**Internal Revenue**
# bulletin

**Bulletin No. 2004-49**
**December 6, 2004**

## HIGHLIGHTS OF THIS ISSUE

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

## INCOME TAX

### Rev. Rul. 2004–106, page 893.

**Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate.** For purposes of sections 382, 642, 1274, 1288, and other sections of the Code, tables set forth the rates for December 2004.

### REG–155608–02, page 924.

Proposed regulations provide updated guidance on tax-shelter annuities, custodial accounts of public schools and section 501(c)(3) tax-exempt organizations and church retirement income accounts authorized under section 403(b) of the Code. These regulations would provide the public with guidance necessary to comply with the law and affect sponsors of section 403(b) contracts, administrators, participants, and beneficiaries. A public hearing is scheduled for February 15, 2005.

### Notice 2004–79, page 898.

This notice provides guidance regarding the definition of dependent under section 106 of the Code.

### Rev. Proc. 2004–69, page 906.

**Insurance companies; loss reserves; discounting unpaid losses.** The loss payment patterns and discount factors are set forth for the 2004 accident year. These factors will be used to compute discounted unpaid losses under section 846 of the Code.

### Rev. Proc. 2004–70, page 918.

**Insurance companies; discounted estimated salvage recoverable.** The salvage discount factors are set forth for the 2004 accident year. These factors will be used to compute discounted estimated salvage recoverable under section 832 of the Code.

## EMPLOYEE PLANS

### REG–155608–02, page 924.

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## EXEMPT ORGANIZATIONS

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## EMPLOYMENT TAX

### T.D. 9159, page 895.

Temporary regulations define the term “salary reduction agreement” for purposes of section 3121(a)(5)(D) of the Code.

**(Continued on the next page)**

**Announcements of Disbarments and Suspensions begin on page 951.**
**Finding Lists begin on page ii.**

Department of the Treasury
**Internal Revenue Service**

**REG–155608–02, page 924.**
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## ADMINISTRATIVE

**Rev. Proc. 2004–64, page 898.**
**Optional standard mileage rates.** This procedure announces 40.5 cents as the optional rate for deducting or accounting for expenses for business use of an automobile, 14 cents as the optional rate for use of an automobile as a charitable contribution, and 15 cents as the optional rate for use of an automobile as a medical or moving expense for 2005. It provides rules for substantiating the deductible expenses of using an automobile for business, moving, medical, or charitable purposes. Rev. Proc. 2003–76 superseded.

**Announcement 2004–97, page 957.**
This document contains corrections to Rev. Rul. 2003–84, 2003–32 I.R.B. 289 and 2003–2 C.B. 289, relating to regulated investment companies. Rev. Rul. 2003–84 corrected.

# The IRS Mission

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

# Introduction

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

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

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

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

The Bulletin is divided into four parts as follows:

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

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

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

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

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

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

## Section 42.—Low-Income Housing Credit

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 2004. See Rev. Rul. 2004-106, page 893.

## Section 62.—Adjusted Gross Income Defined

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

Rules are provided under which a reimbursement or other expense allowance arrangement for the cost of operating an automobile for business purposes will satisfy the requirements of section 62(c) of the Code as to business connection, substantiation, and returning amounts in excess of expenses. See Rev. Proc. 2004-64, page 898.

## Section 106.—Contributions by Employer to Accident and Health Plans

A notice provides guidance regarding the effect of the Working Families Tax Relief Act of 2004 (WFTRA) on the exclusion from the gross income of an employee under § 106 of the Code. See Notice 2004-79, page 898.

## Section 162.—Trade or Business Expenses

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

Rules are provided for substantiating the amount of a deduction or an expense for business use of an automobile. See Rev. Proc. 2004-64, page 898.

## Section 170.—Charitable, etc., Contributions and Gifts

*26 CFR 1.170A–1: Charitable, etc., contributions and gifts; allowance of deduction.*

Rules are provided for substantiating the amount of a deduction or an expense for charitable use of an automobile. See Rev. Proc. 2004-64, page 898.

## Section 213.—Medical, Dental, etc., Expenses

*26 CFR 1.213–1: Medical, dental, etc., expenses.*

Rules are provided for substantiating the amount of a deduction or an expense for use of an automobile to obtain medical services. See Rev. Proc. 2004-64, page 898.

## Section 217.—Moving Expenses

*26 CFR 1.217–2: Moving expenses*

Rules are provided for substantiating the amount of a deduction or an expense for use of an automobile as part of a move. See Rev. Proc. 2004-64, page 898.

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

*26 CFR 1.274–5: Substantiation requirements.*

Rules are provided for substantiating the amount of ordinary and necessary business expenses of an employee for automobile expenses when a payor provides a mileage allowance for the expenses. Rules are also provided for employees and self-employed individuals to use in substantiating a trade or business deduction for automobile expenses. See Rev. Proc. 2004-64, page 898.

## Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of December 2004. See Rev. Rul. 2004-106, page 893.

## Section 382.—Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change

The adjusted applicable federal long-term rate is set forth for the month of December 2004. See Rev. Rul. 2004-106, page 893.

## Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 2004. See Rev. Rul. 2004-106, page 893.

## Section 467.—Certain Payments for the Use of Property or Services

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 2004. See Rev. Rul. 2004-106, page 893.

## Section 468.—Special Rules for Mining and Solid Waste Reclamation and Closing Costs

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 2004. See Rev. Rul. 2004-106, page 893.

## Section 482.—Allocation of Income and Deductions Among Taxpayers

Federal short-term, mid-term, and long-term rates are set forth for the month of December 2004. See Rev. Rul. 2004-106, page 893.

## Section 483.—Interest on Certain Deferred Payments

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 2004. See Rev. Rul. 2004-106, page 893.

## Section 642.—Special Rules for Credits and Deductions

Federal short-term, mid-term, and long-term rates are set forth for the month of December 2004. See Rev. Rul. 2004-106, page 893.

## Section 807.—Rules for Certain Reserves

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 2004. See Rev. Rul. 2004-106, page 893.

## Section 832.—Insurance Company Taxable Income

*26 CFR 1.832–4: Gross income.*

The salvage discount factors are set forth for 2004. These factors must be used to compute discounted estimated salvage recoverable for purposes of section 832 of the Code. See Rev. Proc. 2004-70, page 918.

## Section 846.—Discounted Unpaid Losses Defined

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 2004. See Rev. Rul. 2004-106, page 893.

*26 CFR 1.846–1: Application of discount factors.*

The loss payment patterns and discount factors are set forth for the 2004 accident year. These factors will be used for computing discounted unpaid losses under section 846 of the Code. See Rev. Proc. 2004-69, page 906.

*26 CFR 1.846–1: Application of discount factors.*

The salvage discount factors are set forth for the 2004 accident year. These factors will be used for computing estimated salvage recoverable for purposes of section 832 of the Code. See Rev. Proc. 2004-70, page 918.

## Section 1016.—Adjustments to Basis

*26 CFR 1.1016–3: Exhaustion, wear and tear, obsolescence, amortization, and depletion for periods since February 28, 1913.*

Rules are provided for reduction of basis for business use of an automobile under either the optional standard mileage rate method or a mileage allowance under a reimbursement or other expense allowance arrangement. See Rev. Proc. 2004-64, page 898.

## Section 1274.—Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

*(Also Sections 42, 280G, 382, 412, 467, 468, 482, 483, 642, 807, 846, 1288, 7520, 7872.)*

**Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate.** For purposes of sections 382, 642, 1274, 1288, and other sections of the Code, tables set forth the rates for December 2004.

## Rev. Rul. 2004–106

This revenue ruling provides various prescribed rates for federal income tax purposes for December 2004 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520. Finally, Table 6 contains the 2005 interest rate for sections 846 and 807.

REV. RUL. 2004–106 TABLE 1

Applicable Federal Rates (AFR) for December 2004

| | *Period for Compounding* | | | |
|---|---|---|---|---|
| | *Annual* | *Semiannual* | *Quarterly* | *Monthly* |
| *Short-term* | | | | |
| AFR | 2.48% | 2.46% | 2.45% | 2.45% |
| 110% AFR | 2.73% | 2.71% | 2.70% | 2.69% |
| 120% AFR | 2.97% | 2.95% | 2.94% | 2.93% |
| 130% AFR | 3.23% | 3.20% | 3.19% | 3.18% |
| *Mid-term* | | | | |
| AFR | 3.56% | 3.53% | 3.51% | 3.50% |
| 110% AFR | 3.92% | 3.88% | 3.86% | 3.85% |
| 120% AFR | 4.28% | 4.24% | 4.22% | 4.20% |
| 130% AFR | 4.64% | 4.59% | 4.56% | 4.55% |
| 150% AFR | 5.37% | 5.30% | 5.27% | 5.24% |
| 175% AFR | 6.28% | 6.18% | 6.13% | 6.10% |
| *Long-term* | | | | |
| AFR | 4.68% | 4.63% | 4.60% | 4.59% |
| 110% AFR | 5.15% | 5.09% | 5.06% | 5.04% |
| 120% AFR | 5.64% | 5.56% | 5.52% | 5.50% |
| 130% AFR | 6.11% | 6.02% | 5.98% | 5.95% |

REV. RUL. 2004–106 TABLE 2

Adjusted AFR for December 2004

*Period for Compounding*

| | *Annual* | *Semiannual* | *Quarterly* | *Monthly* |
|---|---|---|---|---|
| Short-term adjusted AFR | 1.88% | 1.87% | 1.87% | 1.86% |
| Mid-term adjusted AFR | 2.84% | 2.82% | 2.81% | 2.80% |
| Long-term adjusted AFR | 4.19% | 4.15% | 4.13% | 4.11% |

REV. RUL. 2004–106 TABLE 3

Rates Under Section 382 for December 2004

| | |
|---|---|
| Adjusted federal long-term rate for the current month | 4.19% |
| Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.) | 4.27% |

REV. RUL. 2004–106 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for December 2004

| | |
|---|---|
| Appropriate percentage for the 70% present value low-income housing credit | 7.96% |
| Appropriate percentage for the 30% present value low-income housing credit | 3.41% |

REV. RUL. 2004–106 TABLE 5

Rate Under Section 7520 for December 2004

| | |
|---|---|
| Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest | 4.20% |

REV. RUL. 2004–106 TABLE 6

| | |
|---|---|
| Applicable rate of interest for 2005 for purposes of sections 846 and 807 | 4.44% |

## Section 1288.—Treatment of Original Issue Discount on Tax-Exempt Obligations

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 2004. See Rev. Rul. 2004-106, page 893.

## Section 3121.—Definitions

*26 CFR 31.3121(a)(5)–2T: Payments under or to an annuity contract described in section 403(b) (temporary).*

## T.D. 9159

## DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 31

## Payments Made by Reason of a Salary Reduction Agreement

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulation.

SUMMARY: This document contains a temporary regulation that defines the term "salary reduction agreement" for purposes of section 3121(a)(5)(D) of the Internal Revenue Code (Code). The temporary regulation provides guidance to employers (public educational institutions and section 501(c)(3) organizations) purchasing annuity contracts described in section 403(b) on behalf of their employees. The text of the temporary regulation also serves as the text of the proposed regulation (REG–155608–02) set forth in the notice of proposed rulemaking on this subject in this issue of the Bulletin.

DATES: *Effective Date*: This regulation is effective on November 16, 2004.

*Applicability Date*: For dates of applicability, see §31.3121(a)(5)–2T(b).

FOR FURTHER INFORMATION CONTACT: Neil D. Shepherd, (202) 622–6040 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

**Background**

This temporary regulation amends the Employment Tax Regulations (26 CFR part 31) by providing guidance relating to section 3121(a)(5)(D). The Federal Insurance Contributions Act (FICA) imposes taxes on employees and employers equal to a percentage of the wages received with respect to employment. Code section 3121(a) defines wages for FICA tax purposes as all remuneration for employment unless otherwise excepted. Code section 3121(a)(5)(D), added by the Social Security Amendments of 1983 (Public Law 98–21 (97 Stat. 65)), generally excepts from wages payments made by an employer for the purchase of an annuity contract described in section 403(b). In a codification of long–standing administrative practice, however, section 3121(a)(5)(D) expressly excludes from the exception payments made by reason of a salary reduction agreement (whether evidenced by a written instrument or otherwise). *See* Rev. Rul. 65–208, 1965–2 C.B. 383, and S. Rep. No. 98–23, at 41, 98th Cong., 1st Sess. (1983). This temporary regulation defines the term "salary reduction agreement" for purposes of section 3121(a)(5)(D).

**Explanation of Provisions**

The FICA taxation of payments made by an employer for the purchase of annuity contracts described in section 403(b) has been shaped by a congressional concern for the social security revenue base and for employees' social security benefits. In the context of contributions for the purchase of such annuity contracts, Congress has interpreted the term "wages" for FICA tax purposes more broadly than the term "gross income" for income tax purposes. *See* S. Rep. No. 98–23, at 39, 98th Cong., 1st Sess. (1983) relating to the Social Security Amendments of 1983 (Public Law 98–21 (97 Stat. 65)).

An amount is generally includible in wages for FICA tax purposes at the time it is actually or constructively paid by the employer and received by the employee. Additionally, wages generally include an amount that an employer contributes to a plan only if the employee agrees to reduce his or her compensation. For income tax purposes, however, section 403(b) provides an exclusion from gross income for contributions made by an employer, including contributions made pursuant to a cash or deferred election or other salary reduction agreement. *See* section 1450(a) of the Small Business Job Protection Act of 1996 (Public Law 104–188 (110 Stat. 1755)). Conversely, for FICA tax purposes, wages include contributions made by an employer to a section 403(b) contract pursuant to a cash or deferred election or other salary reduction agreement. *See* S. Rep. No. 98–23, at 40–41, 98th Cong., 1st Sess. (1983). Thus, while section 403(b) excludes from gross income contributions made pursuant to certain cash or deferred elections, such contributions are made by reason of a salary reduction agreement under section 3121(a)(5)(D) and are included in wages for FICA tax purposes. Consequently, this temporary regulation explicitly provides that the term "salary reduction agreement" includes a plan or arrangement whereby a payment will be made if the employee elects to reduce his or her compensation pursuant to a cash or deferred election as defined at §1.401(k)–1(a)(3) of the Income Tax Regulations.

