983 Amendments added section 3121(v)(2), which provides a special timing rule for wages (within the meaning of section 3121(a)) that constitute an amount deferred under a nonqualified deferred compensation plan.[1]

Under section 3121(v)(2)(A), any amount deferred under a nonqualified deferred compensation plan must be taken into account as wages for FICA tax purposes as of the later of (1) when the services are performed or (2) when there is no substantial risk of forfeiture of the rights to such amount. This special timing rule may result in imposition of FICA tax before the benefit payments under the plan begin.

Section 3121(v)(2)(B) provides a special exclusion (the nonduplication rule) that prevents double taxation. Once an amount deferred under a nonqualified deferred compensation plan is taken into account as wages under the special timing rule, the nonduplication rule provides that neither that amount nor the income attributable to that amount is again treated as FICA wages. Thus, benefit payments under a nonqualified deferred compensation plan are not subject to FICA tax when actually or constructively paid (i.e., under the general timing rule for wage inclusion) if the benefit payments consist of amounts deferred under the plan that were previously taken into account as FICA wages under the special timing rule plus attributable income. Conversely, benefits under a nonqualified deferred compensation plan are subject to FICA tax when actually or constructively paid to the extent the benefits relate to an amount deferred that was not previously taken into account under the special timing rule.

Repeal of Wage Based Limitation

Section 3121(a)(1) imposes a dollar limit on the annual amount of wages subject to the OASDI portion of FICA tax. Section 13207 of the Omnibus Budget Reconciliation Act of 1993 repealed the dollar limit on the annual amount of wages subject to the HI portion of FICA tax, effective for 1994 and later years.

Application of these Regulations to Taxes Imposed by the Railroad Retirement Tax Act

In accordance with the cross-reference in section 3231(e)(8)(B), the provisions of section 3121(v)(2) and these final regulations also apply for purposes of the taxes imposed by the Railroad Retirement Tax Act under sections 3201 through 3231.

Overview of Final Regulations

In general, comments received on the proposed regulations were favorable and, accordingly, the final regulations retain the general structure and substance of the proposed regulations, including a wide variety of examples illustrating the substance of the final regulations. However, commentators made a number of specific recommendations for modifications and clarifications of the regulations. In response to these comments, the final regulations incorporate the modifications and clarifications described below.

- The proposed regulations provided that certain types of benefits do not result from the deferral of compensation and, accordingly, are not subject to the special timing rule under section 3121(v)(2). The final regulations generally retain these rules. However, in response to comments, the final regulations allow certain cost-of-living adjustments provided to former employees to be treated as deferred compensation for purposes of section 3121(v)(2) and provide transition relief for window programs that begin before the effective date of the final regulations. The final regulations also clarify the rules under which stock options, death benefits, disability benefits, and severance pay are excluded from the special timing rule.
- The final regulations retain the distinction between the method of calculating the amount deferred (and the income on that amount) for account balance plans and the method for nonaccount balance plans, but provide additional guidance simplifying those calculations. The final regulations provide that a plan that

[1] 1 The 1983 Amendments did not amend the definition of net earnings from self- employment under section 1402(a) or the timing of the tax on self-employment income under section 1401. Accordingly, the special timing rule under section 3121(v)(2) does not apply to nonqualified deferred compensation that constitutes net earnings from self-employment.

bases benefits on an account balance but permits optional forms (such as annuities) can use the simple methodology that applies to account balance plans if the plan terms preclude a subsidized optional form. Also, a nonaccount balance plan that provides multiple benefit distribution options or commencement dates under plan terms that preclude subsidized optional forms and commencement dates can determine the amount deferred by assuming that a participant elects to receive the normal form of payment (regardless of which option is actually elected).

- The final regulations clarify the rules governing when income under an account balance plan is excluded from FICA wages. The final regulations also provide that, while the determination of whether an account balance plan is using a reasonable interest rate generally is made annually, a rate that is specified for a fixed period of up to five years is treated as reasonable for that period if it was reasonable when it was specified (even if it ceases to be reasonable during the period for which it is specified).
- The final regulations retain the structure of the rules in the proposed regulations under which FICA tax payments are not required to be made on amounts that are not reasonably ascertainable until certain uncertainties related to benefit payments are resolved. Those rules permit earlier inclusion with a true-up at the resolution date, when those uncertainties are resolved. However, the final regulations modify the calculation of the true-up to eliminate the risk that additional amounts will have to be taken into account at the resolution date because of changes in interest rates between the early inclusion date and the resolution date.
- The final regulations permit an employer to choose how the amounts deferred under a plan over a series of years can be allocated among those years when the plan formula does not do so by its terms (for example, where the plan has a benefit formula that includes an offset of another plan's benefit).
- The final regulations retain the flexibility provided in the proposed regulations permitting an employer to delay the date on which amounts deferred are taken into account to a later date within the year, and also broaden and simplify two options that provide additional time to calculate the amount deferred. The first option permits an employer to estimate the amount deferred and then adjust it at any time within three months. Alternatively, FICA tax payment can be postponed by treating the entire amount deferred as if it were deferred on a date that is within three months of the date the amount is otherwise required to be taken into account, provided that the amount deferred is increased by interest at the applicable federal rate[2] (AFR) until it is included in wages.
- The final regulations include a number of special transition rules that provide relief to employers that, prior to the effective date of the regulations, followed a reasonable, good faith interpretation of section 3121(v)(2). Under the final regulations, amounts deferred for 1994 and 1995 can be taken into account, without interest, as late as March 31, 2000. Further, the final regulations reflect the transition rule in the proposed regulations under which amounts deferred that would have been required or permitted to be taken into account before 1994 are treated as having been correctly taken into account before 1994.

Summary of Comments Received and Changes Made

a. Application of the Special Timing Rule

The special timing rule provided under section 3121(v)(2) is set forth in paragraph (a) of the regulations. The special timing rule imposes FICA tax on amounts deferred under nonqualified deferred compensation plans at the later of the date when the services creating the right to the amount deferred are performed and the date on which the right to that amount is no longer subject to a substantial risk of forfeiture. This date usually is earlier than when any benefit is paid. Several commentators requested clarification as to whether the special timing rule is elective and whether failure to comply with the special timing rule may lead to the imposition of interest or penalties. The special timing rule is not elective and, if an employer does not take an amount deferred into account (including payment of any resulting FICA tax) when required by section 3121(v)(2), interest and penalties may be imposed. Moreover, to the extent that the amount deferred is not taken into account in accordance with the special timing rule, the nonduplication rule, under which amounts deferred that are properly taken into account under the special timing rule are excluded from FICA wages upon payment, does not apply.

b. Amounts or Benefits that Do Not Result from the Deferral of Compensation

The definition of a nonqualified deferred compensation plan for purposes of section 3121(v)(2) is set forth in paragraph (b) of the regulations. A number of comments were received on the rules in the proposed regulations for determining whether an amount or benefit results from the deferral of compensation subject to the special timing rule of section 3121(v)(2). The final regulations make several clarifications and changes to reflect these comments. The regulations clarify that the grant (as well as the exercise) of stock options, stock appreciation rights, and other stock value rights generally is not subject to section 3121(v)(2). Thus, FICA tax is not imposed at the time of grant, but is generally imposed at the time of exercise. No inference is intended as to whether or not these options and rights are deferred compensation for any tax purposes other than section 3121(v)(2).

The final regulations retain the rule in the proposed regulations that benefits established after termination of employment are not subject to section 3121(v)(2). However, in response to comments, the final regulations provide an exception under which certain payments to which the employee obtains a legally binding right after termination of employment that are in the nature of cost-of-living adjustments are nonetheless subject to section 3121(v)(2).

The final regulations retain the rule in the proposed regulations that window

[2] The regulations define the applicable federal rate as the mid-term applicable federal rate, as defined pursuant to section 1274(d), for January 1 of the calendar year, compounded annually.

benefits do not result from the deferral of compensation. However, the final regulations include a transition rule under which window benefits can be treated as subject to section 3121(v)(2) if the window program commences prior to January 1, 2000 (the general effective date of the final regulations). Payments made pursuant to a window program that qualifies for the transition rule are not subject to FICA tax under the general timing rule at the time payment is made, provided that the present value of the window benefits has been taken into account under section 3121(v)(2) on a timely basis.

c. Account Balance Plans

Paragraph (c) of the regulations defines account balance plan and provides that, for purposes of section 3121(v)(2), the amount deferred under an account balance plan generally is based on the amount of principal credited to the account. Commentators asked whether a plan that permits optional forms of benefit can be treated as an account balance plan. The final regulations provide that if the plan's terms preclude subsidies of optional forms of benefit (for example, if, under the terms of the plan at the time the amount is deferred, alternative forms of payment will be actuarially equivalent to the account balance based on a rate of interest that will be reasonable at the time the optional form is elected), the plan does not fail to be an account balance plan merely because of the availability of optional forms of benefit.

d. Income and Reasonable Rate of Interest

Under paragraph (d) of the proposed regulations, if an account balance plan credits income based on a reasonable rate of interest or a rate of return that does not exceed the rate of return on a predetermined actual investment specified under the plan, FICA tax would not be imposed on that income. A number of commentators requested clarification as to whether a rate of interest that was fixed for an extended period could be reasonable for this purpose. The final regulations clarify that the determination of whether interest credited under an account balance plan is reasonable is generally made annually. However, a rate that is specified for a fixed period of up to five years and that was reasonable when it was specified is treated as continuing to be reasonable (even if it subsequently ceases to be reasonable during the period for which it is specified).

The final regulations also clarify what constitutes a predetermined actual investment and provide rules for determining the amount deferred in cases in which income is credited under a plan that uses neither a predetermined actual investment nor a reasonable interest rate. In these cases, the final regulations generally provide for the income credited in excess of AFR to be treated as an additional amount deferred. However, the final regulations provide that if the employer takes into account as an additional amount deferred the income credited to the extent it exceeds a reasonable rate of interest calculated by the employer, the remaining income (which is no greater than a reasonable rate of interest) is excluded from FICA wages.

Some commentators suggested that the employer's creditworthiness should be permitted to be considered in determining whether the interest rate credited under a plan of the employer is reasonable. The final regulations, like the proposed regulations, permit the amount deferred to be calculated after application of a discount to reflect the time value of money and the risk that benefits will not be paid due to death. However, no discount is permitted for the risk that the amount deferred will not be paid by the employer. Permitting employers to implicitly achieve the same result through the interest rate credited under an account balance plan would be inconsistent with this restriction. Accordingly, the final regulations do not permit the employer's creditworthiness to be considered in determining whether the interest rate credited under a plan of the employer is reasonable.

e. Treatment of Amounts Deferred that are not Reasonably Ascertainable

Paragraph (e) of the final regulations retains the rule in the proposed regulations that the amount deferred need not be taken into account until it is reasonably ascertainable. This rule addresses the difficulty of determining the appropriate amount to be taken into account for a plan that provides benefits that are not fixed until certain future events occur, such as a nonaccount balance plan with subsidized optional forms or a long-term incentive plan that depends on subsequent corporate performance. The final regulations retain the rule in the proposed regulations that allows optional inclusion of these amounts at an earlier date with a true-up at the resolution date when the amount deferred becomes reasonably ascertainable.

Under the proposed regulations, the early inclusion amount was to be accumulated to the resolution date at an interest rate (and with a mortality assumption, if appropriate) that was reasonable at the early inclusion date. That accumulated amount was then compared to the present value of payments using actuarial assumptions that were reasonable at the resolution date. This methodology exposes the employer to the risk that an additional amount could be required to be taken into account at the resolution date solely as a result of changes in interest rates between the early inclusion date and the resolution date. In response to comments, this true-up methodology has been modified.

Under the final regulations, in performing the true-up, the amount taken into account at the early inclusion date is converted to an actuarially equivalent benefit payment stream in the form, and with the commencement date, in which benefits are actually paid. The conversion is done using actuarial assumptions that were reasonable as of the early inclusion date. The benefit payment stream thus derived is compared to the benefits actually payable. To the extent the benefit payment stream actually payable exceeds the benefit payment stream that is actuarially equivalent to the amount taken into account at the early inclusion date, the present value of the excess (determined using actuarial assumptions that are reasonable as of the resolution date) must be taken into account on the resolution date. If the benefit payment stream that is actuarially equivalent to the amount taken into account at the early inclusion date equals (or exceeds) the actual benefit payment stream, no additional amount is required to be taken into account at the resolution date, regardless of any changes in interest rates between the early inclusion date and the resolution date. This method—an annuity purchase model—eliminates the risk that the employer will be required to take additional amounts into account merely because of interest rate changes between the early inclusion date and the resolution date.

In addition, the final regulations provide that an amount deferred under certain nonaccount balance plans that permit optional forms of benefit or alternative commencement dates will not fail to be reasonably ascertainable merely because the form or commencement date has not been selected. If the terms of a nonaccount balance plan, at the time an amount is deferred, provide that the amount payable under each optional form and commencement date will be equivalent using actuarial assumptions that are reasonable at the resolution date (generally, the time the optional form and commencement date are selected) the amount deferred can be calculated based solely on the normal form of payment commencing at normal commencement date (regardless of which optional form or commencement date is ultimately selected). For this purpose, the normal form of benefit commencing at normal commencement date is the form and date of commencement under which the payments due to an employee under the plan are expressed, before adjustments for form or timing of commencement of payments.

The final regulations clarify how to allocate amounts deferred among periods for purposes of the early inclusion rules, including a rule requested by commentators concerning plan offsets. For example, the final regulations provide a rule to determine how amounts deferred are to be allocated among years in cases in which an employee obtains a legally binding right in each of several years to receive payments from a nonqualified deferred compensation plan that provides a specified gross benefit for the years which is to be offset by the benefits payable under a qualified plan. Under this rule, the amount deferred in the first year may be treated as equal to the gross benefit for the year, reduced by the offset applicable at the end of the first year (even if the offset increases after the end of that year). The same method applies to subsequent years, with adjustments for amounts allocated to an earlier year.

The regulations also retain the rule of administrative convenience that was in the proposed regulations under which the amount deferred during a year can be treated as required to be taken into account at any later date during the year, provided that income attributable to the amount deferred through that date is included. Thus, in a nonaccount balance plan this rule permits the present value of amounts deferred throughout a year to be determined as of the end of the year based on the employee's age and appropriate actuarial assumptions at the end of the year.

f. Withholding Rules

For purposes of withholding and depositing FICA tax, paragraph (f) of the final regulations provides that an amount deferred under a nonqualified deferred compensation plan generally is treated as wages paid by the employer and received by the employee at the time it is taken into account under section 3121(v)(2) and these regulations. However, in certain situations, the employer may be unable to readily calculate the amount deferred for a given year by December 31 of that year. The proposed regulations provided relief in these situations by allowing employers to use either of two alternative methods, the estimated method and the lag method, for withholding and depositing FICA tax.

The final regulations provide broader relief by permitting these methods to be used as of any date during the year and for the methods to be available without regard to whether the amount deferred can be readily calculated. Thus, the final regulations provide that, under the estimated method, an employer may make a reasonable estimate of the amount deferred as of the date the amount deferred is required to be taken into account. If the employer underestimates the amount deferred that should have been taken into account and, therefore, deposits less FICA tax than the amount due, the employer may treat the shortfall as wages either on the estimate date or on any date that is within three months thereafter. If the employer overestimates the amount deferred that should have been taken into account as wages on the estimate date, the employer may claim a refund or credit in accordance with sections 6402, 6413, and 6511. If the employer treats any shortfall as wages on the estimate date or overestimates the amount deferred on the estimate date, the employer must correct any previously-reported wage information.

Further, the final regulations provide that, under the second alternative method, the lag method, an employer may treat the amount deferred on any date as wages paid on any date that is no later than three months following the date the amount deferred is required to be taken into account. In addition, in response to comments, the final regulations simplify use of the lag method by permitting the FICA tax due to be calculated using a fixed rate of interest, not less than AFR, rather than on the basis of income under the plan.

Effective Dates

These final regulations are applicable on and after January 1, 2000. However, the final regulations include certain special transition provisions for periods before January 1, 2000.

For amounts deferred and benefits paid before the January 1, 2000 general effective date, an employer may rely on a reasonable, good faith interpretation of section 3121(v)(2), taking into account Notice 94–96. The final regulations specifically provide that an employer will be deemed to have determined FICA tax liability and satisfied FICA tax withholding requirements in accordance with a reasonable, good faith interpretation of section 3121(v)(2) if that liability is determined in accordance with the final regulations and the withholding method and timing comply with the final regulations. An employer will also be deemed to have determined FICA tax liability and satisfied FICA tax withholding requirements in accordance with a reasonable, good faith interpretation of section 3121(v)(2) if that liability is determined in accordance with the proposed regulations and the withholding method and timing comply with the proposed regulations. Whether an employer has made a reasonable, good faith interpretation of section 3121(v)(2) will be determined based on the relevant facts and circumstances, including consistency of treatment by the employer and the extent to which the employer has resolved unclear issues in its favor.

The regulations address consistency in the treatment of stock options, stock appreciation rights, or other stock value rights that are exercised before the January 1, 2000 general effective date. Under the final regulations, the grant of these options and rights cannot be treated as subject to section 3121(v)(2) after December 31, 1999, and FICA tax generally applies at exercise. For periods before January 1, 2000, an employer that treats the grant of such an option or right as subject to section 3121(v)(2) has not acted in accordance with a reasonable, good faith interpretation of section 3121(v)(2) if the employer has not treated that grant and all earlier grants as subject to section 3121(v)(2).

The final regulations include a transition rule for periods[3] before 1994 that applies if the employer acted in accordance with a reasonable, good faith interpretation of section 3121(v)(2). Under this rule, an amount deferred that would be required or permitted to be taken into account in any period that ends prior to January 1, 1994, under the final regulations, is treated as if it had been taken into account in accordance with the final regulations.[4] For example, in the case of an amount deferred before 1994 that was not reasonably ascertainable, the employer is treated as having taken the amount deferred into account at an early inclusion date before 1994 using a method permitted in the final regulations, including anticipation of the actual form in which the benefit payments attributable to the amount deferred are paid and the actual date of commencement. Thus, the employer is not required to pay any additional FICA tax when the amount deferred becomes reasonably ascertainable or when the benefit payments attributable to the amount deferred are actually or constructively paid.

[3] For purposes of FICA tax, the period of limitations is generally based on calendar quarters (whereas, for purposes of the Federal Unemployment Tax Act (FUTA) tax, the period of limitations is based on calendar years). See section 6501.

[4] The proposed regulations (as amended in 1997) included a similar rule applicable to periods that were closed as of January 1, 1998 (which generally would have been periods before 1994). Commentators recommended that this rule apply even if the period is kept open beyond the normal period of limitations, such as by agreement with the IRS or by a claim for refund. In response to those comments, the final regulations provide that this rule applies to all periods prior to 1994 regardless of whether the period remains

The final regulations include a new transition rule for amounts deferred that were required to be taken into account in 1994 or 1995. Under the final regulations, an employer will be treated as taking the amount deferred into account under the final regulations to the extent the employer takes the amount into account by treating it as wages paid by the employer and received by the employee as of any date prior to April 1, 2000. The amount taken into account before April 1, 2000, is not required to be increased by attributable income or interest.

These and the other transition provisions of the final regulations are in addition to the interest-free adjustment procedures that are available under section 6205 at any time before the period of limitations has expired. Thus, for example, with respect to a FICA tax return (Form 941) for a period before the effective date, an employer may make an adjustment to take an amount deferred under a nonqualified deferred compensation plan into account in accordance with the final regulations if the period is still open.

Section 31.3121(v)(2)–2 of the final regulations provides special rules relating to a March 24, 1983 agreement and certain agreements adopted after March 24, 1983, and before January 1, 1984. The final regulations also include certain clarifications to the transition rules that have been made in response to comments on the proposed regulations, including clarification of the effect of post-1983 amendments.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the notice of proposed rulemaking was issued prior to March 29, 1996, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal authors of these regulations are Janine Cook, Linda E. Alsalihi, and Margaret A. Owens, Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 31 and 602 are amended as follows:

PART 31—EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT SOURCE

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

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

Par. 2. Sections 31.3121(v)(2)–1 and 31.3121(v)(2)–2 are added to read as follows:

§31.3121(v)(2)–1 Treatment of amounts deferred under certain nonqualified deferred compensation plans.

(a) *Timing of wage inclusion*—(1) *General timing rule for wages.* Remuneration for employment that constitutes wages within the meaning of section 3121(a) generally is taken into account for purposes of the Federal Insurance Contributions Act (FICA) taxes imposed under sections 3101 and 3111 at the time the remuneration is actually or constructively paid. See §31.3121(a)–2(a).

(2) *Special timing rule for an amount deferred under a nonqualified deferred compensation plan*—(i) *In general.* To the extent that remuneration deferred under a nonqualified deferred compensation plan constitutes wages within the meaning of section 3121(a), the remuneration is subject to the special timing rule described in this paragraph (a)(2). Remuneration is considered deferred under a nonqualified deferred compensation plan within the meaning of section 3121(v)(2) and this section only if it is provided pursuant to a plan described in paragraph (b) of this section. The amount deferred under a nonqualified deferred compensa-

tion plan is determined under paragraph (c) of this section.

(ii) *Special timing rule.* Except as otherwise provided in this section, an amount deferred under a nonqualified deferred compensation plan is required to be taken into account as wages for FICA tax purposes as of the later of—

(A) The date on which the services creating the right to that amount are performed (within the meaning of paragraph (e)(2) of this section); or

(B) The date on which the right to that amount is no longer subject to a substantial risk of forfeiture (within the meaning of paragraph (e)(3) of this section).

(iii) *Inclusion in wages only once (nonduplication rule).* Once an amount deferred under a nonqualified deferred compensation plan is taken into account (within the meaning of paragraph (d)(1) of this section), then neither the amount taken into account nor the income attributable to the amount taken into account (within the meaning of paragraph (d)(2) of this section) is treated as wages for FICA tax purposes at any time thereafter.

(iv) *Benefits that do not result from a deferral of compensation.* If a nonqualified deferred compensation plan (within the meaning of paragraph (b)(1) of this section) provides both a benefit that results from the deferral of compensation (within the meaning of paragraph (b)(3) of this section) and a benefit that does not result from the deferral of compensation, the benefit that does not result from the deferral of compensation is not subject to the special timing rule described in this paragraph (a)(2). For example, if a nonqualified deferred compensation plan provides retirement benefits which result from the deferral of compensation and disability pay (within the meaning of paragraph (b)(4)(iv)(C) of this section) which does not result from the deferral of compensation, the retirement benefits provided under the plan are subject to the special timing rule in this paragraph (a)(2) and the disability pay is not.

(v) *Remuneration that does not constitute wages.* If remuneration under a nonqualified deferred compensation plan does not constitute wages within the meaning of section 3121(a), then that remuneration is not taken into account as wages for FICA tax purposes under either the general timing rule described in paragraph (a)(1) of this section or the special timing rule described in this paragraph (a)(2). For example, benefits under a death benefit plan described in section 3121(a)(13) do not constitute wages for FICA tax purposes. Therefore, these benefits are not included as wages under the general timing rule described in paragraph (a)(1) of this section or the special timing rule described in this paragraph (a)(2), even if the death benefit plan would otherwise be considered a nonqualified deferred compensation plan within the meaning of paragraph (b)(1) of this section.

(b) *Nonqualified deferred compensation plan*—(1) *In general.* For purposes of this section, the term *nonqualified deferred compensation plan* means any plan or other arrangement, other than a plan described in section 3121(a)(5), that is established (within the meaning of paragraph (b)(2) of this section) by an employer for one or more of its employees, and that provides for the deferral of compensation (within the meaning of paragraph (b)(3) of this section). A nonqualified deferred compensation plan may be adopted unilaterally by the employer or may be negotiated among or agreed to by the employer and one or more employees or employee representatives. A plan may constitute a nonqualified deferred compensation plan under this section without regard to whether the deferrals under the plan are made pursuant to an election by the employee or whether the amounts deferred are treated as deferred compensation for income tax purposes (e.g., whether the amounts are subject to the deduction rules of section 404). In addition, a plan may constitute a nonqualified deferred compensation plan under this section whether or not it is an employee benefit plan under section 3(3) of the Employee Retirement Income Security Act of 1974 (ERISA), as amended (29 U.S.C. 1002(3)). For purposes of this section, except where the context indicates otherwise, the term plan includes a plan or other arrangement.

(2) *Plan establishment*—(i) *Date plan is established.* For purposes of this section, a plan is established on the latest of the date on which it is adopted, the date on which it is effective, and the date on which the material terms of the plan are set forth in writing. For purposes of this section, a plan will be deemed to be set forth in writing if it is set forth in any other form that is approved by the Commissioner. The material terms of the plan include the amount (or the method or formula for determining the amount) of deferred compensation to be provided under the plan and the time when it may or will be provided.

(ii) *Plan amendments.* In the case of an amendment that increases the amount deferred under a nonqualified deferred compensation plan, the plan is not considered established with respect to the additional amount deferred until the plan, as amended, is established in accordance with paragraph (b)(2)(i) of this section.

(iii) *Transition rule for written plan requirement.* For purposes of this section, an unwritten plan that was adopted and effective before March 25, 1996, is treated as established under this section as of the later of the date on which it was adopted or became effective, provided that the material terms of the plan are set forth in writing before January 1, 2000.

(3) *Plan must provide for the deferral of compensation*—(i) *Deferral of compensation defined.* A plan provides for the *deferral of compensation* with respect to an employee only if, under the terms of the plan and the relevant facts and circumstances, the employee has a legally binding right during a calendar year to compensation that has not been actually or constructively received and that, pursuant to the terms of the plan, is payable to (or on behalf of) the employee in a later year. An employee does not have a legally binding right to compensation if that compensation may be unilaterally reduced or eliminated by the employer after the services creating the right to the compensation have been performed. For this purpose, compensation is not considered subject to unilateral reduction or elimination merely because it may be reduced or eliminated by operation of the objective terms of the plan, such as the application of an objective provision creating a substantial risk of forfeiture (within the meaning of section 83). Similarly, an employee does not fail to have a legally binding right to compensation merely because the amount of compensation is de-

termined under a formula that provides for benefits to be offset by benefits provided under a plan that is qualified under section 401(a), or because benefits are reduced due to investment losses or, in a final average pay plan, subsequent decreases in compensation.

(ii) *Compensation payable pursuant to the employer's customary payment timing arrangement.* There is no deferral of compensation (within the meaning of this paragraph (b)(3)) merely because compensation is paid after the last day of a calendar year pursuant to the timing arrangement under which the employer ordinarily compensates employees for services performed during a payroll period described in section 3401(b).

(iii) *Short-term deferrals.* If, under a nonqualified deferred compensation plan, there is a deferral of compensation (within the meaning of this paragraph (b)(3)) that causes an amount to be deferred from a calendar year to a date that is not more than a brief period of time after the end of that calendar year, then, at the employer's option, that amount may be treated as if it were not subject to the special timing rule described in paragraph (a)(2) of this section. An employer may apply this option only if the employer does so for all employees covered by the plan and all substantially similar nonqualified deferred compensation plans. For purposes of this paragraph (b)(3)(iii), whether compensation is deferred to a date that is not more than a brief period of time after the end of a calendar year is determined in accordance with §1.404(b)-1T, Q&A-2, of this chapter.

(4) *Plans, arrangements, and benefits that do not provide for the deferral of compensation*—(i) *In general.* Notwithstanding paragraph (b)(3)(i) of this section, an amount or benefit described in any of paragraphs (b)(4)(ii) through (viii) of this section is not treated as resulting from the deferral of compensation for purposes of section 3121(v)(2) and this section and, thus, is not subject to the special timing rule of paragraph (a)(2) of this section.

(ii) *Stock options, stock appreciation rights, and other stock value rights.* The grant of a stock option, stock appreciation right, or other stock value right does not constitute the deferral of compensation for purposes of section 3121(v)(2). In addition, amounts received as a result of the exercise of a stock option, stock appreciation right, or other stock value right do not result from the deferral of compensation for purposes of section 3121(v)(2) if such amounts are actually or constructively received in the calendar year of the exercise. For purposes of this paragraph (b)(4)(ii), a stock value right is a right granted to an employee with respect to one or more shares of employer stock that, to the extent exercised, entitles the employee to a payment for each share of stock equal to the excess, or a percentage of the excess, of the value of a share of the employer's stock on the date of exercise over a specified price (greater than zero). Thus, for example, the term stock value right does not include a phantom stock or other arrangement under which an employee is awarded the right to receive a fixed payment equal to the value of a specified number of shares of employer stock.

(iii) *Restricted property.* If an employee receives property from, or pursuant to, a plan maintained by an employer, there is no deferral of compensation (within the meaning of section 3121(v)(2)) merely because the value of the property is not includible in income (under section 83) in the year of receipt by reason of the property being nontransferable and subject to a substantial risk of forfeiture. However, a plan under which an employee obtains a legally binding right to receive property (whether or not the property is restricted property) in a future year may provide for the deferral of compensation within the meaning of paragraph (b)(3) of this section and, accordingly, may constitute a nonqualified deferred compensation plan, even though benefits under the plan are or may be paid in the form of property.

(iv) *Certain welfare benefits*—(A) *In general.* Vacation benefits, sick leave, compensatory time, disability pay, severance pay, and death benefits do not result from the deferral of compensation for purposes of section 3121(v)(2), even if those benefits constitute wages within the meaning of section 3121(a).

(B) *Severance pay.* Benefits that are provided under a severance pay arrangement (within the meaning of section 3(2)(B)(i) of ERISA) that satisfies the conditions in 29 CFR 2510.3–2(b)(1)(i) through (iii) are considered severance pay for purposes of this paragraph (b)(4)(iv). If benefits are provided under a severance pay arrangement (within the meaning of section 3(2)(B)(i) of ERISA), but do not satisfy one or more of the conditions in 29 CFR 2510.3–2(b)(1)(i) through (iii), then whether those benefits are severance pay within the meaning of this paragraph (b)(4)(iv) depends upon the relevant facts and circumstances. For this purpose, relevant facts and circumstances include whether the benefits are provided over a short period of time commencing immediately after (or shortly after) termination of employment or for a substantial period of time following termination of employment and whether the benefits are provided after any termination or only after retirement (or another specified type of termination). Benefits provided under a severance pay arrangement (within the meaning of section 3(2)(B)(i) of ERISA) are in all cases severance pay within the meaning of this paragraph (b)(4)(iv) if the benefits payable under the plan upon an employee's termination of employment are payable only if that termination is involuntary.

(C) *Death benefits and disability pay*—(*1*) *General definition.* Payments made under a nonqualified deferred compensation plan in the event of death are death benefits within the meaning of this paragraph (b)(4)(iv), but only to the extent the total benefits payable under the plan exceed the lifetime benefits payable under the plan. Similarly, payments made under a nonqualified deferred compensation plan in the event of disability are disability pay within the meaning of this paragraph (b)(4)(iv), but only to the extent the disability benefits payable under the plan exceed the lifetime benefits payable under the plan. Accordingly, any benefits that a nonqualified deferred compensation plan provides in the event of death or disability that are associated with an amount deferred under this section are disregarded in applying this section to the extent the benefits payable under the plan in the event of death or in the event of disability have a value in excess of the lifetime benefits payable under the plan.

(*2*) *Total benefits payable defined.* For purposes of paragraph (b)(4)(iv)(C)(1) of this section, the term total benefits payable under a plan means the present value of the *total benefits payable* to or on behalf of the employee (including benefits payable in the event of the employee's death) under the plan, disregarding any benefits that are payable only in the event of disability and determined separately with respect to each form of distribution or other election that may apply with respect to the employee.

(*3*) *Disability benefits payable defined.* For purposes of paragraph (b)(4)(iv)-(C)(*1*) of this section, the term *disability benefits payable* under a plan means the present value of the benefits payable to or on behalf of the employee under the plan, including benefits payable in the event of the employee's disability but excluding death benefits within the meaning of this paragraph (b)(4)(iv).

(*4*) *Lifetime benefits payable defined.* For purposes of paragraph (b)(4)(iv)-(C)(*1*) of this section, the term *lifetime benefits payable* under a plan means the present value of the benefits that could be payable to the employee under the plan during the employee's lifetime, determined under the plan's optional form of distribution or other election that is or was available to the employee at any time with respect to the amount deferred and that provides the largest present value to the employee during the employee's lifetime of any such form or election so available.

(5) *Rules of application.* For purposes of determining present value under this paragraph (b)(4)(iv)(C), present value is determined as of the time immediately preceding the time the amount deferred under a nonqualified deferred compensation plan is required to be taken into account under paragraph (e) of this section, using actuarial assumptions that are reasonable as of that date but taking into consideration only benefits that result from the deferral of compensation, as determined under this paragraph (b), and benefits payable in the event of death or disability. In addition, for purposes of paragraph (b)(4)(iv)(C)(*4*) of this section, present value must be determined without any discount for the probability that the employee may die before benefit payments commence and without regard to any benefits payable solely in the event of disability.

(v) *Certain benefits provided in connection with impending termination*—(A) *In general.* Benefits provided in connection with impending termination of employment under paragraph (b)(4)(v)(B) or (C) of this section do not result from the deferral of compensation within the meaning of section 3121(v)(2).

(B) *Window benefits*—(*1*) *In general.* For purposes of this paragraph (b)(4)(v), except as provided in paragraph (b)(4)(v)(B)(3) of this section, a window benefit is provided in connection with impending termination of employment. For this purpose, a window benefit is an early retirement benefit, retirement-type subsidy, social security supplement, or other form of benefit made available by an employer for a limited period of time (no greater than one year) to employees who terminate employment during that period or to employees who terminate employment during that period under specified circumstances.

(2) *Special rule for recurring window benefits.* A benefit will not be considered a window benefit if an employer establishes a pattern of repeatedly providing for similar benefits in similar situations for substantially consecutive, limited periods of time. Whether the recurrence of these benefits constitutes a pattern of amendments is determined based on the facts and circumstances. Although no one factor is determinative, relevant factors include whether the benefits are on account of a specific business event or condition, the degree to which the benefits relate to the event or condition, and whether the event or condition is temporary or discrete or is a permanent aspect of the employer's business.

(3) *Transition rule for window benefits.* In the case of a window benefit that is made available for a period of time that begins before January 1, 2000, an employer may choose to treat the window benefit as a benefit that results from the deferral of compensation if the sole reason the window benefit would otherwise fail to be provided pursuant to a nonqualified deferred compensation plan is the application of paragraph (b)(4)(v)(B)(1) of this section.

(C) *Termination within 12 months of establishment of a benefit or plan.* For purposes of this paragraph (b)(4)(v), a benefit is provided in connection with impending termination of employment, without regard to whether it constitutes a window benefit, if—

(*1*) An employee's termination of employment occurs within 12 months of the establishment of the plan (or amendment) providing the benefit; and

(*2*) The facts and circumstances indicate that the plan (or amendment) is established in contemplation of the employee's impending termination of employment.