Pursuant to regulation §1.401(k)–1(a)(3)(iv) of this chapter, a cash or deferred election does not include a one-time irrevocable election made upon an employee's commencement of employment with the employer. Similarly, pursuant to section 402(g)(3), while the term "elective deferrals" generally includes any employer contribution to purchase an annuity contract under section 403(b) under a salary reduction agreement (within the meaning of section 3121(a)(5)(D)), an employer contribution made pursuant to a one-time irrevocable election is not treated as an elective deferral. *See* H.R. Rep. No. 100–795, at 145, 100th Cong., 2d Sess. (1988) and S. Rep. No. 100–445, at 151, 100th Cong., 2d Sess. (1988) relating to the amendment of section 402(g)(3) by the Technical and Miscellaneous Revenue Act of 1988 (Public Law 100–647 (102 Stat. 3342)). Notwithstanding that section 403(b) contributions made pursuant to a one-time irrevocable election are excluded from cash or deferred elections under section 401(k) and from elective deferrals under section 402(g)(3), such contributions are made pursuant to a salary reduction agreement. If the employee had not made a one-time irrevocable election, the employer's cash payment to the employee would be includible in the employee's gross income and in wages for FICA tax purposes. Consequently, this temporary regulation explicitly provides that the term "salary reduction agreement" includes a plan or arrangement whereby a payment will be made if the employee elects to

reduce his or her compensation pursuant to a one-time irrevocable election made at or before the time of initial eligibility to participate in such plan or arrangement (or pursuant to a similar arrangement involving a one-time irrevocable election).

A contribution that is made as a condition of employment and that reduces an employee's compensation generally constitutes an employee contribution includible in wages for FICA tax purposes. *See* section 1015 of the Employee Retirement Income Security Act of 1974 (Public Law 93–406 (88 Stat. 829)) relating to amounts designated as employee contributions under section 414(h) of the Code; *see also* H.R. Rep. No. 93–807, at 145, 93d Cong., 2d Sess. (1974) wherein Congress stated that "[u]nder present law, contributions which are designated as employee contributions are generally treated as employee contributions for purposes of the Federal tax law." Code section 414(h)(1) merely codified the existing administrative and judicial treatment of amounts designated as employee contributions. *See*, for example, *Howell v. United States*, 775 F.2d 887 (7th Cir. 1985) holding that mandatory contributions to a state retirement plan of amounts designated as employee contributions and withheld from the employee's salary are employee contributions includible in the employee's gross income. Thus, as with employer contributions made pursuant to cash or deferred elections and one-time irrevocable elections, employer contributions that are made as a condition of employment and in lieu of mandatory employee contributions and that reduce an employee's compensation are amounts otherwise includible in wages for FICA tax purposes.

Whether a contribution that reduces an employee's compensation is required by statute, contract, or otherwise, an employee implicitly agrees to the contribution as a condition of employment. The acceptance of employment and the subsequent performance of services manifests the employee's agreement to the contribution. *See* H.R. Conf. Rep. No. 98–861, at 1415, 98th Cong., 2d Sess. (1984) relating to the amendment of section 3121(v)(1)(B), wherein Congress stated that "[t]he conferees intend that the term salary reduction agreement also includes any salary reduction arrangement, regardless of whether there is approval or choice of participation by individual employees or whether such approval or choice is mandated by State statute." In *Public Employees' Retirement Board v. Shalala*, 153 F.3rd 1160, at 1166 (10th Cir. 1998), the court noted that "an employee's decision to go to work or continue to work . . . constitutes conduct manifesting assent to a salary reduction." Accordingly, the court held that a designated employee contribution picked up by an employer with a corresponding reduction in the employee's gross salary constitutes a contribution made pursuant to a salary reduction agreement. Similarly, this temporary regulation explicitly provides that the term "salary reduction agreement" includes a plan or arrangement whereby a payment will be made if the employee agrees as a condition of employment (whether such condition is set by statute, contract, or otherwise) to make a contribution that reduces the employee's compensation.

**Special Analyses**

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

**Drafting Information**

The principal author of this regulation is Neil D. Shepherd, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury Department participated in its development.

* * * * *

**Amendments to the Regulations**

Accordingly, 26 CFR part 31 is amended as follows:

PART 31—EMPLOYMENT TAXES

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

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

Par. 2. Section 31.3121(a)(5)–2T is added to read as follows:

*§ 31.3121(a)(5)–2T Payments under or to an annuity contract described in section 403(b) (temporary).*

(a) *Salary reduction agreement defined*. For purposes of section 3121(a)(5)(D), the term *salary reduction agreement* means a plan or arrangement (whether evidenced by a written instrument or otherwise) whereby payment will be made by an employer, on behalf of an employee or his or her beneficiary, under or to an annuity contract described in section 403(b)—

(1) If the employee elects to reduce his or her compensation pursuant to a cash or deferred election as defined at §1.401(k)–1(a)(3) of this chapter;

(2) If the employee elects to reduce his or her compensation pursuant to a one-time irrevocable election made at or before the time of initial eligibility to participate in such plan or arrangement (or pursuant to a similar arrangement involving a one-time irrevocable election); or

(3) If the employee agrees as a condition of employment (whether such condition is set by statute, contract, or otherwise) to make a contribution that reduces his or her compensation.

(b) *Effective date*. (1) This section is applicable on November 16, 2004.

(2) The applicability of this section expires on or before November 16, 2007.

Nancy Jardini,
*Acting Deputy Commissioner for Services and Enforcement.*

Approved November 1, 2004.

Gregory Jenner,
*Acting Assistant Secretary of the Treasury.*

(Filed by the Office of the Federal Register on November 15, 2004, 8:45 a.m., and published in the issue of the Federal Register for November 16, 2004, 69 F.R. 67054)

## Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 2004. See Rev. Rul. 2004-106, page 893.

## Section 7872.—Treatment of Loans With Below-Market Interest Rates

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 2004. See Rev. Rul. 2004-106, page 893.

# Part III. Administrative, Procedural, and Miscellaneous

## Effect of the Working Families Tax Relief Act of 2004 on Employer-Provided Accident or Health Plans

## Notice 2004–79

I. *PURPOSE*

This notice provides guidance regarding the effect of the Working Families Tax Relief Act of 2004 (WFTRA), Pub. L. No. 108–311, 118 Stat. 1166, on the exclusion from the gross income of an employee under § 106 of the Internal Revenue Code (Code) of employer-provided coverage under an accident or health plan.

II. *BACKGROUND*

Section 201 of WFTRA amended the definition of dependent in § 152, effective for taxable years beginning after December 31, 2004. Pursuant to § 152, as amended, an individual must be either a "qualifying child" or a "qualifying relative" to be a dependent. Section 152(c), as amended, provides that an individual must meet relationship, residency, and age requirements to be a qualifying child. In addition, an individual is not a qualifying child if the individual provided over one-half of his or her own support for the calendar year. Section 152(c)(3)(A) provides that an individual meets the age requirement if the individual has not attained age 19 as of the close of the calendar year or if the individual is a student who has not attained age 24 as of the close of the calendar year. Under § 152(c)(3)(B), an individual is treated as meeting the age requirement if the individual is permanently and totally disabled (as defined in § 22(e)(3)) at any time during the calendar year.

Section 152(d)(1), as amended, provides, in general, that a qualifying relative is an individual who bears a relationship to the taxpayer described in §152(d)(2), whose gross income is less than the exemption amount (as defined in § 151(d)), who receives over one-half of his or her support from the taxpayer, and who is not a qualifying child of the taxpayer or any other taxpayer.

Section 207 of WFTRA contains several technical and conforming amendments to Code sections that refer to the § 152 definition of dependent, including an amendment to § 105(b). Section 105(b) generally excludes from an employee's gross income employer-provided medical care reimbursements paid directly or indirectly to the employee for the medical care of the employee and the employee's spouse and dependents, as defined in § 152. Under the WFTRA amendment to § 105(b), an individual's status as a dependent for purposes of § 105(b) will be determined without regard to new § 152(b)(1) and (b)(2), which contain certain exceptions to the definition of dependent, and without regard to new § 152(d)(1)(B), which contains the gross income limitation for a qualifying relative. It appears that the intent of Congress in making these conforming amendments was to generally maintain the current law definition of dependent for purposes of employer-provided medical care reimbursements.

Section 106(a) provides that the gross income of an employee does not include employer-provided coverage under an accident or health plan. Thus, premiums and other amounts that an employer pays on behalf of an employee to an accident or health plan are not included in gross income. Treas. Reg. § 1.106–1 provides that the exclusion from gross income extends to contributions which the employer makes to an accident or health plan on behalf of the employee and the employee's spouse or dependents, as defined in § 152. Because the reference to "dependents" under § 106 appears only in the regulations under that section and not in the statute itself, Congress made no conforming amendments to § 106 in WFTRA.

Under current law, the exclusion under § 106(a) for employer-provided coverage under an accident or health plan parallels the exclusion under § 105(b) for employer-provided reimbursements of medical care expenses incurred by the employee and the employee's spouse and dependents, as defined in § 152. However, as a result of the changes made by WFTRA, the definition of dependent in § 105(b) differs from the definition in the regulations under § 106(a). Accordingly, if the regulations under § 106(a) continued to be applied as currently written after the effective date of section 201 of WFTRA, the value of employer-provided coverage for an individual who is not a qualifying child and who does not meet the gross income limitation for a qualifying relative would have to be included in the employee's gross income. Because, in general, the intent of Congress was not to change the definition of dependent for purposes of employer-provided health plans, regulations under § 106 should be revised to provide that the same definition of dependent applies to § 106 as applies to amended § 105(b).

III. *APPLICATION*

The IRS intends to revise the regulations at 26 C.F.R. 1.106–1 to provide that the term "dependent" for purposes of § 106 shall have the same meaning as in § 105(b). The revised regulations will be effective for taxable years beginning after December 31, 2004.

Taxpayers may rely on this notice pending the issuance of the revised regulations. Accordingly, an employee may exclude from gross income the value of employer-provided coverage for an individual who meets the definition of a qualifying relative except that the individual's gross income equals or exceeds the exemption amount.

DRAFTING INFORMATION

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

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*26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.*
*(Also Part I, Sections 62, 162, 170, 213, 217, 274, 1016; 1.62–2, 1.162–17, 1.170A–1, 1.213–1, 1.217–2, 1.274–5, 1.1016–3.)*

## Rev. Proc. 2004–64

SECTION 1. PURPOSE

This revenue procedure updates Rev. Proc. 2003–76, 2003–2 C.B. 924, by providing optional standard mileage rates for

employees, self-employed individuals, or other taxpayers to use in computing the deductible costs of operating an automobile for business, charitable, medical, or moving expense purposes. This revenue procedure also provides rules under which the amount of ordinary and necessary expenses of local travel or transportation away from home that are paid or incurred by an employee will be deemed substantiated under § 1.274–5 of the Income Tax Regulations if a payor (the employer, its agent, or a third party) provides a mileage allowance under a reimbursement or other expense allowance arrangement to pay for the expenses. Use of a method of substantiation described in this revenue procedure is not mandatory and a taxpayer may use actual allowable expenses if the taxpayer maintains adequate records or other sufficient evidence for proper substantiation.

SECTION 2. SUMMARY OF STANDARD MILEAGE RATES

.01 Standard mileage rates.

| | |
|---|---|
| (1) Business (section 5 below) | 40.5 cents per mile |
| (2) Charitable (section 7 below) | 14 cents per mile |
| (3) Medical and moving (section 7 below) | 15 cents per mile |

.02 *Determination of standard mileage rates*. The business, medical, and moving standard mileage rates reflected in this revenue procedure are based on an annual study of the fixed and variable costs of operating an automobile conducted on behalf of the Internal Revenue Service by an independent contractor, and the charitable standard mileage rate is provided in § 170(i) of the Internal Revenue Code.

SECTION 3. BACKGROUND AND CHANGES

.01 Section 162(a) allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Under that provision, an employee or self-employed individual may deduct the cost of operating an automobile to the extent that it is used in a trade or business. However, under § 262, no portion of the cost of operating an automobile that is attributable to personal use is deductible.

.02 Section 274(d) provides, in part, that no deduction is allowed under § 162 with respect to any listed property (as defined in § 280F(d)(4) to include passenger automobiles and any other property used as a means of transportation) unless the taxpayer complies with certain substantiation requirements. Section 274(d) further provides that regulations may prescribe that some or all of the substantiation requirements do not apply to an expense that does not exceed an amount prescribed by the regulations.

.03 Section 1.274–5(j), in part, grants the Commissioner of Internal Revenue the authority to establish a method under which a taxpayer may use mileage rates to substantiate, for purposes of § 274(d), the amount of the ordinary and necessary expenses of using a vehicle for local transportation and transportation to, from, and at the destination while traveling away from home.

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

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

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

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

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

Section 62(c) further provides that the substantiation requirements described therein do not apply to any expense to the extent that, under the grant of regulatory authority prescribed in § 274(d), the Commissioner has provided that substantiation is not required for the expense.

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

of the allowance that relates to miles of travel not substantiated.

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

.09 Under § 1.62–2(h)(2)(i)(B)(4), the Commissioner may, in his or her discretion, prescribe special rules regarding the timing of withholding and payment of employment taxes on mileage allowances.

.10 Section 5.06(1) of this revenue procedure revises the limitation on simultaneous use of multiple automobiles to allow a taxpayer using up to four vehicles simultaneously to use the standard mileage rate.