(vi) *Benefits established after termination.* Benefits established with respect to an employee after the employee's termination of employment do not result from a deferral of compensation within the meaning of section 3121(v)(2). However, cost-of-living adjustments on benefit payments under a nonqualified deferred compensation plan (within the meaning of paragraph (b) of this section) shall not be considered benefits established after the employee's termination of employment for purposes of this paragraph (b)(4)(vi) merely because the employee does not obtain the right to the adjustment until after the employee's termination of employment. For purposes of the preceding sentence, *cost-of-living adjustments* are payments that satisfy conditions similar to those of 29 CFR 2510.3–2(g)(1)(ii) and (iii).

(vii) *Excess parachute payments.* An excess parachute payment (as defined in section 280G(b)) under an agreement entered into or renewed after June 14, 1984, in taxable years ending after such date, does not result from the deferral of compensation within the meaning of section 3121(v)(2). For this purpose, any contract entered into before June 15, 1984, that is amended after June 14, 1984, in any relevant significant aspect, is treated as a contract entered into after June 14, 1984.

(viii) *Compensation for current services.* A plan does not provide for the deferral of compensation within the meaning of section 3121(v)(2) if, based on the relevant facts and circumstances, the compensation is paid for current services.

(5) *Examples.* This paragraph (b) is illustrated by the following examples:

Example 1. (i) In December of 2001, Employer L tells Employee A that, if specified goals are satisfied for 2002, Employee A will receive a bonus on July 1, 2003, equal to a specified percentage of 2002 compensation. Because Employee A meets the specified goals, Employer L pays the bonus to Employee A on July 1, 2003, consistent with its oral commitment.

(ii) This arrangement is not a nonqualified deferred compensation plan under this section because its terms were not set forth in writing and, therefore, it was not established in accordance with paragraph (b)(2) of this section.

Example 2. (i) In 2004, Employer M establishes a compensation arrangement for Employee B under which Employer M agrees to pay Employee B a specified amount based on a percentage of his salary for 2004. The amount due is to be paid out of the general assets of Employer M and is payable in 2008.

(ii) Employee B has a legally binding right during 2004 to an amount of compensation that has not been actually or constructively received and that, pursuant to the terms of the arrangement, is payable in a later year. Therefore, the arrangement provides for the deferral of compensation.

Example 3. (i) Employer N establishes a nonqualified deferred compensation plan (within the meaning of paragraph (b)(1) of this section) for Employee C in 1984. The plan is amended on January 1, 2001, to increase benefits, and the amendment provides that the increase in benefits is on account of Employee C's performance of services for Employer N from 1985 through 2000.

(ii) The additional benefits that resulted from the plan amendment cannot be taken into account as amounts deferred for 1985 through 2000, even though the plan was established before then. Pursuant to paragraphs (b)(2)(ii) and (e)(1) of this section, the additional benefits cannot be taken into account before the latest of the date on which the amendment is adopted, the date on which the amendment is effective, or the date on which the material terms of the plan, as amended, are set forth in writing.

Example 4. (i) In 2002, Employer O, a state or local government, establishes a plan for certain employees that provides for the deferral of compensation and that is subject to section 457(a).

(ii) Paragraph (b)(1) of this section provides that nonqualified deferred compensation plan means any plan that is established by an employer and that provides for the deferral of compensation, other than a plan described in section 3121(a)(5). Section 3121(a)(5) lists, among other plans, an exempt governmental deferred compensation plan as defined in section 3121(v)(3). Under section 3121(v)(3)(A), this definition does not include any plan to which section 457(a) applies. Thus, the plan established by Employer O is not an exempt governmental deferred compensation plan described in section 3121(v)(3) and, consequently, is not a plan described in section 3121(a)(5). Accordingly, the plan is a nonqualified deferred compensation plan within the meaning of section 3121(v)(2) and paragraph (b)(1) of this section.

(iii) However, the general timing rule of paragraph (a)(1) of this section and the special timing rule of paragraph (a)(2) of this section apply only to remuneration for employment that constitutes wages. Under section 3121(b)(7), certain service performed in the employ of a state, or any political subdivision of a state, is not employment. Thus, even though the plan is a nonqualified deferred compensation plan, the extent to which section 3121(v)(2) applies to a participating employee will depend on whether or not the service performed for Employer O is excluded from the definition of employment under section 3121(b)(7).

Example 5. (i) In 2000, Employer P establishes a plan that provides for bonuses to be paid to employees based on an objective formula that takes into account the employees' performance for the year. Employer P does not have the discretion to reduce the amount of any employee's bonus after the end of the year. The bonus is not actually calculated until March 1 of the following year, and is paid on March 15 of that following year.

(ii) The plan provides for the deferral of compensation because the employees have a legally binding right, as of the last day of a calendar year, to an amount of compensation that has not been actually or constructively received and, pursuant to the terms of the plan, that compensation is payable in a later year. However, because the bonuses under the plan are paid within a brief period of time after the end of the calendar year from which they are deferred, Employer P may choose, pursuant to paragraph (b)(3)(iii) of this section, to treat all the bonuses as if they are not subject to the special timing rule of paragraph (a)(2) of this section.

(iii) If the employer uses the special timing rule, the amount deferred would be taken into account as wages on December 31, 2000. If the employer chooses not to use the special timing rule, the amount of the bonus is wages on the date it is actually or constructively paid, March 15, 2000.

Example 6. (i) Employer Q establishes a plan under which bonuses based on performance in one year may be paid on February 1 of the following year at the discretion of the board of directors. The board of directors meets in January of each year to determine the amount, if any, of the bonuses to be paid based on performance in the prior year.

(ii) Because an employee does not have a legally binding right to any bonus until January of the year in which the bonus is paid, any bonus paid under the plan in that year is not deferred from the preceding calendar year, and the plan does not provide for the deferral of compensation within the meaning of paragraph (b)(3)(i) of this section.

Example 7. (i) Employer R maintains a plan for employees that provides nonqualified stock options described in §1.83-7(a) of this chapter. Under the plan, employees are granted in 2001 the option to acquire shares of employer stock at the fair market value of the shares on the date of grant ($50 per share). The options can be exercised at any time from the date of grant through 2010. The options do not have a readily ascertainable fair market value for purposes of section 83 at the date of grant, and shares are issued upon the exercise of the options without being subject to a substantial risk of forfeiture within the meaning of section 83. In 2005, when the fair market value of a share of employer stock is $80, Employee D exercises an option to acquire 1,000 shares.

(ii) Under paragraph (b)(4)(ii) of this section, neither the grant of a stock option nor amounts received currently as a result of the exercise of a stock option result from the deferral of compensation for purposes of section 3121(v)(2). Thus, under the general timing rule of paragraph (a)(1) of this section, the $30,000 spread between the amount paid for the shares ($50,000) and the fair market value of the shares on the date of exercise ($80,000) is taken into account as wages for FICA tax purposes in the year of exercise.

(iii) If the options had been granted at $45 per share, $5 per share below the fair market value on date of grant, the $35,000 spread between the amount paid for the shares ($45,000) and the fair market value of the shares on the date of exercise ($80,000) would similarly be taken into account as wages for FICA tax purposes in the year of exercise.

Example 8. (i) Employer T establishes a phantom stock plan for certain employees. Under the plan, an employee is credited on the last day of each calendar year with a dollar amount equal to the fair market value of 1,000 shares of employer stock. Upon termination of employment for any reason, each employee is entitled to receive the value on the date of termination, in cash or employer stock, of the shares with which he or she has been credited.

(ii) Because compensation to which the employee has a legally binding right as of the last day of one year is paid in a subsequent year, the phantom stock plan provides for the deferral of compensation. The phantom stock plan does not provide stock value rights within the meaning of paragraph (b)(4)(ii) of this section because it provides for awards equal in value to the full fair market value of a specified number of shares of Employer T stock, rather than the excess of that fair market value over a specified price.

Example 9. (i) Employer U establishes a severance pay arrangement (within the meaning of section 3(2)(b)(i) of ERISA) which provides for payments solely upon an employee's death, disability, or dismissal from employment. The amount of the payments to an employee is based on the length of continuous active service with Employer U at the time of dismissal, and is paid in monthly installments over a period of three years.

(ii) Because benefits payable under the plan upon termination of employment are payable only upon an employee's involuntary termination, the plan is a severance pay plan within the meaning of paragraph (b)(4)(iv)(B) of this section. Thus, the benefits are not treated as resulting from the deferral of compensation for purposes of section 3121(v)(2).

Example 10. (i) Employer V establishes a nonqualified deferred compensation plan under which employees will receive benefit payments commencing at age 65 as a life annuity or in one of several actuarially equivalent annuity forms. If an employee dies before benefit payments commence under the plan, a benefit is payable to the employee's designated beneficiary in a single sum payment equal to the present value of the employee's annuity benefit. This benefit (sometimes called a full reserve death benefit) is calculated using the applicable interest rate specified in section 417(e) and, for the period after age 65, the applicable mortality table specified in section 417(e), both of which are reasonable actuarial assumptions. During 2002, Employee E obtains a legally binding right to an annuity benefit under the plan, payable at age 65. This annuity benefit has a present value of $10,000 at the end of 2002, determined using the same assumptions as are used under the plan to calculate the full reserve death benefit.

(ii) The present value, at the end of 2002, of the total benefits payable to or on behalf of Employee E (i.e., the sum of the present value of the annuity benefit commencing at age 65, and the present value of the full reserve death benefit, with both determined using the actuarial assumptions described in paragraph (i) of this *Example 10*, except also taking into account the probability of death prior to age 65) is $10,000. This present value does not exceed the present value of the annuity benefits that could be payable to Employee E under the plan during Employee E's lifetime determined without a discount for the possibility that Employee E might die before age 65 (also $10,000). Thus, the benefit payable in the event of the Employee E's death is not a death benefit for purposes of paragraph (b)(4)(iv) of this section.

(iii) The same result would apply in the case of a plan that bases benefits on an interest bearing account balance and pays the account balance at termination of employment or death (because the sum of the deferred benefits payable in the future if the employee terminates employment before death with a discount for the probability of death before that date plus the present value of the benefit payable in the event of death necessarily equals the present value of the deferred benefits payable with no discount for the probability of death).

Example 11. (i) The facts are the same as in *Example 10,* except that, in lieu of the full reserve death benefit, the plan provides a monthly life annuity benefit to an employee's spouse in the event of the employee's death before benefit payments commence equal to 100 percent of the monthly annuity that would be payable to the employee at age 65 under the life annuity form. Employee E is age 63 and has a spouse who is age 51. The sum of the present value of Employee E's annuity benefit commencing at age 65 determined with a discount for the possibility that Employee E might die before age 65 and the present value of the 100 percent annuity death benefit for Employee E's spouse exceeds $10,000.

(ii) The amount deferred for 2002 is $10,000 (because the 100 percent annuity death benefit for Employee E's spouse is disregarded to the extent that the total benefits payable to or on behalf of Employee E exceeds the present value of the annuity benefits that could be payable to Employee E under the plan during the Employee E's lifetime without a discount for the probability of Employee E's death before benefit payments commence).

Example 12. (i) On January 1, 2001, Employer W establishes a plan that covers only Employee F, who owns a significant portion of the business and who has 30 years of service as of that date. The plan provides that, upon Employee F's termination of employment at any time, he will receive $200,000 per year for each of the immediately succeeding five years. Employee F terminates employment on March 1, 2001.

(ii) Because Employee F terminates employment within 12 months of the establishment of the plan and the facts and circumstances set forth above indicate that the plan was established in contemplation of impending termination of employment, the plan is considered to be established in connection with impending termination within the meaning of paragraph (b)(4)(v) of this section. Therefore, the benefits provided under the plan are not treated as resulting from the deferral of compensation for purposes of section 3121(v)(2).

Example 13. (i) Employer X establishes a plan on January 1, 2004, to supplement the qualified retirement benefits of recently hired 55-year old Employee G, who forfeited retirement benefits with her former employer in order to accept employment with Employer X. The plan provides that Employee G will receive $50,000 per year for life beginning at age 65, regardless of when she terminates employment. On April 15, 2004, Employee G unexpectedly terminates employment.

(ii) The facts and circumstances indicate that the plan was not established in contemplation of impending termination. Thus, even though Employee G terminated employment within 12 months of the establishment of the plan, the plan is not considered to be established in connection with impending termination within the meaning of paragraph (b)(4)(v) of this section. Benefits provided under the plan are treated as resulting from the deferral of compensation for purposes of section 3121(v)(2).

Example 14. (i) Employer Y establishes a plan to provide supplemental retirement benefits to a group of management employees who are at various stages of their careers. All employees covered by the plan are subject to the same benefit formula. Employee H is planning to (and actually does) retire within six months of the date on which the plan is established.

(ii) Even though Employee H terminated employment within 12 months of the establishment of the plan, the plan is not considered to have been established in connection with Employee H's impending termination within the meaning of paragraph (b)(4)(v) of this section because the facts and circumstances indicate otherwise.

Example 15. (i) Employee J owns 100 percent of Employer Z, a corporation that provides consulting services. Substantially all of Employer Z's revenue is derived as a result of the services performed by Employee J. In each of 2001, 2002, and 2003, Employer Z has gross receipts of $180,000 and expenses (other than salary) of $80,000. In each of 2001 and 2002, Employer Z pays Employee J a salary of $100,000 for services performed in each of those years. On December 31, 2002, Employer Z establishes a plan to pay Employee J $80,000 in 2003. The plan recites that the payment is in recognition of prior services. In 2003, Employer Z pays Employee J a salary of $20,000 and the $80,000 due under the plan.

(ii) The facts and circumstances described above indicate that the $80,000 paid pursuant to the plan is based on services performed by Employee J in 2003 and, thus, is paid for current services within the meaning of paragraph (b)(4)(viii) of this section. Accordingly, the plan does not provide for the deferral of compensation within the meaning of section 3121(v)(2), and the $80,000 payment is included as wages in 2003 under the general timing rule of paragraph (a)(1) of this section.

(c) *Determination of the amount deferred*—(1) *Account balance plans*—(i) *General rule.* For purposes of this section, if benefits for an employee are provided under a nonqualified deferred compensation plan that is an account balance plan, the amount deferred for a period equals the principal amount credited to the employee's account for the period, increased or decreased by any income attributable to the principal amount through the date the principal amount is required to be taken into account as wages under paragraph (e) of this section.

(ii) *Definitions*—(A) *Account balance plan.* For purposes of this section, an account balance plan is a nonqualified deferred compensation plan under the terms of which a principal amount (or amounts) is credited to an individual account for an employee, the income attributable to each principal amount is credited (or debited) to the individual account, and the benefits payable to the employee are based solely on the balance credited to the individual account.

(B) *Income.* For purposes of this section, *income* means any increase or decrease in the amount credited to an employee's account that is attributable to amounts previously credited to the employee's account, regardless of whether the plan denominates that increase or decrease as income.

(iii) *Additional rules*—(A) *Commingled accounts.* A plan does not fail to be an account balance plan merely because, under the terms of the plan, benefits payable to an employee are based solely on a specified percentage of an account maintained for all (or a portion of) plan participants under which principal amounts and income are credited (or debited) to such account.

(B) *Bifurcation permitted.* An employer may treat a portion of a nonqualified deferred compensation plan as a separate account balance plan if that portion satisfies the requirements of this paragraph (c)(1) and the amount payable to employees under that portion is determined independently of the amount payable under the other portion of the plan.

(C) *Actuarial equivalents.* A plan does not fail to be an account balance plan merely because the plan permits employees to elect to receive their benefits under the plan in a form of benefit other than payment of the account balance, provided the amount of benefit payable in that other form is actuarially equivalent to payment of the account balance using actuarial assumptions that are reasonable. Conversely, a plan is not an account balance plan if it provides an optional form of benefit that is not actuarially equivalent to the account balance using actuarial assumptions that are reasonable. For this purpose, the determination of whether forms are actuarially equivalent using actuarial assumptions that are reasonable is determined under the rules applicable to nonaccount balance plans under paragraph (c)(2)(iii) of this section.

(2) *Nonaccount balance plans*—(i) *General rule.* For purposes of this section, if benefits for an employee are provided under a nonqualified deferred compensation plan that is not an account balance plan (a nonaccount balance plan), the amount deferred for a period equals the present value of the additional future payment or payments to which the employee has obtained a legally binding right (as described in paragraph (b)(3)(i) of this section) under the plan during that period.

(ii) *Present value defined.* For purposes of this section, present value means the value as of a specified date of an amount or series of amounts due thereafter, where each amount is multiplied by the probability that the condition or conditions on which payment of the amount is contingent will be satisfied, and is discounted according to an assumed rate of interest to reflect the time value of money. For purposes of this section, the present value must be determined as of the date the amount deferred is required to be taken into account as wages under paragraph (e) of this section using actuarial assumptions and methods that are reasonable as of that date. For this purpose, a discount for the probability that an employee will die before commencement of benefit payments is permitted, but only to the extent that benefits will be forfeited upon death. In addition, the present value cannot be discounted for the probability that payments will not be made (or will be reduced) because of the unfunded status of the plan, the risk associated with any deemed or actual investment of amounts deferred under the plan, the risk that the employer, the trustee, or another party will be unwilling or unable to pay, the possibility of future plan amendments, the possibility of a future change in the law, or similar risks or contingencies. Nor is the present value affected by the possibility that some of the payments due under the plan will be eligible for one of the exclusions from wages in section 3121(a).

(iii) *Treatment of actuarially equivalent benefits*—(A) *In general.* In the case of a nonaccount balance plan that permits employees to receive their benefits in more than one form or commencing at more than one date, the amount deferred is determined by assuming that payments are made in the normal form of benefit commencing at normal commencement date if the requirements of paragraph (c)(2)(iii)(B) of this section are satisfied. Accordingly, in the case of a nonaccount balance plan that permits employees to receive their benefits in more than one form or commencing at more than one date, unless the requirements of paragraph (c)(2)(iii)(B) of this section are satisfied, the amount deferred is treated as not reasonably ascertainable under the rules of paragraph (e)(4)(i)(B) of this section until a form of benefit and a time of commencement are selected.

(B) *Use of normal form commencing at normal commencement date.* The requirements of this paragraph (c)(2)(iii)(B) are satisfied by a nonaccount balance plan if the plan has a single normal form of benefit commencing at normal commencement date for the amount deferred and each other optional form is actuarially equivalent to the normal form of benefit commencing at normal commencement date using actuarial assumptions that are reasonable. For this purpose, each form of benefit for payment of the amount deferred commencing at a date is a separate optional form. For purposes of this paragraph (c)(2)(iii)(B), each optional form is actuarially equivalent to the normal form of benefit commencing at normal commencement date only if the terms of the plan in effect when the amount is deferred provide for every optional form to be actuarially equivalent and further provide for actuarial assumptions to determine actuarial equivalency that will be reasonable at the time the optional form is selected, without regard to whether market interest rates are higher or lower at the time the optional form is selected than at the time the amount is deferred. Thus, a plan that provides for every optional form to be actuarially equivalent satisfies this paragraph (c)(2)(iii)(B) if it provides for actuarial equivalence to be determined—

(*1*) When an optional form is selected or when benefit payments under the optional form commence, based on assumptions that are reasonable then;

(*2*) Based on an index that reflects market rates of interest from time to time (for example, the plan specifies that all benefits will be actuarially equivalent using the applicable interest rate and applicable mortality table specified in section 417(e)); or

(*3*) Based on actuarial assumptions specified in the plan and provides for those assumptions to be revised to be reasonable assumptions if they cease to be reasonable assumptions.

(C) *Fixed mortality assumptions permitted.* A plan does not fail to satisfy paragraph (c)(2)(iii)(B) of this section merely because the plan specifies a fixed mortality assumption that is reasonable at the time the amount is deferred, even if that assumption is not reasonable at the time the optional form is selected. (But see paragraph (c)(2)(iii)(E) of this section for additional rules that apply if the mortality assumption is not reasonable at the time the optional form is selected.)

(D) *Normal form of benefit commencing at normal commencement date defined.* For purposes of this paragraph (c)(2)(iii), the normal form of benefit commencing at normal commencement date under the plan is the form, and date of commencement, under which the payments due to the employee under the plan are expressed, prior to adjustments for form or timing of commencement of payments.

(E) *Rule applicable if actuarial assumptions cease to be reasonable.* If the terms of the plan in effect when an amount is deferred provide for actuarial assumptions to determine actuarial equivalency that will be reasonable at the time the optional form is selected or payments commence as provided in paragraph (c)(2)(iii)(B) of this section, but, at that time, the actuarial assumptions used under the plan are not reasonable, the employee will be treated as obtaining a legally binding right at that time (or, if earlier, at the date on which the plan is amended to provide actuarial assumptions that are not reasonable) to any additional benefits that result from the use of an unreasonable actuarial assumption. This might occur, for example, if the plan specifies that the actuarial assumptions will be reasonable assumptions to be set at the time the optional form is selected and the assumptions used are in fact not reasonable at that time.

(3) *Separate determination for each period.* The amount deferred under this paragraph (c) is determined separately for each period for which there is an amount deferred under the plan. In addition, paragraphs (d) and (e) of this section are applied separately with respect to the amount deferred for each such period. Thus, for example, the fraction described in paragraph (d)(1)(ii)(B) of this section and the amount of the true-up at the resolution date described in paragraph (e)(4)(ii)(B) of this section are determined separately with respect to each amount deferred. See paragraph (e)(4)(ii)(D) of this section for special rules for allocating amounts deferred over more than one year.

(4) *Examples.* This paragraph (c) is illustrated by the following examples. (The examples illustrate the rules in this paragraph (c) and include various interest rate and mortality table assumptions, including the applicable section 417(e) mortality table, the GAM 83 (male) mortality table, and UP-84 mortality table. These tables can be obtained from the Society of Actuaries at its internet site at http://www.soa.org.) The examples are as follows:

Example 1. (i) Employer M establishes a nonqualified deferred compensation plan for Employee A. Under the plan, 10 percent of annual compensation is credited on behalf of Employee A on December 31 of each year. In addition, a reasonable rate of interest is credited quarterly on the balance credited to Employee A as of the last day of the preceding quarter. All amounts credited under the plan are 100 percent vested and the benefits payable to Employee A are based solely on the balance credited to Employee A's account.

(ii) The plan is an account balance plan. Thus, pursuant to paragraph (c)(1) of this section, the amount deferred for a calendar year is equal to 10 percent of annual compensation.

Example 2. (i) Employer N establishes a nonqualified deferred compensation plan for Employee B. Under the plan, 2.5 percent of annual compensation is credited quarterly on behalf of Employee B. In addition, a reasonable rate of interest is credited quarterly on the balance credited to Employee B's account as of the last day of the preceding quarter. All amounts credited under the plan are 100 percent vested, and the benefits payable to Employee B are based solely on the balance credited to Employee B's account. As permitted by paragraph (e)(5) of this section, any amount deferred under the plan for the calendar year is taken into account as wages on the last day of the year.

(ii) The plan is an account balance plan. Thus, pursuant to paragraph (c)(1) of this section, the amount deferred for a calendar year equals 10 percent of annual compensation (i.e., the sum of the principal amounts credited to Employee B's account for the year) plus the interest credited with respect to that 10 percent principal amount through the last day of the calendar year. If Employer N had not chosen to apply paragraph (e)(5) of this section and, thus, had taken into account 2.5 percent of compensation quarterly, the interest credited with respect to those quarterly amounts would not have been treated as part of the amount deferred for the year.

Example 3. (i) Employer O establishes a nonqualified deferred compensation plan for a group of five employees. Under the plan, a specified sum is credited to an account for the benefit of the group of employees on July 31 of each year. Income on the balance of the account is credited annually at a rate that is reasonable for each year. The benefit payable to an employee is equal to one-fifth of the account balance and is payable, at the employee's option, in a lump sum or in 10 annual installments that reflect income on the balance.

(ii) The plan is an account balance plan notwithstanding the fact that the employee's benefit is equal to a specified percentage of an account maintained for a group of employees.

Example 4. (i) The facts are the same as in *Example 3,* except that the plan also permits an employee to elect a life annuity that is actuarially equivalent to the account balance based on the applicable interest rate and applicable mortality table specified in section 417(e) at the time the benefit is elected by the employee.

(ii) Under paragraphs (c)(1)(iii)(C) and (c)(2)(iii) of this section, the plan does not fail to be an account balance plan merely because the plan permits employees to elect to receive their benefits under the plan in a form that is actuarially equivalent to payment of the account balance using actuarial assumptions that are reasonable at the time the form is selected.

Example 5. (i) Employer P establishes a nonqualified deferred compensation plan for a group of employees. Under the plan, each participating employee has a fully vested right to receive a life annuity, payable monthly beginning at age 65, equal to the product of 2 percent for each year of service and the employee's highest average annual compensation for any 3-year period. The plan also provides that, if an employee dies before age 65, the present value of the future payments will be paid to his or her beneficiary. As permitted under paragraph (e)(5) of this section, any amount deferred under the plan for a calendar year is taken into account as FICA wages as of the last day of the year. As of December 31, 2002, Employee C is age 60, has 25 years of service, and high 3-year average compensation of $100,000 (the average for the years 2000 through 2002). As of December 31, 2003, Employee C is age 61, has 26 years of service, and has high 3-year average compensation of $104,000. As of December 31, 2004, Employee C is age 62, has 27 years of service, and has high 3-year average compensation of $105,000. The assumptions that Employer P uses to determine the amount deferred for 2003 (a 7 percent interest rate and, for the period after commencement of benefit payments, the GAM 83 (male) mortality table) and for 2004 (a 7.5 percent interest rate and, for the period after commencement of benefit payments, the GAM 83 (male) mortality table) are assumed, solely for purposes of this example, to be reasonable actuarial assumptions.

(ii) As of December 31, 2002, Employee C has a legally binding right to receive lifetime payments of $50,000 (2 percent × 25 years × $100,000) per year. As of December 31, 2003, Employee C has a legally binding right to receive lifetime payments of $54,080 (2 percent × 26 years × $104,000) per year. Thus, during 2003, Employee C has earned a legally binding right to additional lifetime payments of $4,080 ($54,080 – $50,000) per year beginning at age 65. The amount deferred for 2003 is the present value, as of December 31, 2003, of these additional payments, which is $28,767 ($4,080 × the present value factor for a deferred annuity payable at age 65, using the specified actuarial assumptions for 2003). Similarly, during 2004, Employee C has earned a legally binding right to additional lifetime payments of $2,620 (2 percent × 27 years × $105,000, minus $54,080) per year beginning at age 65. The amount deferred for 2004 is the present value, as of December 31, 2004, of these additional payments, which is $18,845 ($2,620 × the present value factor for a deferred annuity payable at age 65, using the specified actuarial assumptions for 2004).

Example 6. (i) Employer Q establishes a nonqualified deferred compensation plan for Employee D on January 1, 2001, when Employee D is age 63. During 2001, Employee D obtains a fully vested right to receive a life annuity under the nonqualified deferred compensation plan equal to the excess of $200,000 over the life annuity benefits payable to Employee D under a qualified defined benefit pension plan sponsored by Employer Q. The life annuity benefit payable annually under the qualified plan is the lesser of $200,000 and the section 415(b)(1)(A) limitation in effect for the year, where the section 415(b)(1)(A) limitation is automatically adjusted to reflect changes in the cost of living. Benefits under both the qualified and nonqualified plan are payable monthly beginning at age 65. For purposes of this example, the section 415(b)(1)(A) limit for 2001 is assumed to be $140,000. The nonqualified plan provides no benefits in the event Employee D dies prior to commencement of benefit payments. As permitted under paragraph (e)(5) of this section, any amount deferred under the plan for a calendar year is taken into account as FICA wages as of the last day of the year. The assumptions that Employer Q uses to determine the amount deferred for 2001 (a 7 percent interest rate, a 3 percent increase in the cost of living and the GAM 83 (male) mortality table) are assumed, solely for purposes of this example, to be reasonable actuarial assumptions. As of December 31, 2001, Employee D has a legally binding right to receive lifetime payments as set forth in the following table:

Year	Annual Gross Amount	Assumed Qualified Plan Annual Payment (based on cost of living)	Net Annual Payment under Nonqualified Plan
2003	$200,000	$145,000	$55,000
2004	$200,000	$150,000	$50,000
2005	$200,000	$155,000	$45,000
2006	$200,000	$160,000	$40,000
2007	$200,000	$165,000	$35,000
2008	$200,000	$170,000	$30,000
2009	$200,000	$175,000	$25,000
2010	$200,000	$180,000	$20,000
2011	$200,000	$185,000	$15,000
2012	$200,000	$190,000	$10,000
2013	$200,000	$195,000	$5,000
2014 and thereafter	$200,000	$205,000 or greater	$0

(ii) The amount deferred for 2001 is the present value, as of December 31, 2001, of the net lifetime payments under the nonqualified plan, or $223,753.

(d) *Amounts taken into account and income attributable thereto*—(1) *Amounts taken into account*—(i) *In general.* For purposes of this section, an amount deferred under a nonqualified deferred compensation plan is taken into account as of the date it is included in computing the amount of *wages* as defined in section 3121(a), but only to the extent that any additional FICA tax that results from such inclusion (including any interest and penalties for late payment) is actually paid before the expiration of the applicable period of limitations for the period in which the amount deferred was required to be taken into account under paragraph (e) of this section. Because an amount deferred for a calendar year is combined with the employee's other wages for the year for purposes of computing FICA taxes with respect to the employee for the year, if the employee has other wages that equal or exceed the wage base limitations for the Old-Age, Survivors, and Disability Insurance (OASDI) portion (or, in the case of years before 1994, the Hospital Insurance (HI) portion) of FICA for the year, no portion of the amount deferred will actually result in additional OASDI (or HI) tax. However, because there is no wage base limitation for the HI portion of FICA for years after 1993, the entire amount deferred (in addition to all other wages) is subject to the HI tax for the year and, thus, will not be considered taken into account for purposes of this section unless the HI tax relating to the amount deferred is actually paid. In determining whether any additional FICA tax relating to the amount deferred is actually paid, any FICA tax paid in a year is treated as paid with respect to an amount deferred only after FICA tax is paid on all other wages for the year.

(ii) *Amounts not taken into account*—(A) *Failure to take an amount deferred into account under the special timing rule.* If an amount deferred for a period (as determined under paragraph (c) of this section) is not taken into account, then the nonduplication rule of paragraph (a)(2)(iii) of this section does not apply, and benefit payments attributable to that amount deferred are included as wages in accordance with the general timing rule of paragraph (a)(1) of this section. For example, if an amount deferred is required to be taken into account in a particular year under paragraph (e) of this section, but the employer fails to pay the additional FICA tax resulting from that amount, then the amount deferred and the income attributable to that amount must be included as wages when actually or constructively paid.

(B) *Failure to take a portion of an amount deferred into account under the special timing rule.* If, as of the date an amount deferred is required to be taken into account, only a portion of the amount deferred (as determined under paragraph (c) of this section) has been taken into account, then a portion of each subsequent benefit payment that is attributable to that amount is excluded from wages pursuant to the nonduplication rule of paragraph (a)(2)(iii) of this section and the balance is subject to the general timing rule of paragraph (a)(1) of this section. The portion that is excluded from wages is fixed immediately before the attributable benefit payments commence (or, if later, the date the amount deferred is required to be taken into account) and is determined by multiplying each such payment by a fraction, the numerator of which is the amount that was taken into account (plus income attributable to that amount determined under paragraph (d)(2) of this section through the date the portion is fixed) and the denominator of which is the present value of the future benefit payments attributable to the amount deferred, determined as of the date the portion is fixed. For this purpose, if the requirements of paragraph (c)(2)(iii)(B) of this section are satisfied, the present value is determined by assuming that payments are made in the normal form of benefit commencing at normal commencement date. In addition, if the employer demonstrates that the amount deferred was determined using reasonable actuarial assumptions as determined by the Commissioner, the present value of the future benefit payments attributable to the amount deferred is determined using those assumptions. In any other case, see paragraph (d)(2)(iii) of this section.

(2) *Income attributable to the amount taken into account*—(i) *Account balance plans*—(A) *In general.* For purposes of the nonduplication rule of paragraph (a)(2)(iii) of this section, in the case of an account balance plan, the income attributable to the amount taken into account means any amount credited on behalf of an employee under the terms of the plan that is income (within the meaning of paragraph (c)(1)(ii)(B) of this section) attributable to an amount previously taken into account (within the meaning of paragraph (d)(1) of this section), but only if the income reflects a rate of return that does not exceed either the rate of return on a predetermined actual investment (as determined in accordance with paragraph (d)(2)(i)(B) of this section) or, if the income does not reflect the rate of return on a predetermined actual investment (as so determined), a reasonable rate of interest (as determined in accordance with paragraph (d)(2)(i)(C) of this section).

(B) *Rules relating to actual investment*—(*1*) *In general*. For purposes of this paragraph (d)(2)(i), the rate of return on a predetermined actual investment for any period means the rate of total return (including increases or decreases in fair market value) that would apply if the account balance were, during the applicable period, actually invested in one or more investments that are identified in accordance with the plan before the beginning of the period. For this purpose, an account balance plan can determine income based on the rate of return of a predetermined actual investment regardless of whether assets associated with the plan or the employer are actually invested therein and regardless of whether that investment is generally available to the public. For example, an account balance plan could provide that income on the account balance is determined based on an employee's prospective election among various investment alternatives that are available under the employer's section 401(k) plan, even if one of those investment alternatives is not generally available to the public. In addition, an actual investment includes an investment identified by reference to any stock index with respect to which there are positions traded on a national securities exchange described in section 1256(g)(7)(A).

(*2*) *Certain rates of return not based on predetermined actual investment.* A rate of return will not be treated as the rate of return on a predetermined actual investment within the meaning of this paragraph (d)(2)(i)(B) if the rate of return (to any extent or under any conditions) is based on the greater of the rate of return of two or more actual investments, is based on the greater of the rate of return on an actual investment and a rate of interest (whether or not the rate of interest would otherwise be reasonable under paragraph (d)(2)(i)(C) of this section), or is based on the rate of return on an actual investment that is not predetermined. For example, if a plan bases the rate of return on the greater of the rate of return on a predetermined actual investment (such as the value of the employer's stock), and a 0 percent interest rate (i.e., without regard to decreases in the value of that investment), the plan is using a rate of return that is not a rate of return on a predetermined actual investment within the meaning of this paragraph (d)(2)(i)(B).

(C) *Rules relating to reasonable interest rates*—(*1*) *In general.* If income for a period is credited to an account balance plan on a basis other than the rate of return on a predetermined actual investment (as determined in accordance with paragraph (d)(2)(i)(B) of this section), then, except as otherwise provided in this paragraph (d)(2)(i)(C), the determination of whether the income for the period is based on a reasonable rate of interest will be made at the time the amount deferred is required to be taken into account and annually thereafter.

(*2*) *Fixed rates permitted.* If, with respect to an amount deferred for a period, an account balance plan provides for a fixed rate of interest to be credited, and the rate is to be reset under the plan at a specified future date that is not later than the end of the fifth calendar year that begins after the beginning of the period, the rate is reasonable at the beginning of the period, and the rate is not changed before the reset date, then the rate will be treated as reasonable in all future periods before the reset date.

(ii) *Nonaccount balance plans.* For purposes of the nonduplication rule of paragraph (a)(2)(iii) of this section, in the case of a nonaccount balance plan, the *income attributable to the amount taken into account* means the increase, due solely to the passage of time, in the present value of the future payments to which the employee has obtained a legally binding right, the present value of which constituted the amount taken into account (determined as of the date such amount was taken into account), but only if the amount taken into account was determined using reasonable actuarial assumptions and methods. Thus, for each year, there will be an increase (determined using the same interest rate used to determine the amount taken into account) resulting from the shortening of the discount period before the future payments are made, plus, if applicable, an increase in the present value resulting from the employee's survivorship during the year. As a result, if the amount deferred for a period is determined using a reasonable interest rate and other reasonable actuarial assumptions and methods, and the amount is taken into account when required under paragraph (e) of this section, then, under the nonduplication rule of paragraph (a)(2)(iii) of this section, none of the future payments attributable to that amount will be subject to FICA tax when paid.

(iii) *Unreasonable rates of return*—(A) *Account balance plans.* This paragraph (d)(2)(iii)(A) applies to an account balance plan under which the income credited is based on neither a predetermined actual investment, within the meaning of paragraph (d)(2)(i)(B) of this section, nor a rate of interest that is reasonable, within the meaning of paragraph (d)(2)(i)(C) of this section, as determined by the Commissioner. In that event, the employer must calculate the amount that would be credited as income under a reasonable rate of interest, determine the excess (if any) of the amount credited under the plan over the income that would be credited using the reasonable rate of interest, and take that excess into account as an additional amount deferred in the year the income is credited. If the employer fails to calculate the amount that would be credited as income under a reasonable rate of interest and to take the excess into account as an additional amount deferred in the year the income is credited, or the employer otherwise fails to take the full amount deferred into account, then the excess of the income credited under the plan over the income that would be credited using *AFR* will be treated as an amount deferred in the year the income is credited. For purposes of this section, AFR means the mid-term applicable federal rate (as defined pursuant to section 1274(d)) for January 1 of the calendar year, compounded annually. In addition, pursuant to paragraph (d)(1)(ii) of this section, the excess over the income that would result from the application of AFR and any income attributable to that excess are subject to the general timing rule of paragraph (a)(1) of this section.

(B) *Nonaccount balance plans.* If any actuarial assumption or method used to determine the amount taken into account under a nonaccount balance plan is not reasonable, as determined by the Commissioner, then the income attributable to the amount taken into account is limited to the income that would result from the application of the AFR and, if applicable, the applicable mortality table under section 417(e)(3)(A)(ii)(I) (the 417(e) mortality table), both determined as of the January 1 of the calendar year in which the amount was taken into account. In addition, paragraph (d)(1)(ii)(B) of this section applies and, in calculating the fraction described in paragraph (d)(1)(ii)(B) of this section (at the date specified in paragraph (d)(1)(ii)(B) of this section), the numerator is the amount taken into account plus income (as limited under this paragraph (d)(2)(iii)(B)), and the present value in the denominator is determined using the AFR, the 417(e) mortality table, and reasonable assumptions as to cost of living, each determined as of the time the amount deferred was required to be taken into account.

(3) *Examples.* This paragraph (d) is illustrated by the following examples:

Example 1. (i) In 2001, Employer M establishes a nonqualified deferred compensation plan for Employee A under which all benefits are 100 percent vested. In 2002, Employee A has $200,000 of current annual compensation from Employer M that is subject to FICA tax. The amount deferred under the plan on behalf of Employee A for 2002 is $20,000. Thus, Employee A has total wages for FICA tax purposes of $220,000. Because Employee A has other wages that exceed the OASDI wage base for 2002, no additional OASDI tax is due as a result of the $20,000 amount deferred. Because there is no wage base limitation for the HI portion of FICA, additional HI tax liability results from the $20,000 amount deferred. However, Employer M fails to pay the additional HI tax.

(ii) Under paragraph (d)(1)(i) of this section, an amount deferred is considered taken into account as wages for FICA tax purposes as of the date it is included in computing FICA wages, but only if any additional FICA tax liability that results from inclusion of the amount deferred is actually paid. Because the HI tax resulting from the $20,000 amount deferred was not paid, that amount deferred was not taken into account within the meaning of paragraph (d)(1) of this section. Thus, pursuant to paragraph (d)(1)(ii) of this section, benefit payments attributable to the $20,000 amount deferred will be included as wages in accordance with the general timing rule of paragraph (a)(1) of this section and will be subject to the HI portion of FICA tax when actually or constructively paid (and the OASDI portion of FICA tax to the extent Employee A's wages do not exceed the OASDI wage base limitation).

Example 2. (i) The facts are the same as in *Example 1,* except that Employer M takes all actions necessary to correct its failure to pay the additional tax before the applicable period of limitations expires for 2002 (including payment of any applicable interest and penalties).

(ii) Because the HI tax resulting from the $20,000 amount deferred is paid, that amount deferred is considered taken into account for 2002. Thus, in accordance with paragraph (a)(2)(iii) of this section, neither the amount deferred nor the income attributable to the amount taken into account will be treated as wages for FICA tax purposes at any time thereafter.

Example 3. (i) Employer N establishes a nonqualified deferred compensation plan under which all benefits are 100 percent vested. Under the plan, an employee's account is credited with a contribution equal to 10 percent of salary on December 31 of each year. The employee's account balance also is increased each December 31 by *interest* on the total amounts credited to the employee's account as of the preceding December 31. The interest rate specified in the plan results in income credits that are not based on the rate of return on a predetermined actual investment within the meaning of paragraph (d)(2)(i)(B) of this section, and that are greater than the income that would result from application of a reasonable rate of interest within the meaning of paragraph (d)(2)(i)(C) of this section. Employer N fails to take into account an additional amount for the excess of the income credited under the plan over a reasonable rate of interest.

(ii) Pursuant to paragraph (d)(2)(iii)(A) of this section, the income credits in excess of the income that would be credited using the AFR are considered additional amounts deferred in the year credited.

Example 4. (i) The facts are the same as in *Example 3,* except that the annual increase is based on Moody's Average Corporate Bond Yield.

(ii) Because this index reflects a reasonable rate of interest, the income credited under the plan is considered income attributable to the amount taken into account within the meaning of paragraph (d)(2)(i) of this section.

Example 5. (i) The facts are the same as in *Example 3,* except that the annual increase (or decrease) is based on the rate of total return on Employer N's publicly traded common stock.

(ii) Because the income credited under the plan does not exceed the actual rate of return on a predetermined actual investment, the income credited is considered income attributable to the amount taken into account within the meaning of paragraph (d)(2)(i) of this section.

Example 6. (i) The facts are the same as in *Example 3,* except that the annual rate of increase or decrease is equal to the greater of the rate of total return on a specified aggressive growth mutual fund or the rate of return on a specified income-oriented mutual fund. Employer N fails to take into account an additional amount for the excess of the income credited under the plan over a reasonable rate of interest.

(ii) Because the rate of increase or decrease is based on the greater of two rates of returns, the increase is not based on the return on a predetermined actual investment within the meaning of paragraph (d)(2)(i)(B) of this section. Thus, if the rate of return credited under the plan (i.e., the greater of the rates of return of the two mutual funds) exceeds the income that would be credited using the AFR, the excess is not considered income attributable to the amount taken into account within the meaning of paragraph (d)(2)(i) of this section and, pursuant to paragraph (d)(2)(iii)(A) of this section, is considered an additional amount deferred.

Example 7. (i) The facts are the same as in Example 6, except that the annual increase or decrease with respect to 50 percent of the employee's account is equal to the rate of total return on the specified aggressive growth mutual fund and the annual increase or decrease with respect to the other 50 percent of the employee's account is equal to the increase or decrease in the Standard & Poor's 500 Index.

(ii) Because the increase or decrease attributable to any portion of the employee's account is based on the return on a predetermined actual investment, the entire increase or decrease is considered income attributable to the amount taken into account within the meaning of paragraph (d)(2)(i) of this section.

Example 8. (i) The facts are the same as in *Example 3,* except that, pursuant to the terms of the plan, before the beginning of each year, the board of directors of Employer N designates a specific investment on which the following year's annual increase or decrease will be based. The board is authorized to switch investments more frequently on a prospective basis. Before the beginning of 2004, the board designates Company A stock as the investment for 2004. Before the beginning of 2005, the board designates Company B stock as the investment for 2005. At the end of 2005, the board determines that the return on Company B stock was lower than expected and changes its designation for 2005 to the rate of return on Company C stock, which had a higher return during 2005. Employer N fails to take into account an additional amount for the excess of the income credited under the plan over a reasonable rate of interest.

(ii) The annual increase or decrease for 2004 is based on the return of a predetermined actual investment. Although the annual increase or decrease for 2005 is based on an actual investment, the actual investment is not predetermined since it was not designated before the beginning of 2005. Pursuant to paragraph (d)(2)(iii)(A) of this section, the excess of the income credited under the plan over the income determined using AFR is an additional amount deferred for 2005.

Example 9. (i) Employer O establishes a nonqualified deferred compensation plan for Employee B. Under the plan, if Employee B survives until age 65, he has a fully vested right to receive a lump sum payment at that age, equal to the product of 10 percent per year of service and Employee B's highest average annual compensation for any 3-year period, but no benefits are payable in the event Employee B dies prior to age 65. As permitted under paragraph (e)(5) of this section, any amount deferred under the plan for the calendar year is taken into account as wages as of the last day of the year. As of December 31, 2002, Employee B has 25 years of service and Employee B's high 3-year average compensation is $100,000 (the average for the years 2000 through 2002). As of December 31, 2002, Employee B has a legally binding right to receive a payment at age 65 of $250,000 (10 percent x 25 years x $100,000). As of December 31, 2003, Employee B is age 63, has 26 years of service, and has high 3-year average compensation of $104,000. As of December 31, 2003, Employee B has a legally binding right to receive a payment at age 65 of $270,400 (10 percent x 26 years x $104,000). Thus, during 2003, Employee B has earned a legally binding right to an additional payment at age 65 of $20,400 ($270,400 - $250,000). The assumptions that Employer O uses to determine the amount deferred for 2003 are a 7 percent interest rate and the GAM 83 (male) mortality table, which, solely for purposes of this example, are assumed to be reasonable actuarial assumptions. The amount deferred for 2003 is the present value, as of December 31, 2003, of the $20,400 payment, which is $17,353. Employer O takes this amount into account by including it in Employee B's FICA wages for 2003 and paying the additional FICA tax.

(ii) Under paragraph (d)(2)(ii) of this section, the income attributable to the amount that was taken into account is the increase in the present value of the future payment due solely to the passage of time, because the amount deferred was determined using reasonable actuarial assumptions and methods. As of the payment date at age 65, the present value of the future payment earned during 2003 is $20,400. The entire difference between the $20,400 and the $17,353 amount deferred ($3,047) is the increase in the present value of the future payment due solely to the passage of time, and thus constitutes income attributable to the amount taken into account. Because the amount deferred was taken into account, the entire payment of $20,400 represents either an amount deferred that was previously taken into account ($17,353) or income attributable to that amount ($3,047). Accordingly, pursuant to the nonduplication rule of paragraph (a)(2)(iii) of this section, none of the payment is included in wages.

Example 10. (i) The facts are the same as in *Example 9,* except that, instead of providing a lump sum equal to 10 percent of average compensation per year of service, the plan provides Employee B with a fully vested right to receive a life annuity, payable monthly beginning at age 65, equal to the product of 2 percent for each year of service and Employee B's highest average annual compensation for any 3-year period. The plan also provides that, if Employee B dies before age 65, the present value of the future payments will be paid to his or her beneficiary. As of December 31, 2002, Employee B has a legally binding right to receive lifetime payments of $50,000 (2 percent $\times$ 25 years $\times$ $100,000) per year. As of December 31, 2003, Employee B has a legally binding right to receive lifetime payments of $54,080 (2 percent $\times$ 26 years $\times$ $104,000) per year. Thus, during 2003, Employee B has earned a legally binding right to additional lifetime payments of $4,080 ($54,080 – $50,000) per year beginning at age 65. The amount deferred for 2003 is $32,935, which is the present value, as of December 31, 2003, of these additional payments, determined using the same actuarial assumptions and methods used in *Example 9,* except that there is no discount for the probability of death prior to age 65. Employer O takes this amount into account by including it in Employee B's FICA wages for 2003 and paying the additional FICA tax.

(ii) Under paragraph (d)(2)(ii) of this section, the income attributable to the amount that was taken into account is the increase in the present value of the future payments due solely to the passage of time, because the amount deferred was determined using reasonable actuarial assumptions and methods. Because the amount deferred was taken into account, each annual payment of $4,080 attributable to the amount deferred in 2003 represents either an amount deferred that was previously taken into account or income attributable to that amount. Accordingly, pursuant to the nonduplication rule of paragraph (a)(2)(iii) of this section, none of the payments are included in wages.

Example 11. (i) The facts are the same as in *Example 10,* except that no amount is taken into account for 2003 because Employer O fails to pay the additional FICA tax.

(ii) Under paragraph (d)(1)(ii)(A) of this section, if an amount deferred for a period is not taken into account, then the benefit payments attributable to that amount deferred are included as wages in accordance with the general timing rule of paragraph (a)(1) of this section. In this case, assuming that the amounts deferred in other periods were taken into account, $4,080 of each year's total benefit payments will be included in wages when actually or constructively paid, in accordance with the general timing rule.

Example 12. (i) Employer P establishes an account balance plan on January 1, 2002, under which all benefits are 100 percent vested. The plan provides that amounts deferred will be credited annually with interest beginning in 2002 at a rate that is greater than a reasonable rate of interest. Employer P treats the excess over the applicable interest rate in section 417(e) as an additional amount deferred for 2002 and in each year thereafter, and takes the additional amount into account by including it in FICA wages and paying the additional FICA tax for the year.

(ii) Under the nonduplication rule in paragraph (a)(2)(iii) of this section, the benefits paid under the plan will be excluded from wages for FICA tax purposes.

Example 13. (i) The facts are the same as in *Example 9,* except that, in determining the amount deferred, Employer O uses a 15 percent interest rate, which, solely for purposes of this example, is assumed not to be a reasonable interest rate. Employer O determines that the amount deferred for 2003 is the present value, as of December 31, 2003, of the $20,400 payment, which is $15,023. Employer O includes $15,023 in wages and pays any resulting FICA tax. Solely for purposes of this example, it is assumed that the AFR as of January 1, 2003, is 7 percent.

(ii) Under paragraph (d)(2)(iii)(B) of this section, if any actuarial assumption or method is not reasonable, then the income attributable to the amount taken into account is limited to the income that would result from application of the AFR and, if applicable, the 417(e) mortality table. Because the 15 percent interest rate is unreasonable, the income attributable to the amount taken into account is limited to the income that would result from using a 7 percent interest rate and, in this case, an increase for survivorship using the 417(e) mortality table. Under these assumptions, the income attributable to the $15,023 amount taken into account for 2003 is $1,199 in 2004 and $1,313 in 2005. Under paragraph (d)(1)(ii) of this section, the sum of these amounts ($17,535) is excluded from Employee B's wages pursuant to the nonduplication rule of paragraph (a)(2)(iii) of this section, and the balance of the payment ($2,865) is subject to the general timing rule of paragraph (a)(1) of this section and, thus, is included in Employee B's wages when actually or constructively paid.

(iii) The same result can be reached by multiplying the attributable benefit payments by a fraction, the numerator of which is the amount taken into account, and the denominator of which is the amount deferred that would have been taken into account at the same time had the amount deferred been calculated using the AFR and the 417(e) mortality table. These assumptions are determined as of January 1 of the calendar year in which the amount was taken into account. In this *Example 13,* the fraction would be $15,023 divided by $17,478, which equals .85954. The $20,400 payment is multiplied by this fraction to determine the amount of the payment that is excluded from wages pursuant to the nonduplication rule of paragraph (a)(2)(iii) of this section. Thus, $17,535 ($20,400 $\times$ .85954) is excluded from wages and the balance ($2,865) is subject to FICA tax when actually or constructively paid.

Example 14. (i) The facts are the same as *Example 10,* except that Employer O calculates the amount deferred for 2003 as $18,252 and takes that amount into account by including that amount in wages and paying any resulting FICA tax. The assumptions that Employer O uses to determine the amount deferred are a 15 percent interest rate and, for the period after commencement of benefit payments, the GAM 83 (male) mortality table. The 15 percent interest rate is assumed, solely for purposes of this example, not to be a reasonable actuarial assumption. Solely for purposes of this example, it is assumed that the AFR as of January 1, 2003, is 7 percent.

(ii) Under paragraph (d)(2)(iii)(B) of this section, if any actuarial assumption or method used is not reasonable, then the income attributable to the amount taken into account is limited to the income that would result from application of the AFR and, if applicable, the 417(e) mortality table. Because the 15 percent interest rate is not reasonable, the income attributable to the amount taken into account is equal to the income that would result from using a 7 percent interest rate and the amount taken into account is treated as if it represented a portion of the amount deferred for purposes of applying paragraph (d)(1)(ii)(B) of this section. Under these assumptions, the income attributable to the $18,252 amount taken into account for 2003 is $1,278 in 2004 and $1,367 in 2005. Under paragraph (d)(1)(ii)(B) of this section, the portion of each benefit payment attributable to the amount deferred that is excluded from wages pursuant to the nonduplication rule of paragraph (a)(2)(iii) of this section is determined at benefit commencement by multiplying each benefit payment by a fraction, the numerator of which is the amount taken into account (plus income attributable to that amount) and the denominator of which is the present value of future benefit payments attributable to the amount deferred. Because the interest rate assumption is not reasonable, not only is the income limited to the application of the AFR, but the present value in the denominator must be determined using the AFR and (if applicable) the 417(e) mortality table. In this case, the present value is $40,283 and thus the fraction is $20,897 divided by $40,283, or .51875. Thus, $2,116 (.51875 × $4,080) of each year's benefit payment is excluded from wages and the balance of each year's payment ($1,964) is subject to the general timing rule of paragraph (a)(1) of this section and is included in wages when actually or constructively paid.

(iii) The same result can be reached by multiplying the attributable benefit payments by a fraction the numerator of which is the amount taken into account, and the denominator of which is the amount deferred that would have been taken into account at the same time had the amount deferred been calculated using the AFR and the 417(e) mortality table. These assumptions are determined as of January 1 of the calendar year in which the amount was taken into account. In this Example 14, the fraction would be $18,252 divided by $35,185, which equals .51875. The $4,080 annual payment is multiplied by this fraction to determine the amount of the payment that is excluded from wages pursuant to the nonduplication rule of paragraph (a)(2)(iii) of this section. Thus, $2,116 ($4,080 × .51875) is excluded from wages and the balance ($1,964) is subject to FICA tax when actually or constructively paid.

(e) *Time amounts deferred are required to be taken into account*—(1) *In general.* Except as otherwise provided in this paragraph (e), an amount deferred under a nonqualified deferred compensation plan must be taken into account as wages for FICA tax purposes as of the later of the date on which services creating the right to the amount deferred are performed (within the meaning of paragraph (e)(2) of this section) or the date on which the right to the amount deferred is no longer subject to a substantial risk of forfeiture (within the meaning of paragraph (e)(3) of this section). However, in no event may any amount deferred under a nonqualified deferred compensation plan be taken into account as wages for FICA tax purposes prior to the establishment of the plan providing for the amount deferred (or, if later, the plan amendment providing for the amount deferred). Therefore, if an amount is deferred pursuant to the terms of a legally binding agreement that is not put in writing until after the amount would otherwise be taken into account under this paragraph (e)(1), the amount deferred (including any attributable income) must be taken into account as wages for FICA tax purposes as of the date the material terms of the plan are put in writing.

(2) *Services creating the right to an amount deferred.* For purposes of this section, services creating the right to an amount deferred under a nonqualified deferred compensation plan are considered to be performed as of the date on which, under the terms of the plan and all the facts and circumstances, the employee has performed all of the services necessary to obtain a legally binding right (as described in paragraph (b)(3)(i) of this section) to the amount deferred.

(3) *Substantial risk of forfeiture.* For purposes of this section, the determination of whether a substantial risk of forfeiture exists must be made in accordance with the principles of section 83 and the regulations thereunder.

(4) *Amount deferred that is not reasonably ascertainable under a nonaccount balance plan*—(i) *In general*—(A) *Date required to be taken into account.* Notwithstanding any other provision of this paragraph (e), an amount deferred under a nonaccount balance plan is not required to be taken into account as wages under the special timing rule of paragraph (a)(2) of this section until the first date on which all of the amount deferred is reasonably ascertainable (the resolution date). In this case, the amount required to be taken into account as of the resolution date is determined in accordance with paragraph (c)(2) of this section.

(B) *Definition of reasonably ascertainable.* For purposes of this paragraph (e)(4), an amount deferred is considered reasonably ascertainable on the first date on which the amount, form, and commencement date of the benefit payments attributable to the amount deferred are known, and the only actuarial or other assumptions regarding future events or circumstances needed to determine the amount deferred are interest and mortality. For this purpose, the form and commencement date of the benefit payments attributable to the amount deferred are treated as known if the requirements of paragraph (c)(2)(iii)(B) of this section (under which payments are treated as being made in the normal form of benefit commencing at normal commencement date) are satisfied. In addition, an amount deferred does not fail to be reasonably ascertainable on a date merely because the exact amount of the benefit payable cannot readily be calculated on that date or merely because the exact amount of the benefit payable depends on future changes in the cost of living. If the exact amount of the benefit payable depends on future changes in the cost of living, the amount deferred must be determined using a reasonable assumption as to the future changes in the cost of living. For example, the amount of a benefit is treated as known even if the exact amount of the benefit payable cannot be determined until future changes in the cost of living are reflected in the section 415 limitation on benefits payable under a qualified retirement plan.

(ii) *Earlier inclusion permitted*—(A) *In general.* With respect to an amount deferred that is not reasonably ascertainable, an employer may choose to take an amount into account at any date or dates (an early inclusion date or dates) before the resolution date (but not before the date described in paragraph (e)(1) of this section with respect to the amount deferred).

Thus, for example, with respect to an amount deferred under a nonaccount balance plan that is not reasonably ascertainable because the plan permits employees to receive their benefits in more than one form or commencing at more than one date (and the requirements of paragraph (c)(2)(iii) of this section are not satisfied), an employer may choose to take an amount into account on the date otherwise described in paragraph (e)(1) of this section before the form and commencement date are selected (based on assumptions as to the form and commencement date for the benefit payments) or may choose to wait until the form and commencement date of the benefit payments are selected. An employer that chooses to take an amount into account at an early inclusion date under this paragraph (e)(4)(ii) for an employee under a plan is not required until the resolution date to identify the period to which the amount taken into account relates.

(B) *True-up at resolution date.* If, with respect to an amount deferred for a period, an employer chooses to take an amount into account as of an early inclusion date in accordance with this paragraph (e)(4)(ii) and the benefit payments attributable to the amount deferred exceed the benefit payments that are actuarially equivalent to the amount taken into account at the early inclusion date (payable in the same form and using the same commencement date as the benefit payments attributable to the amount deferred), then the present value of the difference in the benefits, determined in accordance with paragraph (c)(2) of this section, must be taken into account as of the resolution date.

(C) *Actuarial assumptions.* For purposes of determining the benefits that are actuarially equivalent to the amount taken into account as of an early inclusion date, the amount taken into account is converted to an actuarially equivalent benefit payable in the same form and commencing on the same date as the actual benefit payments attributable to the amount deferred using an interest rate, and, if applicable, mortality and cost-of-living assumptions, that were reasonable as of the early inclusion date. Thus, with respect to an amount deferred for a period, the amount required to be taken into account as of the resolution date is the present value (determined using an interest rate, and, if applicable, mortality and cost-of-living assumptions, that are reasonable as of the resolution date) of the excess, if any, of the future benefit payments attributable to the amount deferred over the future benefits payable in the same form and commencing on the same date that are actuarially equivalent to the portion of the amount deferred that was taken into account as of the early inclusion date (where actuarial equivalence is determined using an interest rate, and, if applicable, mortality and cost-of-living assumptions, that were reasonable as of the early inclusion date).

(D) *Allocation rules for amounts deferred over more than one period*—(*1*) *General rule.* The rules of this paragraph (e)(4)(ii)(D) apply for purposes of determining whether an amount has been included under this paragraph (e)(4) before the earliest date permitted under paragraph (e)(1) of this section.

(*2*) *Future compensation increases.* Increases in an employee's compensation after the early inclusion date must be disregarded.

(*3*) *Early retirement subsidies.* An early retirement subsidy that the employee ultimately receives may be taken into account at an early inclusion date if the employee would have a legally binding right to the subsidy at the early inclusion date but for any condition that the employee continue to render services. Accordingly, an employer may take into account at an early inclusion date any early retirement subsidy that the employee ultimately receives to the extent that elimination or reduction of that subsidy would violate section 411(d)(6)(B)(i) if that section applied to the plan.

(*4*) *Allocation with respect to offsets.* In any case in which a series of amounts are deferred over more than one period, the amounts deferred are not reasonably ascertainable until a single resolution date and the benefit payments attributable to the entire series are determined under a formula that provides a gross benefit that in the aggregate is subject to an objective reduction for future events under the terms of the plan, such as an offset for the aggregate benefits payable under a plan qualified under section 401(a), the attribution of benefit payments to the amount deferred in each period is determined under the rules of this paragraph (e)(4)ii)-(D)(4). In a case described in the preceding sentence, the benefit payments made as a result of the series of amounts deferred may be treated as attributable to the amount deferred as of the earliest period in which the employee obtained a legally binding right to a benefit under the plan equal to the excess, if any, of the amount of the gross benefit attributable to that period (determined at the resolution date), over the amount of the reduction determined as of the end of that period. Thus, for example, if an employee obtains a legally binding right in each of several years to benefit payments from a nonqualified deferred compensation plan that provides for a specified gross benefit for the years to be offset by the benefits payable under a qualified plan, the amount deferred in the first year may be treated as equal to the gross benefit for the year, reduced by the offset applicable at the end of the year (even if the offset increases after the end of the year).

(E) *Treatment of benefits paid before the resolution date.* If a benefit payment is attributable to an amount deferred that is not reasonably ascertainable at the time of payment (or is paid before the date selected under paragraph (e)(5) of this section), and the employer has previously taken an amount into account with respect to the amount deferred under the early inclusion rule of this paragraph (e)(4), then, in lieu of the pro rata rule provided in paragraph (d)(1)(ii)(B) of this section, a first-in-first-out rule applies in determining the portion of the benefit payment attributable to the amount taken into account. Under this first-in-first-out rule, the benefit payment is compared to the sum of the amount taken into account at the early inclusion date and the income attributable to that amount. If the benefit payment equals or exceeds the amount taken into account at the early inclusion date and the income attributable to that amount as of the date of the benefit payment, the benefit payment is included as wages under the general timing rule of paragraph (a)(1) of this section to the extent of any excess, and the amount taken into account at the early inclusion date (and income attributable to that amount) is disregarded thereafter with respect to the amount deferred. If the amount taken into account at the early inclusion date and the income attributable to that amount as of the date of the benefit payment exceeds the benefit payment, the benefit payment is not included as wages under the general timing rule of paragraph (a)(1) of this section and, in determining the amount that must be taken into account thereafter with respect to the amount deferred, the amount taken into account at the early inclusion date, plus attributable income as of the date of the benefit payment, is reduced by the amount of the benefit payment, and only the excess plus future income attributable to the excess (credited using assumptions that were reasonable on the early inclusion date) is taken into consideration. If amounts have been taken into account at more than one early inclusion date, this paragraph (e)(4)(ii)(E) applies on a first-in-first-out basis, beginning with the amount taken into account at the earliest early inclusion date (including income attributable thereto).

(5) *Rule of administrative convenience.* For purposes of this section, an employer may treat an amount deferred as required to be taken into account under this paragraph (e) on any date that is later than, but within the same calendar year as, the actual date on which the amount deferred is otherwise required to be taken into account under this paragraph (e). For example, if services creating the right to an amount deferred are considered performed under paragraph (e)(2) of this section periodically throughout a year, the employer may nevertheless treat the services creating the right to that amount deferred as performed on December 31 of that year. If an employer uses the rule of administrative convenience described in this paragraph (e)(5), any determination of whether the income attributable to an amount deferred under an account balance plan is based on a reasonable rate of interest or whether the actuarial assumptions used to determine the present value of an amount deferred in a nonaccount balance plan are reasonable will be made as of the date the employer selects to take the amount into account.

(6) *Portions of an amount deferred required to be taken into account on more than one date.* If different portions of an amount deferred are required to be taken into account under paragraph (e)(1) of this section on more than one date (e.g., on account of a graded vesting schedule), then each such portion is considered a separate amount deferred for purposes of this section.

(7) *Examples.* This paragraph (e) is illustrated by the following examples:

Example 1. (i) Employer M establishes a nonqualified deferred compensation plan for Employee A on November 1, 2005. Under the plan, which is an account balance plan, Employee A obtains a legally binding right on the last day of each calendar year (if Employee A is employed on that date) to be credited with a principal amount equal to 5 percent of compensation for the year. In addition, a reasonable rate of interest is credited quarterly. Employee A's account balance is nonforfeitable and is payable upon Employee A's termination of employment. For 2006, the principal amount credited to Employee A under the plan (which, in this case, is also the amount deferred within the meaning of paragraph (c) of this section) is $25,000.

(ii) Under paragraph (e)(2) of this section, the services creating the right to the $25,000 amount deferred are considered performed as of December 31, 2006, the date on which Employee A has performed all of the services necessary to obtain a legally binding right to the amount deferred. Thus, in accordance with paragraph (e)(1) of this section, the $25,000 amount deferred must be taken into account as of December 31, 2006, which is the later of the date on which services creating the right to the amount deferred are performed or the date on which the right to the amount deferred is no longer subject to a substantial risk of forfeiture.

Example 2. (i) The facts are the same as in *Example 1,* except that the principal amount credited under the plan on the last day of each year (and attributable interest) is forfeited if the employee terminates employment within five years of that date.

(ii) Under paragraph (e)(3) of this section, the determination of whether the right to an amount deferred is subject to a substantial risk of forfeiture is made in accordance with the principles of section 83. Under §1.83–3(c) of this chapter, a substantial risk of forfeiture generally exists where rights in property that are transferred are conditioned, directly or indirectly, upon the future performance of substantial services. Because Employee A's right to receive the $25,000 principal amount (and attributable interest) is conditioned on the performance of services for five years, a substantial risk of forfeiture exists with respect to that amount deferred until December 31, 2011.

(iii) December 31, 2011, is the later of the date on which services creating the right to the amount deferred are performed or the date on which the right to the amount deferred is no longer subject to a substantial risk of forfeiture. Thus, in accordance with paragraph (e)(1) of this section, the amount deferred (which, pursuant to paragraph (c)(1) of this section, is equal to the $25,000 principal amount credited to Employee A's account on December 31, 2006, plus the interest credited with respect to that principal amount through December 31, 2011) must be taken into account as of December 31, 2011.

Example 3. (i) The facts are the same as in *Example 2,* except that the principal amount credited under the plan on the last day of each year (and attributable interest) becomes nonforfeitable according to a graded vesting schedule under which 20 percent is vested as of December 31, 2007; 40 percent is vested as of December 31, 2008; 60 percent is vested as of December 31, 2009; 80 percent is vested as of December 31, 2010; and 100 percent is vested as of December 31, 2011. Because these dates are later than the date on which the services creating the right to the amount deferred are considered performed (December 31, 2006), the amount deferred is required to be taken into account as of these dates that fall in five different years.

(ii) Paragraph (e)(6) of this section provides that, if different portions of an amount deferred are required to be taken into account under paragraph (e)(1) of this section on more than one date, then each such portion is considered a separate amount deferred for purposes of this section. Thus, $5,000 of the principal amount, plus interest credited through December 31, 2007, is taken into account as an amount deferred on December 31, 2007; $5,000 of the principal amount, plus interest credited through December 31, 2008, is taken into account as a separate amount deferred on December 31, 2008; etc.

Example 4. (i) On November 21, 2001, Employer N establishes a nonqualified deferred compensation plan under which all benefits are 100 percent vested. The plan provides for Employee B (who is age 45) to receive a lump sum benefit of $500,000 at age 65. This benefit will be forfeited if Employee B dies before age 65.

(ii) Because the amount, form, and commencement date of the benefit are known, and the only assumptions needed to determine the amount deferred are interest and mortality, the amount deferred is reasonably ascertainable within the meaning of paragraph (e)(4)(i) of this section on November 21, 2001.

Example 5 (i) The facts are the same as in *Example 4,* except that plan provides that the lump sum will be paid at the later of age 65 or termination of employment and provides that the $500,000 payable to Employee B is increased by 5 percent per year for each year that payment is deferred beyond age 65.

(ii) Because the commencement date of the benefit payment is contingent on when Employee B terminates employment, the commencement date of the benefit payment is not known. Thus, the amount deferred is not reasonably ascertainable within the meaning of paragraph (e)(4)(i) of this section, unless the plan satisfies the requirements of paragraph (c)(2)(iii)(B) of this section. Because the fixed 5 percent factor may not be reasonable at the time benefit payments commence (i.e., 5 percent might be higher or lower than a reasonable interest rate when payments commence), the plan fails to satisfy paragraph (c)(2)(iii)(B) of this section and accordingly the amount deferred is not reasonably ascertainable until termination of employment,

Example 6. (i) The facts are the same as in *Example 4,* except that the $500,000 is payable to Employee B at the later of age 55 or termination of employment.

(ii) Because the commencement date of the benefit payment is contingent on when Employee B terminates employment, the commencement date of the benefit payment is not known. Thus, the amount deferred is not reasonably ascertainable until termination of employment.

Example 7. (i) The facts are the same as in *Example 4*, except that Employee B may elect to take the benefit in the form of a life annuity of $50,000 per year (commencing at age 65).

(ii) Because the plan permits employees to elect to receive benefits in more than one form and the alternative forms may not have the same value when Employee B makes his election, the plan fails to satisfy the requirements of paragraph (c)(2)(iii)(B) of this section until a form of benefit is selected. Thus, the amount deferred is not reasonably ascertainable until then.

Example 8. (i) Employer O establishes a nonqualified deferred compensation plan. The plan is a supplemental executive retirement plan (SERP) that provides Employee C with a fully vested right to receive a pension, in the form of a life annuity payable monthly, beginning at age 65, equal to the excess of 3 percent of Employee C's final 3-year average pay for each year of participation up to 15 years, over the amount payable to Employee C from Employer O's qualified pension plan. The amount payable under the qualified pension plan is a life annuity payable monthly, beginning at age 65, equal to 1.5 percent of final 3-year average pay for each year of employment, excluding pay in excess of the section 401(a)(17) compensation limit. No benefits are payable under the SERP if Employee C dies before age 65. Employee C becomes a participant in the SERP on January 1, 2001, at age 44. The amount deferred under the SERP for any year is not reasonably ascertainable prior to termination of employment because the amount of the benefit is not known and the determination of the amount deferred requires assumptions other than interest and mortality (e.g., an assumption as to Employee C's average pay for the final three years of employment). As permitted by paragraph (e)(4)(i) of this section, Employer O chooses not to take any amount into account for any year before the resolution date. Employee C terminates employment on December 31, 2018 when he is age 62.