## SECTION 4. DEFINITIONS

.01 *Standard mileage rate*. The term "standard mileage rate" means the applicable amount provided by the Service for optional use by employees or self-employed individuals in computing the deductible costs of operating automobiles (including vans, pickups, or panel trucks) they own or lease for business purposes, or by taxpayers in computing the deductible costs of operating automobiles for charitable, medical, or moving expense purposes.

.02 *Transportation expenses*. The term "transportation expenses" means the expenses of operating an automobile for local travel or transportation away from home.

.03 *Mileage allowance*. The term "mileage allowance" means a payment under a reimbursement or other expense allowance arrangement that meets the requirements specified in § 1.62–2(c)(1) and that is:

(1) paid with respect to the ordinary and necessary business expenses incurred, or that the payor reasonably anticipates will be incurred, by an employee for transportation expenses in connection with the performance of services as an employee of the employer,

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

(3) paid at the applicable standard mileage rate, a flat rate or stated schedule, or in accordance with any other Service-specified rate or schedule.

.04 *Flat rate or stated schedule*. A mileage allowance is paid at a flat rate or stated schedule if it is provided on a uniform and objective basis with respect to the expenses described in section 4.03 of this revenue procedure. The allowance may be paid periodically at a fixed rate, at a cents-per-mile rate, at a variable rate based on a stated schedule, at a rate that combines any of these rates, or on any other basis that is consistently applied and in accordance with reasonable business practice. Thus, for example, a periodic payment at a fixed rate to cover the fixed costs (including depreciation (or lease payments), insurance, registration and license fees, and personal property taxes) of driving an automobile in connection with the performance of services as an employee of the employer, coupled with a periodic payment at a cents-per-mile rate to cover the operating costs (including gasoline and all taxes thereon, oil, tires, and routine maintenance and repairs) of using an automobile for those purposes, is an allowance paid at a flat rate or stated schedule. Likewise, a periodic payment at a variable rate based on a stated schedule for different locales to cover the costs of driving an automobile in connection with the performance of services as an employee is an allowance paid at a flat rate or stated schedule.

## SECTION 5. BUSINESS STANDARD MILEAGE RATE

.01 *In general*. The standard mileage rate for transportation expenses is 40.5 cents per mile for all miles of use for business purposes. The Service will adjust the business standard mileage rate (to the extent warranted) annually and prospectively.

.02 *Use of the business standard mileage rate*. A taxpayer may use the business standard mileage rate with respect to an automobile that is either owned or leased by the taxpayer. A taxpayer generally may deduct an amount equal to either the business standard mileage rate times the number of business miles traveled or the actual costs (both operating and fixed) paid or incurred by the taxpayer that are allocable to traveling those business miles.

.03 *Business standard mileage rate in lieu of operating and fixed costs*. A deduction using the standard mileage rate for business miles is computed on a yearly basis and is in lieu of all operating and fixed costs of the automobile allocable to business purposes (except as provided in section 9.06 of this revenue procedure). Items such as depreciation (or lease payments), maintenance and repairs, tires, gasoline (including all taxes thereon), oil, insurance, and license and registration fees are included in operating and fixed costs for this purpose.

.04 *Parking fees, tolls, interest, and taxes*. Parking fees and tolls attributable to use of the automobile for business purposes may be deducted as separate items. Likewise, interest relating to the purchase of the automobile as well as state and local personal property taxes may be deducted as separate items, but only to the extent allowable under § 163 or § 164, respectively. Section 163(h)(2)(A) expressly provides that interest is nondeductible personal interest if it is paid or accrued on indebtedness properly allocable to the trade or business of performing services as an employee. Section 164 expressly provides that state and local taxes that are paid or accrued by a taxpayer in connection with an acquisition or disposition of property will be treated as part of the cost of the acquired property or as a reduction in the amount realized on the disposition of the property. If the automobile is operated less than 100 percent for business purposes, an allocation is required to determine the business and nonbusiness portion of the taxes and interest deduction allowable.

.05 *Depreciation*. For owned automobiles placed in service for business purposes, and for which the business standard mileage rate has been used for any year, depreciation will be considered to have been allowed at the rate of 15 cents

per mile for 2001 and 2002, 16 cents per mile for 2003 and 2004, and 17 cents per mile for 2005, for those years in which the business standard mileage rate was used. If actual costs were used for one or more of those years, the rates above will not apply to any year in which the costs were used. The depreciation described above will reduce the basis of the automobile (but not below zero) in determining adjusted basis as required by § 1016.

.06 *Limitations*.

(1) The business standard mileage rate may not be used to compute the deductible expenses of (a) automobiles used for hire, such as taxicabs, or (b) five or more automobiles owned or leased by a taxpayer and used simultaneously (such as in fleet operations).

(2) The business standard mileage rate may not be used to compute the deductible business expenses of an automobile leased by a taxpayer unless the taxpayer uses either the business standard mileage rate or a FAVR allowance (as provided in section 8 of this revenue procedure) to compute the deductible business expenses of the automobile for the entire lease period (including renewals). For a lease commencing on or before December 31, 1997, the "entire lease period" means the portion of the lease period (including renewals) remaining after that date.

(3) The business standard mileage rate may not be used to compute the deductible expenses of an automobile for which the taxpayer has (a) claimed depreciation using a method other than straight-line for its estimated useful life, (b) claimed a § 179 deduction, or (c) used the Accelerated Cost Recovery System under former § 168 or the Modified Accelerated Cost Recovery System (MACRS) under current § 168. By using the business standard mileage rate, the taxpayer has elected to exclude the automobile (if owned) from MACRS pursuant to § 168(f)(1). If, after using the business standard mileage rate, the taxpayer uses actual costs, the taxpayer must use straight-line depreciation for the automobile's remaining estimated useful life (subject to the applicable depreciation deduction limitations under § 280F).

(4) The business standard mileage rate and this revenue procedure may not be used to compute the amount of the deductible automobile expenses of an employee of the United States Postal Service incurred in performing services involving the collection and delivery of mail on a rural route if the employee receives qualified reimbursements (as defined in § 162(o)) for the expenses. *See* § 162(o) for the rules that apply to these qualified reimbursements.

## SECTION 6. RESERVED

## SECTION 7. CHARITABLE, MEDICAL, AND MOVING STANDARD MILEAGE RATE

.01 *Charitable*. Section 170(i) provides a standard mileage rate of 14 cents per mile for purposes of computing the charitable deduction for use of an automobile in connection with rendering gratuitous services to a charitable organization under § 170.

.02 *Medical and moving*. The standard mileage rate is 15 cents per mile for use of an automobile (a) to obtain medical care described in § 213, or (b) as part of a move for which the expenses are deductible under § 217. The Service will adjust the medical and moving expense standard mileage rates (to the extent warranted) annually and prospectively.

.03 *Charitable, medical, or moving expense standard mileage rate in lieu of operating expenses*. A deduction computed using the applicable standard mileage rate for charitable, medical, or moving expense miles is in lieu of all operating expenses (including gasoline and oil) of the automobile allocable to those purposes. Costs for items such as depreciation (or lease payments), insurance, and license and registration fees are not deductible, and are not included in the standard mileage rates.

.04 *Parking fees, tolls, interest, and taxes.* Parking fees and tolls attributable to the use of the automobile for charitable, medical, or moving expense purposes may be deducted as separate items. Interest relating to the purchase of the automobile and state and local personal property taxes are not deductible as charitable, medical, or moving expenses, but they may be deducted as separate items to the extent allowable under § 163 or § 164, respectively.

## SECTION 8. FIXED AND VARIABLE RATE ALLOWANCE

.01 *In general.*

(1) The ordinary and necessary expenses paid or incurred by an employee in driving an automobile owned or leased by the employee in connection with the performance of services as an employee of the employer will be deemed substantiated (in an amount determined under section 9 of this revenue procedure) when a payor reimburses those expenses with a mileage allowance using a flat rate or stated schedule that combines periodic fixed and variable rate payments that meet all the requirements of section 8 of this revenue procedure (a FAVR allowance).

(2) The amount of a FAVR allowance must be based on data that (a) is derived from the base locality, (b) reflects retail prices paid by consumers, and (c) is reasonable and statistically defensible in approximating the actual expenses employees receiving the allowance would incur as owners of the standard automobile.

.02 *Definitions*.

(1) *FAVR allowance*. A FAVR allowance includes periodic fixed payments and periodic variable payments. A payor may maintain more than one FAVR allowance. A FAVR allowance that uses the same payor, standard automobile (or an automobile of the same make and model that is comparably equipped), retention period, and business use percentage is considered one FAVR allowance, even though other features of the allowance may vary. A FAVR allowance also includes any optional high mileage payments; however, optional high mileage payments are included in the employee's gross income, are reported as wages or other compensation on the employee's Form W–2, and are subject to withholding and payment of employment taxes when paid. See section 9.05 of this revenue procedure. An optional high mileage payment covers the additional depreciation for a standard automobile attributable to business miles driven and substantiated by the employee for a calendar year in excess of the annual business mileage for that year. If an employee is covered by the FAVR allowance for less than the entire calendar year, the annual business mileage may be prorated on a monthly basis for purposes of the preceding sentence.

(2) *Periodic fixed payment*. A periodic fixed payment covers the projected fixed costs (including depreciation (or lease payments), insurance, registration and license

fees, and personal property taxes) of driving the standard automobile in connection with the performance of services as an employee of the employer in a base locality, and must be paid at least quarterly. A periodic fixed payment may be computed by (a) dividing the total projected fixed costs of the standard automobile for all years of the retention period, determined at the beginning of the retention period, by the number of periodic fixed payments in the retention period, and (b) multiplying the resulting amount by the business use percentage.

(3) *Periodic variable payment*. A periodic variable payment covers the projected operating costs (including gasoline and all taxes thereon, oil, tires, and routine maintenance and repairs) of driving a standard automobile in connection with the performance of services as an employee of the employer in a base locality, and must be paid at least quarterly. The rate of a periodic variable payment for a computation period may be computed by dividing the total projected operating costs for the standard automobile for the computation period, determined at the beginning of the computation period, by the computation period mileage. A computation period can be any period of a year or less. Computation period mileage is the total mileage (business and personal) a payor reasonably projects a standard automobile will be driven during a computation period and equals the retention mileage divided by the number of computation periods in the retention period. For each business mile substantiated by the employee for the computation period, the periodic variable payment must be paid at a rate that does not exceed the rate for that computation period.

(4) *Base locality*. A base locality is the particular geographic locality or region of the United States in which the costs of driving an automobile in connection with the performance of services as an employee of the employer are generally paid or incurred by the employee. Thus, for purposes of determining the amount of fixed costs, the base locality is generally the geographic locality or region in which the employee resides. For purposes of determining the amount of operating costs, the base locality is generally the geographic locality or region in which the employee drives the automobile in connection with the performance of services as an employee of the employer.

(5) *Standard automobile*. A standard automobile is the automobile selected by the payor on which a specific FAVR allowance is based.

(6) *Standard automobile cost*. The standard automobile cost for a calendar year may not exceed 95 percent of the sum of (a) the retail dealer invoice cost of the standard automobile in the base locality, and (b) state and local sales or use taxes applicable on the purchase of the automobile. Further, the standard automobile cost may not exceed $27,600.

(7) *Annual mileage*. Annual mileage is the total mileage (business and personal) a payor reasonably projects a standard automobile will be driven during a calendar year. Annual mileage equals the annual business mileage divided by the business use percentage.

(8) *Annual business mileage*. Annual business mileage is the mileage a payor reasonably projects a standard automobile will be driven by an employee in connection with the performance of services as an employee of the employer during the calendar year, but may not be less than 6,250 miles for a calendar year. Annual business mileage equals the annual mileage multiplied by the business use percentage.

(9) *Business use percentage*. A business use percentage is determined by dividing the annual business mileage by the annual mileage. The business use percentage may not exceed 75 percent. In lieu of demonstrating the reasonableness of the business use percentage based on records of total mileage and business mileage driven by the employees annually, a payor may use a business use percentage that is less than or equal to the following percentages for a FAVR allowance that is paid for the following annual business mileage:

| *Annual business mileage* | *Business use percentage* |
|---|---|
| 6,250 or more but less than 10,000 | 45 percent |
| 10,000 or more but less than 15,000 | 55 percent |
| 15,000 or more but less than 20,000 | 65 percent |
| 20,000 or more | 75 percent |

(10) *Retention period*. A retention period is the period in calendar years selected by the payor during which the payor expects an employee to drive a standard automobile in connection with the performance of services as an employee of the employer before the automobile is replaced. The period may not be less than two calendar years.

(11) *Retention mileage*. Retention mileage is the annual mileage multiplied by the number of calendar years in the retention period.

(12) *Residual value*. The residual value of a standard automobile is the projected amount for which it could be sold at the end of the retention period after being driven the retention mileage. The Service will accept the following safe harbor residual values for a standard automobile computed as a percentage of the standard automobile cost:

| Retention period | Residual value |
|---|---|
| 2-year | 70 percent |
| 3-year | 60 percent |
| 4-year | 50 percent |

.03 *FAVR allowance in lieu of operating and fixed costs*.

(1) A reimbursement computed using a FAVR allowance is in lieu of the employee's deduction of all the operating and fixed costs paid or incurred by an employee in driving the automobile in connection with the performance of services as an employee of the employer, except as provided in section 9.06 of this revenue procedure. Items such as depreciation (or lease payments), maintenance and repairs, tires, gasoline (including all taxes thereon), oil, insurance, license and registration fees, and personal property taxes are included in operating and fixed costs for this purpose.

(2) Parking fees and tolls attributable to an employee driving the standard automobile in connection with the performance of services as an employee of the employer are not included in fixed and operating costs and may be deducted as separate items. Similarly, interest relating to the purchase of the standard automobile may be deducted as a separate item, but only to the extent that the interest is an allowable deduction under § 163.

.04 *Depreciation*.