(ii) As of the date Employee C terminates employment, the amount of the benefit is known and the only actuarial or other assumptions needed to determine the amount deferred are an interest rate assumption and a mortality assumption. At that time, the amount deferred in each past year becomes reasonably ascertainable, and Employer O is able to determine that during 2001 Employee C earned a legally binding right to a life annuity of $4,000 per year beginning in 2021 when Employee C is age 65. Employer O determines the present value of Employee C's future benefit payments under the SERP as of this resolution date (December 31, 2018), using a 7 percent interest rate and the UP-84 mortality table, which, solely for purposes of this example, are assumed to be reasonable actuarial assumptions for December 31, 2018. The special timing rule will be satisfied if the resulting present value, $26,950, is taken into account on that date in accordance with paragraph (d)(1) of this section.

Example 9. (i) The facts are the same as in *Example 8*, except that the plan provides that Employee C may choose to receive early retirement benefits on an unreduced basis at any time after age 60 if Employee C has completed 15 years of service by that date.

(ii) As of the date Employee C terminates employment, the amount of the benefit is known and the only actuarial or other assumptions needed to determine the amount deferred are an interest rate assumption and a mortality assumption. At that time, the amount deferred in each past year becomes reasonably ascertainable, and Employer O is able to determine that during 2001 Employee C earned a legally binding right to a life annuity of $4,000 per year beginning on December 31, 2018 when Employee C is age 62. Employer O determines the present value of Employee C's future benefit payments under the SERP as of this resolution date (December 31, 2018), using a 7 percent interest rate and the UP-84 mortality table, which, solely for purposes of this example, are assumed to be reasonable actuarial assumptions for December 31, 2018. The special timing rule will be satisfied if the resulting present value, $37,576, is taken into account on that date in accordance with paragraph (d)(1) of this section.

Example 10. (i) The facts are the same as in *Example 9*, except that, as permitted under paragraph (e)(4)(ii) of this section, Employer O chooses to take an amount into account before the amount deferred for 2001 is reasonably ascertainable. The amount that Employer O takes into account on December 31, 2001, is $13,043 (the present value of a life annuity of $4,000 per year, payable at age 62, using a 6 percent interest rate and the UP-84 mortality table). Employer O does not take any other amount into account before the resolution date.

(ii) In accordance with paragraph (e)(4)(ii)(B) of this section, Employer O must determine any additional amount required to be taken into account in 2018. If the $4,000 payable in the form of a life annuity beginning at age 62 exceeds the life annuity which is actuarially equivalent to the $13,043 previously taken into account, the present value of the excess must be taken into account. In this Example 10, the $13,043 previously taken into account is actuarially equivalent to a $4,000 annuity commencing at age 62 using a 6 percent interest rate and the UP-84 mortality table (which, solely for purposes of this example, are assumed to be reasonable actuarial assumptions for December 31, 2001). Accordingly, no additional amount need be taken into account in 2018, regardless of any changes in market rates of interest between 2001 and 2018.

Example 11. (i) The facts are the same as in *Example 9*, except that, as permitted under paragraph (e)(4)(ii) of this section, Employer O chooses to take an amount into account before the amount deferred for 2001 is reasonably ascertainable. The amount that Employer O takes into account on December 31, 2001, is $9,569 (the present value of a life annuity of $4,000 per year, payable at age 65, using a 6 percent interest rate and the UP-84 mortality table). Employer O does not take any other amount into account before the resolution date.

(ii) In accordance with paragraph (e)(4)(ii)(B) of this section, Employer O must determine any additional amount required to be taken into account in 2018. If the $4,000 payable in the form of a life annuity beginning in 2018 at age 62 exceeds the life annuity which is actuarially equivalent to the $9,569 previously taken into account, the present value of the excess must be taken into account. In this case, the $9,569 previously taken into account is actuarially equivalent to a $2,935 annuity commencing at age 62 using a 6 percent interest rate and the UP-84 mortality table (which, solely for purposes of this example, are assumed to be reasonable actuarial assumptions for December 31, 2001). Accordingly, an additional amount needs to be taken into account in 2018 equal to the present value of the excess of the $4,000 annual stream of benefit payments to which Employee C obtained a legally binding right during 2001 over the $2,935 annual stream of benefit payments which is actuarially equivalent to the amount previously taken into account. This present value (i.e., the present value of a life annuity equal to $4,000 minus $2,935, or $1,065 annually) is determined by Employer O to be $10,005 as of the resolution date using a 7 percent interest rate and the UP-84 mortality table (which, solely for purposes of this example, are assumed to be reasonable actuarial assumptions for December 31, 2018).

Example 12. (i) The facts are the same as in *Example 9*, except that the amount that Employer O takes into account on December 31, 2001, is $15,834 (the present value of $4,000, payable at age 60, using a 6 percent interest rate and the UP-84 mortality table). Employer O does not take any other amount into account before the resolution date.

(ii) In accordance with paragraph (e)(4)(ii)(B) of this section, Employer O must determine any additional amount required to be taken into account in 2018. If the $4,000 payable in the form of a life annuity beginning at age 62 exceeds the life annuity which is actuarially equivalent to the $15,834 previously taken into account, the present value of the excess must be taken into account. In this case, the $15,834 previously taken into account is actuarially equivalent to a $4,856 annuity commencing at age 62 using a 6 percent interest rate and the UP-84 mortality table (which, solely for purposes of this example, are assumed to be reasonable actuarial assumptions for December 31, 2001). Because the life annuity of $4,856 per year (which is equivalent to the amount taken into account at the early inclusion date) exceeds the $4,000 annuity attributable to the amount deferred in 2001, no additional amount is required to be taken into account for that amount deferred as of the resolution date. Employer O may claim a refund or credit for the overpayment of FICA tax with respect to amounts taken into account prior to the resolution date to the extent permitted by sections 6402, 6413, and 6511.

Example 13. (i) The facts are the same as in *Example 12*, except that Employee C became a participant in the SERP on January 1, 2000. In addition, Employer O determines in 2018 that during 2000 Employee C earned a legally binding right to a life annuity of $1,500 per year beginning on December 31, 2018.

(ii) Employer O may allocate the $15,834 previously taken into account among any amounts deferred on or before the early inclusion date. At the resolution date, Employer O will have to take into account the present value of an annuity equal to the excess of the life annuity attributable to the amounts deferred for 2000 and 2001 over a life annuity of $4,856 per year.

Example 14. (i) In 2003, Employer P establishes a nonqualified deferred compensation plan for Employee D. The plan provides that, in consideration of Employee D's services to be performed on Project X in 2004, Employee D will have a nonforfeitable right to receive 1 percent per year of Employer P's net profits associated with Project X for each of the immediately succeeding three years. No services beyond 2004 are required. The 1 percent of net profits payable each year will be paid on March 31 of the immediately succeeding year. One percent of net profits associated with Project X is $750,000 in 2005, $400,000 in 2006, and $90,000 in 2007. Employee D receives $750,000 on March 31, 2006, $400,000 on March 31, 2007, and $90,000 on March 31, 2008.

(ii) Because the services creating the right to all of the amount deferred are performed in 2004, the benefit payments based on the 2005, 2006, and 2007 net profits are all attributable to the amount deferred in 2004. However, because the present value of Employee D's future benefit is contingent on future profits, the determination of the amount deferred requires the use of assumptions other than interest, mortality, and cost of living. Thus, all of the amount deferred in 2004 will not be reasonably ascertainable within the meaning of paragraph (e)(4)(i) of this section until December 31, 2007 (which is the resolution date). Employer P does not choose to take any amount into account prior to the amount deferred becoming reasonably ascertainable.

(iii) However, paragraph (d)(1)(ii)(A) of this section provides that a benefit payment attributable to an amount deferred under a nonqualified deferred compensation plan must be included as wages when actually or constructively paid if the amount deferred has not been taken into account as wages under the special timing rule of paragraph (a)(2) of this section. Thus, the benefit payments in 2006 and 2007 must be included as wages when paid.

(iv) As of December 31, 2007, all of the amount deferred under the plan becomes reasonably ascertainable because the amount of the benefit payable attributable to the amount deferred is treated as known under paragraph (e)(4)(i)(B) of this section, and the only assumption needed to determine the present value of the future benefits is interest. However, since Employer P was required to treat the payments in 2006 and 2007 as wages when paid under the general timing rule of paragraph (a)(1) of this section, only the present value of the payment to be made in 2008 is required to be taken into account as of the resolution date (December 31, 2007) under the special timing rule of paragraph (a)(2) of this section. Using an interest rate of 10 percent per year (which, solely for purposes of this Example 14, is assumed to be reasonable), Employer P determines that on December 31, 2007, the present value of the future benefits is $87,881, and Employer P includes that additional amount in wages for 2007. (Note that Employer P can choose to use the lag method of withholding described in paragraph (f)(3) of this section, which allows the resolution date amount to be taken into account no later than March 31, 2008, provided that the amount deferred is increased by interest using the AFR for January of 2008.)

Example 15. (i) The facts are the same as in *Example 14,* except that Employer P chooses the early inclusion option permitted by paragraph (e)(4)(ii) of this section to take $1,000,000 into account on December 31, 2004, before the amount deferred for 2004 is reasonably ascertainable.

(ii) Pursuant to paragraph (e)(4)(ii)(E) of this section, in applying the nonduplication rule of paragraph (a)(2)(iii) of this section, a first-in-first-out rule applies in determining the benefit payments that are attributable to amounts previously taken into account. Using the 10 percent interest rate, Employer P determines that the $750,000 benefit payment on March 31, 2006, and the March 31, 2007, benefit payment of $400,000 are less than the $1,000,000 taken into account at the early inclusion date, plus attributable income, and, therefore, are not included in wages when paid.

(iii) Under paragraph (e)(4)(ii)(E) of this section, if an employer chooses to take an amount into account before the resolution date, the amount taken into account (plus income attributable to that amount) is disregarded to the extent the amount is attributed to benefit payments made before the resolution date. Thus, Employer P must reduce the $1,000,000 taken into account in 2004 (plus income attributable to that amount) based upon the two benefit payments ($750,000 and $400,000) that were excluded from wages. Using an interest rate of 10 percent, Employer P determines that the amount taken into account in 2004 plus interest to the resolution date and reduced based upon the two benefit payments is $15,228 and the additional amount that is required to be taken into account as of December 31, 2007, is $72,653 ($87,881 – $15,228).

Example 16. (i) Employee E obtains a fully vested, legally binding right during 2002, 2003, and 2004 to payments from a nonqualified deferred compensation plan of Employer Q under which the benefits are based on a formula that includes an actuarial offset by the account balance under a qualified defined contribution plan of Employer Q as of December 31, 2004. The payments from the nonqualified deferred compensation plan are to commence on December 31, 2005. At the resolution date for the amounts earned during 2002, 2003, and 2004, which is December 31, 2004, Employee E has a legally binding right to a net annual benefit of $100,000 payable for life to commence on December 31, 2005. On the resolution date, Employer Q determines that on December 31, 2002, Employee E had a legally binding right to receive $100,000 annually for life beginning on December 31, 2005 (as a result of the gross benefit under the nonqualified plan being $120,000 annually for life, and the offset being $20,000 annually for life, as of December 31, 2002). On December 31, 2003, Employee E had a legally binding right to receive $95,000 annually for life beginning on December 31, 2005 (as a result of the gross benefit under the nonqualified plan being $135,000 annually for life, and the offset being $40,000 annually for life, as of December 31, 2003). On December 31, 2004, Employee E had a legally binding right to receive $100,000 annually for life beginning on December 31, 2005 (as a result of the gross benefit under the nonqualified plan being $145,000 annually for life, and the offset being $45,000 annually for life, as of December 31, 2004).

(ii) In this case, pursuant to paragraph (e)(4)(ii)(D)(4) of this section, Employer Q can attribute the entire $100,000 life annuity to the amount deferred for 2002, even though Employee E's benefit under the nonqualified deferred compensation plan is reduced to $95,000 in 2003.

Example 17. (i) In 2010, Employee F performs services for which she earns a right to 10 percent of the proceeds from the sale of a motion picture. In 2011, Employee F performs services for which she earns a right to 10 percent of the proceeds from the sale of another motion picture. These proceeds are calculated by subtracting the total advertising expenses for both movies. Payment is to be made in the year following the date on which both pictures have been sold, but not later than 2018. At the end of 2010, the advertising expenses for both pictures totaled $300,000. The first motion picture is sold for $10,000,000 in 2014. The second motion picture is sold for $17,000,000 in 2017. At the end of 2017, the advertising expenses totaled $1,700,000. In 2018, Employee F is paid $2,530,000 (10 percent of the sum of $10,000,000 and $17,000,000 minus $1,700,000).

(ii) Pursuant to paragraph (e)(4)(ii)(D)(4) of this section, $970,000 (10 percent of the excess of the gross proceeds from the sale of the first motion picture at the resolution date in 2017 over the advertising expenses incurred at the end of 2010) of the payment made in 2018 can be attributed to the amount deferred in 2010 (and with the remaining payment of $1,560,000 to be attributed to the amount deferred in 2011).

(f) *Withholding*—(1) *In general.* Unless an employer applies an alternative method described in paragraph (f)(2) or (3) of this section, an amount deferred under a nonqualified deferred compensation plan for any employee is treated, for purposes of withholding and depositing FICA tax, as wages paid by the employer and received by the employee at the time it is taken into account in accordance with paragraph (e) of this section. However, paragraphs (f)(2) and (3) of this section provide alternative methods which may be used with respect to an amount deferred for an employee. An employer is not required to be consistent in applying the alternatives described in this paragraph (f) with respect to different employees or amounts deferred.

(2) *Estimated method*—(i) *In general.* Under the alternative method provided in this paragraph (f)(2), the employer may make a reasonable estimate of the amount deferred on the date on which the amount is taken into account in accordance with paragraph (e) of this section and take that estimated amount into account as wages paid by the employer and received by the employee on that date (the estimate date), for purposes of withholding and depositing FICA tax.

(ii) *Underestimate of the amount deferred*—(A) *General rule.* If the employer underestimates the amount deferred (as determined after calculating the actual amount deferred that should have been taken into account as of the date on which the amount was taken into account in accordance with paragraph (e) of this section, using an interest rate and other actuarial assumptions that are reasonable as of that date), the employer may treat the shortfall as wages paid as of the estimate date or as of any date that is no later than three months after the estimate date. In either case, the shortfall does not include the income credited to the amount deferred after the amount is taken into account in accordance with paragraph (e) of this section.

(B) *Shortfall is treated as wages paid on a date after the estimate date.* If the employer chooses to treat the shortfall as wages paid on a date that is no later than three months after the estimate date, the employer must take that shortfall into account as wages paid by the employer and received by the employee on that date, for purposes of withholding and depositing FICA tax.

(C) *Shortfall is treated as wages paid on the estimate date.* If the employer chooses to treat the shortfall as wages paid as of the estimate date, the shortfall is treated as an error for purposes of withholding and depositing FICA tax. Appropriate adjustments may be made in accordance with section 6205(a) and the regulations thereunder; however, for purposes of §31.6205–1(b), the error need not be treated as ascertained before the date that is three months after the estimate date.

(D) *Reporting.* The employer must report the shortfall as wages on Form 941, Employer's Quarterly Federal Tax Return (and, if applicable, Form 941c, Supporting Statement to Correct Information) and Form W-2, Wage and Tax Statement (or, if applicable, Form W-2c, Corrected Wage and Tax Statement) in accordance with its treatment of the shortfall under paragraph (f)(2)(ii)(B) or (C) of this section.

(iii) *Overestimate of the amount deferred.* If the employer overestimates the amount deferred (as determined after calculating the actual amount deferred that should have been taken into account as of the date on which the amount was taken into account in accordance with paragraph (e) of this section, using an interest rate and actuarial assumptions that are reasonable as of that date) and deposits more than the amount required, the employer may claim a refund or credit in accordance with sections 6402, 6413, and 6511. A Form 941c, or an equivalent statement, must accompany each claim for refund. In addition, Form W-2 or, if applicable, Form W-2c must also reflect the actual amount deferred that should have been taken into account.

(3) *Lag method.* Under the alternative method provided in this paragraph (f)(3), an amount deferred, plus interest, may be treated as wages paid by the employer and received by the employee, for purposes of withholding and depositing FICA tax, on any date that is no later than three months after the date the amount is required to be taken into account in accordance with paragraph (e) of this section. For purposes of this paragraph (f)(3), the amount deferred must be increased by interest through the date on which the wages are treated as paid, at a rate that is not less than AFR. If the employer withholds and deposits FICA tax in accordance with this paragraph (f)(3), the employer will be treated as having taken into account the amount deferred plus income to the date on which the wages are treated as paid.

(4) *Examples.* This paragraph (f) is illustrated by the following examples:

Example 1. (i) Employer M maintains a nonqualified deferred compensation plan that is an account balance plan. The plan provides for annual bonuses based on current year profits to be deferred until termination of employment. Employer M's profits for 2003, and thus the amount deferred, is reasonably ascertainable, but Employer M calculates the amount deferred on March 3, 2004, when the relevant data is available.

(ii) In accordance with the alternative method described in paragraph (f)(2) of this section, Employer M makes a reasonable estimate that the amount deferred that must be taken into account as of December 31, 2003, for Employee A is $20,000, and withholds and deposits FICA tax on that amount as if it were wages paid by Employer M and received by Employee A on that date. In January of 2004, Employer M files and furnishes Form W-2 for Employee A including the $20,000 in FICA wages. On March 3, 2004, Employer M determines that the actual amount deferred that should have been taken into account on December 31, 2003, was $22,000.

(iii) In accordance with the alternative method described in paragraph (f)(2)(ii) of this section, Employer M may treat the additional $2,000 as wages paid to and received by Employee A on December 31, 2003, the estimate date. Employer M may treat the $2,000 shortfall as an error ascertained on March 3, 2004, and withhold and deposit FICA tax on that amount. Form W-2c for Employee A for 2003 must include the $2,000 shortfall in FICA wages. Employer M must also correct the information on Form 941 for the last quarter of 2003, reporting the adjustment on Form 941 for the first quarter of 2004, accompanied by Form 941c for the last quarter of 2003.

(iv) Instead, Employer M may treat the $2,000 shortfall as wages paid on March 31, 2004, and withhold and deposit FICA tax on that amount as if it were wages paid by Employer M and received by Employee A on that date. Form W-2 for Employee A for 2004 and Form 941 for the first quarter of 2004 must include the $2,000 shortfall in FICA wages.

Example 2. (i) The facts are the same as in *Example 1,* except that on March 3, 2004, Employer M determines that the actual amount deferred that should have been taken into account on December 31, 2003, was $19,000.

(ii) Under paragraph (f)(2)(iii) of this section, Employer M may, in accordance with sections 6402, 6413, and 6511, claim a refund or credit for the overpayment of tax resulting from the overestimate. In addition, Employer M must file and furnish a Form W-2c for Employee A and must correct the information on Form 941 for the last quarter of 2003.

Example 3. (i) The facts are the same as in *Example 1,* except that Employer M does not make a reasonable estimate of the amount deferred that must be taken into account as of December 31, 2003. Instead, Employer M withholds and deposits FICA tax on the amount deferred plus interest on that amount using AFR (for January 2004) as if it were wages paid by Employer M and received by Employee A on March 15, 2004.

(ii) Under the alternative method described in paragraph (f)(3) of this section, the amount taken into account on March 15, 2004 (including the interest), will be treated as FICA wages paid to and received by Employee A on March 15, 2004.

Example 4. (i) The facts are the same as in *Example 1,* except that an amount is also deferred for Employee B which is required to be taken into account on October 15, 2003, and Employer M chooses to use the lag method in paragraph (f)(3) of this section in order to provide time to calculate the amount deferred.

(ii) Employer M may use any date not later than January 15, 2004, to take the amount deferred into account (provided that the amount deferred includes interest, at AFR for January 1, 2003, through December 31, 2003, and at AFR for January 1, 2004, through January 15, 2004).

(g) *Effective date and transition rules*—(1) *General effective date.* Except for paragraphs (g)(2) through (4) of this section, this section is applicable on and after January 1, 2000. Thus, paragraphs (a) through (f) of this section apply to amounts deferred on or after January 1, 2000; to amounts deferred before January 1, 2000, which cease to be subject to a substantial risk of forfeiture on or after January 1, 2000, or for which a resolution date occurs on or after January 1, 2000; and to benefits actually or constructively paid on or after January 1, 2000.

(2) *Reasonable, good faith interpretation for amounts deferred and benefits paid before January 1, 2000*—(i) *In general.* For periods before January 1, 2000 (including amounts deferred before January 1, 2000, and any benefits actually or constructively paid before January 1, 2000, that are attributable to those amounts deferred), an employer may rely on a reasonable, good faith interpretation of section 3121(v)(2), taking into account pre-existing guidance. An employer will be deemed to have determined FICA tax liability and satisfied FICA withholding requirements in accordance with a reasonable, good faith interpretation of section 3121(v)(2) if the employer has complied with paragraphs (a) through (f) of this section. For purposes of paragraphs (g)(2) through (4) of this section, and subject to paragraphs (g)(2)(ii) and (iii) of this section, whether an employer that has not complied with paragraphs (a) through (f) of this section has determined FICA tax liability and satisfied FICA withholding requirements in accordance with a reasonable, good faith interpretation of section 3121(v)(2) will be determined based on the relevant facts and circumstances, including consistency of treatment by the employer and the extent to which the employer has resolved unclear issues in its favor.

(ii) *Plan must be established or adopted.* If an amount is deferred under a plan before January 1, 2000, and benefit payments attributable to that amount are actually or constructively paid on or after January 1, 2000, then in no event will an employer's treatment of the amount deferred be considered to be in accordance with a reasonable, good faith interpretation of section 3121(v)(2) if the employer treats that amount as taken into account as wages for FICA tax purposes prior to the establishment of the plan (within the meaning of paragraph (b)(2) of this section) providing for the deferred compensation (or, if later, the establishment of the plan as amended to provide for the deferred compensation, as provided in paragraph (b)(2)(ii) of this section). If an amount is deferred under a plan before January 1, 2000, and benefit payments attributable to that amount are actually or constructively paid before January 1, 2000, then in no event will the employer's treatment of that amount deferred be considered to be in accordance with a reasonable, good faith interpretation of section 3121(v)(2) if the employer treats that amount as taken into account as wages for FICA tax purposes prior to the adoption of the plan providing for the deferred compensation (or, if later, the adoption of the plan amendment providing the deferred compensation). For example, awards, bonuses, raises, incentive payments, and other similar amounts granted under a plan as compensation for past services may not be taken into account under section 3121(v)(2) prior to the establishment (or, if applicable, the adoption) of the plan.

(iii) *Certain changes in position for stock options, stock appreciation rights, and other stock value rights not reasonable, good faith interpretation.* In the case of a stock option, stock appreciation right, or other stock value right (as defined in paragraph (b)(4)(ii) of this section) that is exercised before January 1, 2000, an employer that treats the exercise as not subject to FICA tax as a result of the nonduplication rule of section 3121(v)(2)(B) is not acting in accordance with a reasonable, good faith interpretation of section 3121(v)(2) if the employer has not treated that grant and all earlier grants as subject to section 3121(v)(2) by reporting the current value of such options and rights as FICA wages on Form 941 filed for the quarter during which each grant was made (or, if later, for the quarter during which each grant ceased to be subject to a substantial risk of forfeiture).

(3) *Optional adjustments to conform with this section for pre-effective-date open periods*–(i) *General rule.* If an employer determined FICA tax liability with respect to section 3121(v)(2) in any period ending before January 1, 2000, for which the applicable period of limitations has not expired on January 1, 2000 (pre-effective-date open periods), in a manner that was not in accordance with this section, the employer may adjust its FICA tax determination for that period to conform to this section. Thus, if an amount deferred was taken into account in a pre-effective-date open period when it was not required to be taken into account (e.g., an amount taken into account before it became reasonably ascertainable), the employer may claim a refund or credit for any FICA tax paid on that amount to the extent permitted by sections 6402, 6413, and 6511.

(ii) *Consistency required.* In the case of a plan that is not a nonqualified deferred compensation plan (within the meaning of paragraph (b)(1) of this section), if any payment was actually or constructively paid to an employee under the plan in a pre-effective-date open period and that payment was not included in FICA wages by reason of the employer's treatment of the plan as a nonqualified deferred compensation plan, then the employer may claim a refund or credit for FICA tax paid on amounts treated as amounts deferred under the plan (in accordance with the employer's treatment of the plan as a nonqualified deferred compensation plan) for that employee for pre-effective-date open periods only to the extent that the FICA tax paid on all amounts treated as amounts deferred for the employee in all pre-effective-date open periods under the plan exceeds the FICA tax that would have been due on the benefits actually or constructively paid to the employee in those periods under the plan if those benefits were included in FICA wages when paid. If any benefit payments attributable to amounts deferred after December 31, 1993, were actually or constructively paid to an employee under a nonqualified deferred compensation plan (within the meaning of paragraph (b)(1) of this section) in a pre-effective-date open period, but these payments were treated as subject to FICA tax because the employer treated the plan as not being a nonqualified deferred compensation plan, then the employer may claim a refund or credit for the FICA tax paid on those benefit payments only to the extent that the FICA tax paid on those benefit payments exceeds the FICA tax that would have been due on the amounts deferred to which those benefit payments are attributable if those amounts deferred had been taken into account when they would have been required to have been taken into account under this section (if this section had been in effect then).

(iii) *Reporting.* Any employer that adjusts its FICA tax determination in accordance with paragraphs (g)(3)(i) and (ii) of this section must make appropriate adjustments on Form 941 and Form 941c for the affected periods, and, in addition, must file and furnish Form W-2, or, if applicable, Form W-2c, for any affected employee so that the Social Security Administration may correctly post the amount deferred to the employee's earnings record. The adjustments may be made in accordance with section 6205(a) and the regulations thereunder; however, for purposes of §31.6205-1(b), the error is not required to be treated as ascertained before March 31, 2000.

(4) *Application of reasonable, good faith standard*—(i) *Plans that are not subject to section 3121(v)(2).* If a plan is not a nonqualified deferred compensation plan within the meaning of paragraph (b)(1) of this section, but, for a period ending prior to January 1, 2000, and, pursuant to a reasonable, good faith interpretation of section 3121(v)(2), an amount under the plan was taken into account (within the meaning of paragraph (d)(1) of this section) as an amount deferred under a nonqualified deferred compensation plan, then, pursuant to paragraph (g)(2) of this section, the following rules shall apply—

(A) With respect to benefit payments actually or constructively paid before January 1, 2000, that are attributable to amounts previously taken into account under the plan, no additional FICA tax will be due;

(B) On or after January 1, 2000, benefit payments under the plan must be taken into account as wages when actually or constructively paid in accordance with paragraph (a)(1) of this section; and

(C) To the extent permitted by paragraph (g)(3) of this section, the employer may claim a refund or credit for FICA tax actually paid on amounts taken into account prior to January 1, 2000.

(ii) *Plans that are subject to section 3121(v)(2) for which the amount deferred has not been fully taken into account*—(A) *In general.* The rules of paragraphs (g)(4)(ii)(B) through (E) of this section apply if a plan is a nonqualified deferred compensation plan (within the meaning of paragraph (b)(1) of this section) and, with respect to an amount deferred under the plan for an employee prior to January 1, 2000, the employer, in accordance with a reasonable, good faith interpretation of section 3121(v)(2), either took into account an amount that is less than the amount that would have been required to be taken into account if paragraphs (a) through (f) of this section had been in effect for that period or took no amount into account. Thus, paragraphs (g)(4)(ii)(B) through (E) of this section apply both to an employer that treated the plan as if it were not a nonqualified deferred compensation plan within the meaning of section 3121(v)(2) (by withholding and paying FICA tax due on benefits actually or constructively paid under the plan during that period, if any) and to an employer that treated the plan as a nonqualified deferred compensation plan within the meaning of section 3121(v)(2).

(B) *No additional tax required.* Pursuant to paragraph (g)(2) of this section, no additional FICA tax will be due for any period ending prior to January 1, 2000.

(C) *General timing rule applicable.* In accordance with paragraph (d)(1)(ii) of this section, except as provided in paragraphs (g)(4)(ii)(D) and (E), the general timing rule described in paragraph (a)(1) of this section applies to benefits actually or constructively paid on or after January 1, 2000, attributable to an amount deferred in a period before January 1, 2000, to the extent the amount taken into account was less than the amount that would have been required to be taken into account if paragraphs (a) through (f) of this section had been in effect before January 1, 2000.

(D) *Special rule for amounts deferred before 1994.* The difference between the amount that was taken into account in any period ending prior to January 1, 1994, and the amount that would have been required or permitted to be taken into account in that period if paragraphs (a) through (f) of this section had been in effect is treated as if it had been taken into account within the meaning of paragraph (d)(1) of this section. For example, in the case of an amount deferred before 1994 that was not reasonably ascertainable (and which was not subject to a substantial risk of forfeiture), the employer is treated as if it had anticipated the actual amount, form, and commencement date for the benefit payments attributable to the amount deferred and had taken the amount deferred into account at an early inclusion date before 1994 using a method permitted under this section. Thus, with respect to such an amount deferred, the employer is not required to take any additional amount into account when the amount deferred becomes reasonably ascertainable, and no additional FICA tax will be due when the benefit payments attributable to the amount deferred are actually or constructively paid.

(E) *Special rule for amounts required to be taken into account in 1994 or 1995.* In the case of an amount deferred that would have been required to be taken into account in 1994 or 1995 if paragraphs (a) through (f) of this section had been in effect, an employer will be treated as taking the amount deferred into account under paragraph (d)(1) of this section to the extent the employer takes the amount into account by treating it as wages paid by the employer and received by the employee as of any date prior to April 1, 2000.

(iii) *Plans that are subject to section 3121(v)(2) for which more than the amount deferred has been taken into account.* If a plan is a nonqualified deferred compensation plan (within the meaning of paragraph (b)(1) of this section) and an amount was taken into account under the plan for an employee before January 1, 2000, in accordance with a reasonable, good faith interpretation of section 3121(v)(2), but that amount could not have been taken into account before January 1, 2000, if paragraphs (a) through (f) of this section had been in effect then, the following rules apply—

(A) The determination of the amount deferred for any period beginning on or after January 1, 2000, must be made in accordance with paragraph (c) of this section, and the time when amounts deferred under the plan are required to be taken into account must be determined in accordance with paragraph (e) of this section, without regard to any such amount that was taken into account for any period ending before January 1, 2000; and

(B) To the extent permitted by sections 6402, 6413, and 6511, the employer may claim a refund or credit for an overpayment of tax caused by the overinclusion of wages that occurred before January 1, 2000.

(5) *Examples.* This paragraph (g) is illustrated by the following examples:

Example 1. (i) In 1996, Employer M establishes a nonqualified deferred compensation plan that is a nonaccount balance plan for Employee A. All benefits under the plan are 100 percent vested. In order to determine the amount deferred on behalf of Employee A under the plan for 1996 and 1997, Employer M must make assumptions as to the date on which Employee A will retire and the form of benefit Employee A will elect, in addition to interest, mortality, and cost-of-living assumptions. Based on assumptions made with respect to all of these contingencies, Employer M determines that the amount deferred for 1996 is $50,000 and the amount deferred for 1997 is $55,000. In 1996 and 1997, Employee A's total wages (without regard to the amounts deferred) exceed the OASDI wage bases. Employer M withholds and deposits HI tax on the $50,000 and $55,000 amounts. Employee A does not retire before January 1, 2000. Employer M chooses under paragraph (g)(3) of this section to apply this section to 1996 and 1997 before the January 1, 2000, general effective date.

(ii) Under this section, the amounts deferred in 1996 and 1997 are not reasonably ascertainable (within the meaning of paragraph (e)(4)(i) of this section) before January 1, 2000. Thus, as long as the applicable period of limitations has not expired for the periods in 1996 and 1997, Employer M may, to the extent permitted under paragraph (g)(3) of this section, apply for a refund or credit for the HI tax paid on the amounts deferred for 1996 and 1997 and, in accordance with paragraph (e)(4) of this section, take into account the amounts deferred when they become reasonably ascertainable.

Example 2. (i) Employer N adopts a plan on January 1, 1994, that covers Employee B, who has 10 years of service as of that date. The plan provides that, in consideration of Employee B's outstanding services over the past 10 years, Employee B will be paid a $500,000 lump sum distribution upon termination of employment at any time. On January 15, 1996, Employee B terminates employment with Employer N. Employer N determines, based on a reasonable, good faith interpretation of section 3121(v)(2), that the plan is a nonqualified deferred compensation plan under that section. Employer N treats the $500,000 as having been taken into account as an amount deferred in 1993 and earlier years.

(ii) Under paragraph (g)(2)(ii) of this section, if all amounts are deferred and all benefits are paid under a plan before January 1, 2000, then in no event will an employer's treatment of amounts deferred under the plan be considered to be in accordance with a reasonable, good faith interpretation of section 3121(v)(2) if the employer treats these amounts as taken into account as wages for FICA tax purposes prior to the adoption of the plan. Accordingly, Employer N's treatment is not in accordance with a reasonable, good faith interpretation of section 3121(v)(2) because Employer N treated amounts as taken into account in years before the adoption of the plan. As a result, the payment made to Employee B in 1996 was subject to both the OASDI and HI portions of FICA tax when paid.

Example 3. (i) Employer O adopts a bonus plan on December 1, 1993, that becomes effective and legally binding on January 1, 1994. Under the plan, which is not set forth in writing, a specified bonus amount (which is 100 percent vested) is credited to Employee C's account each December 31. A reasonable rate of interest on Employee C's account balance is credited quarterly. Employee C's account balance will begin to be paid in equal annual installments over 10 years beginning on January 1, 2000. Employer O determines, based on a reasonable, good faith interpretation of section 3121(v)(2), that the bonus plan is a nonqualified deferred compensation plan under that section and, therefore, treats the amounts credited from January 1, 1994, through December 31, 1999, as amounts deferred and, in accordance with a reasonable, good faith interpretation of section 3121(v)(2), takes those amounts deferred into account as wages for FICA tax purposes as of those dates. The bonus plan is set forth in writing on May 1, 1999, and, thus, is treated as established as of January 1, 1994.

(ii) Under paragraph (g)(2)(ii) of this section, if an amount is deferred before January 1, 2000, and the attributable benefit is paid on or after January 1, 2000, then in no event will an employer's treatment of the amount deferred under a plan be considered to be in accordance with a reasonable, good faith interpretation of section 3121(v)(2) if the employer treats the amount deferred as taken into account as wages for FICA tax purposes prior to the establishment of the plan (within the meaning of paragraph (b)(2) of this section). Because the bonus plan is treated as established on January 1, 1994 (pursuant to the transition rule for unwritten plans in paragraph (b)(2)(iii) of this section), and because Employer O, in accordance with a reasonable, good faith interpretation of section 3121(v)(2), took amounts deferred into account in 1994 through 1999, the amounts paid to Employee C attributable to those amounts deferred will not be subject to FICA tax when paid.

Example 4. (i) In 1985, Employer P establishes a compensation arrangement for Employee D that provides for a lump sum payment to be made after termination of employment but the arrangement is not a nonqualified deferred compensation plan (within the meaning of paragraph (b)(1) of this section). However, prior to January 1, 2000, and in accordance with a reasonable, good faith interpretation of section 3121(v)(2), Employer P treats the arrangement as a nonqualified deferred compensation plan under section 3121(v)(2). Employer P determines that Employee D's total wages (without regard to the amount deferred) for each year from 1985 through 1993 exceed the applicable OASDI and HI wage bases for each of those years and, consequently, there is no FICA tax liability with respect to the amounts deferred for those years. In 1994, Employee D's total wages (without regard to the amount deferred) exceed the OASDI wage base. However, because there is no limit on the HI wage base, the amount deferred for 1994 results in additional HI tax liability of $290, which is timely paid by Employer P.

(ii) Employee D terminates employment with Employer P in 1995 and receives a plan payment of $50,000. In that year, Employee D also receives wages of $60,000 from Employer P. In accordance with its treatment of the plan as a nonqualified deferred compensation plan under section 3121(v)(2), Employer P does not treat the $50,000 payment in 1995 as wages for FICA tax purposes in that year.

(iii) Because amounts under a plan were taken into account (within the meaning of paragraph (d)(1) of this section) as amounts deferred under a nonqualified deferred compensation plan pursuant to a reasonable, good faith interpretation of section 3121(v)(2)(A), but that plan is not a nonqualified deferred compensation plan within the meaning of paragraph (b)(1) of this section, the transition rules provided in paragraph (g)(4)(i) of this section apply. Thus, no additional FICA tax will be due on the benefits paid in 1995.

(iv) Because $290 of HI tax was paid on the amount deferred in 1994, Employer P is entitled to a refund or credit for that amount to the extent permitted under sections 6402, 6413, and 6511 — but only to the extent that $290 exceeds the FICA tax that would have been due on the $50,000 payment in 1995 if that payment had been subject to FICA tax when paid (i.e., if paragraphs (a) through (f) of this section had been effective for those years). In 1995, Employee D had other wages of $60,000. Thus, only $1,200 (the $61,200 OASDI wage base, less the $60,000 of other wages) of the $50,000 payment would have been subject to OASDI; the full $50,000 would have been subject to HI. This would have resulted in $148.80 of OASDI tax ($1,200 $\times$ 12.4 percent) and $1,450 of HI tax ($50,000 $\times$ 2.9 percent). Employer P is not entitled to a refund or credit under the consistency rule of paragraph (g)(3)(ii) because the $290 of HI tax paid in 1994 is less than the total $1,598.80 of FICA tax liability that would have resulted if this section had applied for 1995.

(v) However, if the benefit payment is instead actually or constructively paid on or after January 1, 2000, the benefit payment must be taken into account as wages when actually or constructively paid in accordance with the general timing rule of paragraph (a)(1) of this section (and paragraph (g)(4)(i)(B) of this section).

Example 5. (i) In 1985, Employer Q establishes a compensation arrangement for Employee E that is a nonqualified deferred compensation plan within the meaning of paragraph (b)(1) of this section. However, prior to January 1, 2000, Employer Q determines, based on a reasonable, good faith interpretation of section 3121(v)(2), that the arrangement is not a nonqualified deferred compensation plan within the meaning of that section. Thus, when Employee E retires at the end of 1996 and benefit payments under the arrangement begin in 1997, Employer Q withholds and deposits FICA tax on the amounts paid to Employee E. Payments under the arrangement continue on or after January 1, 2000. Employer Q does not choose (under paragraph (g)(3) of this section) to adjust its FICA tax determination for a pre-effective-date open period by treating this section as in effect for all amounts deferred and benefits actually or constructively paid for any such period. The periods in 1994 and 1995 are not pre-effective-date open periods for Employer Q.

(ii) Under paragraph (g)(4)(ii) of this section, for purposes of determining whether benefits actually or constructively paid on or after January 1, 2000, were previously taken into account for purposes of applying the nonduplication rule of section 3121(v)(2)(B), any amount that would have been required to have been taken into account before 1994 will be treated as if it had been taken into account within the meaning of paragraph (d)(1) of this section. Under the nonduplication rule, benefit payments attributable to an amount that has been so treated as taken into account is not treated as wages for FICA tax purposes at any later time (such as upon payment).

(iii) Because Employer Q does not adjust its FICA tax determination by treating this section as in effect for all amounts deferred for periods ending after December 31, 1993, any benefit payments attributable to amounts deferred in periods ending after December 31, 1993, will be included in wages when actually or constructively paid in accordance with the general timing rule of paragraph (a)(1) of this section.

Example 6. (i) The facts are the same as in *Example 5,* except that Employer Q chooses (in accordance with paragraph (g)(3) of this section) to adjust its FICA tax determination for all pre-effective-date open periods by treating this section as in effect for all amounts deferred for those periods. In addition, Employer Q chooses (in accordance with paragraph (g)(4)(ii)(E) of this section) to take the amounts deferred for 1994 and 1995 into account by treating these amounts as FICA wages paid and received by Employee E on January 15, 2000.

(ii) In accordance with the nonduplication rule of paragraph (a)(2)(iii) of this section, because all amounts deferred for Employee E under the plan were taken into account (or treated as taken into account), any benefit payments made to Employee E under the plan will not be included as FICA wages when actually or constructively paid.

Example 7. (i) The facts are the same as in *Example 5,* except that Employer Q does not withhold and deposit the FICA tax due on benefits actually or constructively paid before January 1, 2000.

(ii) Because Employer Q did not withhold and deposit the FICA tax due on benefits actually or constructively paid before January 1, 2000, Employer Q did not determine FICA tax liability and satisfy FICA tax withholding requirements in accordance with a reasonable, good faith interpretation of section 3121(v)(2). Thus, the transition rules provided in paragraphs (g)(3) and (4) of this section do not apply. As a result, any amount that would have been required to have been taken into account under this section before 1994 is not treated as if it had been so taken into account under paragraph (g)(4)(ii)(D) of this section, and benefit payments attributable to amounts deferred before January 1, 2000, are treated as FICA wages when actually or constructively paid in accordance with the general timing rule of paragraph (a)(1) of this section.

Example 8. (i) In 1993, Employer R establishes a nonqualified deferred compensation plan for Employee F under which Employee F will have a fully vested right to receive a lump sum payment in 2000 equal to 50 percent of Employee F's highest rate of salary. On December 31, 1993, Employee F's highest salary is $1 million. In accordance with a reasonable, good faith interpretation of section 3121(v)(2), Employer R determines that, for 1993, there is an amount deferred that must be taken into account as wages for FICA tax purposes. Based Employer R's estimate that Employee F's highest salary will be $3 million in 2000, Employer R determines that the amount deferred is equal to the present value in 1993 of $1.5 million payable in 2000. However, because Employee F has other wages in 1993 that exceed the applicable OASDI and HI wage bases for that year, no additional FICA tax is paid as a result of that amount deferred being taken into account for 1993. In addition, Employer R takes no amounts into account under the plan after 1993 for Employee F. Under paragraphs (e)(1) and (4)(ii)(D)(2) of this section, the largest amount that could have been taken into account in 1993 is the present value of a lump sum payment of $500,000, payable in 2000, because that is the maximum amount to which Employee R has a legally binding right as of December 31, 1993. Employee F's highest salary is, in fact, $3 million in 2000 and Employee F receives $1.5 million under the plan on December 31, 2000.

(ii) In accordance with paragraphs (g)(1) and (4)(iii)(A) of this section, the determination of the amount deferred under the plan for any period beginning on or after January 1, 2000, and the time when that amount deferred is required to be taken into account must be determined in accordance with this section. In addition, these determinations must be made without regard to any amount deferred that was taken into account for any period ending before January 1, 2000, that could not be taken into account before January 1, 2000, if paragraphs (a) through (f) of this section had been in effect. Because no FICA tax was actually paid on that $1 million in 1993, no overpayment of tax was caused by the overinclusion of wages in 1993 and, thus, Employer R is not entitled to a refund or credit (even assuming that the period of limitations has been kept open for periods in 1993). In addition, because the difference between the present value of the $1.5 million payment and the present value of a $500,000 payment was not taken into account for periods beginning on or after January 1, 1994, $1 million must be included in FICA wages under the general timing rule when paid.

§31.3121(v)(2)–2 Effective dates and transition rules.

(a) *General statutory effective date.* Except as otherwise provided in paragraphs (b) through (e) of this section, section 3121(v)(2) and the amendments made to section 3121(a)(2), (a)(3), and (a)(13) by the Social Security Amendments of 1983 (Public Law 98-21, 97 Stat. 65), as amended by section 2662(f)(2) of the Deficit Reduction Act of 1984 (Public Law 98-369, 98 Stat. 494), apply to amounts deferred and benefits paid after December 31, 1983.

(b) *Definitions.* For purposes of §31.3121(v)(2)–1 and this section, the following definitions apply:

(1) *FICA. FICA* means the Federal Insurance Contributions Act (26 U.S.C. 3101 et seq.).

(2) *457(a) plan.* A *457(a) plan* means an eligible deferred compensation plan of a State or local government or of a tax-exempt organization to which section 457(a) applies.

(3) *Gap agreement. Gap agreement* means an agreement adopted after March 24, 1983, and on or before December 31, 1983, between an individual and a nonqualified deferred compensation plan within the meaning of §31.3121(v)(2)–1(b). Such an agreement does not fail to be a gap agreement merely because the terms of the plan are changed after December 31,1983.

(4) *Individual party to a gap agreement. Individual party to a gap agreement* means an individual who was eligible to participate in a gap agreement on December 31, 1983, under the terms of the agreement on that date. An individual will be treated as an individual party to a gap agreement even if the individual has not accrued any benefits under the plan by December 31, 1983, and regardless of whether the individual has taken any specific action to become a party to the agreement. However, an individual who becomes eligible to participate in a gap agreement after December 31, 1983, is not an individual party to a gap agreement.

(5) *Individual party to a March 24, 1983 agreement. Individual party to a March 24, 1983 agreement* means an individual who was eligible to participate in a March 24, 1983 agreement under the terms of the agreement on March 24, 1983. An individual will be treated as an individual party to a March 24, 1983 agreement even if the individual has not accrued any benefits under the plan by March 24, 1983, and regardless of whether the individual has taken any specific action to become a party to the agreement. However, an individual who becomes eligible to participate in a March 24, 1983 agreement after March 24, 1983, is not an individual party to a March 24, 1983 agreement.

(6) *March 24, 1983 agreement. March 24, 1983 agreement* means an agreement in existence on March 24, 1983, between an individual and a nonqualified deferred compensation plan within the meaning of §31.3121(v)(2)–1(b). Such an agreement does not fail to be a March 24, 1983 agreement merely because the terms of the plan are changed after March 24, 1983. In addition, for purposes of this paragraph (b)(6) only, any plan (or agreement) that provides for payments that qualify for one of the retirement payment exclusions is treated as a nonqualified deferred compensation plan. For example, §31.3121(v)(2)–1(b)(4)(v) provides that certain benefits established in connection with impending termination do not result from the deferral of compensation and thus are not considered deferred under a nonqualified deferred compensation plan. However, a plan that provides such bene-

fits and that was in existence on March 24, 1983, is treated as a nonqualified deferred compensation plan for purposes of this paragraph (b) to the extent it provides benefits that would have satisfied one of the retirement payment exclusions.

(7) *Retirement payment exclusions. Retirement payment exclusions* are the exclusions from wages (for FICA tax purposes) for retirement payments under section 3121(a)(2)(A), (a)(3), and (a)(13)-(A)(iii), as in effect on April 19, 1983 (the day before enactment of the Social Security Amendments of 1983).

(8) *Transition benefits. Transition benefits* are payments made after December 31, 1983, attributable to services rendered before January 1, 1984. For this purpose, transition benefits are determined without regard to any changes made in the terms of the plan after March 24, 1983, in the case of a March 24, 1983 agreement or after December 31, 1983, in the case of a gap agreement.

(c) *Transition rules*—(1) *In general.* Except as provided in paragraph (c)(2) or (3) of this section, the general statutory effective date described in paragraph (a) of this section applies to benefit payments after December 31, 1983. Thus, except as provided in paragraph (c)(2) or (3) of this section, section 3121(v)(2) applies, and the retirement payment exclusions do not apply, to benefit payments made after December 31, 1983, even if the benefit payments are made under a March 24, 1983 agreement or a gap agreement.

(2) *Transition benefits under a March 24, 1983 agreement.* With respect to an individual party to a March 24, 1983 agreement, transition benefits paid under that March 24, 1983 agreement (except for those paid under a 457(a) plan) are not subject to the special timing rule of section 3121(v)(2) and are subject to section 3121(a) as in effect on April 19, 1983. Thus, transition benefits under a March 24, 1983 agreement (except for those under a 457(a) plan) to an individual party to a March 24, 1983 agreement are excluded from wages (for FICA tax purposes) only if they qualify for any of the retirement payment exclusions (or any other exclusion provided under section 3121(a) as in effect on April 19, 1983).

(3) *Transition benefits under a gap agreement.* With respect to an individual party to a gap agreement, the payor of transition benefits under the gap agreement must choose to either—

(i) Take the transition benefits into account as wages when paid; or

(ii) Take the amount deferred (within the meaning of §31.3121(v)(2)–1(c)) with respect to the transition benefits into account as wages under section 3121(v)(2) (as if section 3121(v)(2) had applied before its general statutory effective date).

(d) *Determining transition benefit portion.* For purposes of determining the portion of total benefits under a nonqualified deferred compensation plan that represents transition benefits, if, under the terms of the plan, benefit payments are not attributed to specific years of service, the employer may use any reasonable method. For example, if a plan provides that the employee will receive benefits equal to 2 percent of high 3-year average compensation multiplied by years of service, and the employee retires after 25 years of service, 9 of which are before 1984, the employer may determine that 9/25 of the total benefit payments to be received beginning in 2000 are transition benefits attributable to services performed before 1984.

(e) *Order of payment.* If an employer determines, in accordance with paragraph (d) of this section, that a portion of the total benefits under a nonqualified deferred compensation plan constitutes transition benefits, then, for purposes of determining the portion of each benefit payment that constitutes transition benefits, the employer must treat each benefit payment as consisting of transition benefits in the same proportion as the transition benefits that have not been paid (as of January 1, 2000) bear to total benefits that have not been paid (as of January 1, 2000), unless such allocation is inconsistent with the terms of the plan. However, for a benefit payment made before January 1, 2000, the employer may use any reasonable allocation method to determine the portion of a payment that consists of transition benefits, provided that the allocation method is consistent with the terms of the plan.

PART 602 - OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 3. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 4. In §602.101, paragraph (c) is amended by adding the following entry in the table in numerical order to read as follows:

§602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
31.3121(v)(2)–1	1545–1643
* * * * *	

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved December 23, 1998.

Donald C. Lubick,
Assistant Secretary of the Treasury.
(Tax Policy)

(Filed by the Office of the Federal Register on January 28, 1999, 8:45 a.m., and published in the issue of the Federal Register for January 29, 1999, 64 F.R. 4542)

Section 3306.—Definitions

26 CFR 31.3306(r)(2)–1: Treatment of amounts deferred under certain non-qualified deferred compensation plans.

T.D. 8815

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 31

Federal Unemployment Tax Act (FUTA) Taxation of Amounts Under Employee Benefit Plans

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations under section 3306(r)(2) of the Internal Revenue Code (Code), that provide guidance as to when amounts deferred under or paid from a nonqualified deferred compensation plan are taken into account as wages for purposes of the employment taxes imposed by the Federal Unemployment Tax Act (FUTA). Section 3306(r)(2), relating to treatment of certain nonqualified deferred compensation, was added to the Code by section 324 of the Social Security Amendments of 1983. These regulations provide guidance to employers who maintain nonqualified deferred compensation plans.

DATES: *Effective Date:* These regulations are effective January 29, 1999.

Applicability Date: These regulations are applicable on and after January 1, 2000. In addition, these regulations provide certain transition rules for amounts deferred and benefits paid before January 1, 2000, including allowing employers to use a reasonable, good faith interpretation of section 3306(r)(2).

FOR FURTHER INFORMATION CONTACT: Janine Cook, Linda E. Alsalihi, or Margaret A. Owens, (202) 622-6040 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

These final regulations amend the Employment Tax Regulations (26 CFR part 31) under section 3306(r)(2). Section 3306(r)(2) was added to the Internal Revenue Code (Code) by section 324 of the Social Security Amendments of 1983 (1983 Amendments). Section 2662(f)(2) of the Deficit Reduction Act of 1984 (DEFRA) amended section 324 of the 1983 Amendments.

Notice 94–96 (1994–2 C.B. 564) provides that until final regulations are issued, the IRS will not challenge an employer's determination of FUTA tax liability with respect to a nonqualified deferred compensation plan for periods before the effective date of any final regulations if the determination is based on a reasonable, good faith interpretation of section 3306(r)(2). On January 25, 1996, a notice of proposed rulemaking (EE–55–95), under section 3306(r)(2) was published in the **Federal Register** (61 F.R. 2214), providing guidance related to the FUTA tax treatment of amounts deferred under or paid from certain nonqualified deferred compensation plans. On December 24, 1997, a notice of proposed rulemaking (REG–209484–87 and REG–209807–95), under section 3306(r)(2), extending the proposed general effective date of the regulations to January 1, 1998, was published in the **Federal Register** (62 F.R. 67304).

Comments regarding the proposed regulations were received from the public, and on June 24, 1996, the IRS held a public hearing concerning the proposed amendments. After consideration of the public comments received and the statements made at the public hearing, the proposed regulations are adopted as revised by this Treasury decision.

Explanation of Provisions

These final regulations provide guidance under section 3306(r)(2), relating to when amounts deferred under or paid from nonqualified deferred compensation plans are taken into account as wages for FUTA purposes. These rules are substantially similar to the rules applicable to the FICA (Federal Insurance Contributions Act) tax treatment of such amounts deferred under section 3121(v)(2). Thus, these final regulations cross-reference the final regulations under section 3121(v)(2) (FICA tax treatment of nonqualified deferred compensation), published elsewhere in this issue of the **Federal Register.**

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the notice of proposed rulemaking was issued prior to March 29, 1996, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal authors of these regulations are Janine Cook, Linda E. Alsalihi, and Margaret A. Owens, Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 31 is amended as follows:

PART 31—EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT SOURCE

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

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

Par. 2. Section 31.3306(r)(2)-1 is added to read as follows:

§31.3306(r)(2)–1 Treatment of amounts deferred under certain nonqualified deferred compensation plans.

(a) *In general.* Section 3306(r)(2) provides a special timing rule for the tax imposed by section 3301 with respect to any amount deferred under a nonqualified deferred compensation plan. Section 31.3121(v)(2)–1 contains rules relating to when amounts deferred under certain nonqualified deferred compensation plans are wages for purposes of sections 3121(v)(2), 3101, and 3111. The rules in §31.3121(v)(2)–1 also apply to the special timing rule of section 3306(r)(2). For purposes of applying the rules in §31.3121(v)(2)–1 to section 3306(r)(2) and this paragraph (a), references to the Federal Insurance Contributions Act are considered references to the Federal Unemployment Tax Act (26 U.S.C. 3301 et seq.), references to FICA are considered references to FUTA, references to section 3101 or 3111 are considered references to section 3301, references to section 3121(v)(2) are considered references to section 3306(r)(2), references to section 3121(a), (a)(5), and (a)(13) are considered references to section 3306(b), (b)(5), and (b)(10), respectively, and references to §31.3121(a)–2(a) are considered references to §31.3301–4.

(b) *Effective dates and transition rules.* Except as otherwise provided, section 3306(r)(2) applies to remuneration paid after December 31, 1984. Section 31.3121(v)(2)–2 contains effective date rules for certain remuneration paid after December 31, 1983, for purposes of section 3121(v)(2). The rules in §31.3121(v)(2)–2 also apply to section 3306(r)(2). For purposes of applying the rules in §31.3121(v)(2)–2 to section 3306(r)(2) and this paragraph (b), references to section 3121(v)(2) are considered references to section 3306(r)(2), and references to section 3121(a)(2), (a)(3), or (a)(13) are considered references to section 3306(b)(2), (b)(3), or (b)(10), respectively. In addition, references to §31.3121(v)(2)–1 are considered references to paragraph (a) of this section. For purposes of applying the rules of §31.3121(v)(2)–2 to this paragraph (b) –

(1) References to "December 31, 1983" are considered references to "December 31, 1984";

(2) References to "before 1984" are considered references to "before 1985";

(3) References to "Federal Insurance Contributions Act" are considered references to "Federal Unemployment Tax Act"; and

(4) References to "FICA" are considered references to "FUTA".

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved December 23, 1998.

Donald C. Lubick,
Assistant Secretary of the Treasury. (Tax Policy)

(Filed by the Office of the Federal Register on January 28, 1999, 8:45 a.m., and published in the issue of the Federal Register for January 29, 1999, 64 F.R. 4540)

Section 7502.—Timely Mailing Treated as Timely Filing and Paying

26 CFR 301.7502–1: Timely mailing treated as timely filing.

T.D. 8807

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 301

Timely Mailing Treated as Timely Filing/Electronic Postmark

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains temporary and final regulations relating to timely mailing treated as timely filing and paying under section 7502. The temporary regulations generally reflect changes to the law made by the **Internal Revenue Service Restructuring and Reform Act of 1998.** The temporary regulations affect taxpayers that file documents or make payments or deposits. The text of the temporary regulations is also set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section of this issue of the **Federal Register.**

DATES: *Effective date:* These regulations are effective January 15, 1999.

Applicability date: For dates of applicability, see §301.7502–1T(f)(3).

FOR FURTHER INFORMATION CONTACT: Charles A. Hall (202) 622- 4940 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Regulations on Procedure and Administration (26 CFR part 301) under section 7502 relating to timely mailing treated as timely filing and paying. **Section 7502(c)(2) was amended by section 2003(b) of the Internal Revenue Service Restructuring and Reform Act of 1998, Public Law 105–206 (112 Stat. 725 (1998)), to authorize the Secretary to provide the extent to which the prima facie evidence of delivery and postmark date rules apply to electronic filing.**

Explanation of Provisions

These temporary regulations add §301.7502–1T(d) to provide that the date of an electronic postmark given by an authorized electronic return transmitter will be deemed the filing date if the date of the electronic postmark is on or before the filing due date. It also permits the Commissioner to enter into an agreement with an electronic return transmitter or to prescribe in forms, instructions, or other appropriate guidance the procedures under which the electronic return transmitter is authorized to provide taxpayers with an electronic postmark to acknowledge the date and time that the electronic return transmitter received the electronically filed document.

An electronic return transmitter is defined for purposes of the regulation the same as in the revenue procedures governing the Electronic Filing Program, currently Rev. Proc. 98–50 (1998–38 I.R.B. 8 (September 21, 1998)), and the On-Line Filing Program, currently Rev. Proc. 98–51 (1998–38 I.R.B. 20 (September 21, 1998)). An electronic postmark is a record of the date and time that an authorized electronic return transmitter receives the transmission of the taxpayer's electronically filed document on its host system.

For tax year 1998, the rules on electronic postmarks are effective for income tax returns filed through electronic return transmitters authorized to provide an electronic postmark pursuant to an agreement under the Electronic Tax Administration's Request for Agreement released on November 26, 1997. For taxable years beginning after 1998, the rules on electronic postmarks are effective for documents submitted to electronic return transmitters that are authorized to provide an electronic postmark pursuant to §301.7502–1T(d)(2).

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C.

chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Charles A. Hall, Office of Assistant Chief Counsel (Income Tax & Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 301 is amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 is amended by adding an entry in numerical order to read as follows:

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

Section 301.7502–1T also issued under 26 U.S.C. 7502(c) * * *

Par. 2. Section 301.7502–1 is amended by:

1. Redesignating paragraphs (d) and (e) as paragraphs (e) and (f) respectively.

2. Adding new paragraph (d).

The addition reads as follows:

§301.7502–1 Timely mailing treated as timely filing.

* * * * *

(d) [**Reserved**]. For further guidance regarding timely filing of electronically filed documents for taxable years beginning after December 31, 1997, see §301.7502–1T(d).

* * * * *

Par. 3. Section 301.7502–1T is added to read as follows:

§301.7502–1T Timely mailing treated as timely filing (temporary).

(a) through (c) [Reserved]. For further guidance, see §301.7502–1(a) through (c).

(d) *Electronically filed documents*—(1) *In general.* A document filed electronically with an electronic return transmitter (as defined in paragraph (d)(3)(i) of this section and authorized pursuant to paragraph (d)(2) of this section) in the manner and time prescribed by the Commissioner is deemed to be filed on the date of the electronic postmark (as defined in paragraph (d)(3)(ii) of this section) given by the authorized electronic return transmitter. Thus, if the electronic postmark is timely, the document is considered filed timely although it is received by the agency, officer, or office after the last date, or the last day of the period, prescribed for filing such document.

(2) *Authorized electronic return transmitters.* The Commissioner may enter into an agreement with an electronic return transmitter or prescribe in forms, instructions, or other appropriate guidance the procedures under which the electronic return transmitter is authorized to provide taxpayers with an electronic postmark to acknowledge the date and time that the electronic return transmitter received the electronically filed document.

(3) *Definitions*—(i) *Electronic return transmitter.* For purposes of this paragraph (d), the term electronic return transmitter has the same meaning as contained in section 3.02(4) of Rev. Proc. 98–50 (1998–38 I.R.B. 8 (September 21, 1998)), and section 3.02(3) of Rev. Proc. 98–51 (1998–38 I.R.B. 20 (September 21, 1998))(See §601.601(d)(2) of this chapter.), or in procedures subsequently prescribed by the Commissioner.

(ii) *Electronic postmark.* For purposes of this paragraph (d), the term *electronic postmark* means a record of the date and time (in a particular time zone) that an authorized electronic return transmitter receives the transmission of a taxpayer's electronically filed document on its host system. However, if the taxpayer and the electronic return transmitter are located in different time zones, it is the time in the taxpayer's time zone that controls the timeliness of the electronically filed document.

(e) through (f)(2) [**Reserved**]. For further guidance, see §301.7502–1(e) through (f)(2)

(f)(3) *Electronically filed documents*—(i) *For taxable year 1998.* For taxable year 1998, paragraph (d) of this section only applies to electronically filed income tax returns transmitted to an electronic return transmitter that was authorized to provide an electronic postmark pursuant to an agreement entered into in response to submissions received in reply to the Electronic Tax Administration's Request for Agreement released on November 26, 1997.

(ii) *For taxable years after 1998.* For taxable years after 1998, paragraph (d) of this section applies to any electronically filed return, claim, statement, or other document transmitted to an electronic return transmitter that is authorized to provide an electronic postmark pursuant to paragraph (d)(2) of this section. This section expires on January 14, 2002 .

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved December 30, 1998.

Donald C. Lubick,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on January 14, 1999, 8:45 a.m., and published in the issue of the Federal Register for January 15, 1999, 64 F.R. 2568)

Section 7701.—Definitions

26 CFR 301.7701–7: Trusts-domestic and foreign.

T.D. 8813

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 301 and 602

Residence of Trusts and Estates—7701

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations providing guidance regarding the definition of a trust as a United States person (domestic trust) or a foreign trust. This document also provides guidance regarding the election for certain trusts to remain domestic trusts for taxable years beginning after December

31, 1996. The regulations incorporate changes to the law made by the Small Business Job Protection Act of 1996 and by the Taxpayer Relief Act of 1997. The final regulations affect the determination of the residency of trusts as foreign or domestic for federal tax purposes.

DATES: *Effective Date:* These regulations are effective February 2, 1999.

Dates of Applicability: See §301.7701–7(e).

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, James A. Quinn at (202) 622-3060 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget for review in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1600.

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 control number.

The collections of information in these final regulations are in §301.7701–7(d)-(2)(ii) and (f). This information is required by the IRS to assure compliance with the provisions of the Small Business Job Protection Act of 1996 and by the Taxpayer Relief Act of 1997 for trusts seeking to retain their residency as domestic or foreign trusts in the event of an inadvertent change and for trusts electing to remain domestic trusts. The likely respondents are trusts. The estimated average annual burden per respondent is 0.5 hours.

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

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

Background

On June 5, 1997, the IRS published in the **Federal Register** a notice of proposed rulemaking (62 F.R. 30796 [REG.–251703–96, 1997–1 C.B. 795]) to provide guidance on the definition of a foreign trust and a domestic trust under section 7701(a)(30) and (31), as amended by section 1907 of the Small Business Job Protection Act of 1996 (SBJP Act), Public Law 104-188, 110 Stat. 1755 (August 20, 1996).

Written comments responding to the notice of proposed rulemaking were received, and a public hearing was held on September 16, 1997. After consideration of the comments received, the proposed regulations are adopted as revised by this Treasury decision.

Section 1161(a) of the Taxpayer Relief Act of 1997 (TRA 1997), Public Law 105-34, 111 Stat. 788 (August 5, 1997), provides that, to the extent prescribed in regulations by the Secretary of the Treasury or his delegate, a trust that was in existence on August 20, 1996 (other than a trust treated as owned by the grantor under subpart E of part I of subchapter J of chapter 1 of the Internal Revenue Code of 1986 (Code)), and that was treated as a United States person on August 19, 1996, may elect to continue to be treated as a United States person notwithstanding the enactment of section 7701(a)(30)(E). Notice 98–25 (1998–18 I.R.B. 11) provides guidance regarding the election to remain a domestic trust. The IRS and the Treasury Department are incorporating the guidance contained in Notice 98–25 concerning the election to remain a domestic trust in these final regulations. The final regulations also provide guidance regarding the circumstances that cause a termination of the election and guidance concerning revocation of the election to remain a domestic trust.

In addition, section 1601(i)(3)(A) of TRA 1997 amended section 7701(a)(30)-(E)(ii) by striking the word “fiduciaries” and inserting “persons” in its place. The final regulations have been drafted consistent with this change.

Explanation of Provisions

A. *Court Test and Safe Harbor Issues*

1. *Foreign classification bias and safe harbor.* Some commentators point out generally that the Code and the proposed regulations are biased in favor of trusts being treated as foreign trusts. The commentators recommend that the regulations should reduce the bias in favor of foreign treatment. The safe harbor in the proposed regulations provides that a trust is a domestic trust if, pursuant to the terms of a trust instrument, the trust has only United States fiduciaries, such fiduciaries are administering the trust exclusively in the United States, and the trust is not subject to an automatic migration provision. One commentator recommends that the safe harbor be made clearly applicable in the case of any trust if a majority of the trustees are United States persons and the other requirements are met.

The IRS and the Treasury Department agree with the commentator that the safe harbor should not be limited to trusts with only United States fiduciaries. Since the primary concern addressed by the safe harbor is the difficulty in determining whether the court of a particular state would assert primary supervision over the administration of a trust if that trust had never appeared before a court, the final regulations provide a safe harbor only for the court test. A trust that satisfies the safe harbor, therefore, would also need to meet the control test in order to be a domestic trust. In addition, an example has been added to the control test illustrating that the control test is satisfied if United States persons control all substantial decisions by a majority vote.

Commentators note that many trust instruments do not direct where the trust is to be administered. Therefore, they suggest that a trust should satisfy the safe harbor if the trust is in fact administered in the United States (regardless of whether this is mandated by the trust document).

The IRS and the Treasury Department believe that, if a trust is administered exclusively in the United States, it is not necessary that the trust instrument actually direct that the trust be administered in the United States. Accordingly, the final regulations provide that a trust satisfies the safe harbor if the trust instrument does not direct that the trust be administered in a jurisdiction outside the United States, and the trust is in fact administered in the United States.

These changes in the final regulations will allow more trusts to fall within the safe harbor.

2. *Automatic migration or flee clauses.* The proposed regulations provide that a trust will not satisfy the court test if the trust instrument contains an automatic migration clause that would cause the trust to migrate from the United States if a United States court attempts to assert jurisdiction or otherwise supervise the administration of the trust. Commentators argue that the rule in the proposed regulations concerning automatic migration clauses is too broad. They argue that an automatic migration clause should not cause a trust to be treated as a foreign trust if migration is triggered only by events that are not particular to a given trust, its trustees, beneficiaries, or grantors. For example, if a trust will migrate because of foreign invasion of the United States, the residency of the trust should not be affected.

The final regulations adopt the suggestion and provide that a trust will not fail the court test if the trust instrument provides that the trust will migrate from the United States only in the case of foreign invasion of the United States or widespread confiscation or nationalization of property in the United States.

3. *Clarify that the list of specific situations for meeting the court test is not an exclusive list.* Commentators recommend that the regulations be clarified to provide that the situations set forth in §301.7701-7(d)(2) of the proposed regulations that meet the court test are not the exclusive ways to meet the court test.

The purpose of setting forth specific situations that meet the court test was to provide bright-line rules that would give taxpayers certainty of treatment to the extent possible. These rules, however, are not exclusive. The court test will also be satisfied by meeting the requirements set forth in the final regulations in §301.7701–7(c).

4. *Disregard state law.* A commentator recommends that the regulations should establish bright-line rules for the court test without reference to state law.

The IRS and the Treasury Department believe that the proper interpretation of section 7701(a)(30)(E) requires that state law be applied under the court test. In addition, the proposed regulations provide bright-line rules for both the court test and the control test to the extent permitted by the statute. For example, the regulations provide a safe harbor and provide for specific cases where the court test is satisfied. Therefore, the final regulations remain unchanged in this regard.

5. *Court test excessively broad.* One commentator argues that the court test is excessively broad because many trusts that are, in the commentator's view, foreign trusts will potentially be deemed domestic trusts. Specifically, the commentator is concerned about a trust in which the only domestic aspect is a single United States trustee who controls all substantial decisions of the trust. Another commentator recommends that the regulations should make clear that trustee meetings and other trustee activities in the United States will not cause the court test to be met.

The IRS and the Treasury Department do not believe that there is statutory authority for modifying the court test as suggested and, therefore, the final regulations remain unchanged. Furthermore, trustee meetings and activities in the United States may be a relevant factor to be taken into account in determining whether the court test has been met.

6. *Petition of court by a single beneficiary.* A commentator recommends that §301.7701–7(d)(2)(iii) of the proposed regulations should be clarified to provide that the court test is met only if either (i) a court within the United States actually exercises primary supervision over the trust, or (ii) a majority of beneficiaries take steps to cause a United States court to exercise primary supervision. The commentator expresses concern about a possible situation where, under the commentator's interpretation of the regulations, a single beneficiary of a foreign trust takes steps with a United States court petitioning it to assume primary supervision of the trust and, regardless of whether the court does in fact exercise primary supervision of the trust, the foreign trust becomes a domestic trust.