(1) A FAVR allowance may not be paid with respect to an automobile for which the employee has (a) claimed depreciation using a method other than straight-line for its estimated useful life, (b) claimed a § 179 deduction, or (c) used the Accelerated Cost Recovery System under former § 168 or the Modified Accelerated Cost Recovery System under current § 168. If an employee uses actual costs for an owned automobile that has been covered by a FAVR allowance, the employee must use straight-line depreciation for the automobile's remaining estimated useful life (subject to the applicable depreciation deduction limitations under § 280F).

(2) Except as provided in section 8.04(3) of this revenue procedure, the total amount of the depreciation component for the retention period taken into account in computing the periodic fixed payments for that retention period may not exceed the excess of the standard automobile cost over the residual value of the standard automobile. In addition, the total amount of the depreciation component may not exceed the sum of the annual § 280F limitations on depreciation (in effect at the beginning of the retention period) that apply to the standard automobile during the retention period.

(3) If the depreciation component of periodic fixed payments exceeds the limitations in section 8.04(2) of this revenue procedure, that section will be treated as satisfied in any year during which the total annual amount of the periodic fixed payments and the periodic variable payments made to an employee driving 80 percent of the annual business mileage of the standard automobile does not exceed the amount obtained by multiplying 80 percent of the annual business mileage of the standard automobile by the applicable business standard mileage rate for that year (under section 5.01 of the applicable revenue procedure).

(4) The depreciation included in each periodic fixed payment portion of a FAVR allowance paid with respect to an automobile will reduce the basis of the automobile (but not below zero) in determining adjusted basis as required by § 1016. See section 8.07(2) of this revenue procedure for the requirement that the employer report the depreciation component of a periodic fixed payment to the employee.

.05 *FAVR allowance limitations*.

(1) A FAVR allowance may be paid only to an employee who substantiates to the payor for a calendar year at least 5,000 miles driven in connection with the performance of services as an employee of the employer or, if greater, 80 percent of the annual business mileage of that FAVR allowance. If the employee is covered by the FAVR allowance for less than the entire calendar year, these limits may be prorated on a monthly basis.

(2) A FAVR allowance may not be paid to a control employee (as defined in § 1.61–21(f)(5) and (6), excluding the $100,000 limitation in paragraph (f)(5)(iii)).

(3) An employer may not pay a FAVR allowance if at any time during a calendar year a majority of the employees covered by the FAVR allowance are management employees.

(4) An employer may not pay a FAVR allowance unless at all times during a calendar year at least five employees of the employer are covered by one or more FAVR allowances.

(5) A FAVR allowance may be paid only with respect to an automobile (a) owned or leased by the employee receiving the payment, (b) the cost of which, when new, is at least 90 percent of the standard automobile cost taken into account for purposes of determining the FAVR allowance for the first calendar year the employee receives the allowance with respect to that automobile, and (c) the model year of which does not differ from the current calendar year by more than the number of years in the retention period.

(6) A FAVR allowance may not be paid with respect to an automobile leased by an employee for which the employee has used actual expenses to compute the deductible business expenses of the automobile for any year during the entire lease period. For a lease commencing on or before December 31, 1997, the "entire lease period" means the portion of the lease period (including renewals) remaining after that date.

(7) The insurance cost component of a FAVR allowance must be based on the rates charged in the base locality for insurance coverage on the standard automobile during the current calendar year without taking into account rate-increasing factors such as poor driving records or young drivers.

(8) A FAVR allowance may be paid only to an employee whose insurance coverage limits on the automobile with respect to which the FAVR allowance is paid are at least equal to the insurance coverage lim-

its used to compute the periodic fixed payment under that FAVR allowance.

.06 *Employee reporting*. Within 30 days after an employee's automobile is initially covered by a FAVR allowance, or is again covered by a FAVR allowance if coverage has lapsed, the employee by written declaration must provide the payor with the following information: (a) the make, model, and year of the employee's automobile, (b) written proof of the insurance coverage limits on the automobile, (c) the odometer reading of the automobile, (d) if owned, the purchase price of the automobile or, if leased, the price at which the automobile is ordinarily sold by retailers (the gross capitalized cost of the automobile), and (e) if owned, whether the employee has claimed depreciation with respect to the automobile using any of the depreciation methods prohibited by section 8.04(1) of this revenue procedure or, if leased, whether the employee has computed deductible business expenses with respect to the automobile using actual expenses. The information described in (a), (b), and (c) of the preceding sentence also must be supplied by the employee to the payor within 30 days after the beginning of each calendar year that the employee's automobile is covered by a FAVR allowance.

.07 *Payor recordkeeping and reporting*.

(1) The payor or its agent must maintain written records setting forth (a) the statistical data and projections on which the FAVR allowance payments are based, and (b) the information provided by the employees pursuant to section 8.06 of this revenue procedure.

(2) Within 30 days of the end of each calendar year, the employer must provide each employee covered by a FAVR allowance during that year with a statement that, for automobile owners, lists the amount of depreciation included in each periodic fixed payment portion of the FAVR allowance paid during that calendar year and explains that by receiving a FAVR allowance the employee has elected to exclude the automobile from the Modified Accelerated Cost Recovery System pursuant to § 168(f)(1). For automobile lessees, the statement must explain that by receiving the FAVR allowance the employee may not compute the deductible business expenses of the automobile using actual expenses for the entire lease period (including renewals). For a lease commencing on or before December 31, 1997, the "entire lease period" means the portion of the lease period (including renewals) remaining after that date.

.08 *Failure to meet section 8 requirements*. If an employee receives a mileage allowance that fails to meet one or more of the requirements of section 8 of this revenue procedure, the employee may not be treated as covered by any FAVR allowance of the payor during the period of the failure. Nevertheless, the expenses to which that mileage allowance relates may be deemed substantiated using the method described in sections 5, 9.01(1), and 9.02 of this revenue procedure to the extent the requirements of those sections are met.

SECTION 9. APPLICATION

.01 If a payor pays a mileage allowance in lieu of reimbursing actual transportation expenses incurred or to be incurred by an employee, the amount of the expenses that is deemed substantiated to the payor is either:

(1) for any mileage allowance other than a FAVR allowance, the lesser of the amount paid under the mileage allowance or the applicable standard mileage rate in section 5.01 of this revenue procedure multiplied by the number of business miles substantiated by the employee; or

(2) for a FAVR allowance, the amount paid under the FAVR allowance less the sum of (a) any periodic variable rate payment that relates to miles in excess of the business miles substantiated by the employee and that the employee fails to return to the payor although required to do so, (b) any portion of a periodic fixed payment that relates to a period during which the employee is treated as not covered by the FAVR allowance and that the employee fails to return to the payor although required to do so, and (c) any optional high mileage payments.

.02 If the amount of transportation expenses is deemed substantiated under the rules provided in section 9.01 of this revenue procedure, and the employee actually substantiates to the payor the elements of time, place (or use), and business purpose of the transportation expenses in accordance with paragraphs (b)(2) (travel away from home) and (b)(6) (listed property, which includes passenger automobiles and any other property used as a means of transportation) of § 1.274–5T, and paragraph (c) of § 1.274–5, the employee is deemed to satisfy the adequate accounting requirements of § 1.274–5(f) as well as the requirement to substantiate by adequate records or other sufficient evidence for purposes of § 1.274–5(c). *See* § 1.62–2(e)(1) for the rule that an arrangement must require business expenses to be substantiated to the payor within a reasonable period of time.

.03 An arrangement providing mileage allowances will be treated as satisfying the requirement of § 1.62–2(f)(2) with respect to returning amounts in excess of expenses as follows:

(1) For a mileage allowance other than a FAVR allowance, the requirement to return excess amounts will be treated as satisfied if the employee is required to return within a reasonable period of time (as defined in § 1.62–2(g)) any portion of the allowance that relates to miles of travel not substantiated by the employee, even though the arrangement does not require the employee to return the portion of the allowance that relates to the miles of travel substantiated and that exceeds the amount of the employee's expenses deemed substantiated. For example, assume a payor provides an employee an advance mileage allowance of $90 based on an anticipated 200 business miles at 45 cents per mile (at a time when the applicable business standard mileage rate is 40.5 cents per mile), and the employee substantiates 120 business miles. The requirement to return excess amounts will be treated as satisfied if the employee is required to return the portion of the allowance that relates to the 80 unsubstantiated business miles ($36) even though the employee is not required to return the portion of the allowance ($5.40) that exceeds the amount of the employee's expenses deemed substantiated under section 9.01 of this revenue procedure ($48.60) for the 120 substantiated business miles. However, the $5.40 excess portion of the allowance is treated as paid under a nonaccountable plan as discussed in section 9.05.

(2) For a FAVR allowance, the requirement to return excess amounts will be treated as satisfied if the employee is required to return within a reasonable period of time (as defined in § 1.62–2(g)), (a) the portion (if any) of the periodic variable

payment received that relates to miles in excess of the business miles substantiated by the employee, and (b) the portion (if any) of a periodic fixed payment that relates to a period during which the employee was not covered by the FAVR allowance.

.04 An employee is not required to include in gross income the portion of a mileage allowance received from a payor that is less than or equal to the amount deemed substantiated under section 9.01 of this revenue procedure, provided the employee substantiates in accordance with section 9.02. *See* § 1.274–5T(f)(2)(i). In addition, that portion of the allowance is treated as paid under an accountable plan, is not reported as wages or other compensation on the employee's Form W–2, and is exempt from withholding and payment of employment taxes. *See* §§ 1.62–2(c)(2) and (c)(4).

.05 An employee is required to include in gross income only the portion of a mileage allowance received from a payor that exceeds the amount deemed substantiated under section 9.01 of this revenue procedure, provided the employee substantiates in accordance with section 9.02 of this revenue procedure. *See* § 1.274–5T(f)(2)(ii). In addition, the excess portion of the allowance is treated as paid under a nonaccountable plan, is reported as wages or other compensation on the employee's Form W–2, and is subject to withholding and payment of employment taxes. *See* §§ 1.62–2(c)(3)(ii), (c)(5), and (h)(2)(i)(B).

.06 If an employee's substantiated expenses are less than the employee's actual expenses, the following rules apply:

(1) Except as otherwise provided in section 9.06(2) of this revenue procedure with respect to leased automobiles, if the amount of the expenses deemed substantiated under the rules provided in section 9.01 of this revenue procedure is less than the amount of the employee's business transportation expenses, the employee may claim an itemized deduction for the amount by which the business transportation expenses exceed the amount that is deemed substantiated, provided the employee substantiates all the business transportation expenses, includes on Form 2106, *Employee Business Expenses*, the deemed substantiated portion of the mileage allowance received from the payor, and includes in gross income the portion (if any) of the mileage allowance received from the payor that exceeds the amount deemed substantiated. *See* § 1.274–5T(f)(2)(iii). However, for purposes of claiming this itemized deduction, substantiation of the amount of the expenses is not required if the employee is claiming a deduction that is equal to or less than the applicable standard mileage rate multiplied by the number of business miles substantiated by the employee minus the amount deemed substantiated under section 9.01 of this revenue procedure. The itemized deduction is subject to the 2-percent floor on miscellaneous itemized deductions provided in § 67.

(2) An employee whose business transportation expenses with respect to a leased automobile are deemed substantiated under section 9.01(1) of this revenue procedure (relating to an allowance other than a FAVR allowance) may not claim a deduction based on actual expenses under section 9.06(1) unless the employee does so consistently beginning with the first business use of the automobile after December 31, 1997. However, an employee whose business transportation expenses with respect to a leased automobile are deemed substantiated under section 9.01(2) of this revenue procedure (relating to a FAVR allowance) may not claim a deduction based on actual expenses.

.07 An employee may deduct an amount computed pursuant to section 5.01 of this revenue procedure only as an itemized deduction. This itemized deduction is subject to the 2-percent floor on miscellaneous itemized deductions provided in § 67.

.08 A self-employed individual may deduct an amount computed pursuant to section 5.01 of this revenue procedure in determining adjusted gross income under § 62(a)(1).

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

SECTION 10. WITHHOLDING AND PAYMENT OF EMPLOYMENT TAXES

.01 The portion of a mileage allowance (other than a FAVR allowance), if any, that relates to the miles of business travel substantiated and that exceeds the amount deemed substantiated for those miles under section 9.01(1) of this revenue procedure is subject to withholding and payment of employment taxes. *See* § 1.62–2(h)(2)(i)(B).

(1) In the case of a mileage allowance paid as a reimbursement, the excess described in section 10.01 of this revenue procedure is subject to withholding and payment of employment taxes in the payroll period in which the payor reimburses the expenses for the business miles substantiated. *See* § 1.62–2(h)(2)(i)(B)(2).

(2) In the case of a mileage allowance paid as an advance, the excess described in section 10.01 of this revenue procedure is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the business miles with respect to which the advance was paid are substantiated. *See* § 1.62–2(h)(2)(i)(B)(3). If some or all of the business miles with respect to which the advance was paid are not substantiated within a reasonable period of time and the employee does not return the portion of the allowance that relates to those miles within a reasonable period of time, the portion of the allowance that relates to those miles is subject to withholding and payment of employment taxes no later than the first payroll period following the end of the reasonable period. *See* § 1.62–2(h)(2)(i)(A).

(3) In the case of a mileage allowance that is not computed on the basis of a fixed amount per mile of travel (for example, a mileage allowance that combines periodic fixed and variable rate payments, but that does not satisfy the requirements of section 8 of this revenue procedure), the payor must compute periodically (no less frequently than quarterly) the amount, if any, that exceeds the amount deemed substantiated under section 9.01(1) of this revenue procedure by comparing the total mileage allowance paid for the period to the applicable standard mileage rate in section

5.01 of this revenue procedure multiplied by the number of business miles substantiated by the employee for the period. Any excess is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the excess is computed. *See* § 1.62–2(h)(2)(i)(B)(4).