While §301.7701–7(d)(2)(iii) of the proposed regulations permits the trustees and/or beneficiaries of a trust to take steps to ensure that the court test is satisfied, taking preliminary steps with a United States court without in fact causing the administration of the trust to be subject to the primary supervision of the United States court would not satisfy the court test. Thus, the concern about a single beneficiary altering the residence of the trust by merely taking preliminary steps is unwarranted.

B. *Control Test Issues*

1. *Who counts for purposes of the control test.* The proposed regulations provide that substantial decisions do not include decisions exercisable by a grantor or by a beneficiary of the trust that affect solely the beneficiary's interest in the trust, unless the grantor or beneficiary is acting in a fiduciary capacity. The proposed regulations provide this rule because the statute prior to amendment by TRA 1997 provided that United States *fiduciaries* must control all substantial decisions of a domestic trust. Therefore, the proposed regulations exclude decisions by those who are not holding powers in a fiduciary capacity.

As noted, TRA 1997 substituted "persons" for "fiduciaries" in the control test. In light of the change in the statute, commentators point out that there is no statutory basis for ignoring the powers held by grantors and beneficiaries for purposes of the control test.

Therefore, the final regulations change the rule set forth in the proposed regulations and, for purposes of the control test, count all powers held by grantors and powers held by beneficiaries including those that affect solely the portion of the trust in which the beneficiary has an interest. Accordingly, all persons with any power over substantial decisions of the trust, whether acting in a fiduciary capacity or not, must be counted for purposes of the control test.

Under the proposed regulations, excluding grantors (and beneficiaries) from the control test would have allowed certain individual retirement accounts (IRAs) and other tax-exempt trusts to continue to be treated as domestic trusts and thus retain their tax-exempt status even if the grantor/beneficiary of the trust is a foreign person. The IRS and the

Treasury Department believe that Congress did not intend the TRA 1997 changes to affect the tax-exempt status of IRAs and other tax-exempt trusts whose tax-exempt status depends on their being domestic trusts. Because these trusts are required to be created or organized in the United States, and are subject to other detailed requirements for qualification under the Code, the final regulations provide that these trusts satisfy the control test, provided that United States fiduciaries control all of the substantial decisions of the trust that are made by trust fiduciaries. This provision of the final regulations generally reaches the same result as the provision in the proposed regulations.

2. *Time to correct inadvertent changes in fiduciaries.* The proposed regulations provide that in the event of an inadvertent change in the fiduciaries that would cause a change in the residency of a trust, the trust is allowed six months from the date of change in the fiduciaries to adjust either the fiduciaries or the residence of the fiduciaries so as to avoid a change in the residence of the trust.

Commentators recommend that trusts be given more time to take corrective action to avoid a change in residency or, alternatively, the regulations should give the IRS discretionary authority to continue treating a trust that inadvertently fails the control test as a domestic trust even if the control test is not met within six months.

The final regulations extend the period of time to 12 months from the date of the change to complete corrective action. The final regulations also provide that the district director may grant an extension of time to make the modification if the failure to make the modification within the 12-month period was due to reasonable cause. In addition, the final regulations define the term *inadvertent change* to mean a change with respect to a person who has a power to make a substantial decision of the trust, if such change (if not corrected) would cause an unintended change to the foreign or domestic residency of the trust.

3. *Effect of power to veto decisions.* The proposed regulations define control to mean having the power, by vote or otherwise, to make all of the substantial decisions of the trust, with no other person having the power to veto any of the substantial decisions. Thus, if United States fiduciaries have the power to make all the substantial decisions of the trust, but a foreign person could veto one of the decisions, the trust would fail the control test and would be a foreign trust. A commentator disagrees with the conclusion that the power to veto decisions may be determinative of who has control.

The final regulations retain the definition of control set forth in the proposed regulations. The effect of a veto power is specifically noted in the legislative history. H.R. Rep. No. 542, Part 2, 104th Cong., 2d Sess. 31 (1996). Furthermore, control should be defined to mean full power over the trust consistent with a trustee's traditional role in trust administration. Accordingly, if a United States person only has the power to veto the decisions of a foreign trustee, the control test is not satisfied. Likewise, if a foreign person has the power to veto the decisions of a United States trustee, the control test is not satisfied. Thus, in both cases, the trust would be a foreign trust.

4. *Power to remove, add, or replace a trustee.* Some commentators disagree with treating a decision to remove, add, or replace a trustee as a substantial decision. Commentators also argue that the proposed regulations are not consistent with the rules that apply for determining the ownership of grantor trusts or with the rules for determining whether property is included in a decedent's estate for estate tax purposes. A commentator recommends that the final regulations provide that a decision to appoint a trustee to succeed a trustee who has died, resigned, or otherwise ceased to act as a trustee, without the power to remove the trustee, is not a substantial decision.

The IRS and the Treasury Department believe that the purpose of the control test is to determine the residence of a trust and therefore is different from the purpose of the rules for grantor trusts and for estate taxes. The final regulations continue to treat the decision to remove, add, or replace a trustee as a substantial decision. In addition, the final regulations provide that the decision to appoint a successor fiduciary to succeed a fiduciary who has died, resigned, or otherwise ceased to act as a trustee, even if it is not accompanied by an unrestricted power to remove a trustee, is a substantial decision, unless this power is limited such that it cannot be exercised in a manner that would change the trust's residency from foreign to domestic, or vice versa.

5. *Investment decisions.* Commentators argue that investment decisions should not be treated as substantial decisions.

The final regulations continue to treat investment decisions as substantial decisions. However, the final regulations provide that if a United States fiduciary contracts for the services of an investment advisor, and the advisor's power to make investment decisions can be terminated at the will of the United States fiduciary, the United States fiduciary will be treated as retaining control over the investment decisions made by the investment advisor, whether the investment advisor is foreign or domestic.

C. *Transition Rule and Grandfathering Issues*

1. *Pre-existing foreign trusts.* Commentators recommend various grandfathering rules for pre-existing foreign trusts that would allow them to remain treated as foreign trusts. A commentator recommends that a trust would be deemed to be a foreign trust prior to the effective date of section 7701(a)(30) and (31), as amended by the SBJP Act (new law), if the trust is treated as a foreign trust under the new law. In particular, the commentator expresses concern that some trusts believed to be foreign trusts under section 7701(a)(30) and (31), prior to amendment by the SBJP Act (prior law), may have in fact been domestic trusts under prior law. If such trusts qualify as foreign trusts under the new law, they will be considered to have changed their classification from domestic to foreign on January 1, 1997. Trusts that change from domestic to foreign may be subject to tax for the deemed transfer to a foreign trust under section 1491 (as in effect prior to its repeal by TRA 1997) and subject to penalties for failure to report such transfer under section 6677 if they continue to treat themselves as foreign trusts.

In addition, a commentator recommends that trusts that were formed prior to August 20, 1996, as group trust arrangements exempt from tax under sections 501(a) and 408(e) and described in

Rev. Rul. 81–100 (1981–1 C.B. 326) not be subject to section 7701(a)(30) and (31) as amended by the SBJP Act, but should be subject to section 7701(a)(30) and (31) as in effect prior to August 20, 1996.

The IRS and the Treasury Department do not believe that there is statutory authority for adopting the requested grandfathering rules for pre-existing foreign trusts or for applying prior law to group trust arrangements described in Rev. Rul. 81–100. The election provision included in TRA 1997 provides specific transition relief only for trusts that treated themselves as domestic trusts prior to August 20, 1996, not for trusts that treated themselves as foreign trusts. Therefore, the final regulations do not include the recommended transition rules.

2. *Foreign trust safe harbor.* A commentator recommends that newly-created trusts established under foreign law should benefit from a foreign trust safe harbor. The commentator suggests a safe harbor that would provide that a trust established under foreign law, which does not by its terms provide for administration in the United States, and which does not file United States federal income tax returns as a United States trust will fail the court test and will be treated as a foreign trust unless the trust is described in §301.7701–7(d)(2)(i) or (ii) of the proposed regulations (situations that meet the court test).

Given the statutory bias towards foreign trust classification, the IRS and Treasury Department do not agree that a safe harbor for foreign trusts is necessary because sufficient guidance is given as to the circumstances that will cause a trust to be foreign. Therefore, the final regulations do not include the recommended rules.

D. *Puerto Rico Trusts*

The statute uses the term *the United States* in a geographical sense and thus, for purposes of the court test, the United States includes only the States and the District of Columbia. See Section 7701(a)(9). Accordingly, a court within a territory or possession of the United States is not a court within the United States and all trusts subject to the supervision of such a court are thereby foreign. That rule was stated explicitly in the proposed regulations.

Some commentators argue that adverse tax consequences result from this rule. Therefore, they recommend that the final regulations provide, contrary to what the statute implies, that Puerto Rico courts are "courts within the United States" for purposes of section 7701(a)(30)(E)(i) and, therefore, that Puerto Rico trusts will meet the court test.

The final regulations do not adopt the suggestion. Rather, the final regulations continue to provide that a trust that is subject to the primary supervision of the Puerto Rico courts will be treated as a foreign trust for federal tax purposes.

E. *Effective date*

The proposed regulations provide that the regulations would be applicable to trusts for taxable years beginning after December 31, 1996, and to trusts whose trustees have elected to apply sections 7701(a)(30) and (31) to the trusts for taxable years ending after August 20, 1996, under section 1907(a)(3)(B) of the SBJP Act.

The final regulations modify the effective date in the proposed regulations. Except for §301.7701–7(f) of the final regulations, which applies beginning February 2, 1999, the final regulations are applicable to trusts for taxable years ending after February 2, 1999. In addition, trusts may rely on the final regulations (i) for taxable years of the trusts beginning after December 31, 1996, and (ii) for taxable years ending after August 20, 1996, in the case of trusts electing under section 1907(a)(3)(B) of the SBJP Act.

If a trust is created after August 19, 1996, and before April 3, 1999, and the trust satisfies the control test set forth in the proposed regulations published under section 7701(a)(30) and (31) (62 F.R. 30796, June 5, 1997), but does not satisfy the control test set forth in the final regulations, the trust may be modified to satisfy the control test of the final regulations by December 31, 1999. If the modification is completed by December 31, 1999, the trust will be treated as satisfying the control test of the final regulations for taxable years beginning after December 31, 1996 (and for taxable years ending after August 20, 1996, if the election under section 1907(a)(3)(B) of the SBJP Act has been made for the trust).

Effect on Other Documents

Notice 98–25 (1998–18 I.R.B. 11) is obsolete as of February 2, 1999.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It is hereby certified that the collections of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that the estimated average burden per trust in complying with the collection of information in §301.7701–7(d)(2)(ii) and (f) is 0.5 hours. In addition, each trust will only have to file the election statement to remain a domestic trust once. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is James A. Quinn of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 301 and 602 are amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 continues to read in part as follows:

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

§301.7701–5 [Amended]

Par. 2. The last sentence of §301.7701–5 is removed.

Par. 3. Section 301.7701–7 is added to read as follows:

§301.7701-7 Trusts—domestic and foreign.

(a) *In general.* (1) A trust is a United States person if—

(i) A court within the United States is able to exercise primary supervision over the administration of the trust (court test); and

(ii) One or more United States persons have the authority to control all substantial decisions of the trust (control test).

(2) A trust is a United States person for purposes of the Internal Revenue Code (Code) on any day that the trust meets both the court test and the control test. For purposes of the regulations in this chapter, the term *domestic trust* means a trust that is a United States person. The term *foreign trust* means any trust other than a domestic trust.

(3) Except as otherwise provided in part I, subchapter J, chapter 1 of the Code, the taxable income of a foreign trust is computed in the same manner as the taxable income of a nonresident alien individual who is not present in the United States at any time. Section 641(b). Section 7701(b) is not applicable to trusts because it only applies to individuals. In addition, a foreign trust is not considered to be present in the United States at any time for purposes of section 871(a)(2), which deals with capital gains of nonresident aliens present in the United States for 183 days or more.

(b) *Applicable law.* The terms of the trust instrument and applicable law must be applied to determine whether the court test and the control test are met.

(c) *The court test*—(1) *Safe harbor.* A trust satisfies the court test if–

(i) The trust instrument does not direct that the trust be administered outside of the United States;

(ii) The trust in fact is administered exclusively in the United States; and

(iii) The trust is not subject to an automatic migration provision described in paragraph (c)(4)(ii) of this section.

(2) *Example.* The following example illustrates the rule of paragraph (c)(1) of this section:

Example. A creates a trust for the equal benefit of *A*'s two children, *B* and *C*. The trust instrument provides that *DC*, a State *Y* corporation, is the trustee of the trust. State *Y* is a state within the United States. *DC* administers the trust exclusively in State *Y* and the trust instrument is silent as to where the trust is to be administered. The trust is not subject to an automatic migration provision described in paragraph (c)(4)(ii) of this section. The trust satisfies the safe harbor of paragraph (c)(1) of this section and the court test.

(3) *Definitions.* The following definitions apply for purposes of this section:

(i) *Court.* The term court includes any federal, state, or local court.

(ii) *The United States.* The term *the United States* is used in this section in a geographical sense. Thus, for purposes of the court test, the United States includes only the States and the District of Columbia. See section 7701(a)(9). Accordingly, a court within a territory or possession of the United States or within a foreign country is not a court within the United States.

(iii) *Is able to exercise.* The term *is able to exercise* means that a court has or would have the authority under applicable law to render orders or judgments resolving issues concerning administration of the trust.

(iv) *Primary supervision.* The term *primary supervision* means that a court has or would have the authority to determine substantially all issues regarding the administration of the entire trust. A court may have primary supervision under this paragraph (c)(3)(iv) notwithstanding the fact that another court has jurisdiction over a trustee, a beneficiary, or trust property.

(v) *Administration.* The term *administration* of the trust means the carrying out of the duties imposed by the terms of the trust instrument and applicable law, including maintaining the books and records of the trust, filing tax returns, managing and investing the assets of the trust, defending the trust from suits by creditors, and determining the amount and timing of distributions.

(4) *Situations that cause a trust to satisfy or fail to satisfy the court test.* (i) Except as provided in paragraph (c)(4)(ii) of this section, paragraphs (c)(4)(i)(A) through (D) of this section set forth some specific situations in which a trust satisfies the court test. The four situations described are not intended to be an exclusive list.

(A) *Uniform Probate Code.* A trust meets the court test if the trust is registered by an authorized fiduciary or fiduciaries of the trust in a court within the United States pursuant to a state statute that has provisions substantially similar to Article VII, *Trust Administration*, of the Uniform Probate Code, 8 Uniform Laws Annotated 1 (West Supp. 1998), available from the National Conference of Commissioners on Uniform State Laws, 676 North St. Clair Street, Suite 1700, Chicago, Illinois 60611.

(B) *Testamentary trust.* In the case of a trust created pursuant to the terms of a will probated within the United States (other than an ancillary probate), if all fiduciaries of the trust have been qualified as trustees of the trust by a court within the United States, the trust meets the court test.

(C) *Inter vivos trust.* In the case of a trust other than a testamentary trust, if the fiduciaries and/or beneficiaries take steps with a court within the United States that cause the administration of the trust to be subject to the primary supervision of the court, the trust meets the court test.

(D) *A United States court and a foreign court are able to exercise primary supervision over the administration of the trust.* If both a United States court and a foreign court are able to exercise primary supervision over the administration of the trust, the trust meets the court test.

(ii) *Automatic migration provisions.* Notwithstanding any other provision in this section, a court within the United States is not considered to have primary supervision over the administration of the trust if the trust instrument provides that a United States court's attempt to assert jurisdiction or otherwise supervise the administration of the trust directly or indirectly would cause the trust to migrate from the United States. However, this paragraph (c)(4)(ii) will not apply if the trust instrument provides that the trust will migrate from the United States only in the case of foreign invasion of the United States or widespread confiscation or nationalization of property in the United States.

(5) *Examples.* The following examples illustrate the rules of this paragraph (c):

Example 1. A, a United States citizen, creates a trust for the equal benefit of *A*'s two children, both of whom are United States citizens. The trust instrument provides that *DC*, a domestic corporation, is to act as trustee of the trust and that the trust is to be administered in Country *X*, a foreign country. *DC* maintains a branch office in Country *X* with personnel authorized to act as trustees in Country *X*. The trust instrument provides that the law of State *Y*, a state within the United States, is to govern the interpretation of the trust. Under the law of Country *X*, a court within Country *X* is able to exercise primary supervision over the administration of the trust. Pursuant to the trust instrument, the Country *X* court applies the law of State *Y* to the trust. Under the terms of the trust instrument the trust is administered in Country *X*. No court within the United States is able to exercise primary supervision over the administration of the trust. The trust fails to satisfy the court test and therefore is a foreign trust.

Example 2. A, a United States citizen, creates a trust for *A*'s own benefit and the benefit of *A*'s spouse, *B*, a United States citizen. The trust instrument provides that the trust is to be administered in State *Y*, a state within the United States, by *DC*, a State *Y* corporation. The trust instrument further provides that in the event that a creditor sues the trustee in a United States court, the trust will automatically migrate from State *Y* to Country *Z*, a foreign country, so that no United States court will have jurisdiction over the trust. A court within the United States is not able to exercise primary supervision over the administration of the trust because the United States court's jurisdiction over the administration of the trust is automatically terminated in the event the court attempts to assert jurisdiction. Therefore, the trust fails to satisfy the court test from the time of its creation and is a foreign trust.

(d) *Control test*—(1) *Definitions*—(i) *United States person.* The term *United States person* means a United States person within the meaning of section 7701(a)(30). For example, a domestic corporation is a United States person, regardless of whether its shareholders are United States persons.

(ii) *Substantial decisions*. The term substantial decisions means those decisions that persons are authorized or required to make under the terms of the trust instrument and applicable law and that are not ministerial. Decisions that are ministerial include decisions regarding details such as the bookkeeping, the collection of rents, and the execution of investment decisions. Substantial decisions include, but are not limited to, decisions concerning–

(A) Whether and when to distribute income or corpus;

(B) The amount of any distributions;

(C) The selection of a beneficiary;

(D) Whether a receipt is allocable to income or principal;

(E) Whether to terminate the trust;

(F) Whether to compromise, arbitrate, or abandon claims of the trust;

(G) Whether to sue on behalf of the trust or to defend suits against the trust;

(H) Whether to remove, add, or replace a trustee;

(I) Whether to appoint a successor trustee to succeed a trustee who has died, resigned, or otherwise ceased to act as a trustee, even if the power to make such a decision is not accompanied by an unrestricted power to remove a trustee, unless the power to make such a decision is limited such that it cannot be exercised in a manner that would change the trust's residency from foreign to domestic, or vice versa; and

(J) Investment decisions; however, if a United States person under section 7701(a)(30) hires an investment advisor for the trust, investment decisions made by the investment advisor will be considered substantial decisions controlled by the United States person if the United States person can terminate the investment advisor's power to make investment decisions at will.

(iii) *Control.* The term *control* means having the power, by vote or otherwise, to make all of the substantial decisions of the trust, with no other person having the power to veto any of the substantial decisions. To determine whether United States persons have control, it is necessary to consider all persons who have authority to make a substantial decision of the trust, not only the trust fiduciaries.

(iv) *Treatment of certain employee benefit trusts.* Provided that United States fiduciaries control all of the substantial decisions made by the trustees or fiduciaries, the following types of trusts are deemed to satisfy the control test set forth in paragraph (a)(1)(ii) of this section–

(A) A qualified trust described in section 401(a);

(B) A trust described in section 457(g);

(C) A trust that is an individual retirement account described in section 408(a);

(D) A trust that is an individual retirement account described in section 408(k) or 408(p);

(E) A trust that is a Roth IRA described in section 408A;

(F) A trust that is an education individual retirement account described in section 530;

(G) A trust that is a voluntary employees' beneficiary association described in section 501(c)(9);

(H) Such additional categories of trusts as the Commissioner may designate in revenue procedures, notices, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(b)).

(v) *Examples.* The following examples illustrate the rules of paragraph (d)(1) of this section:

Example 1. Trust has three fiduciaries, *A*, *B*, and *C*. *A* and *B* are United States citizens and *C* is a nonresident alien. No persons except the fiduciaries have authority to make any decisions of the trust. The trust instrument provides that no substantial decisions of the trust can be made unless there is unanimity among the fiduciaries. The control test is not satisfied because United States persons do not control all the substantial decisions of the trust. No substantial decisions can be made without *C*'s agreement.

Example 2. Assume the same facts as in *Example 1,* except that the trust instrument provides that all substantial decisions of the trust are to be decided by a majority vote among the fiduciaries. The control test is satisfied because a majority of the fiduciaries are United States persons and therefore United States persons control all the substantial decisions of the trust.

Example 3. Assume the same facts as in *Example 2,* except that the trust instrument directs that *C* is to make all of the trust's investment decisions, but that *A* and *B* may veto *C*'s investment decisions. *A* and *B* cannot act to make the investment decisions on their own. The control test is not satisfied because the United States persons, *A* and *B*, do not have the power to make all of the substantial decisions of the trust.

Example 4. Assume the same facts as in *Example 3*, except *A* and *B* may accept or veto *C*'s investment decisions and can make investments that *C* has not recommended. The control test is satisfied because the United States persons control all substantial decisions of the trust.

(2) *Replacement of any person who had authority to make a substantial decision of the trust*—(i) *Replacement within 12 months.* In the event of an inadvertent change in any person that has the power to make a substantial decision of the trust that would cause the domestic or foreign residency of the trust to change, the trust is allowed 12 months from the date of the change to make necessary changes either with respect to the persons who control the substantial decisions or with respect to the residence of such persons to avoid a change in the trust's residency. For purposes of this section, an inadvertent change means the death, incapacity, resignation, change in residency or other change with respect to a person that has a power to make a substantial decision of the trust that would cause a change to the residency of the trust but that was not intended to change the residency of the trust. If the necessary change is made within 12 months, the trust is treated as retaining its pre-change residency during

the 12-month period. If the necessary change is not made within 12 months, the trust's residency changes as of the date of the inadvertent change.

(ii) *Request for extension of time.* If reasonable actions have been taken to make the necessary change to prevent a change in trust residency, but due to circumstances beyond the trust's control the trust is unable to make the modification within 12 months, the trust may provide a written statement to the district director having jurisdiction over the trust's return setting forth the reasons for failing to make the necessary change within the required time period. If the district director determines that the failure was due to reasonable cause, the district director may grant the trust an extension of time to make the necessary change. Whether an extension of time is granted is in the sole discretion of the district director and, if granted, may contain such terms with respect to assessment as may be necessary to ensure that the correct amount of tax will be collected from the trust, its owners, and its beneficiaries. If the district director does not grant an extension, the trust's residency changes as of the date of the inadvertent change.

(iii) *Examples.* The following examples illustrate the rules of paragraphs (d)(2)(i) and (ii) of this section:

Example 1. A trust that satisfies the court test has three fiduciaries, *A*, *B*, and *C*. *A* and *B* are United States citizens and *C* is a nonresident alien. All decisions of the trust are made by majority vote of the fiduciaries. The trust instrument provides that upon the death or resignation of any of the fiduciaries, *D*, is the successor fiduciary. *A* dies and *D* automatically becomes a fiduciary of the trust. When *D* becomes a fiduciary of the trust, *D* is a nonresident alien. Two months after *A* dies, *B* replaces *D* with *E*, a United States person. Because *D* was replaced with *E* within 12 months after the date of *A*'s death, during the period after *A*'s death and before *E* begins to serve, the trust satisfies the control test and remains a domestic trust.

Example 2. Assume the same facts as in *Example 1* except that at the end of the 12-month period after *A*'s death, *D* has not been replaced and remains a fiduciary of the trust. The trust becomes a foreign trust on the date A died unless the district director grants an extension of the time period to make the necessary change.

(3) *Automatic migration provisions.* Notwithstanding any other provision in this section, United States persons are not considered to control all substantial decisions of the trust if an attempt by any governmental agency or creditor to collect information from or assert a claim against the trust would cause one or more substantial decisions of the trust to no longer be controlled by United States persons.

(4) *Examples.* The following examples illustrate the rules of this paragraph (d):

Example 1. A, a nonresident alien individual, is the grantor and, during *A*'s lifetime, the sole beneficiary of a trust that qualifies as an individual retirement account (IRA). *A* has the exclusive power to make decisions regarding withdrawals from the IRA and to direct its investments. The IRA's sole trustee is a United States person within the meaning of section 7701(a)(30). The control test is satisfied with respect to this trust because the special rule of paragraph (d)(1)(iv) of this section applies.

Example 2. A, a nonresident alien individual, is the grantor of a trust and has the power to revoke the trust, in whole or in part, and revest assets in *A*. *A* is treated as the owner of the trust under sections 672(f) and 676. *A* is not a fiduciary of the trust. The trust has one trustee, *B*, a United States person, and the trust has one beneficiary, *C*. *B* has the discretion to distribute corpus or income to *C*. In this case, decisions exercisable by *A* to have trust assets distributed to *A* are substantial decisions. Therefore, the trust is a foreign trust because *B* does not control all substantial decisions of the trust.

Example 3. A trust, Trust *T*, has two fiduciaries, *A* and *B*. Both *A* and *B* are United States persons. *A* and *B* hire *C*, an investment advisor who is a foreign person, and may terminate *C*'s employment at will. The investment advisor makes the investment decisions for the trust. *A* and *B* control all other decisions of the trust. Although *C* has the power to make investment decisions, *A* and *B* are treated as controlling these decisions. Therefore, the control test is satisfied.

Example 4. G, a United States citizen, creates a trust. The trust provides for income to *A* and *B* for life, remainder to *A*'s and *B*'s descendants. *A* is a nonresident alien and *B* is a United States person. The trustee of the trust is a United States person. The trust instrument authorizes *A* to replace the trustee. The power to replace the trustee is a substantial decision. Because *A*, a nonresident alien, controls a substantial decision, the control test is not satisfied.

(e) *Effective date*—(1) *General rule.* Except for the election to remain a domestic trust provided in paragraph (f) of this section, this section is applicable to trusts for taxable years ending after February 2, 1999. This section may be relied on by trusts for taxable years beginning after December 31, 1996, and also may be relied on by trusts whose trustees have elected to apply sections 7701(a)(30) and (31) to the trusts for taxable years ending after August 20, 1996, under section 1907(a)(3)(B) of the Small Business Job Protection Act of 1996, (the SBJP Act) Public Law 104-188, 110 Stat. 1755 (26 U.S.C. 7701 note).

(2) *Trusts created after August 19, 1996.* If a trust is created after August 19, 1996, and before April 3, 1999, and the trust satisfies the control test set forth in the regulations project REG–251703–96 published under section 7701(a)(30) and (31) (1997–1 C.B. 795) (See §601.601(d)-(2) of this chapter), but does not satisfy the control test set forth in paragraph (d) of this section, the trust may be modified to satisfy the control test of paragraph (d) by December 31, 1999. If the modification is completed by December 31, 1999, the trust will be treated as satisfying the control test of paragraph (d) for taxable years beginning after December 31, 1996, (and for taxable years ending after August 20, 1996, if the election under section 1907(a)(3)(B) of the SBJP Act has been made for the trust).

(f) *Election to remain a domestic trust*—(1) *Trusts eligible to make the election to remain domestic.* A trust that was in existence on August 20, 1996, and that was treated as a domestic trust on August 19, 1996, as provided in paragraph (f)(2) of this section, may elect to continue treatment as a domestic trust notwithstanding section 7701(a)(30)(E). This election is not available to a trust that was wholly-owned by its grantor under subpart E, part I, subchapter J, chapter 1, of the Code on August 20, 1996. The election is available to a trust if only a portion of the trust was treated as owned by the grantor under subpart E on August 20, 1996. If a partially-owned grantor trust makes the election, the election is effective for the entire trust. Also, a trust may not make the election if the trust has made an election pursuant to section 1907(a)(3)(B) of the SBJP Act to apply the new trust criteria to the first taxable year of the trust ending after August 20, 1996, because that election, once made, is irrevocable.

(2) *Determining whether a trust was treated as a domestic trust on August 19, 1996*—(i) *Trusts filing Form 1041 for the taxable year that includes August 19, 1996.* For purposes of the election, a trust is considered to have been treated as a domestic trust on August 19, 1996, if: the trustee filed a Form 1041, "U.S. Income Tax Return for Estates and Trusts," for the trust for the period that includes August

19, 1996 (and did not file a Form 1040NR, “U.S. Nonresident Alien Income Tax Return,” for that year); and the trust had a reasonable basis (within the meaning of section 6662) under section 7701(a)(30) prior to amendment by the SBJP Act (prior law) for reporting as a domestic trust for that period.

(ii) *Trusts not filing a Form 1041*. Some domestic trusts are not required to file Form 1041. For example, certain group trusts described in Rev. Rul. 81–100 (1981–1 C.B. 326) (See §601.601(d)-(2) of this chapter) consisting of trusts that are parts of qualified retirement plans and individual retirement accounts are not required to file Form 1041. Also, a domestic trust whose gross income for the taxable year is less than the amount required for filing an income tax return and that has no taxable income is not required to file a Form 1041. Section 6012(a)(4). For purposes of the election, a trust that filed neither a Form 1041 nor a Form 1040NR for the period that includes August 19, 1996, will be considered to have been treated as a domestic trust on August 19, 1996, if the trust had a reasonable basis (within the meaning of section 6662) under prior law for being treated as a domestic trust for that period and for filing neither a Form 1041 nor a Form 1040NR for that period.

(3) *Procedure for making the election to remain domestic*—(i) *Required Statement*. To make the election, a statement must be filed with the Internal Revenue Service in the manner and time described in this section. The statement must be entitled “Election to Remain a Domestic Trust under Section 1161 of the Taxpayer Relief Act of 1997,” be signed under penalties of perjury by at least one trustee of the trust, and contain the following information—

(A) A statement that the trust is electing to continue to be treated as a domestic trust under section 1161 of the Taxpayer Relief Act of 1997;

(B) A statement that the trustee had a reasonable basis (within the meaning of section 6662) under prior law for treating the trust as a domestic trust on August 19, 1996. (The trustee need not explain the reasonable basis on the election statement.);

(C) A statement either that the trust filed a Form 1041 treating the trust as a domestic trust for the period that includes August 19, 1996, (and that the trust did not file a Form 1040NR for that period), or that the trust was not required to file a Form 1041 or a Form 1040NR for the period that includes August 19, 1996, with an accompanying brief explanation as to why a Form 1041 was not required to be filed; and

(D) The name, address, and employer identification number of the trust.

(ii) *Filing the required statement with the Internal Revenue Service.* (A) Except as provided in paragraphs (f)(3)(ii)(E) through (G) of this section, the trust must attach the statement to a Form 1041. The statement may be attached to either the Form 1041 that is filed for the first taxable year of the trust beginning after December 31, 1996 (1997 taxable year), or to the Form 1041 filed for the first taxable year of the trust beginning after December 31, 1997 (1998 taxable year). The statement, however, must be filed no later than the due date for filing a Form 1041 for the 1998 taxable year, plus extensions. The election will be effective for the 1997 taxable year, and thereafter, until revoked or terminated. If the trust filed a Form 1041 for the 1997 taxable year without the statement attached, the statement should be attached to the Form 1041 filed for the 1998 taxable year.

(B) If the trust has insufficient gross income and no taxable income for its 1997 or 1998 taxable year, or both, and therefore is not required to file a Form 1041 for either or both years, the trust must make the election by filing a Form 1041 for either the 1997 or 1998 taxable year with the statement attached (even though not otherwise required to file a Form 1041 for that year). The trust should only provide on the Form 1041 the trust’s name, name and title of fiduciary, address, employer identification number, date created, and type of entity. The statement must be attached to a Form 1041 that is filed no later than October 15, 1999.

(C) If the trust files a Form 1040NR for the 1997 taxable year based on application of new section 7701(a)(30)(E) to the trust, and satisfies paragraph (f)(1) of this section, in order for the trust to make the election the trust must file an amended Form 1040NR return for the 1997 taxable year. The trust must note on the amended Form 1040NR that it is making an election under section 1161 of the Taxpayer Relief Act of 1997. The trust must attach to the amended Form 1040NR the statement required by paragraph (f)(3)(i) of this section and a completed Form 1041 for the 1997 taxable year. The items of income, deduction and credit of the trust must be excluded from the amended Form 1040NR and reported on the Form 1041. The amended Form 1040NR for the 1997 taxable year, with the statement and the Form 1041 attached, must be filed with the Philadelphia Service Center no later than the due date, plus extensions, for filing a Form 1041 for the 1998 taxable year.

(D) If a trust has made estimated tax payments as a foreign trust based on application of section 7701(a)(30)(E) to the trust, but has not yet filed a Form 1040NR for the 1997 taxable year, when the trust files its Form 1041 for the 1997 taxable year it must note on its Form 1041 that it made estimated tax payments based on treatment as a foreign trust. The Form 1041 must be filed with the Philadelphia Service Center (and not with the service center where the trust ordinarily would file its Form 1041).

(E) If a trust forms part of a qualified stock bonus, pension, or profit sharing plan, the election provided by this paragraph (f) must be made by attaching the statement to the plan’s annual return required under section 6058 (information return) for the first plan year beginning after December 31, 1996, or to the plan’s information return for the first plan year beginning after December 31, 1997. The statement must be attached to the plan’s information return that is filed no later than the due date for filing the plan’s information return for the first plan year beginning after December 31, 1997, plus extensions. The election will be effective for the first plan year beginning after December 31, 1996, and thereafter, until revoked or terminated.

(F) Any other type of trust that is not required to file a Form 1041 for the taxable year, but that is required to file an information return (for example, Form 5227) for the 1997 or 1998 taxable year must attach the statement to the trust’s information return for the 1997 or 1998 taxable year. However, the statement must be attached to an information return that is filed no later than the due date for filing the trust's information return for the 1998 taxable year, plus extensions. The election will be effective for the 1997 taxable year, and thereafter, until revoked or terminated.

(G) A group trust described in Rev. Rul. 81–100 consisting of trusts that are parts of qualified retirement plans and individual retirement accounts (and any other trust that is not described above and that is not required to file a Form 1041 or an information return) need not attach the statement to any return and should file the statement with the Philadelphia Service Center. The trust must make the election provided by this paragraph (f) by filing the statement by October 15, 1999. The election will be effective for the 1997 taxable year, and thereafter, until revoked or terminated.

(iii) *Failure to file the statement in the required manner and time.* If a trust fails to file the statement in the manner or time provided in paragraphs (f)(3)(i) and (ii) of this section, the trustee may provide a written statement to the district director having jurisdiction over the trust setting forth the reasons for failing to file the statement in the required manner or time. If the district director determines that the failure to file the statement in the required manner or time was due to reasonable cause, the district director may grant the trust an extension of time to file the statement. Whether an extension of time is granted shall be in the sole discretion of the district director. However, the relief provided by this paragraph (f)(3)(iii) is not ordinarily available if the statute of limitations for the trust's 1997 taxable year has expired. Additionally, if the district director grants an extension of time, it may contain terms with respect to assessment as may be necessary to ensure that the correct amount of tax will be collected from the trust, its owners, and its beneficiaries.

(4) *Revocation or termination of the election*—(i) *Revocation of election.* The election provided by this paragraph (f) to be treated as a domestic trust may only be revoked with the consent of the Commissioner. See sections 684, 6048, and 6677 for the federal tax consequences and reporting requirements related to the change in trust residence.

(ii) *Termination of the election.* An election under this paragraph (f) to remain a domestic trust terminates if changes are made to the trust subsequent to the effective date of the election that result in the trust no longer having any reasonable basis (within the meaning of section 6662) for being treated as a domestic trust under section 7701(a)(30) prior to its amendment by the SBJP Act. The termination of the election will result in the trust changing its residency from a domestic trust to a foreign trust on the effective date of the termination of the election. See sections 684, 6048, and 6677 for the federal tax consequences and reporting requirements related to the change in trust residence.

(5) *Effective date.* This paragraph (f) is applicable beginning on February 2, 1999.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 4. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 5. In §602.101, paragraph (c) is amended by adding an entry in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

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(c) * * *

CFR part of section where identified and described	Current OMB control No.
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301.7701–7	1545–1600
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Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved January 13, 1999.

Donald C. Lubick,
Assistant Secretary of the Treasury.

(Filed by the Office of Federal Register on February 1, 1999, 8:45 a.m., and published in the isue of the Federal Register for February 2, 1999, 64 F.R. 4967)

Part III. Administrative, Procedural, and Miscellaneous

Electronic Funds Transfer — Temporary Waiver of Failure to Deposit Penalty for Certain Taxpayers

Notice 99–12

This notice provides guidance relating to the waiver of penalties announced in News Release IR–98–68, issued November 18, 1998. In IR–98–68, the Internal Revenue Service announced that it will waive the failure-to-deposit penalty under § 6656 of the Internal Revenue Code for certain taxpayers first required to make federal tax deposits by electronic funds transfer beginning on or after July 1, 1997.

BACKGROUND

Section 6302(h)(1)(A) provides that the Secretary will prescribe regulations necessary for the development and implementation of an electronic funds transfer system for the collection of depository taxes. Section 6302(h)(2) provides a phase-in schedule for the system.

Section 31.6302–1(h) of the Employment Taxes and Collection of Income Tax at Source Regulations prescribes rules for implementing an electronic funds transfer system for the collection of depository taxes. Under the regulation, taxpayers are required to deposit taxes by electronic funds transfer if the amount of their depository taxes in a specified earlier year exceeds the applicable threshold amount. The regulation provides that taxpayers with more than $50,000 of federal employment tax deposits in calendar year 1995 must use electronic funds transfer to make deposits that are due on or after July 1, 1997, and relate to return periods beginning on or after January 1, 1997. Taxpayers with more than $50,000 in employment tax deposits in calendar year 1996 must use electronic funds transfer to make deposits of taxes relating to return periods beginning on or after January 1, 1998. Taxpayers with more than $50,000 in employment tax deposits in calendar year 1997 must begin to use electronic funds transfer to make deposits of taxes relating to return periods beginning on or after January 1, 1999.

In addition, under the regulations, taxpayers with no employment tax deposits in either 1995 or 1996, but with more than $50,000 in other federal tax deposits in either 1995 or 1996, must use electronic funds transfer to make deposits of taxes relating to return periods beginning on or after January 1, 1998. Taxpayers with no employment tax deposits in 1997, but with more than $50,000 in other federal tax deposits in 1997, must use electronic funds transfer to make deposits of taxes relating to return periods beginning on or after January 1, 1999.

Section 6656(a) provides that in the case of any failure by any person to deposit taxes on the prescribed date in an authorized government depository, a penalty applies unless the failure is due to reasonable cause and not due to willful neglect. Rev. Rul. 95–68, 1995–2 C.B. 272, provides that, absent reasonable cause, a taxpayer that is required to deposit federal taxes by electronic funds transfer is subject to the 10 percent failure-to-deposit penalty if the taxpayer deposits the taxes by means other than electronic funds transfer.

Notice 97–43, 1997–30 I.R.B. 9, provides that, in the case of taxpayers first required to deposit electronically on or after July 1, 1997, the Internal Revenue Service will not impose the failure-to-deposit penalty under § 6656 solely for the failure to make the deposit electronically, provided the deposit is otherwise made in a timely manner. This waiver applies only to deposit obligations incurred on or before December 31, 1997.

Section 931 of the Taxpayer Relief Act of 1997, Pub. L. No. 105–34, 111 Stat. 881, provides that no penalty shall be imposed under the Internal Revenue Code solely by reason of a failure by a person to use the electronic fund transfer system established under § 6302(h) of the Code if (1) the person is a member of a class of taxpayers first required to use such system on or after July 1, 1997, and (2) the failure occurs before July 1, 1998.

Notice 98–30, 1998–22 I.R.B. 9, provides that, in the case of taxpayers first required to deposit electronically on or after July 1, 1997, the Internal Revenue Service will not impose the failure to deposit penalty under § 6656 solely for the failure to make the deposit electronically provided the deposit is otherwise made in a timely manner. This waiver applies only to deposit obligations incurred on or before December 31, 1998.

CONTINUED TEMPORARY WAIVER OF PENALTY FOR CERTAIN TAXPAYERS

For taxpayers first required to make federal tax deposits electronically on or after July 1, 1997, the Service will not impose the 10 percent § 6656 penalty solely for the failure to make those deposits by electronic funds transfer. However, a taxpayer will remain liable for the failure to deposit penalty under § 6656 (absent reasonable cause) if the taxpayer fails to make a required deposit in a timely manner.

This waiver of the failure to deposit penalty applies only to deposit obligations incurred on or before June 30, 1999. The penalty waiver includes deposits made after June 30, 1999, provided the deposit obligation was incurred on or before June 30, 1999.

This waiver of the failure to deposit penalty does not apply to taxpayers that were required to begin using electronic funds transfer in 1995 or 1996.

DRAFTING INFORMATION

The principal author of this notice is Vincent G. Surabian of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding the penalty waiver, contact Mr. Surabian at (202) 622-4940 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking Notice of Public Hearing

Relief From Disqualification for Plans Accepting Rollovers

REG–245562–96

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Proposed regulations; amendment.

SUMMARY: This document contains an amendment to the proposed regulations that implements section 1509 of the Taxpayer Relief Act of 1997 (TRA '97). The proposed regulations provide guidance on the qualification of retirement plans which accept rollover contributions from employees. This amendment to the proposed regulations clarifies that it is not necessary for the distributing plan to have a favorable IRS determination letter in order for the receiving plan administrator to reach a reasonable conclusion that a contribution is a valid rollover contribution. This amendment applies to any qualified retirement plan receiving or distributing eligible rollover distributions.

DATES: Written comments must be received by March 17, 1999.

ADDRESSES: Send submissions to CC:DOM:CORP:R (REG–245562–96), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (REG–245562–96), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html.

FOR FURTHER INFORMATION CONTACT: Marjorie Hoffman, (202) 622-6030 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On September 22, 1995, Final Income Tax Regulations (T.D. 8619) under sections 401(a)(31) and 402(c) were published in the **Federal Register** (60 F.R. 49199). The final regulations provide guidance for complying with the Unemployment Compensation Amendments of 1992 (UCA). A proposed amendment to the regulations under section 401(a)(31) was published in the **Federal Register** on September 19, 1996 (REG–245562–96) (61 F.R. 49279).

UCA expanded the types of distributions from a qualified plan that are eligible to be rolled over to an individual retirement account or individual retirement annuity, or to another qualified plan that accepts rollovers (collectively referred to as eligible retirement plans). Such distributions are referred to as eligible rollover distributions. UCA also added a new qualification provision under section 401(a)(31) that requires qualified plans to provide employees with a direct rollover option. Under a direct rollover option, an employee may elect to have an eligible rollover distribution paid directly to an eligible retirement plan. The direct rollover option is provided in addition to the pre-existing rollover provisions under section 402. Thus, an employee who receives an eligible rollover distribution but who does not elect a direct rollover still has the option to roll over the distribution to an eligible retirement plan within 60 days of receipt.

The final regulations under section 401(a)(31) provide that a plan that accepts a direct rollover from another plan will not fail to satisfy section 401(a) or 403(a) merely because the plan making the distribution is, in fact, not qualified under section 401(a) or 403(a) at the time of the distribution if, prior to accepting the rollover, the receiving plan reasonably concluded that the distributing plan was qualified under section 401(a) or 403(a). The regulations provide, by way of example, that the receiving plan may reasonably conclude that the distributing plan was qualified under section 401(a) or 403(a) where, before the receiving plan accepted the rollover, the plan administrator of the distributing plan provided the receiving plan with a statement that the distributing plan had received an IRS determination letter indicating that the plan was qualified.

The relief provided in the 1996 proposed regulations under section 401(a)(31) would expand and clarify the guidance previously issued in the Final Income Tax Regulations under sections 401(a)(31) and 402(c). First, the proposed regulations would clarify and expand the relief from disqualification currently provided for plans that accept direct rollovers. The protection would be expanded to be available not only if the plan administrator reasonably concludes the distributing plan is qualified under section 401(a) or 403(a) (even if later it is determined that the distributing plan is not a qualified plan), but also if the plan administrator reasonably concludes that a distribution meets the other requirements to be an eligible rollover distribution (but later it is determined that this conclusion was incorrect). Second, the regulations would extend this expanded relief from disqualification to plans that accept rollover contributions other than direct rollover contributions.

The 1996 proposed regulations do not mandate any particular documentation or procedures that a plan administrator must use in order to reach a reasonable conclusion that a rollover is valid. The 1996 proposed regulations contain a series of examples to illustrate the types of documentation and procedures that would be sufficient to support this conclusion. In each example, the employee making the rollover contribution provides the plan administrator with a letter from the plan administrator of the distributing plan stating that the distributing plan has received an IRS determination letter indicating that the distributing plan is qualified under section 401(a). In response to concerns that the examples might be read to imply that only a distribution from a plan with a favorable IRS determination letter could support a reasonable conclusion that a rollover was valid, section 1509 of TRA '97 directs the IRS to issue guidance clarifying that it is not necessary for the distributing plan to have a favorable IRS determination letter in order for the plan administrator of the receiving plan to reasonably conclude that a contribution is a valid rollover contribution.

Explanation of Provisions

This amendment to the 1996 proposed regulations is being issued in response to the congressional directive in section 1509 of TRA '97 to clarify that it is not necessary for a distributing plan to have a favorable IRS determination letter in order for the receiving plan administrator to reasonably conclude that a contribution is a valid rollover contribution. Accordingly, the proposed regulations have been amended to provide explicitly that it is not necessary for the distributing plan to have a favorable IRS determination letter in order for the plan administrator of the receiving plan to reach a reasonable conclusion that a contribution is a valid rollover contribution. In addition, an example has been added in which an employee does not provide a statement from the plan administrator of the distributing plan that the distributing plan has received a favorable IRS determination letter, but provides a statement from the distributing plan administrator relating to the qualification of the distributing plan. Of course, this example and the other examples in the 1996 proposed regulations are not intended to describe the only types of information that a plan administrator can find to be sufficient and, thus, the examples are not intended to preclude reliance on other types of information, such as opinions or statements regarding the plan's qualification provided by appropriate professionals expert in plan qualification requirements.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

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

A public hearing may be scheduled if requested in writing by a person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the **Federal Register.**

Drafting Information

The principal author of these regulations is Pamela R. Kinard, Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.401(a)(31)–1 as proposed on September 19, 1996, at 61 F.R. 49279, is amended as follows:

1. Under Q&A-14, paragraph (a) is amended by adding a sentence immediately after the second sentence.

2. Under Q&A-14, paragraph (c) is amended by redesignating *Example 2* and *Example 3* as *Example 3* and *Example 4* respectively, and adding a new *Example 2*.

The additions read as follows:

§1.401(a)(31)–1 Requirement to offer direct rollover of eligible rollover distributions; questions and answers.

* * * * *

A-14: (a) *Acceptance of Invalid Rollover Contribution.* * * * While evidence that the distributing plan is the subject of a determination letter from the Commissioner indicating that the distributing plan is qualified would be useful to the receiving plan administrator in reasonably concluding that the contribution is a valid rollover contribution, it is not necessary for the distributing plan to have such a determination letter in order for the receiving plan administrator to reach that conclusion. * * *

* * * * *

(c) *Examples.* * * *

Example 2. (a) The facts are the same as *Example 1*, except that, instead of the letter provided in paragraph (c) of *Example 1*, Employee A provides the plan administrator of Plan M with a letter from the plan administrator of Plan O representing that Plan O satisfies the requirements of section 401(a) (or representing that Plan O is intended to satisfy the requirements of section 401(a) and that the administrator of Plan O is not aware of any Plan O provision or operation that would result in the disqualification of Plan O).

(b) Based upon such a letter, absent facts to the contrary, a plan administrator may reasonably conclude that Plan O is qualified and that the amount paid as a direct rollover is an eligible rollover distribution.

* * * * *

John M. Dalrymple,
Acting Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on December 18, 1998, 8:45 a.m., and published in the issue of the Federal Register for December 21, 1998, 63 F.R. 70356)

Notice of Proposed Rulemaking Notice of Public Hearing

Communications Excise Tax; Prepaid Telephone Cards

REG–118620–97

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed rules for the application of the communications excise tax to prepaid telephone cards (PTCs). The regulations implement certain changes made by the Taxpayer Relief Act of 1997. They affect certain telecommunications carriers, resellers, and purchasers of PTCs. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments must be received by, March 17, 1998. Outlines of topics to be discussed at the public hearing scheduled for May 5, 1999, must be received by April 14, 1999.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–118620–97), 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 5 p.m. to: CC:DOM:CORP:R (REG–118620–97), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the hearing, submission of written comments, and to be placed on the building access list to attend the hearing, LaNita VanDyke, (202) 622-7180; concerning the regulations, Bernard H. Weberman (202) 622-3130 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget,** Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service,** Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224. Comments on the collection of information should be received by, February 16, 1998. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the **Internal Revenue Service,** including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

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

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

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

The collection of information in this proposed regulation is in §49.4251–4(d)(2). This information is required to document the status of certain purchasers of PTCs. The collection of information is required to obtain a benefit. The likely respondents and recordkeepers are businesses and small businesses.

Estimated total annual reporting burden: 24 hours.

Estimated average burden per respondent: .25 hour.

Estimated number of respondents: 96.

Estimated annual frequency of responses: On occasion.

Estimated total annual recordkeeping burden: 10 hours.

Estimated average annual burden per recordkeeper: 1.2 hours.

Estimated number of recordkeepers: 8.

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

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

Background

Section 4251 imposes a 3 percent excise tax on amounts paid for three communications services: local telephone service, toll telephone service, and teletypewriter exchange service. The tax is paid by the person paying for those communications services and, under section 4291, is collected by the person receiving that payment.

Section 1034 of the Taxpayer Relief Act of 1997 added section 4251(d), effective November 1, 1997, which provides special rules for the treatment of PTCs. Under section 4251(d), a PTC is any card or similar arrangement that permits its holder to obtain communications services and to pay for such services in advance. The face amount of the PTC is treated as an amount paid for communications services and that amount is treated as paid when the PTC is transferred by any telecommunications carrier to any person that is not a carrier.

Explanation of Provisions

These proposed regulations provide rules relating to the imposition of tax, the determination of the face amount upon which tax is imposed, and the identification of the person liable for tax and the person responsible for collecting tax. The purpose of the rules for determining the face amount is to implement Congressional intent that the tax be imposed on a PTC's retail value, whether a carrier sells a PTC at retail or at wholesale to a transferee reseller. In certain limited circumstances, these rules permit the use of a safe harbor under which the face amount is equal to $0.30 per minute of service provided. Because the IRS and Treasury expect the retail value of PTCs to change over time and intend to review the per-minute rate at regular intervals, this safe harbor expires on December 31, 2001.

For purposes of determining whether a transferor is a carrier and whether a transferee is a person that is not a carrier, the proposed regulations adopt the definition of telecommunications carrier used by the Federal Communications Commission. In general, this definition treats any provider of telecommunications service as a telecommunications carrier. In addition, the proposed regulations provide that a transferor carrier is not responsible for collecting the tax if it has been notified, in writing, by the purchaser of the purchaser's status as a carrier and has no reason to believe otherwise. Providing that notification does not relieve the purchaser from liability for tax if the purchaser is not, in fact, a carrier. Furthermore, the rules in the Excise Tax Procedural Regulations (26 CFR part 40) relating to collectors of tax under chapter 33 of the Internal Revenue Code do not apply to noncarrier purchasers.

During the development of the proposed regulations, the IRS and Treasury received inquiries concerning the treatment of multi-use cards and enhanced services cards. Multi-use cards are PTCs that can also be used to purchase items other than communications services, such as gas, groceries, etc. Enhanced services cards are PTCs that can also be used to purchase nontaxable informational services such as stock quotations or access to a 900 number. The proposed regulations do not include special rules for multi-use or enhanced services cards. However, the IRS and Treasury request comments on this issue.

The regulations are proposed to be effective at the beginning of the first calendar quarter after they are published as final regulations. Carriers and transferees may, however, rely on the proposed rules in determining the treatment of PTCs transferred before the effective date.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the time required to prepare or retain the notification is minimal and will not have a significant impact on those small entities that are required to provide notification. Furthermore, notification is provided only once to each seller. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

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

A public hearing has been scheduled for Wednesday, May 5, 1999, at 10 a.m. in room 2615, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. 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 15 minutes before the hearing starts. For information about having a visitor's name placed on the building access list to attend the hearing, see the FOR FURTHER INFORMATION CONTACT caption.

An outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) must be submitted by any person that wishes to present oral comments at the hearing. Outlines must be received by April 14, 1999.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. 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 requests to speak has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Bernard H. Weberman, Office of Assistant Chief Counsel (Passthroughs and Special Industries). 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 49 is proposed to be amended as follows:

PART 49—FACILITIES AND SERVICES EXCISE TAXES

Paragraph 1. The authority citation for part 49 is revised to read as follows:

Authority: 26 U.S.C. 7805, unless otherwise noted.

Section 49.4251–4 also issued under 26 U.S.C. 4251(d).

Par. 2. Section 49.4251–4 is added to read as follows:

§49.4251–4 Prepaid telephone cards.

(a) *In general.* In the case of communications services acquired by means of a prepaid telephone card (PTC), the face amount of the PTC is treated as an amount paid for communications services and that amount is treated as paid when the PTC is transferred by any carrier to any person that is not a carrier. This section provides rules for the application of the section 4251 tax to PTCs.

(b) *Definitions.*

Carrier means a telecommunications carrier as defined in 47 U.S.C. 153.

Comparable PTC means a currently available dollar card or tariffed unit card (other than a PTC transferred in bulk or under special circumstances, such as for promotional purposes) that provides the same type and amount of communications services as the PTC to which it is being compared.

Dollar card means a PTC the value of which is designated by the carrier in dollars (even if also designated in units of service), provided that the designated value is not less than the amount for which the PTC is expected to be sold to a holder.

Holder means a person that purchases other than for resale.

Prepaid telephone card (PTC) means a card or similar arrangement that permits its holder to obtain a fixed amount of communications services by means of a code (such as a personal identification number (PIN)) or other access device provided by the carrier and to pay for those services in advance.

Tariff means a schedule of rates and regulations filed by a carrier with the Federal Communications Commission.

Tariffed unit card means a unit card that is transferred by a carrier—

(1) To a holder at a price that does not exceed the designated number of units on the PTC multiplied by the carrier's tariffed price per unit; or

(2) To a transferee reseller subject to a contractual or other arrangement under which the price at which the PTC is sold to a holder will not exceed the designated number of units on the PTC multiplied by the carrier's tariffed price per unit.

Transferee means the first person that is not a carrier to whom a PTC is transferred by a carrier.

Transferee reseller means a transferee that purchases a PTC for resale.

Unit card means a PTC other than a dollar card.

Untariffed unit card means a unit card other than a tariffed unit card.

(c) *Determination of face amount*—(1) *Dollar card.* The face amount of a dollar card is the designated dollar value.

(2) *Tariffed unit card.* The face amount of a tariffed unit card is the designated number of units on the PTC multiplied by the tariffed price per unit.

(3) *Untariffed unit card*—(i) *Transfer to holder.* The face amount of an untariffed unit card transferred by a carrier to a holder is the amount for which the carrier sells the PTC to the holder.

(ii) *Transfer to transferee reseller*—(A) *In general.* The face amount of an untariffed unit card transferred by a carrier to a transferee reseller is, at the option of the carrier,—

(*1*) The highest amount for which the carrier sells an identical PTC to a holder that ordinarily would not be expected to buy more than one such PTC at a time (if the carrier makes such sales on a regular and arm's-length basis) or the face amount of a comparable PTC (if the carrier does not make such sales on a regular and arm's-length basis);

(*2*) 165 percent of the amount for which the carrier sells the PTC to the transferee reseller (including in that amount, in addition to any sum certain fixed at the time of the sale, any contingent amount per unit multiplied by the designated number of units on the PTC); or

(*3*) If the PTC is transferred before January 1, 2002, and is of a type that ordinarily is used entirely for domestic communications service, $0.30 multiplied by the maximum number of minutes of domestic communications service on the PTC.

(B) *Sales not at arm's length.* In the case of a transfer of an untariffed unit card by a carrier to a transferee reseller otherwise than through an arm's-length transaction, the fair market retail value of the PTC shall be substituted for the amount determined in paragraph (c)(3)(ii)(A)(2) of this section.

(4) *Exclusion.* Any separately stated state or local tax imposed on the furnishing or sale of communications services and any separately stated section 4251 tax are disregarded in determining, for purposes of this paragraph (c), the amount for which a PTC is sold.

(d) *Liability for tax*—(1) *In general.* Under section 4251(d), the section 4251(a) tax is imposed on the transfer of a PTC by a carrier to a transferee. The person liable for the tax is the transferee. Except as provided in paragraph (d)(2) of this section, the person responsible for collecting the tax is the carrier transferring the PTC to the transferee. If a holder purchases a PTC from a transferee reseller, the amount the holder pays for the PTC is not treated as an amount paid for communications services and thus tax is not imposed on that payment.

(2) *Effect of statement that purchaser is a carrier*—(i) *On transferor.* A carrier that transfers a PTC to a purchaser is not responsible for collecting the tax if, at the time of transfer, the transferor carrier has received written notification from the purchaser that the purchaser is a carrier, and the transferor has no reason to believe otherwise. The notification to be provided by the purchaser is a statement, signed under penalties of perjury by a person with authority to bind the purchaser, that the purchaser is a carrier (as defined in paragraph (b) of this section). The statement is not required to take any particular form.

(ii) *On purchaser.* If a purchaser that is not a carrier provides the notification described in paragraph (d)(2)(i) of this section to the carrier that transfers a PTC, the purchaser remains liable for the tax imposed on the transfer of the PTC.

(3) *Exemptions.* Any exemptions available under section 4253 apply to the transfer of a PTC from a carrier to a holder. Section 4253 does not apply to the transfer of a PTC from a carrier to a transferee reseller.

(e) *Examples.* The following examples illustrate the provisions of this section:

Example 1. Unit card; sold to individual. (i) On February 1, 2000, A, a carrier, sells a *prepaid telephone card* at A's retail store to P, an individual, for P's use in making telephone calls. A provides P with a PIN. The face of the card is marked "400 minutes." The sales price is $100. A tariff has not been filed for the units on the card. The toll telephone service acquired by purchasing the card will be obtained by entering the PIN and the telephone number to be called.

(ii) Because P purchased from a carrier other than for resale, P is a holder. The card provides its holder, P, with a fixed amount of communications services (400 minutes of toll telephone service) to be obtained by means of a PIN, for which P pays in advance of obtaining service; therefore, the card is a PTC. Because the value of the PTC is not designated in dollars and a tariff has not been filed for the units on the PTC, the PTC is an untariffed unit card. Because it is transferred by the carrier to the holder, the face amount is the sales price ($100).

(iii) The card is a PTC; thus, under section 4251(d), the face amount is treated as an amount paid for communications services and that amount is treated as paid when the PTC is transferred from A to P. Accordingly, at the time of transfer, P is liable for the 3 percent tax imposed by section 4251(a). The tax is $3 (3% $\times$ $100 (the face amount of the PTC)). Thus, the total paid by P is $103, the $100 sales price plus $3 tax. A is responsible for collecting the tax from P.

Example 2. Unit card; given to individual. (i) The facts are the same as in *Example 1,* except that instead of selling a card, A gives a 40 minute card to P.

(ii) Although the card provides P with a fixed amount of communications services (40 minutes of toll telephone service) to be obtained by means of a PIN, P does not pay for the service. Therefore, the card is not a PTC, even though it is called a "prepaid telephone card" by A.

(iii) Because the card is not a PTC, section 4251(d) does not apply. Furthermore, no tax is imposed by section 4251(a) because no amount is paid for the communications services.

Example 3. Unit card; adding value. (i) After using the card described in *Example 2,* P arranges with A by telephone to have 400 minutes of toll telephone service added to the card. The sales price is $100. P is told to continue using the PIN provided with the card.

(ii) Because P purchased from a carrier other than for resale, P is a holder. The arrangement provides its holder, P, with a fixed amount of communications services (400 minutes of toll telephone service) to be obtained by means of a PIN, for which P pays in advance of obtaining service; therefore, the arrangement is a PTC. Because the value of the PTC is not designated in dollars and a tariff has not been filed for the units on the PTC, the PTC is an untariffed unit card. Because it is transferred by the carrier to the holder, the face amount is the sales price ($100).

(iii) The arrangement is a PTC; thus, under section 4251(d), the face amount is treated as an amount paid for communications services and that amount is treated as paid when the PTC is transferred from A to P. Accordingly, at the time of transfer, P is liable for the 3 percent tax imposed by section 4251(a). The tax is $3 (3% × $100 (the face amount of the PTC)). Thus, the total paid by P is $103, the $100 sales price plus $3 tax. A is responsible for collecting the tax from P.

Example 4. Dollar card; sold other than for resale. (i) On February 1, 2000, B, a carrier, sells 100,000 prepaid telephone cards to Q, an auto dealer. Q will give away a card to each person that visits Q's dealership. B provides Q with a PIN for each card. The face of each card is marked "$2." The sales price for the 100,000 cards is $50,000. The toll telephone service acquired by purchasing the card will be obtained by entering the PIN and the telephone number to be called.

(ii) Because Q purchased from a carrier other than for resale, Q is a holder. Each card provides its holder, Q, with a fixed amount of communications services ($2 of toll telephone service) to be obtained by means of a PIN, for which Q pays in advance of obtaining service; therefore, each card is a PTC even though Q's visitors do not pay for the cards. The value of each PTC is designated in dollars; therefore, each PTC is a dollar card. Because the PTC is a dollar card, the face amount is the designated dollar value ($2).

(iii) The cards are PTCs; thus, under section 4251(d), the face amount is treated as an amount paid for communications services and that amount is treated as paid when the PTCs are transferred from B to Q. Accordingly, at the time of transfer, Q is liable for the 3 percent tax imposed by section 4251(a). The amount of the tax is computed as follows: 3% × $2 (the face amount of the PTC) = $0.06 per PTC × 100,000 PTCs = $6,000 tax. Thus, the total paid by Q is $56,000, the $50,000 sales price plus $6,000 tax. B is responsible for collecting the tax from Q.

Example 5. Unit card; sold to transferee reseller. (i) On February 1, 2000, C, a carrier, sells 10,000 prepaid telephone cards to R, a convenience store owner. R will sell the cards to individuals for their own use. C provides R with a PIN for each card. The face of each card is marked "400 minutes." A tariff has not been filed for the units on the card. C's sales price to R is $40,000 to be paid at the time of sale, plus a contingent amount equal to $0.14 for each minute of service used within 12 months to be paid at the end of the 12-month period. C also sells the identical card at its retail store for $110 to customers purchasing one card, or for $90 each to customers purchasing five or more cards. The toll telephone service acquired by purchasing the card will be obtained by entering the PIN and the telephone number to be called.

(ii) Because R purchased from a carrier for resale, R is a transferee reseller. Because R's customers will purchase other than for resale they will be holders. Each card sold by R provides its holder, R's customer, with a fixed amount of communications services (400 minutes of toll telephone service) to be obtained by means of a PIN, for which R's customer pays in advance of obtaining service; therefore, each card is a PTC. Because the value of each PTC is not designated in dollars and a tariff has not been filed for the units on the PTC, each PTC is an untariffed unit card.

(iii) The PTCs are untariffed unit cards transferred by the carrier to a transferee reseller. Thus, the face amount is determined under paragraph (c)(3)(ii) of this section, which permits C to choose from three alternative methods. Under paragraph (c)(3)(ii)(A)(1) of this section, the face amount of each PTC would be $110, the highest amount for which C sells to customers purchasing a single PTC. Alternatively, under paragraph (c)(3)(ii)(A)(2) of this section, a face amount of $99 per PTC may be used. This face amount is computed as follows: 165% × $600,000 (the $40,000 sum certain plus the $560,000 contingent amount (10,000 PTCs × 400 units = 4,000,000 units × $0.14 per unit)) = $990,000 ÷ 10,000 (the total number of PTCs sold). Finally, under paragraph (c)(3)(ii)(A)(3) of this section (assuming the PTCs are of a type that ordinarily is used entirely for domestic communications services), a face amount of $120 ($0.30 per unit × 400 units) may be used.

(iv) The cards are PTCs; thus, under section 4251(d), the face amount is treated as an amount paid for communications services and that amount is treated as paid when the PTCs are transferred from C to R. Accordingly, at the time of transfer, R is liable for the 3 percent tax imposed by section 4251(a). The amount of the tax is computed as follows (assuming that C chooses to determine the face amount as provided in paragraph (c)(3)(ii)(A)(2) of this section): 3% × $99 (the face amount of the PTC) = $2.97 per PTC × 10,000 PTCs = $29,700 tax. Thus, the total paid by R at the time of transfer is $69,700, the $40,000 sum certain plus $29,700 tax. C is responsible for collecting the tax from R.

(v) In 2000 and 2001, R sells PTCs to its customers for varying amounts. Because any amount paid for a PTC purchased from a transferee reseller is not an amount paid for communications services, no tax is imposed on R's sale of a PTC.

(vi) On February 15, 2001, C informs R that 3,000,000 minutes were used during the 12-month period. R pays C $420,000 ($0.14 × 3,000,000), the contingent amount agreed to when R purchased the PTCs. No tax is imposed on this payment. Tax was imposed when the PTCs were transferred to R. The contingent amount paid in 2001, based on the number of minutes used, does not change R's tax liability.

Example 6. Tariffed unit card; sold to transferee reseller. (i) On February 1, 2000, D, a carrier, sells 1,000 prepaid telephone cards to S, a convenience store owner, for $25,000. The value of the cards is not denominated in dollars, but the face of the card is marked "100 minutes" and a tariff of $0.33 per minute has been filed for the units on the card. S agrees that it will sell the cards to individuals for their own use and at a price that does not exceed $0.33 per minute. S actually sells the cards for $30 each (i.e., at a price of $0.30 per minute). D provides S with a PIN for each card. The toll telephone service acquired by purchasing the card will be obtained by entering the PIN and the telephone number to be called.

(ii) Because S purchased from a carrier for resale, S is a transferee reseller. Because S's customers will purchase other than for resale they will be holders. Each card sold by S provides its holder, S's customer, with a fixed amount of communications services (100 minutes of toll telephone service) to be obtained by means of a PIN, for which S's customer pays in advance of obtaining service; therefore each card is a PTC. Because the value of each PTC is not designated in dollars and D sells the PTCs to S subject to an arrangement under which the price at which the PTCs are sold to holders will not exceed the designated number of units on the PTC multiplied by D's tariffed price per unit, each PTC is an tariffed unit card. Because the PTCs are tariffed unit cards, the face amount of each PTC is $33, the designated number of units on the PTC multiplied by the tariffed price per unit (100 × $0.33 = $33), even though the actual retail sale price of the cards is $30.

(iii) The cards are PTCs; thus, under section 4251(d), the face amount is treated as an amount paid for communications services and that amount is treated as paid when the PTC is transferred from D to S. Accordingly, at the time of transfer, S is liable for the 3 percent tax imposed by section 4251(a). The tax is $990 (3% × $33,000 (1,000 PTCs multiplied by the $33 face amount of each PTC)). Thus, the total paid by S is $25,990, the $25,000 sales price plus $990 tax. D is responsible for collecting the tax from S.

Example 7. Transfer of card that is not a PTC. (i) On February 1, 2000, E, a carrier, provides a telephone card to T, an individual, for T's use in making telephone calls. E provides T with a PIN. The card provides access to an unlimited amount of communications services. E charges T $0.25 per minute of service, and bills T monthly for services used. The communications services acquired by using the card will be obtained by entering the PIN and the telephone number to be called.

(ii) Although the communications services will be obtained by means of a PIN, T does not receive a fixed amount of communications services. Also, T cannot pay in advance since the amount of T's payment obligation depends upon the number of minutes used. Therefore, the card is not a PTC.

(iii) Because the card is not a PTC, section 4251(d) does not apply. However, the tax imposed by section 4251(a) applies to the amounts paid by T to E for communications services. Accordingly, at the time an amount is paid for communications services, T is liable for tax. E is responsible for collecting the tax from T.

(f) *Effective date.* This section is applicable with respect to PTCs transferred by a carrier on or after the first day of the first calendar quarter beginning after the date of publication of the final regulations in the **Federal Register.**

Michael P. Dolan,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on December 16, 1998, 8:45 a.m., and published in the issue of the Federal Register for December 17, 1998, 63 F.R. 69585)

Notice of Proposed Rulemaking Notice of Public Hearing

Acquisition of an S Corporation by a Member of a Consolidated Group

REG–106219–98

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations under section 1502. The proposed regulations provide specific rules that apply to the acquisition of the stock of an S corporation by an affiliated group of corporations that joins in the filing of a consolidated return. These rules eliminate the compliance burdens associated with filing a separate return for the day that an S corporation is acquired by a consolidated group. Additionally, the proposed regulations clarify that §1.1502–76(c) continues to provide rules for the filing of the separate return for a corporation's items for the period not included in the consolidated return. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments must be received by March 10, 1999. Outlines of topics to be discussed at the public hearing scheduled for March 31, 1999, at 10 a.m. must be received by March 17, 1999.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–106219–98), 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 5 p.m. to CC:DOM:CORP:R (REG–106219–98), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at: http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Jeffrey L. Vogel, (202) 622-7770; concerning submissions, the hearing, and/or to be placed on the building access list to attend the hearing, LaNita Van Dyke, (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 1502 of the Internal Revenue Code of 1986 (the consolidated return regulations). The amendments apply to acquisitions by a consolidated group of at least eighty percent of the stock of an S corporation. When a consolidated group acquires an S corporation, the interaction of the consolidated return regulations and the subchapter S rules requires the filing of a separate return for the day of the acquisition. In most situations, complying with this requirement results in an unnecessary administrative burden for taxpayers.

The proposed regulations also clarify the impact of the 1994 revisions to §1.1502–76(b) (T.D. 8560, 1994–2 C.B. 200). The 1994 revisions provided taxpayers greater certainty and prevented inconsistent allocations of items between a separate and a consolidated return. The proposed regulations clarify that the due date for the filing of the separate return for the period not included in the consolidated return continues to be governed by the rules in §1.1502–76(c).