(4) For example, assume an employer pays its employees a mileage allowance at a rate of 45 cents per mile (when the business standard mileage rate is 40.5 cents per mile). The employer does not require the return of the portion of the allowance that exceeds the business standard mileage rate for the business miles substantiated (4.5 cents). In June, the employer advances an employee $225 for 500 miles to be traveled during the month. In July, the employee substantiates to the employer 400 business miles traveled in June and returns $45 to the employer for the 100 business miles not traveled. The amount deemed substantiated for the 400 miles traveled is $162 and the employee is not required to return $18. No later than the first payroll period following the payroll period in which the 400 business miles traveled are substantiated, the employer must withhold and pay employment taxes on $18.

.02 The portion of a FAVR allowance, if any, that exceeds the amount deemed substantiated for those miles under section 9.01(2) of this revenue procedure is subject to withholding and payment of employment taxes. *See* § 1.62–2(h)(2)(i)(B).

(1) Any periodic variable rate payment that relates to miles in excess of the business miles substantiated by the employee and that the employee fails to return within a reasonable period, or any portion of a periodic fixed payment that relates to a period during which the employee is treated as not covered by the FAVR allowance and that the employee fails to return within a reasonable period, is subject to withholding and payment of employment taxes no later than the first payroll period following the end of the reasonable period. *See* § 1.62–2(h)(2)(i)(A).

(2) Any optional high mileage payment is subject to withholding and payment of employment taxes when paid.

SECTION 11. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2003–76, 2003–2 C.B. 924, is superseded for mileage allowances that are paid both (1) to an employee on or after January 1, 2005, and (2) with respect to transportation expenses paid or incurred by the employee on or after January 1, 2005. Rev. Proc. 2003–76 is also superseded for purposes of computing the amount allowable as a deduction for transportation expenses paid or incurred on or after January 1, 2005.

DRAFTING INFORMATION

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

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*26 CFR 601.201: Rulings and determination letters. (Also Part I, sections 846; 1.846–1.)*

# Rev. Proc. 2004–69

SECTION 1. PURPOSE

This revenue procedure prescribes the loss payment patterns and discount factors for the 2004 accident year. These factors will be used for computing discounted unpaid losses under § 846 of the Internal Revenue Code. *See* Rev. Proc. 2003–17, 2003–1 C.B. 427, for background concerning the loss payment patterns and application of the discount factors.

SECTION 2. SCOPE

This revenue procedure applies to any taxpayer that is required to discount its unpaid losses under § 846 for a line of business using discount factors published by the Secretary.

SECTION 3. TABLES OF DISCOUNT FACTORS

.01 The following tables present separately for each line of business the discount factors under § 846 for accident year 2004. All the discount factors presented in this section were determined using the applicable interest rate under § 846(c) for 2004, which is 4.82 percent, and by assuming all loss payments occur in the middle of the calendar year.

.02 If the groupings of individual lines of business on the annual statement change, taxpayers must discount the unpaid losses on the affected lines of business in accordance with the discounting patterns that would have applied to those unpaid losses based on their classification on the 2000 annual statement. *See* Rev. Proc. 2003–17, 2003–1 C.B. 427, section 2, for additional background on discounting under section 846 and the use of the Secretary's tables.

.03 Section V of Notice 88–100, 1988–2 C.B. 439, sets forth a composite method for computing discounted unpaid losses for accident years that are not separately reported on the annual statement. The tables separately provide discount factors for taxpayers who elect to use the composite method of section V of Notice 88–100. *See* Rev. Proc. 2002–74, 2002–2 C.B. 980.

.04 Section 2.03(4) of Rev. Proc 2003–17 requested comments as to whether a methodology should be adopted to smooth the raw payment data and thus produce a more stable pattern of discount factors. This issue will be addressed in the new determination year, which is 2007. Accordingly, taxpayers may still submit comments that should include a reference to **Rev. Proc. 2004–69** on this issue to the following address:

CC:PA:LPD (**Rev. Proc. 2004–69**), room 5207, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Comments may be hand delivered between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD (**Rev. Proc. 2004–69**), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224. Alternatively, e-mail comments to *Notice.Comments@irscounsel.treas.gov*. All comments will be available for public inspection and copying.

.05 Tables.

## Tables of Factors to be Used to Discount Unpaid Losses Incurred in Accident Year 2004

**(Interest rate: 4.82 percent)**

### Accident and Health (Other Than Disability Income or Credit Disability Insurance)

Taxpayers that do not use the composite method of Notice 88–100 should use 97.6738 percent to discount unpaid losses incurred in this line of business in the 2004 accident year and that are outstanding at the end of the 2004 and later taxable years.

Taxpayers that use the composite method of Notice 88–100 should use 97.6738 percent to discount all unpaid losses in this line of business that are outstanding at the end of the 2004 taxable year.

### Auto Physical Damage

| Tax Year | Estimated Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Unpaid Losses at Year End (%) | Discounted Unpaid Losses at Year End (%) | Discount Factors (%) |
|---|---|---|---|---|---|
| 2004 | 89.6468 | 89.6468 | 10.3532 | 10.0914 | 97.4716 |
| 2005 | 99.6845 | 10.0377 | 0.3155 | 0.3011 | 95.4281 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factor to discount unpaid losses incurred in this line of business in the 2004 accident year and that are outstanding at the end of the tax year shown.

| | | | | | |
|---|---|---|---|---|---|
| 2006 and later years | | 0.1578 | 0.1578 | 0.1541 | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 97.6738 percent to discount unpaid losses incurred in this line of business in 2004 and prior years and that are outstanding at the end of the 2006 taxable year.

### Commercial Auto/Truck Liability/Medical

| Tax Year | Estimated Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Unpaid Losses at Year End (%) | Discounted Unpaid Losses at Year End (%) | Discount Factors (%) |
|---|---|---|---|---|---|
| 2004 | 28.8244 | 28.8244 | 71.1756 | 64.9524 | 91.2566 |
| 2005 | 54.9871 | 26.1626 | 45.0129 | 41.2974 | 91.7455 |
| 2006 | 72.8039 | 17.8168 | 27.1961 | 25.0467 | 92.0968 |
| 2007 | 85.0572 | 12.2533 | 14.9428 | 13.7089 | 91.7422 |
| 2008 | 91.6276 | 6.5704 | 8.3724 | 7.6427 | 91.2848 |
| 2009 | 94.9514 | 3.3239 | 5.0486 | 4.6081 | 91.2757 |
| 2010 | 97.0453 | 2.0938 | 2.9547 | 2.6865 | 90.9228 |
| 2011 | 98.1574 | 1.1121 | 1.8426 | 1.6774 | 91.0343 |
| 2012 | 98.7370 | 0.5796 | 1.2630 | 1.1649 | 92.2284 |
| 2013 | 99.1070 | 0.3700 | 0.8930 | 0.8422 | 94.3090 |

**Commercial Auto/Truck Liability/Medical**

Taxpayers that do not use the composite method of Notice 88–100 should use the following factors to discount unpaid losses incurred in this line of business in the 2004 accident year and that are outstanding at the end of the tax year shown.

| | | | | | |
|---|---|---|---|---|---|
| 2014 | | 0.3700 | 0.5230 | 0.5040 | 96.3596 |
| 2015 and later years | | 0.3700 | 0.1530 | 0.1495 | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 96.6098 percent to discount unpaid losses incurred in this line of business in 2004 and prior years and that are outstanding at the end of the 2014 taxable year.

**Composite**

| Tax Year | Estimated Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Unpaid Losses at Year End (%) | Discounted Unpaid Losses at Year End (%) | Discount Factors (%) |
|---|---|---|---|---|---|
| 2004 | 40.9985 | 40.9985 | 59.0015 | 52.8260 | 89.5334 |
| 2005 | 65.8439 | 24.8454 | 34.1561 | 29.9351 | 87.6422 |
| 2006 | 77.5023 | 11.6583 | 22.4977 | 19.4420 | 86.4176 |
| 2007 | 84.6221 | 7.1198 | 15.3779 | 13.0897 | 85.1202 |
| 2008 | 90.2455 | 5.6234 | 9.7545 | 7.9633 | 81.6370 |
| 2009 | 92.2780 | 2.0325 | 7.7220 | 6.2662 | 81.1476 |
| 2010 | 94.3974 | 2.1195 | 5.6026 | 4.3983 | 78.5056 |
| 2011 | 95.2526 | 0.8552 | 4.7474 | 3.7348 | 78.6702 |
| 2012 | 96.2792 | 1.0266 | 3.7208 | 2.8637 | 76.9662 |
| 2013 | 96.4323 | 0.1531 | 3.5677 | 2.8450 | 79.7443 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factors to discount unpaid losses incurred in this line of business in the 2004 accident year and that are outstanding at the end of the tax year shown.

| | | | | | |
|---|---|---|---|---|---|
| 2014 | | 0.1531 | 3.4145 | 2.8253 | 82.7452 |
| 2015 | | 0.1531 | 3.2614 | 2.8048 | 85.9988 |
| 2016 | | 0.1531 | 3.1083 | 2.7832 | 89.5410 |
| 2017 | | 0.1531 | 2.9551 | 2.7605 | 93.4151 |
| 2018 and later years | | 0.1531 | 2.8020 | 2.7368 | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 88.2038 percent to discount unpaid losses incurred in this line of business in 2004 and prior years and that are outstanding at the end of the 2014 taxable year.

**Fidelity/Surety**

| Tax Year | Estimated Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Unpaid Losses at Year End (%) | Discounted Unpaid Losses at Year End (%) | Discount Factors (%) |
|---|---|---|---|---|---|
| 2004 | 38.3328 | 38.3328 | 61.6672 | 57.5027 | 93.2469 |
| 2005 | 58.8485 | 20.5156 | 41.1515 | 39.2701 | 95.4281 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factor to discount unpaid losses incurred in this line of business in the 2004 accident year and that are outstanding at the end of the tax year shown.

| | | | | | |
|---|---|---|---|---|---|
| 2006 and later years | | 20.5758 | 20.5758 | 20.0971 | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 97.6738 percent to discount unpaid losses incurred in this line of business in 2004 and prior years and that are outstanding at the end of the 2006 taxable year.

**Financial Guaranty/Mortgage Guaranty**

| Tax Year | Estimated Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Unpaid Losses at Year End (%) | Discounted Unpaid Losses at Year End (%) | Discount Factors (%) |
|---|---|---|---|---|---|
| 2004 | 4.0723 | 4.0723 | 95.9277 | 89.7666 | 93.5773 |
| 2005 | 40.7639 | 36.6916 | 59.2361 | 56.5278 | 95.4281 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factor to discount unpaid losses incurred in this line of business in the 2004 accident year and that are outstanding at the end of the tax year shown.

| Tax Year | Estimated Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Unpaid Losses at Year End (%) | Discounted Unpaid Losses at Year End (%) | Discount Factors (%) |
|---|---|---|---|---|---|
| 2006 and later years | | 29.6180 | 29.6180 | 28.9291 | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 97.6738 percent to discount unpaid losses incurred in this line of business in 2004 and prior years and that are outstanding at the end of the 2006 taxable year.

**International (Composite)**

| Tax Year | Estimated Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Unpaid Losses at Year End (%) | Discounted Unpaid Losses at Year End (%) | Discount Factors (%) |
|---|---|---|---|---|---|
| 2004 | 40.9985 | 40.9985 | 59.0015 | 52.8260 | 89.5334 |
| 2005 | 65.8439 | 24.8454 | 34.1561 | 29.9351 | 87.6422 |
| 2006 | 77.5023 | 11.6583 | 22.4977 | 19.4420 | 86.4176 |
| 2007 | 84.6221 | 7.1198 | 15.3779 | 13.0897 | 85.1202 |
| 2008 | 90.2455 | 5.6234 | 9.7545 | 7.9633 | 81.6370 |
| 2009 | 92.2780 | 2.0325 | 7.7220 | 6.2662 | 81.1476 |
| 2010 | 94.3974 | 2.1195 | 5.6026 | 4.3983 | 78.5056 |
| 2011 | 95.2526 | 0.8552 | 4.7474 | 3.7348 | 78.6702 |
| 2012 | 96.2792 | 1.0266 | 3.7208 | 2.8637 | 76.9662 |
| 2013 | 96.4323 | 0.1531 | 3.5677 | 2.8450 | 79.7443 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factors to discount unpaid losses incurred in this line of business in the 2004 accident year and that are outstanding at the end of the tax year shown.

| Tax Year | Estimated Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Unpaid Losses at Year End (%) | Discounted Unpaid Losses at Year End (%) | Discount Factors (%) |
|---|---|---|---|---|---|
| 2014 | | 0.1531 | 3.4145 | 2.8253 | 82.7452 |
| 2015 | | 0.1531 | 3.2614 | 2.8048 | 85.9988 |
| 2016 | | 0.1531 | 3.1083 | 2.7832 | 89.5410 |
| 2017 | | 0.1531 | 2.9551 | 2.7605 | 93.4151 |
| 2018 and later | | 0.1531 | 2.8020 | 2.7368 | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 88.2038 percent to discount unpaid losses incurred in this line of business in 2004 and prior years and that are outstanding at the end of the 2014 taxable year.