Acquisition of an S Corporation

Section 1.1502–76(b)(1)(i) provides that a consolidated return must include the common parent's items of income, gain, deduction, loss, and credit for the consolidated return year and each subsidiary's items for the portion of the year for which the subsidiary is a member. Generally under §1.1502–76(b)(1)(ii)(A), a subsidiary becomes a member of the consolidated group at the end of the day on which its status as a member changes, and its tax year ends at that time for all Federal income tax purposes. The subsidiary's items for the period beginning on the day after it becomes a member of the consolidated group are generally included in the consolidated return of the group. The subsidiary's items for the period prior to its becoming a member generally are included in a separate return.

A small business corporation's election under section 1362(a) to be an S corporation terminates under section 1362(d)(2) if it ceases to be a small business corporation. A small business corporation cannot have a corporate shareholder. Thus, an S corporation election terminates when the corporation has another corporation as a shareholder. The termination is effective on the day the corporation becomes a shareholder. When the termination of an S corporation election becomes effective on any day other than the first day of the taxable year, the taxable year in which the termination occurs is an S termination year under section 1362(e)(4). The S termination year is comprised of a short taxable year for which the corporation is an S corporation (the portion of the S termination year ending on the day before the terminating event occurs, or S short year) and a short taxable year for which the corporation is a C corporation (the remainder of the S termination year, or C short year).

Under section 1362(e)(6)(D), if there is a change in ownership of 50 percent or more of the stock in a corporation during the S termination year, items of income, gain, loss, deduction, and credit must be allocated between the S short year and the C short year on the basis of the corporation's normal method of accounting, as determined under section 446 (also referred to as a closing of the corporation's books) as of the close of the S short year, rather than a daily proration or other method. The S short year and the C short year are treated as two separate taxable years for most purposes. Separate returns are required for the S short year and the C short year, and the due date for the S short year return is the date by which the C short year return must be filed.

When an S corporation becomes a member of a consolidated group, the interaction of the consolidated return regulations and the subchapter S rules results in the corporation having three taxable periods for the year of the acquisition for which Federal income tax returns are due: (1) an S short year that ends on the day before the acquisition by the consolidated group, (2) a C short year consisting solely of the day of the acquisition, and (3) a short taxable year (included in the consolidated return) for any items occurring after the day of the acquisition. Although three separate taxable periods are created when an S corporation becomes a member of a consolidated group, existing rules preclude an allocation of items properly attributable to either the C short year or the consolidated year to the S short year, for example, through a daily proration of the items attributable to the year of the acquisition. Section 1362(e)(6)(D).

The IRS and Treasury have determined that the compliance burdens associated with filing a separate return for the day that an S corporation is acquired by a consolidated group are not necessary to achieve the separate goals of section 1362(e) and the consolidated return regulations. The proposed regulations will eliminate this requirement in most situations, while preserving the purpose and effect of the rules under section 1362(e). These proposed regulations will not apply, however, if an S corporation becomes a member of a consolidated group in a qualified stock purchase for which an election under section 338(g) is made. If the common parent of the consolidated group and the shareholders of the S corporation jointly make a section 338(h)(10) election, the administrative relief provided by these proposed regulations is unnecessary because the S corporation election of the old target corporation does not terminate. See §1.338(h)(10)–1(e)(2)(iv).

Under the proposed regulations, an S corporation will become a member of the consolidated group at the beginning of the day that includes the acquisition, and its tax year will end for all Federal income tax purposes at the end of the day preceding the acquisition. Thus, instead of three short taxable years, the corporation will have two short taxable years as a result of the acquisition: (1) the period ending on the day before the S corporation joins the consolidated group, which will be treated as a taxable year in which the corporation was an S corporation, and (2) the period during which the corporation is a member of the consolidated group. The termination of an S corporation election under section 1362(d)(2) continues to become effective on the day of the acquisition. However, because the consolidated return regulations create a separate taxable year for the corporation, the first day of which is the day on which the S corporation election terminates, there is no S termination year within the meaning of section 1362(e)(4). Consequently, section 1362(e) technically does not apply to the corporation.

Notwithstanding that there is no there is no S termination year, the proposed regulations provide rules similar to those that would have applied under section 1362(e). Under the proposed regulations, as under section 1362(e)(1)(A), the S corporation's short taxable year ends at the end of the day preceding the date of the acquisition. The Federal income tax return for the final taxable year of the S corporation will be due at the earlier of: (1) the date the S corporation return would have been due if the taxable year of the S corporation did not end or (2) the date the consolidated group's return for the taxable year that includes the acquisition is due.

These proposed regulations also preclude the availability of ratable allocation under §1.1502–76(b)(2)(ii) and (iii) in order to achieve the same results that would have obtained if section 1362(e)(6)(D) had applied. Accordingly, if an S corporation joins a consolidated group and these proposed regulations apply, then items must be allocated between the two short taxable years that begin and end with the corporation joining the consolidated group on the basis of a closing of the books rather than a ratable allocation of the type that would have been available under section 1362(e)(2) (in the case of the termination of an S corporation election) or §1.1502–76(b)(2)(ii) and (iii) (in the case of a corporation becoming or ceasing to be a member of a consolidated group).

Due Date for Separate Return

Section 1.1502-76(b) provides guidance regarding the items to be included in a consolidated return. Items for the portion of a year not included in the consolidated return must be included in a separate return.

Section 1.1502–76(b)(1)(ii)(A) provides that a subsidiary becomes (or ceases to be) a member of the consolidated group at the end of the day on which its status as a member changes, and its tax year ends at that time for all Federal income tax purposes. Section 1.1502–76(b)(2)(i) generally provides that the returns that end and begin with a subsidiary becoming (or ceasing to be) a member of the consolidated group are subject to the rules of the Internal Revenue Code applicable to short periods, as if the subsidiary ceased to exist on becoming a member (or first existed on becoming a nonmember). Section 1.1502–76(c) provides rules for the filing of the separate return for the period the subsidiary was not included in the consolidated group.

The IRS and Treasury are concerned that a broad application of the provisions of §1.1502–76(b) could be construed to require an accelerated filing of the separate return by the fifteenth day of the third month following the end of the short taxable year that resulted from the corporation joining or leaving the consolidated group. This interpretation would, in effect, override the provisions in §1.1502-76(c) concerning the due date for the filing of a separate return.

The IRS and Treasury did not intend to modify the due date for the separate return for the period not included in the consolidated return by the changes in §1.1502–76(b) (as amended by T.D. 8560). This proposed regulation clarifies that §1.1502–76(c) continues to provide rules for the filing of the separate return.

Proposed Effective Date

The amendments relating to the acquisition of a corporation that, immediately before becoming a member, had an election under section 1362(a) in effect, are proposed to apply to transactions occurring after the date final regulations are published in the **Federal Register.** The amendments relating to the clarification of the due date for the separate return for items not included in the return of a consolidated group are proposed to apply to corporations that became or ceased to be members of consolidated groups on or after January 1, 1995, the effective date of the 1994 amendments to §1.1502–76(b).

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that the proposed regulations will provide administrative relief to small entities by removing the administrative burden of filing a separate one-day return currently required for certain acquisitions. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

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

A public hearing has been scheduled for March 31, 1999, at 10 a.m. in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. 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 15 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 that wish to present oral comments at the hearing must submit written comments (a signed original and eight (8) copies) by March 10, 1999. The outline of topics to be discussed and the time to be devoted to each topic must be received by March 17, 1999.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Jeffrey L. Vogel of the Office of the Assistant Chief Counsel (Corporate), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Section 1.1502–76 also issued under 26 U.S.C. 1502. * * *

Par. 2. Section 1.1362–3 is amended by adding a sentence to the end of paragraph (a) to read as follows:

§1.1362–3 Treatment of S termination year.

(a) *In general.* * * * See, however, §1.1502–76(b)(1)(ii)(A)(2) for special rules for an S election that terminates under section 1362(d) immediately before the S corporation becomes a member of a consolidated group (within the meaning of §1.1502–1(h)).

* * * * *

Par. 3. Section 1.1502–76 is amended as follows:

1. The text of paragraph (b)(1)(ii)(A) is redesignated as paragraph (b)(1)(ii)(A)(*1*).

2. A paragraph heading for newly designated paragraph (b)(1)(ii)(A)(*1*) is added.

3. The first sentence of newly designated paragraph (b)(1)(ii)(A)(*1*) is revised.

4. Paragraph (b)(1)(ii)(A)(*2*) is added.

5. Paragraph (b)(2)(v) is redesignated as paragraph (b)(*2*)(vi).

6. New paragraph (b)(2)(v) is added.

7. Paragraph (b)(5) is redesignated as paragraph (b)(6).

8. Paragraph (b)(4) is redesignated as paragraph (b)(5).

9. New paragraph (b)(4) is added.

10. Newly designated paragraph (b)(5) is amended as follows:

a. The first sentence of paragraph (b)(5), *Example 6*(b) is revised.

b. The second sentence of paragraph (b)(5), *Example 6*(c) is revised.

c. *Example 7* is added to paragraph (b)(5).

11. Newly designated paragraph (b)(6)(i) is revised.

The revisions and additions read as follows:

§1.1502–76 Taxable year of members of group.

* * * * *

(b) * * * (1) * * *

(ii) * * *(A) * * * (*1*) *In general.* If a corporation (S), other than one described in paragraph (b)(1)(ii)(A)(*2*), becomes or ceases to be a member during a consolidated return year, it becomes or ceases to be a member at the end of the day on which its status as a member changes, and its tax year ends for all Federal income tax purposes at the end of that day. * * *

(*2*) *Special rule for former S corporations.* If S becomes a member in a transaction other than in a qualified stock purchase for which an election under section 338(g) is made, and immediately before becoming a member an election under section 1362(a) was in effect, then S will become a member at the beginning of the day the termination of its S corporation election is effective. S's tax year ends for all Federal income tax purposes at the end of the preceding day. This paragraph (b)(1)(ii)(A)(*2*) applies to transactions occurring after the date that final regulations are published in the **Federal Register.**

* * * * *

(2) * * *

(v) *Acquisition of S corporation.* If a corporation is acquired in a transaction to which paragraph (b)(1)(ii)(A)(*2*) of this section applies, then paragraphs (b)(2)(ii) and (iii) of this section do not apply and items of income, gain, loss, deduction, and credit are assigned to each short taxable year on the basis of the corporation's normal method of accounting as determined under section 446. This paragraph (b)(2)(v) applies to transactions occurring after the date that final regulations are published in the Federal Register.

* * * * *

(4) *Determination of due date for separate return.* Paragraph (c) of this section contains rules for the filing of the separate return referred to in this paragraph (b). In applying paragraph (c) of this section, the due date for the filing of S's separate return shall also be determined without regard to the ending of the tax year under paragraph (b)(1)(ii) of this section or the deemed cessation of its existence under paragraph (b)(2)(i) of this section.

* * * * *

(5) * * *

Example 6. Allocation of partnership items. * * *

(b) Analysis. Under paragraph (b)(2)(vi)(A) of this section, T is treated, solely for purposes of determining T's tax year in which the partnership's items are included, as selling or exchanging its entire interest in the partnership as of P's sale of T stock. * * *

(c) *Controlled partnership*. * * * Under paragraph (b)(2)(vi)(B) of this section, T's distributive share of the partnership items is treated as T's items for purposes of paragraph (b)(2) of this section. * * *

Example 7. Acquisition of S corporation. (a) *Facts.* Z is a small business corporation for which an election under section 1362(a) was in effect at all times since Year 1. At all times, Z had only 100 shares of stock outstanding, all of which were owned by individual A. On July 1 of Year 3, P acquired all of the Z stock. P does not make an election under section 338(g) with respect to its purchase of the Z stock.

(b) *Analysis.* As a result of P's acquisition of the Z stock, Z's election under section 1362(a) terminates. See sections 1361(b)(1)(B) and 1362(d)(2). Z is required to join in the filing of the P consolidated return. See §1.1502-75. Z's tax year ends for all Federal income tax purposes on June 30 of Year 3. If no extension of time is sought, Z must file a separate return for the period from January 1 through June 30 of Year 3 on or before March 15 of Year 4. See paragraph (b)(4) of this section. Z will become a member of the P consolidated group as of July 1 of Year 3. See paragraph (b)(1)(ii)(A)(*2*) of this section. P group's Year 3 consolidated return will include Z's items from July 1 to December 31 of Year 3.

(6) *Effective date*—(i) *General rule.* Except as provided in paragraphs (b)(1)(ii)(A)(*2*) and (b)(2)(v) of this section, this paragraph (b) applies to corporations becoming or ceasing to be members of consolidated groups on or after January 1, 1995.

* * * * *

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on December 16, 1998, 8:45 a.m., and published in the issue of the Federal Register for December 17, 1998, 63 F.R. 69581.)

Notice of Proposed Rulemaking Notice of Public Hearing

Timely Mailing Treated as Timely Filing/Electronic Postmark

REG–115433–98

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking; and, withdrawal of previous notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to timely mailing treated as timely filing and paying under section 7502. The proposed regulations generally reflect changes to the law made since 1960. The proposed regulations affect taxpayers that file documents or make payments or deposits. This document also withdraws a previous notice of proposed rulemaking published in the **Federal Register** of December 11, 1979.

DATES: Written comments and requests for a public hearing must be received by April 15, 1999. The notice of proposed rulemaking published at 44 F.R. 71430, December 11, 1979, is withdrawn as of January 15, 1999.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–115433–98), 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 5 p.m. to: CC:DOM:CORP:R (REG–115433–98), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html.

FOR FURTHER INFORMATION CONTACT: Concerning submissions, Michael Slaughter, (202) 622-7180; concerning the regulations, Charles A. Hall, (202) 622-4940 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Regulations on Procedure and Administration (26 CFR part 301) under section 7502 relating to timely mailing treated as timely filing and paying. As originally enacted in the Internal Revenue Code of 1954, Public Law 591, ch. 736 (68A Stat. 895 (1954)), section 7502 provided that if any claim, statement, or other document is delivered to the appropriate agency, officer, or office after the filing date, the date of the United States postmark will be deemed to be the date of delivery if the postmark date is on or before the filing due date. In the case of registered mail, section 7502 provided that the registration will be prima facie evidence of delivery and the date of registration will be deemed the postmark date. At the time, section 7502 did not apply to the mailing of tax returns or payments.

The Technical Amendments Act of 1958, Public Law 85-866 (72 Stat. 1665 (1958)), amended section 7502 by authorizing the Secretary to provide by regulations the extent to which the provisions with respect to prima facie evidence of delivery and the postmark date will apply to certified mail.

Section 5(a) of the Act of November 2, 1966, Public Law 89–713 (80 Stat. 1110 (1966)), amended section 7502 to apply the timely mailing rules to returns and the payment of taxes. Section 106(a) of the Revenue and Expenditure Control Act of 1968, Public Law 90–364 (82 Stat. 266 (1968)), extended these rules to the mailing of deposits of tax. The Deficit Reduction Act of 1984, Public Law 98–369 (98

Stat. 695 (1984)), limited the timely mailing rules to deposits of less than $20,000 in the case of any person who is required to deposit more than once a month.

Minor changes were also made to section 7502 by the Tax Reform Act of 1976, Public Law 94–455 (90 Stat. 1831 and 1834 (1976)), the Act of October 28, 1977, Public Law 95–147 (91 Stat. 1228 (1977)), and the Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2833 (1986)).

The existing regulations (T.D. 6232) under section 7502 were last amended on October 25, 1960 (25 F.R. 10247) to implement changes made by the Technical Amendments Act of 1958. The regulations provide that the prima facie evidence of delivery and postmark date rules apply to certified mail.

A notice of proposed rulemaking (REG–209351–71, formerly LR–1406) was published on December 11, 1979 (44 F.R. 71430) to implement changes made by the Act of November 2, 1966, the Revenue and Expenditure Control Act of 1968, the Tax Reform Act of 1976, and the Act of October 28, 1977. The proposed regulations would have conformed the existing regulations to these changes. Because the proposed changes are incorporated in this document, the earlier notice of proposed rulemaking is withdrawn.

In 1996, section 1210 of The Taxpayer Bill of Rights 2, Public Law 104–168 (110 Stat. 1474 (1996)), added section 7502(f) to provide that the term *United States mail* includes a designated delivery service and that the term *postmark* includes the date recorded or marked by a designated delivery service. The provision allows the IRS to determine whether a service of a private delivery service (PDS) is a designated delivery service. Section 7502(f) also allows the IRS to provide a rule that equates a service provided by a PDS to United States registered or certified mail. The IRS has determined that certain delivery services of four PDSs are designated for purposes of section 7502(f). However, the IRS has not yet determined that any service of a PDS is substantially equivalent to United States registered or certified mail. See Notice 98–47 (1998–37 I.R.B. 8 (September 14, 1998)).

Finally, section 7502(c)(2) was amended by section 2003(b) of the Internal Revenue Service Restructuring and Reform Act of 1998, Public Law 105-206 (112 Stat. 725 (1998)), to authorize the Secretary to provide the extent to which the prima facie evidence of delivery and postmark date rules apply to electronic filing.

Explanation of Provisions

These proposed regulations propose to add a new §301.7502–1(d) to provide that the date of an electronic postmark given by an authorized electronic return transmitter will be deemed the filing date if the date of the electronic postmark is on or before the filing due date. It also permits the Commissioner to enter into an agreement with an electronic return transmitter or to prescribe in forms, instructions, or other appropriate guidance the procedures under which the electronic return transmitter is authorized to provide taxpayers with an electronic postmark to acknowledge the date and time that the electronic return transmitter received the electronically filed document.

An electronic return transmitter is defined for purposes of the regulation the same as in the revenue procedures governing the Electronic Filing Program, currently Rev. Proc. 98–50 (1998–38 I.R.B. 8 (September 21, 1998)), and the On-Line Filing Program, currently Rev. Proc. 98-51 (1998–38 I.R.B. 20 (September 21, 1998)). An electronic postmark is a record of the date and time that an authorized electronic return transmitter receives the transmission of the taxpayer's electronically filed document on its host system.

For tax year 1998, the rules on electronic postmarks are effective for income tax returns filed through electronic return transmitters authorized to provide an electronic postmark pursuant to an agreement under the Electronic Tax Administration's Request for Agreement released on November 26, 1997. For taxable years beginning after 1998, the rules on electronic postmarks are effective for documents submitted to electronic return transmitters that are authorized to provide an electronic postmark pursuant to §301.7502–1(d)(2).

The remainder of the changes contained in §§301.7502–1 and 301.7502–2 conform the regulations to the expanded scope of section 7502 as amended over the years. For instance, §301.7502–1 provides that the timely mailing treated as timely filing rule extends to the mailing of tax returns and payments. Additionally, §301.7502–2 provides guidance on the timely mailing of deposits.

In 1980, IRS and the Treasury Department received comments in response to the notice of proposed rulemaking. Comments have not been requested since that time. Accordingly, the public is encouraged to make comments regarding this notice of proposed rulemaking, including comments regarding whether section 7502 should apply to claims for refunds made on delinquent original income tax returns or whether the prima facie evidence of delivery rule for registered mail should be extended to services of a PDS or to electronic filing of documents.

Effect on other Documents

The notice of proposed rulemaking published in the Federal Register for December 11, 1979 (REG–209351–71, formerly LR-1406, 44 F.R. 71430) is withdrawn as of January 15, 1999.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments (a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested by any person that timely submits comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the **Federal Register.**

Drafting Information

The principal author of these regulations is Charles A. Hall, Office of Assistant Chief Counsel (Income Tax & Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 301 is proposed to be amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 is amended by adding entries in numerical order to read as follows:

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

Section 301.7502–1 also issued under 26 U.S.C. 7502 * * *

Section 301.7502–2 also issued under 26 U.S.C. 7502 * * *

Par. 2. Section 301.7502–1 is revised to read as follows:

§301.7502–1 Timely mailing of documents and payments treated as timely filing and paying.

(a) *General rule.* Section 7502 provides that, if the requirements of that section are met, a document or payment (within the meaning of paragraph (b) of this section) is deemed to be filed or paid on the date of the postmark stamped on the envelope or other appropriate wrapper (envelope) in which the document or payment was mailed. Thus, if the envelope that contains the document or payment has a timely postmark, the document or payment is considered timely filed or paid even if it is received after the last date, or the last day of the period, prescribed for filing the document or making the payment. However, if a document or payment is not considered timely filed or timely paid under section 7502, the document or payment is not deemed to be filed or paid on the date of the postmark stamped on the envelope in which the document or payment was mailed. Thus, section 7502 does not apply to determine the period of time during which there is a failure to file a return or pay a tax for purposes of computing the penalties and additions to tax imposed by section 6651. Except as provided in section 7502(e) and §301.7502–2, relating to the timely mailing of deposits, and paragraph (d) of this section, relating to electronically filed documents, section 7502 is applicable only to those documents or payments as defined in paragraph (b) of this section and only if the document or payment is mailed in accordance with paragraph (c) of this section and is delivered in accordance with paragraph (e) of this section.

(b) *Definitions*—(1) *Document defined.* (i) The term *document*, as used in this section, means any return, claim, statement, or other document required to be filed within a prescribed period or on or before a prescribed date under authority of any provision of the internal revenue laws, except as provided in paragraph (b)(1)(ii), (iii), or (iv) of this section.

(ii) The term does not include returns, claims, statements, or other documents that are required under any provision of the internal revenue laws or the regulations thereunder to be delivered by any method other than mailing.

(iii) The term does not include any document filed in any court other than the Tax Court, but the term does include any document filed with the Tax Court, including a petition for redetermination of a deficiency and a petition for review of a decision of the Tax Court.

(iv) The term does not include any document that is required to be filed with a bank or other depositary under section 6302. However, see §301.7502–2 for special rules relating to the timeliness of deposits and documents required to be filed with deposits.

(2) *Payment defined.* (i) The term *payment,* as used in this section, means any payment required to be made within a prescribed period or on or before a prescribed date under the authority of any provision of the internal revenue laws, except as provided in paragraph (b)(2)(ii), (iii), (iv), or (v) of this section.

(ii) The term does not include any payment that is required under any provision of the internal revenue laws or the regulations thereunder to be delivered by any method other than mailing. See, for example, section 6302(h) and the regulations thereunder regarding electronic funds transfer.

(iii) The term does not include any payment, whether it is made in the form of currency or other medium of payment, unless it is actually received and accounted for. For example, if a check is used as the form of payment, this section does not apply unless the check is honored upon presentation.

(iv) The term does not include any payment to any court other than the Tax Court.

(v) The term does not include any deposit that is required to be made with a bank or other depositary under section 6302. However, see §301.7502-2 for rules relating to the timeliness of deposits.

(3) *Last date or last date prescribed.* As used in this section, the term *the last date, or the last day of the period, prescribed for filing the document or making the payment* includes any extension of time granted for that action. When the last date, or the last day of the period, prescribed for filing the document or making the payment falls on a Saturday, Sunday or legal holiday, section 7503 applies. Therefore, in applying the rules of this paragraph (b)(3), the next succeeding day that is not a Saturday, Sunday, or legal holiday is treated as the last date, or the last day of the period, prescribed for filing the document or making the payment.

(c) *Mailing requirements*—(1) *In general.* Section 7502 does not apply unless the document or payment is mailed in accordance with the following requirements:

(i) *Envelope and address.* The document or payment must be contained in an envelope, properly addressed to the agency, officer, or office with which the document is required to be filed or to which the payment is required to be made.

(ii) *Timely deposited in U.S. mail.* The document or payment must be deposited within the prescribed time in the mail in the United States with sufficient postage prepaid. For this purpose, a document or payment is deposited in the mail in the United States when it is deposited with the domestic mail service of the U.S. Postal Service. The domestic mail service of the U.S. Postal Service, as defined by the Domestic Mail Manual as incorporated by reference in the postal regulations, includes mail transmitted within, among, and between the United States of America, its territories and possessions, and Army post offices (APO), fleet post offices (FPO), and the United Nations, NY. (See Domestic Mail Manual, section G011.2.1, as incorporated by reference in 39 CFR 111.1.) Section 7502 does not apply to any document or payment that is deposited with the mail service of any other country.

(iii) *Postmark*—(A) *U.S. Postal Service postmark.* If the postmark on the envelope is made by the U.S. Postal Service, the postmark must bear a date on or before the last date, or the last day of the period, prescribed for filing the document or making the payment. If the postmark does not bear a date on or before the last date, or the last day of the period, prescribed for filing the document or making the payment, the document or payment is considered not to be timely filed or paid, regardless of when the document or payment is deposited in the mail. Accordingly, the sender who relies upon the applicability of section 7502 assumes the risk that the postmark will bear a date on or before the last date, or the last day of the period, prescribed for filing the document or making the payment. See, however, paragraph (c)(2) of this section with respect to the use of registered mail or certified mail to avoid this risk. If the postmark on the envelope is made by the U.S. Postal Service but is not legible, the person who is required to file the document or make the payment has the burden of proving the date that the postmark was made. Furthermore, if the envelope that contains a document or payment has a timely postmark made by the U.S. Postal Service but it is received after the time when a document or payment postmarked and mailed at that time would ordinarily be received, the sender may be required to prove that it was timely mailed.

(B) *Postmark made by other than U.S. Postal Service*—(*1*) *In general.* If the postmark on the envelope is made other than by the U.S. Postal Service—

(*i*) The postmark so made must bear a legible date on or before the last date, or the last day of the period, prescribed for filing the document or making the payment; and

(*ii*) The document or payment must be received by the agency, officer, or office with which it is required to be filed not later than the time when a document or payment contained in an envelope that is properly addressed, mailed, and sent by the same class of mail would ordinarily be received if it were postmarked at the same point of origin by the U.S. Postal Service on the last date, or the last day of the period, prescribed for filing the document or making the payment.

(*2*) *Document or payment received late.* If the document or payment is received after the time when a document or payment so mailed and so postmarked by the U.S. Postal Service would ordinarily be received, the document or payment is treated as having been received at the time when a document or payment so mailed and so postmarked would ordinarily be received if the person who is required to file the document or make the payment establishes–-

(*i*) That it was actually deposited in the U.S. mail before the last collection of the mail from the place of deposit which was postmarked (except for the metered mail) by the U.S. Postal Service on or before the last date, or the last day of the period, prescribed for filing the document or making the payment;

(*ii*) That the delay in receiving the document or payment was due to a delay in the transmission of the U.S. mail; and

(*iii*) The cause of the delay.

(*3*) *U.S. and non-U.S. postmarks.* If the envelope has a postmark made by the U.S. Postal Service in addition to the postmark not so made, the postmark that was not made by the U.S. Postal Service is disregarded, and whether the envelope was mailed in accordance with this paragraph (c)(1)(iii)(B) will be determined solely by applying the rule of paragraph (c)(1)(iii)(A) of this section.

(2) *Registered or certified mail.* If the document or payment is sent by U.S. registered mail, the date of registration of the document or payment is treated as the postmark date. If the document or payment is sent by U.S. certified mail and the sender's receipt is postmarked by the postal employee to whom the document or payment is presented, the date of the U.S. postmark on the receipt is treated as the postmark date of the document or payment. Accordingly, the risk that the document or payment will not be postmarked on the day that it is deposited in the mail may be eliminated by the use of registered or certified mail.

(d) *Electronically filed documents*—(1) *In general.* A document filed electronically with an electronic return transmitter (as defined in paragraph (d)(3)(i) of this section and authorized pursuant to paragraph (d)(2) of this section) in the manner and time prescribed by the Commissioner is deemed to be filed on the date of the electronic postmark (as defined in paragraph (d)(3)(ii) of this section) given by the authorized electronic return transmitter. Thus, if the electronic postmark is timely, the document is considered filed timely although it is received by the agency, officer, or office after the last date, or the last day of the period, prescribed for filing such document.

(2) *Authorized electronic return transmitters.* The Commissioner may enter into an agreement with an electronic return transmitter or prescribe in forms, instructions, or other appropriate guidance the procedures under which the electronic return transmitter is authorized to provide taxpayers with an electronic postmark to acknowledge the date and time that the electronic return transmitter received the electronically filed document.

(3) *Definitions*—(i) *Electronic return transmitter.* For purposes of this paragraph (d), the term *electronic return transmitter* has the same meaning as contained in section 3.02(4) of Rev. Proc. 98–50 (1998–38 I.R.B. 8 (September 21, 1998)) and section 3.02(3) of Rev. Proc. 98–51 (1998–38 I.R.B. 20 (September 21, 1998))(See §601.601(d)(2) of this chapter.) or in procedures subsequently prescribed by the Commissioner.

(ii) *Electronic postmark.* For purposes of this paragraph (d), the term *electronic postmark* means a record of the date and time (in a particular time zone) that an authorized electronic return transmitter receives the transmission of a taxpayer's electronically filed document on its host system. However, if the taxpayer and the electronic return transmitter are located in different time zones, it is the time in the taxpayer's time zone that controls the timeliness of the electronically filed document.

(e) *Delivery.* (1) Except as provided in section 7502(f) and paragraph (d) of this section, section 7502 is not applicable unless the document or payment is delivered by U.S. mail to the agency, officer, or office with which the document is required to be filed or to which payment is required to be made. However, in the case of a document (but not a payment) sent by registered or certified mail, proof that the document was properly registered or that a postmarked certified mail sender's receipt was properly issued and that the envelope was properly addressed to the agency, officer, or office constitutes prima facie evidence that the document was delivered to the agency, officer, or office.

(2) Section 7502 is applicable only when the document or payment is delivered after the last date, or last day of the period, prescribed for filing the document or making the payment. Thus, section 7502 is applicable when a claim for credit or refund is delivered after the last day of the period specified in section 6511 or in any other corresponding provision of law relating to the limit on the amount of credit or refund that is allowable. For example, taxpayer A was required to file an income tax return for 1993 on or before April 15, 1994, but A secured an extension until August 15, 1994, to file such return. A filed the return on August 15, 1994, but no tax was paid at that time because the tax liability disclosed by the return had been completely satisfied by the income tax that had been withheld on A's wages. On August 14, 1997, A mailed in accordance with the requirements of this section a claim for refund of a portion of this 1993 tax. The envelope containing the claim was postmarked on August 14, 1997, but it was not delivered to the Service Center until August 18, 1997. Under section 6511, A's claim for refund is timely if filed within three years from August 15, 1994. Thus, since A's claim for refund was mailed in accordance with the requirements of this section and was delivered after the last day of the period specified in section 6511, section 7502 is applicable and the claim is deemed to have been filed on August 14, 1997.

(f) *Effective date*—(1) *In general.* This section applies to any payment or document mailed and delivered in accordance with the requirements of this section in an envelope bearing a postmark dated after January 15, 1999.

(2) *Electronically filed documents*—(i) *For taxable year 1998.* For taxable year 1998, this section only applies to electronically filed income tax returns transmitted to an electronic return transmitter that was authorized to provide an electronic postmark pursuant to an agreement entered into in response to submissions received in reply to the Electronic Tax Administration's Request for Agreement released on November 26, 1997.

(ii) *For taxable years after 1998.* For taxable years after 1998, this section applies to any electronically filed return, claim, statement, or other document transmitted to an electronic return transmitter that is authorized to provide an electronic postmark pursuant to paragraph (d)(2) of this section.

Par. 3. Section 301.7502–2 is added to read as follows:

§301.7502–2 Timely mailing of deposits.

(a) *General rule*—(1) *Two day rule.* Section 7502(e) provides that, if the requirements of that section are met, a deposit is deemed to be received on the date the deposit was mailed even though it is received after the date prescribed for making the deposit. The requirements of the section are met if the person required to make the deposit establishes that the date of mailing was on or before the second day preceding the date prescribed for making the deposit. If the date of mailing was not established to be on or before the second day preceding the date prescribed for making the deposit, the deposit will not be considered timely received unless it is actually received on or before the date prescribed for making the deposit. Section 7502(e) only applies to a deposit mailed to the bank, trust company, domestic building and loan association, or credit union authorized to receive that deposit. Thus, section 7502(e) does not apply to any remittance mailed to an internal revenue service center.

(2) *Deposits of $20,000 or more.* Paragraph (a)(1) of this section does not apply with respect to any deposit of $20,000 or more by any person required to deposit any tax more than once a month. Any such deposit must be made by the due date for such deposit, regardless of the method of delivery.

(b) *Deposit defined.* The term *deposit,* as used in this section, means any deposit of tax required to be made on or before a prescribed date pursuant to regulations prescribed under section 6302. For information regarding the making of deposits by electronic funds transfer, see section 6302(h) and the regulations thereunder.

(c) *Mailing requirements*—(1) *In general.* Section 7502(e) does not apply unless the deposit is mailed in accordance with the requirements of paragraph (c)(2) of this section.

(2) *Requirements.* The date of mailing must fall on or before the second day preceding the prescribed date for making a deposit (including any extension of time granted for making the deposit). For example, if a deposit is due on or before January 15, the date of mailing must fall on or before January 13. The deposit must be contained in an envelope or other appropriate wrapper approved for use in the mails by the U.S. Postal Service, properly addressed to the bank, trust company, domestic building and loan association, or credit union authorized to receive the deposit. The deposit must be deposited with sufficient postage prepaid on or before the second day in the mail in the United States within the meaning of §301.7502–1.

(3) *Registered and certified mail.* The provisions of §301.7502–1(c)(2) apply to a deposit sent by U.S. registered mail or U.S. certified mail as if the deposit were a payment, except that the date of registration or the date of the postmark on the sender's receipt is considered the date of mailing of such deposit.

(d) *Delivery.* Section 7502(e) does not apply unless a deposit is actually delivered by U.S. mail to the authorized financial institution with which the deposit is required to be made and is accepted by that financial institution. For rules relating to the acceptance of deposits by authorized financial institutions (see 31 CFR 203.18). The fact that a deposit is sent by U.S. registered or U.S. certified mail does not constitute prima facie evidence that the deposit was delivered to the financial institution authorized to receive the deposit. Section 7502(e) does not apply unless the deposit is delivered after the date prescribed for making the deposit.

(e) Effective date. This section applies to all deposits required to be made after January 15, 1999.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on January 14, 1999, 8:45 a.m., and published in the issue of the Federal Register for January 15, 1999, 64 F.R. 2606)

Announcement Relating to Court Decisions; Correction

Announcement 99–17

The Announcement Relating to Court Decisions in the 1999–4 I.R.B., dated January 25, 1999, contains an error. On page 4, in column 3, in the last paragraph, the statement "The Commissioner WITHDRAWS the following decision" is incorrect. The statement should have read "The Commissioner WITHDRAWS the Action on Decision written in response to the following decision:"

Definition of Terms

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

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

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

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

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

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

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

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

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

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

Abbreviations

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

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

Numerical Finding List[1]

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Key to Abbreviations:

RR	Revenue Ruling
RP	Revenue Procedure
TD	Treasury Decision
CD	Court Decision
PL	Public Law
EO	Executive Order
DO	Delegation Order
TDO	Treasury Department Order
TC	Tax Convention
SPR	Statement of Procedural Rules
PTE	Prohibited Transaction Exemption

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