**Medical Malpractice — Claims-Made**

| Tax Year | Estimated Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Unpaid Losses at Year End (%) | Discounted Unpaid Losses at Year End (%) | Discount Factors (%) |
|---|---|---|---|---|---|
| 2004 | 7.3447 | 7.3447 | 92.6553 | 81.7682 | 88.2499 |
| 2005 | 29.0191 | 21.6744 | 70.9809 | 63.5188 | 89.4872 |
| 2006 | 53.3108 | 24.2917 | 46.6892 | 41.7102 | 89.3358 |
| 2007 | 69.1517 | 15.8409 | 30.8483 | 27.5025 | 89.1538 |
| 2008 | 82.0981 | 12.9464 | 17.9019 | 15.5733 | 86.9925 |
| 2009 | 86.3995 | 4.3014 | 13.6005 | 11.9201 | 87.6445 |
| 2010 | 89.7111 | 3.3116 | 10.2889 | 9.1042 | 88.4854 |
| 2011 | 92.4688 | 2.7577 | 7.5312 | 6.7196 | 89.2237 |
| 2012 | 94.5163 | 2.0475 | 5.4837 | 4.9472 | 90.2171 |
| 2013 | 95.7635 | 1.2471 | 4.2365 | 3.9088 | 92.2647 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factors to discount unpaid losses incurred in this line of business in the 2004 accident year and that are outstanding at the end of the tax year shown.

| Tax Year | Estimated Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Unpaid Losses at Year End (%) | Discounted Unpaid Losses at Year End (%) | Discount Factors (%) |
|---|---|---|---|---|---|
| 2014 | | 1.2471 | 2.9894 | 2.8204 | 94.3465 |
| 2015 | | 1.2471 | 1.7422 | 1.6795 | 96.3974 |
| 2016 and later years | | 1.2471 | 0.4951 | 0.4836 | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 95.1999 percent to discount unpaid losses incurred in this line of business in 2004 and prior years and that are outstanding at the end of the 2014 taxable year.

**Medical Malpractice — Occurrence**

| Tax Year | Estimated Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Unpaid Losses at Year End (%) | Discounted Unpaid Losses at Year End (%) | Discount Factors (%) |
|---|---|---|---|---|---|
| 2004 | 0.8316 | 0.8316 | 99.1684 | 81.9380 | 82.6251 |
| 2005 | 7.4573 | 6.6257 | 92.5427 | 79.1039 | 85.4783 |
| 2006 | 23.5575 | 16.1002 | 76.4425 | 66.4331 | 86.9060 |
| 2007 | 41.0062 | 17.4487 | 58.9938 | 51.7709 | 87.7565 |
| 2008 | 55.5832 | 14.5770 | 44.4168 | 39.3421 | 88.5748 |
| 2009 | 68.9413 | 13.3581 | 31.0587 | 27.5622 | 88.7421 |
| 2010 | 78.2095 | 9.2682 | 21.7905 | 19.4017 | 89.0375 |
| 2011 | 82.8727 | 4.6632 | 17.1273 | 15.5626 | 90.8644 |
| 2012 | 86.3178 | 3.4451 | 13.6822 | 12.7855 | 93.4468 |
| 2013 | 91.0834 | 4.7656 | 8.9166 | 8.5227 | 95.5829 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factor to discount unpaid losses incurred in this line of business in the 2004 accident year and that are outstanding at the end of the tax year shown.

| Tax Year | Estimated Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Unpaid Losses at Year End (%) | Discounted Unpaid Losses at Year End (%) | Discount Factors (%) |
|---|---|---|---|---|---|
| 2014 and later years | | 4.7656 | 4.1510 | 4.0544 | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 97.6738 percent to discount unpaid losses incurred in this line of business in 2004 and prior years and that are outstanding at the end of the 2014 taxable year.

**Miscellaneous Casualty**

| Tax Year | Estimated Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Unpaid Losses at Year End (%) | Discounted Unpaid Losses at Year End (%) | Discount Factors (%) |
|---|---|---|---|---|---|
| 2004 | 79.7790 | 79.7790 | 20.2210 | 19.4151 | 96.0143 |
| 2005 | 94.9417 | 15.1627 | 5.0583 | 4.8271 | 95.4281 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factor to discount unpaid losses incurred in this line of business in the 2004 accident year and that are outstanding at the end of the tax year shown.

| Tax Year | Estimated Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Unpaid Losses at Year End (%) | Discounted Unpaid Losses at Year End (%) | Discount Factors (%) |
|---|---|---|---|---|---|
| 2006 and later years | | 2.5292 | 2.5292 | 2.4703 | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 97.6738 percent to discount unpaid losses incurred in this line of business in 2004 and prior years and that are outstanding at the end of the 2006 taxable year.

**Multiple Peril Lines**
**(Homeowners/Farmowners, Commercial Multiple Peril, and Special Liability**
**(Ocean Marine, Aircraft (All Perils), Boiler and Machinery))**

| Tax Year | Estimated Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Unpaid Losses at Year End (%) | Discounted Unpaid Losses at Year End (%) | Discount Factors (%) |
|---|---|---|---|---|---|
| 2004 | 59.7445 | 59.7445 | 40.2555 | 36.9102 | 91.6900 |
| 2005 | 81.0347 | 21.2902 | 18.9653 | 16.8921 | 89.0684 |
| 2006 | 87.3325 | 6.2978 | 12.6675 | 11.2585 | 88.8771 |
| 2007 | 91.0659 | 3.7334 | 8.9341 | 7.9788 | 89.3078 |
| 2008 | 95.1781 | 4.1122 | 4.8219 | 4.1533 | 86.1338 |
| 2009 | 95.7605 | 0.5824 | 4.2395 | 3.7572 | 88.6237 |
| 2010 | 97.0539 | 1.2933 | 2.9461 | 2.6141 | 88.7309 |
| 2011 | 97.6441 | 0.5903 | 2.3559 | 2.1358 | 90.6591 |
| 2012 | 98.7037 | 1.0596 | 1.2963 | 1.1539 | 89.0187 |
| 2013 | 98.6217 | -0.0821 | 1.3783 | 1.2936 | 93.8496 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factors to discount unpaid losses incurred in this line of business in the 2004 accident year and that are outstanding at the end of the tax year shown.

| Tax Year | Estimated Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Unpaid Losses at Year End (%) | Discounted Unpaid Losses at Year End (%) | Discount Factors (%) |
|---|---|---|---|---|---|
| 2014 | | 0.5226 | 0.8558 | 0.8209 | 95.9252 |
| 2015 and later years | | 0.5226 | 0.3332 | 0.3254 | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 96.3566 percent to discount unpaid losses incurred in this line of business in 2004 and prior years and that are outstanding at the end of the 2014 taxable year.

**Other (Including Credit)**

| Tax Year | Estimated Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Unpaid Losses at Year End (%) | Discounted Unpaid Losses at Year End (%) | Discount Factors (%) |
|---|---|---|---|---|---|
| 2004 | 69.1729 | 69.1729 | 30.8271 | 29.5273 | 95.7837 |
| 2005 | 91.2168 | 22.0439 | 8.7832 | 8.3817 | 95.4281 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factor to discount unpaid losses incurred in this line of business in the 2004 accident year and that are outstanding at the end of the tax year shown.

| | | | | | |
|---|---|---|---|---|---|
| 2006 and later years | | 4.3916 | 4.3916 | 4.2895 | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 97.6738 percent to discount unpaid losses incurred in this line of business in 2004 and prior years and that are outstanding at the end of the 2006 taxable year.

**Other Liability — Claims-Made**

| Tax Year | Estimated Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Unpaid Losses at Year End (%) | Discounted Unpaid Losses at Year End (%) | Discount Factors (%) |
|---|---|---|---|---|---|
| 2004 | 14.9618 | 14.9618 | 85.0382 | 73.5850 | 86.5317 |
| 2005 | 36.2113 | 21.2494 | 63.7887 | 55.3763 | 86.8120 |
| 2006 | 54.2876 | 18.0763 | 45.7124 | 39.5386 | 86.4942 |
| 2007 | 64.2163 | 9.9288 | 35.7837 | 31.2791 | 87.4117 |
| 2008 | 73.2732 | 9.0569 | 26.7268 | 23.5142 | 87.9799 |
| 2009 | 80.5748 | 7.3016 | 19.4252 | 17.1721 | 88.4011 |
| 2010 | 87.6200 | 7.0452 | 12.3800 | 10.7868 | 87.1308 |
| 2011 | 89.9155 | 2.2955 | 10.0845 | 8.9565 | 88.8150 |
| 2012 | 93.3946 | 3.4791 | 6.6054 | 5.8263 | 88.2049 |
| 2013 | 94.6170 | 1.2223 | 5.3830 | 4.8556 | 90.2026 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factors to discount unpaid losses incurred in this line of business in the 2004 accident year and that are outstanding at the end of the tax year shown.

| | | | | | |
|---|---|---|---|---|---|
| 2014 | | 1.2223 | 4.1607 | 3.8382 | 92.2497 |
| 2015 | | 1.2223 | 2.9383 | 2.7718 | 94.3309 |
| 2016 | | 1.2223 | 1.7160 | 1.6539 | 96.3817 |
| 2017 and later years | | 1.2223 | 0.4936 | 0.4822 | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 93.4601 percent to discount unpaid losses incurred in this line of business in 2004 and prior years and that are outstanding at the end of the 2014 taxable year.

**Other Liability — Occurrence**

| Tax Year | Estimated Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Unpaid Losses at Year End (%) | Discounted Unpaid Losses at Year End (%) | Discount Factors (%) |
|---|---|---|---|---|---|
| 2004 | 19.1133 | 19.1133 | 80.8867 | 67.7758 | 83.7909 |
| 2005 | 36.4434 | 17.3301 | 63.5566 | 53.2997 | 83.8618 |
| 2006 | 52.1648 | 15.7215 | 47.8352 | 39.7729 | 83.1457 |
| 2007 | 63.2383 | 11.0734 | 36.7617 | 30.3528 | 82.5662 |
| 2008 | 72.0780 | 8.8397 | 27.9220 | 22.7655 | 81.5325 |
| 2009 | 75.9021 | 3.8241 | 24.0979 | 19.9476 | 82.7774 |
| 2010 | 82.9305 | 7.0284 | 17.0695 | 13.7133 | 80.3380 |
| 2011 | 85.1441 | 2.2136 | 14.8559 | 12.1080 | 81.5027 |
| 2012 | 89.3006 | 4.1565 | 10.6994 | 8.4361 | 78.8462 |
| 2013 | 89.9898 | 0.6892 | 10.0102 | 8.1371 | 81.2878 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factors to discount unpaid losses incurred in this line of business in the 2004 accident year and that are outstanding at the end of the tax year shown.

| Tax Year | Estimated Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Unpaid Losses at Year End (%) | Discounted Unpaid Losses at Year End (%) | Discount Factors (%) |
|---|---|---|---|---|---|
| 2014 | | 0.6892 | 9.3210 | 7.8237 | 83.9359 |
| 2015 | | 0.6892 | 8.6318 | 7.4951 | 86.8318 |
| 2016 | | 0.6892 | 7.9426 | 7.1508 | 90.0309 |
| 2017 | | 0.6892 | 7.2533 | 6.7898 | 93.6092 |
| 2018 and later years | | 0.6892 | 6.5641 | 6.4114 | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 87.9688 percent to discount unpaid losses incurred in this line of business in 2004 and prior years and that are outstanding at the end of the 2014 taxable year.

**Private Passenger Auto Liability/Medical**

| Tax Year | Estimated Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Unpaid Losses at Year End (%) | Discounted Unpaid Losses at Year End (%) | Discount Factors (%) |
|---|---|---|---|---|---|
| 2004 | 43.1926 | 43.1926 | 56.8074 | 52.8961 | 93.1148 |
| 2005 | 72.2008 | 29.0082 | 27.7992 | 25.7467 | 92.6165 |
| 2006 | 84.5632 | 12.3625 | 15.4368 | 14.3308 | 92.8353 |
| 2007 | 91.9316 | 7.3684 | 8.0684 | 7.4776 | 92.6783 |
| 2008 | 95.8729 | 3.9413 | 4.1271 | 3.8029 | 92.1449 |
| 2009 | 97.7804 | 1.9075 | 2.2196 | 2.0333 | 91.6058 |
| 2010 | 98.7957 | 1.0153 | 1.2043 | 1.0918 | 90.6592 |
| 2011 | 99.2491 | 0.4535 | 0.7509 | 0.6802 | 90.5885 |
| 2012 | 99.5195 | 0.2703 | 0.4805 | 0.4362 | 90.7769 |
| 2013 | 99.6353 | 0.1159 | 0.3647 | 0.3386 | 92.8555 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factors to discount unpaid losses incurred in this line of business in the 2004 accident year and that are outstanding at the end of the tax year shown.

**Private Passenger Auto Liability/Medical**

| | | | | |
|---|---|---|---|---|
| 2014 | 0.1159 | 0.2488 | 0.2363 | 94.9794 |
| 2015 | 0.1159 | 0.1330 | 0.1291 | 97.0963 |
| 2016 and later years | 0.1159 | 0.0171 | 0.0167 | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 95.6966 percent to discount unpaid losses incurred in this line of business in 2004 and prior years and that are outstanding at the end of the 2014 taxable year.

**Products Liability — Claims-Made**

| Tax Year | Estimated Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Unpaid Losses at Year End (%) | Discounted Unpaid Losses at Year End (%) | Discount Factors (%) |
|---|---|---|---|---|---|
| 2004 | 6.5804 | 6.5804 | 93.4196 | 77.9688 | 83.4608 |
| 2005 | 26.7183 | 20.1379 | 73.2817 | 61.1094 | 83.3897 |
| 2006 | 43.1834 | 16.4652 | 56.8166 | 47.1976 | 83.0701 |
| 2007 | 43.9209 | 0.7375 | 56.0791 | 48.7174 | 86.8727 |
| 2008 | 54.3806 | 10.4597 | 45.6194 | 40.3568 | 88.4641 |
| 2009 | 78.3630 | 23.9824 | 21.6370 | 17.7485 | 82.0282 |
| 2010 | 82.8643 | 4.5013 | 17.1357 | 13.9954 | 81.6740 |
| 2011 | 68.2184 | -14.6459 | 31.7816 | 29.6647 | 93.3392 |
| 2012 | 79.1582 | 10.9399 | 20.8418 | 19.8942 | 95.4533 |
| 2013 | 89.6963 | 10.5381 | 10.3037 | 10.0640 | 97.6738 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factor to discount unpaid losses incurred in this line of business in the 2004 accident year and that are outstanding at the end of the tax year shown.

| | |
|---|---|
| 2014 and later years | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 94.7093 percent to discount unpaid losses incurred in this line of business in 2004 and prior years and that are outstanding at the end of the 2014 taxable year.

**Products Liability — Occurrence**

| Tax Year | Estimated Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Unpaid Losses at Year End (%) | Discounted Unpaid Losses at Year End (%) | Discount Factors (%) |
|---|---|---|---|---|---|
| 2004 | 9.4198 | 9.4198 | 90.5802 | 74.1927 | 81.9083 |
| 2005 | 20.5845 | 11.1647 | 79.4155 | 66.3381 | 83.5330 |
| 2006 | 36.7807 | 16.1962 | 63.2193 | 52.9537 | 83.7619 |
| 2007 | 55.5974 | 18.8167 | 44.4026 | 36.2412 | 81.6196 |
| 2008 | 66.6238 | 11.0263 | 33.3762 | 26.6991 | 79.9943 |
| 2009 | 77.2636 | 10.6399 | 22.7364 | 17.0927 | 75.1778 |
| 2010 | 79.1888 | 1.9251 | 20.8112 | 15.9456 | 76.6201 |
| 2011 | 83.6816 | 4.4928 | 16.3184 | 12.1144 | 74.2373 |
| 2012 | 85.5507 | 1.8691 | 14.4493 | 10.7846 | 74.6377 |
| 2013 | 85.7291 | 0.1784 | 14.2709 | 11.1218 | 77.9334 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factors to discount unpaid losses incurred in this line of business in the 2004 accident year and that are outstanding at the end of the tax year shown.

**Products Liability — Occurrence**

| | | | | | |
|---|---|---|---|---|---|
| 2014 | | 0.1784 | 14.0925 | 11.4752 | 81.4279 |
| 2015 | | 0.1784 | 13.9141 | 11.8457 | 85.1344 |
| 2016 | | 0.1784 | 13.7357 | 12.2340 | 89.0671 |
| 2017 | | 0.1784 | 13.5573 | 12.6410 | 93.2415 |
| 2018 and later years | | 0.1784 | 13.3789 | 13.0677 | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 85.1384 percent to discount unpaid losses incurred in this line of business in 2004 and prior years and that are outstanding at the end of the 2014 taxable year.

**Reinsurance A (Nonproportional Assumed Property)**

| Tax Year | Estimated Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Unpaid Losses at Year End (%) | Discounted Unpaid Losses at Year End (%) | Discount Factors (%) |
|---|---|---|---|---|---|
| 2004 | 25.0571 | 25.0571 | 74.9429 | 68.5209 | 91.4308 |
| 2005 | 52.0402 | 26.9831 | 47.9598 | 44.1979 | 92.1560 |
| 2006 | 82.4709 | 30.4307 | 17.5291 | 15.1727 | 86.5574 |
| 2007 | 85.6387 | 3.1678 | 14.3613 | 12.6608 | 88.1593 |
| 2008 | 92.7228 | 7.0840 | 7.2772 | 6.0183 | 82.7002 |
| 2009 | 91.8604 | -0.8624 | 8.1396 | 7.1913 | 88.3493 |
| 2010 | 96.5016 | 4.6412 | 3.4984 | 2.7862 | 79.6410 |
| 2011 | 96.1872 | -0.3143 | 3.8128 | 3.2423 | 85.0381 |
| 2012 | 97.6206 | 1.4333 | 2.3794 | 1.9311 | 81.1586 |
| 2013 | 97.8419 | 0.2214 | 2.1581 | 1.7976 | 83.2949 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factors to discount unpaid losses incurred in this line of business in the 2004 accident year and that are outstanding at the end of the tax year shown.

| | | | | | |
|---|---|---|---|---|---|
| 2014 | | 0.2214 | 1.9367 | 1.6576 | 85.5871 |
| 2015 | | 0.2214 | 1.7154 | 1.5109 | 88.0776 |
| 2016 | | 0.2214 | 1.4940 | 1.3571 | 90.8326 |
| 2017 | | 0.2214 | 1.2727 | 1.1958 | 93.9635 |
| 2018 and later years | | 0.2214 | 1.0513 | 1.0269 | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 87.1588 percent to discount unpaid losses incurred in this line of business in 2004 and prior years and that are outstanding at the end of the 2014 taxable year.

**Reinsurance B (Nonproportional Assumed Liability)**

| Tax Year | Estimated Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Unpaid Losses at Year End (%) | Discounted Unpaid Losses at Year End (%) | Discount Factors (%) |
|---|---|---|---|---|---|
| 2004 | 8.9223 | 8.9223 | 91.0777 | 73.9275 | 81.1697 |
| 2005 | 27.3618 | 18.4395 | 72.6382 | 58.6121 | 80.6905 |
| 2006 | 44.5758 | 17.2140 | 55.4242 | 43.8133 | 79.0507 |
| 2007 | 53.8781 | 9.3023 | 46.1219 | 36.4012 | 78.9239 |
| 2008 | 60.8896 | 7.0115 | 39.1104 | 30.9772 | 79.2046 |
| 2009 | 69.7327 | 8.8430 | 30.2673 | 23.4167 | 77.3661 |
| 2010 | 76.6292 | 6.8965 | 23.3708 | 17.4846 | 74.8137 |

**Reinsurance B (Nonproportional Assumed Liability)**

| Tax Year | Estimated Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Unpaid Losses at Year End (%) | Discounted Unpaid Losses at Year End (%) | Discount Factors (%) |
|---|---|---|---|---|---|
| 2011 | 79.4030 | 2.7738 | 20.5970 | 15.4875 | 75.1928 |
| 2012 | 83.8936 | 4.4906 | 16.1064 | 11.6364 | 72.2470 |
| 2013 | 80.1707 | -3.7229 | 19.8293 | 16.0088 | 80.7332 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factors to discount unpaid losses incurred in this line of business in the 2004 accident year and that are outstanding at the end of the tax year shown.

| Tax Year | Estimated Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Unpaid Losses at Year End (%) | Discounted Unpaid Losses at Year End (%) | Discount Factors (%) |
|---|---|---|---|---|---|
| 2014 | | 1.1805 | 18.6487 | 15.5718 | 83.5005 |
| 2015 | | 1.1805 | 17.4682 | 15.1137 | 86.5212 |
| 2016 | | 1.1805 | 16.2877 | 14.6335 | 89.8442 |
| 2017 | | 1.1805 | 15.1072 | 14.1302 | 93.5333 |
| 2018 and later years | | 1.1805 | 13.9266 | 13.6027 | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 85.5743 percent to discount unpaid losses incurred in this line of business in 2004 and prior years and that are outstanding at the end of the 2014 taxable year.

**Reinsurance C (Nonproportional Assumed Financial Lines)**

| Tax Year | Estimated Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Unpaid Losses at Year End (%) | Discounted Unpaid Losses at Year End (%) | Discount Factors (%) |
|---|---|---|---|---|---|
| 2004 | 17.1195 | 17.1195 | 82.8805 | 73.0832 | 88.1791 |
| 2005 | 46.6590 | 29.5395 | 53.3410 | 46.3628 | 86.9179 |
| 2006 | 67.7135 | 21.0545 | 32.2865 | 27.0416 | 83.7552 |
| 2007 | 78.1379 | 10.4244 | 21.8621 | 17.6723 | 80.8355 |
| 2008 | 89.7346 | 11.5967 | 10.2654 | 6.6512 | 64.7929 |
| 2009 | 92.1268 | 2.3921 | 7.8732 | 4.5227 | 57.4441 |
| 2010 | 89.7323 | -2.3945 | 10.2677 | 7.1922 | 70.0468 |
| 2011 | 90.0460 | 0.3137 | 9.9540 | 7.2177 | 72.5104 |
| 2012 | 94.8867 | 4.8407 | 5.1133 | 2.6096 | 51.0353 |
| 2013 | 86.7041 | -8.1827 | 13.2959 | 11.1129 | 83.5811 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factors to discount unpaid losses incurred in this line of business in the 2004 accident year and that are outstanding at the end of the tax year shown.

| Tax Year | Estimated Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Unpaid Losses at Year End (%) | Discounted Unpaid Losses at Year End (%) | Discount Factors (%) |
|---|---|---|---|---|---|
| 2014 | | 1.4277 | 11.8683 | 10.1869 | 85.8328 |
| 2015 | | 1.4277 | 10.4406 | 9.2162 | 88.2727 |
| 2016 | | 1.4277 | 9.0129 | 8.1987 | 90.9665 |
| 2017 | | 1.4277 | 7.5852 | 7.1322 | 94.0277 |
| 2018 and later years | | 1.4277 | 6.1575 | 6.0143 | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 87.3575 percent to discount unpaid losses incurred in this line of business in 2004 and prior years and that are outstanding at the end of the 2014 taxable year.

**Special Property**
**(Fire, Allied Lines, Inland Marine, Earthquake, Glass, Burglary and Theft)**

| Tax Year | Estimated Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Unpaid Losses at Year End (%) | Discounted Unpaid Losses at Year End (%) | Discount Factors (%) |
|---|---|---|---|---|---|
| 2004 | 62.9320 | 62.9320 | 37.0680 | 35.4425 | 95.6148 |
| 2005 | 88.4950 | 25.5631 | 11.5050 | 10.9790 | 95.4281 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factor to discount unpaid losses incurred in this line of business in the 2004 accident year and that are outstanding at the end of the tax year shown.

| | | | | | |
|---|---|---|---|---|---|
| 2006 and later years | | 5.7525 | 5.7525 | 5.6187 | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 97.6738 percent to discount unpaid losses incurred in this line of business in 2004 and prior years and that are outstanding at the end of the 2006 taxable year.

**Workers' Compensation**

| Tax Year | Estimated Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Unpaid Losses at Year End (%) | Discounted Unpaid Losses at Year End (%) | Discount Factors (%) |
|---|---|---|---|---|---|
| 2004 | 28.2489 | 28.2489 | 71.7511 | 62.9119 | 87.6808 |
| 2005 | 57.8739 | 29.6249 | 42.1261 | 35.6138 | 84.5408 |
| 2006 | 71.2999 | 13.4260 | 28.7001 | 23.5846 | 82.1759 |
| 2007 | 77.7584 | 6.4585 | 22.2416 | 18.1090 | 81.4196 |
| 2008 | 81.9301 | 4.1717 | 18.0699 | 14.7108 | 81.4107 |
| 2009 | 83.7739 | 1.8437 | 16.2261 | 13.5322 | 83.3977 |
| 2010 | 86.5350 | 2.7611 | 13.4650 | 11.3576 | 84.3489 |
| 2011 | 88.4367 | 1.9017 | 11.5633 | 9.9580 | 86.1175 |
| 2012 | 89.5926 | 1.1559 | 10.4074 | 9.2545 | 88.9229 |
| 2013 | 91.6441 | 2.0515 | 8.3559 | 7.6003 | 90.9570 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factors to discount unpaid losses incurred in this line of business in the 2004 accident year and that are outstanding at the end of the tax year shown.

| | | | | | |
|---|---|---|---|---|---|
| 2014 | | 2.0515 | 6.3045 | 5.8663 | 93.0502 |
| 2015 | | 2.0515 | 4.2530 | 4.0488 | 95.1976 |
| 2016 | | 2.0515 | 2.2016 | 2.1436 | 97.3675 |
| 2017 and later years | | 2.0515 | 0.1501 | 0.1466 | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 94.3547 percent to discount unpaid losses incurred in this line of business in 2004 and prior years and that are outstanding at the end of the 2014 taxable year.

DRAFTING INFORMATION

The principal author of this revenue procedure is Katherine A. Hossofsky of the Office of the Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue procedure, contact Ms. Hossofsky at (202) 622–8435 (not a toll-free call).

*26 CFR 601.201: Rulings and determination letters. (Also Part I, sections 832, 846; 1.832–4, 1.8461.)*

## Rev. Proc. 2004–70

SECTION 1. PURPOSE

This revenue procedure prescribes the salvage discount factors for the 2004 accident year. These factors must be used to compute discounted estimated salvage recoverable under § 832 of the Internal Revenue Code.

SECTION 2. BACKGROUND

Section 832(b)(5)(A) requires that all estimated salvage recoverable (including that which cannot be treated as an asset for state accounting purposes) be taken into account in computing the deduction for losses incurred. Under § 832(b)(5)(A), paid losses are to be reduced by salvage and reinsurance recovered during the taxable year. This amount is adjusted to reflect changes in discounted unpaid losses on nonlife insurance contracts and in unpaid losses on life insurance contracts. An adjustment is then made to reflect any changes in discounted estimated salvage recoverable and in reinsurance recoverable.

Pursuant to § 832(b), the amount of estimated salvage is determined on a discounted basis in accordance with procedures established by the Secretary.

SECTION 3. SCOPE

This revenue procedure applies to any taxpayer that is required to discount estimated salvage recoverable under § 832.

SECTION 4. APPLICATION

.01 The following tables present separately for each line of business the discount factors under § 832 for the 2004 accident year. All the discount factors presented in this section were determined using the applicable interest rate under § 846(c) for 2004, which is 4.82 percent, and by assuming all estimated salvage is recovered in the middle of each calendar year. *See* Rev. Proc. 2003–18, 2003–1 C.B. 439, for background regarding the tables.

.02 These tables must be used by taxpayers irrespective of whether they elected to discount unpaid losses using their own historical experience under § 846.

.03 Section V of Notice 88–100, 1988–2 C.B. 439, provides a composite discount factor to be used in determining the discounted unpaid losses for accident years that are not separately reported on the NAIC Annual Statement. The tables separately provide discount factors for taxpayers who elect to use the composite method. Rev. Proc. 2002–74, 2002–2 C.B. 980, clarifies that for certain insurance companies subject to tax under § 831 the composite method for discounting unpaid losses set forth in Notice 88–100, section V, 1988–2 C.B. 419, is permitted but not required. This revenue procedure further provides alternative methods for computing discounted unpaid losses that are permitted for insurance companies not using the composite method, and sets forth a procedure for insurance companies to obtain automatic consent of the Commissioner to change to one of the methods described in Rev. Proc. 2002–74.

.04 Tables.

**Tables of Factors to be Used to Discount Salvage Recoverable With Respect to Losses Incurred in Accident Year 2004**

**(Interest rate: 4.82 percent)**

**Accident and Health (Other Than Disability Income or Credit Disability Insurance)**

Taxpayers that do not use the composite method of Notice 88–100 should use 97.6738 percent to discount salvage recoverable with respect to losses incurred in this line of business in the 2004 accident year as of the end of the 2004 and later taxable years.

Taxpayers that use the composite method of Notice 88–100 should use 97.6738 percent to discount all salvage recoverable in this line of business as of the end of the 2004 taxable year.

**Auto Physical Damage**

| Tax Year | Discount Factors (%) |
|---|---|
| 2004 | 96.5590 |
| 2005 | 95.4281 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factor to discount salvage recoverable as of the end of the tax year shown with respect to losses incurred in this line of business in the 2004 accident year.

| | |
|---|---|
| 2006 and later years | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 97.6738 percent to discount salvage recoverable as of the end of the 2006 taxable year with respect to losses incurred in this line of business in 2004 and prior years.

**Commercial Auto/Truck Liability/Medical**

| Tax Year | Discount Factors (%) |
|---|---|
| 2004 | 90.6645 |
| 2005 | 90.3669 |
| 2006 | 90.1327 |
| 2007 | 90.6408 |
| 2008 | 91.1785 |
| 2009 | 90.5988 |
| 2010 | 91.8814 |
| 2011 | 92.9935 |
| 2012 | 93.2915 |
| 2013 | 95.4594 |

**Commercial Auto/Truck Liability/Medical**

Taxpayers that do not use the composite method of Notice 88–100 should use the following factor to discount salvage recoverable as of the end of the tax year shown with respect to losses incurred in this line of business in the 2004 accident year.

| | |
|---|---|
| 2014 and later years | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 97.6738 percent to discount salvage recoverable as of the end of the 2014 taxable year with respect to losses incurred in this line of business in 2004 and prior years.

**Composite**

| Tax Year | Discount Factors (%) |
|---|---|
| 2004 | 90.5683 |
| 2005 | 89.2161 |
| 2006 | 88.6645 |
| 2007 | 88.0367 |
| 2008 | 86.8142 |
| 2009 | 86.8926 |
| 2010 | 86.6271 |
| 2011 | 86.5809 |
| 2012 | 86.7177 |
| 2013 | 88.6805 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factors to discount salvage recoverable as of the end of the tax year shown with respect to losses incurred in this line of business in the 2004 accident year.

| | |
|---|---|
| 2014 | 90.6998 |
| 2015 | 92.7729 |
| 2016 | 94.8883 |
| 2017 | 96.9880 |
| 2018 and later years | 97.6738 |

**Composite**

Taxpayers that use the composite method of Notice 88–100 should use 91.9391 percent to discount salvage recoverable as of the end of the 2014 taxable year with respect to losses incurred in this line of business in 2004 and prior years.

**Fidelity/Surety**

| Tax Year | Discount Factors (%) |
|---|---|
| 2004 | 93.1746 |
| 2005 | 95.4281 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factor to discount salvage recoverable as of the end of the tax year shown with respect to losses incurred in this line of business in the 2004 accident year.

| | |
|---|---|
| 2006 and later years | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 97.6738 percent to discount salvage recoverable as of the end of the 2006 taxable year with respect to losses incurred in this line of business in 2004 and prior years.

**Financial Guaranty/Mortgage Guaranty**

| Tax Year | Discount Factors (%) |
|---|---|
| 2004 | 94.6749 |
| 2005 | 95.4281 |

**Financial Guaranty/Mortgage Guaranty**

Taxpayers that do not use the composite method of Notice 88–100 should use the following factor to discount salvage recoverable as of the end of the tax year shown with respect to losses incurred in this line of business in the 2004 accident year.

| | |
|---|---|
| 2006 and later years | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 97.6738 percent to discount salvage recoverable as of the end of the 2006 taxable year with respect to losses incurred in this line of business in 2004 and prior years.

**International (Composite)**

| Tax Year | Discount Factors (%) |
|---|---|
| 2004 | 90.5683 |
| 2005 | 89.2161 |
| 2006 | 88.6645 |
| 2007 | 88.0367 |
| 2008 | 86.8142 |
| 2009 | 86.8926 |
| 2010 | 86.6271 |
| 2011 | 86.5809 |
| 2012 | 86.7177 |
| 2013 | 88.6805 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factors to discount salvage recoverable as of the end of the tax year shown with respect to losses incurred in this line of business in the 2004 accident year.

| | |
|---|---|
| 2014 | 90.6998 |
| 2015 | 92.7729 |
| 2016 | 94.8883 |
| 2017 | 96.9880 |
| 2018 and later years | 97.6738 |

**International (Composite)**

Taxpayers that use the composite method of Notice 88–100 should use 91.9391 percent to discount salvage recoverable as of the end of the 2014 taxable year with respect to losses incurred in this line of business in 2004 and prior years.

**Medical Malpractice — Claims-Made**

| Tax Year | Discount Factors (%) |
|---|---|
| 2004 | 85.5093 |
| 2005 | 80.4030 |
| 2006 | 85.5474 |
| 2007 | 82.9525 |
| 2008 | 84.0312 |
| 2009 | 77.9665 |
| 2010 | 88.7516 |
| 2011 | 91.9419 |
| 2012 | 95.7422 |
| 2013 | 97.6738 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factor to discount salvage recoverable as of the end of the tax year shown with respect to losses incurred in this line of business in the 2004 accident year.

| | |
|---|---|
| 2014 and later years | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 97.6738 percent to discount salvage recoverable as of the end of the 2014 taxable year with respect to losses incurred in this line of business in 2004 and prior years.

**Medical Malpractice — Occurrence**

| Tax Year | Discount Factors (%) |
|---|---|
| 2004 | 81.0996 |
| 2005 | 82.3752 |
| 2006 | 86.3279 |
| 2007 | 87.9623 |
| 2008 | 74.2782 |
| 2009 | 85.2215 |
| 2010 | 90.8308 |
| 2011 | 94.1660 |
| 2012 | 96.0748 |
| 2013 | 97.6738 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factor to discount salvage recoverable as of the end of the tax year shown with respect to losses incurred in this line of business in the 2004 accident year.

| | |
|---|---|
| 2014 and later years | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 97.6738 percent to discount salvage recoverable as of the end of the 2014 taxable year with respect to losses incurred in this line of business in 2004 and prior years.

**Miscellaneous Casualty**

| Tax Year | Discount Factors (%) |
|---|---|
| 2004 | 96.0374 |
| 2005 | 95.4281 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factor to discount salvage recoverable as of the end of the tax year shown with respect to losses incurred in this line of business in the 2004 accident year.

**Miscellaneous Casualty**

| | |
|---|---|
| 2006 and later years | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 97.6738 percent to discount salvage recoverable as of the end of the 2006 taxable year with respect to losses incurred in this line of business in 2004 and prior years.

**Multiple Peril Lines (Homeowners/Farmowners, Commercial Multiple Peril, and Special Liability (Ocean Marine, Aircraft (All Perils), Boiler and Machinery))**

| Tax Year | Discount Factors (%) |
|---|---|
| 2004 | 91.6039 |
| 2005 | 89.7492 |
| 2006 | 90.5601 |
| 2007 | 90.2475 |
| 2008 | 89.8022 |
| 2009 | 91.1562 |
| 2010 | 91.2128 |
| 2011 | 91.4205 |
| 2012 | 93.1099 |
| 2013 | 95.2655 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factors to discount salvage recoverable as of the end of the tax year shown with respect to losses incurred in this line of business in the 2004 accident year.

| | |
|---|---|
| 2014 | 97.4556 |
| 2015 and later years | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 97.4560 percent to discount salvage recoverable as of the end of the 2014 taxable year with respect to losses incurred in this line of business in 2004 and prior years.

**Other (Including Credit)**

| Tax Year | Discount Factors (%) |
|---|---|
| 2004 | 96.2479 |
| 2005 | 95.4281 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factor to discount salvage recoverable as of the end of the tax year shown with respect to losses incurred in this line of business in the 2004 accident year.

| | |
|---|---|
| 2006 and later years | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 97.6738 percent to discount salvage recoverable as of the end of the 2006 taxable year with respect to losses incurred in this line of business in 2004 and prior years.

**Other Liability — Claims-Made**

| Tax Year | Discount Factors (%) |
|---|---|
| 2004 | 90.0420 |
| 2005 | 80.0175 |
| 2006 | 65.1028 |
| 2007 | 87.1628 |
| 2008 | 83.2875 |
| 2009 | 82.4626 |
| 2010 | 89.1681 |
| 2011 | 92.9417 |
| 2012 | 89.5057 |
| 2013 | 91.5434 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factors to discount salvage recoverable as of the end of the tax year shown with respect to losses incurred in this line of business in the 2004 accident year.

**Other Liability — Claims-Made**

| | |
|---|---|
| 2014 | 93.6283 |
| 2015 | 95.7330 |
| 2016 and later years | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 94.7277 percent to discount salvage recoverable as of the end of the 2014 taxable year with respect to losses incurred in this line of business in 2004 and prior years.

**Other Liability — Occurrence**

| Tax Year | Discount Factors (%) |
|---|---|
| 2004 | 84.4755 |
| 2005 | 85.9883 |
| 2006 | 87.1531 |
| 2007 | 83.6055 |
| 2008 | 87.3020 |
| 2009 | 89.9297 |
| 2010 | 90.3252 |
| 2011 | 92.5157 |
| 2012 | 93.9128 |
| 2013 | 95.9821 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factor to discount salvage recoverable as of the end of the tax year shown with respect to losses incurred in this line of business in the 2004 accident year.

| | |
|---|---|
| 2014 and later years | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 97.6738 percent to discount salvage recoverable as of the end of the 2014 taxable year with respect to losses incurred in this line of business in 2004 and prior years.

**Private Passenger Auto Liability/Medical**

| Tax Year | Discount Factors (%) |
|---|---|
| 2004 | 93.7245 |
| 2005 | 93.5180 |
| 2006 | 93.2272 |
| 2007 | 92.3657 |
| 2008 | 92.1360 |
| 2009 | 91.0524 |
| 2010 | 90.9939 |
| 2011 | 91.0582 |
| 2012 | 92.3235 |
| 2013 | 94.4076 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factors to discount salvage recoverable as of the end of the tax year shown with respect to losses incurred in this line of business in the 2004 accident year.

| | |
|---|---|
| 2014 | 96.4598 |
| 2015 and later years | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 96.6736 percent to discount salvage recoverable as of the end of the 2014 taxable year with respect to losses incurred in this line of business in 2004 and prior years.

**Products Liability — Claims-Made**

| Tax Year | Discount Factors (%) |
|---|---|
| 2004 | 85.9966 |
| 2005 | 86.0537 |
| 2006 | 87.7977 |
| 2007 | 7.9001 |
| 2008 | 79.1822 |
| 2009 | 85.8894 |
| 2010 | 90.6864 |
| 2011 | 95.0912 |
| 2012 | 25.2668 |
| 2013 | 95.5221 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factor to discount salvage recoverable as of the end of the tax year shown with respect to losses incurred in this line of business in the 2004 accident year.

| | |
|---|---|
| 2014 and later years | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 97.6738 percent to discount salvage recoverable as of the end of the 2014 taxable year with respect to losses incurred in this line of business in 2004 and prior years.

**Products Liability — Occurrence**

| Tax Year | Discount Factors (%) |
|---|---|
| 2004 | 80.0842 |
| 2005 | 82.8436 |
| 2006 | 83.5123 |
| 2007 | 86.2999 |
| 2008 | 83.5735 |
| 2009 | 87.2379 |
| 2010 | 90.4562 |
| 2011 | 91.2267 |
| 2012 | 85.5469 |
| 2013 | 87.4740 |

**Products Liability — Occurrence**

Taxpayers that do not use the composite method of Notice 88–100 should use the following factors to discount salvage recoverable as of the end of the tax year shown with respect to losses incurred in this line of business in the 2004 accident year.

| | |
|---|---|
| 2014 | 89.4572 |
| 2015 | 91.4954 |
| 2016 | 93.5825 |
| 2017 | 95.6945 |
| 2018 and later years | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 92.6255 percent to discount salvage recoverable as of the end of the 2014 taxable year with respect to losses incurred in this line of business in 2004 and prior years.

**Reinsurance A (Nonproportional Assumed Property)**

| Tax Year | Discount Factors (%) |
|---|---|
| 2004 | 85.3031 |
| 2005 | 82.2450 |
| 2006 | 86.5640 |
| 2007 | 90.4906 |
| 2008 | 91.1611 |
| 2009 | 92.9938 |
| 2010 | 94.8571 |
| 2011 | 96.1798 |
| 2012 | 96.7980 |
| 2013 | 97.6738 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factor to discount salvage recoverable as of the end of the tax year shown with respect to losses incurred in this line of business in the 2004 accident year.

| | |
|---|---|
| 2014 and later years | 97.6738 |

**Reinsurance A (Nonproportional Assumed Property)**

Taxpayers that use the composite method of Notice 88–100 should use 97.6738 percent to discount salvage recoverable as of the end of the 2014 taxable year with respect to losses incurred in this line of business in 2004 and prior years.

**Reinsurance B (Nonproportional Assumed Liability)**

| Tax Year | Discount Factors (%) |
|---|---|
| 2004 | 84.7610 |
| 2005 | 82.3424 |
| 2006 | 85.7505 |
| 2007 | 83.4780 |
| 2008 | 76.1754 |
| 2009 | 79.9172 |
| 2010 | 79.2255 |
| 2011 | 81.5908 |
| 2012 | 76.2736 |
| 2013 | 84.1702 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factors to discount salvage recoverable as of the end of the tax year shown with respect to losses incurred in this line of business in the 2004 accident year.

| | |
|---|---|
| 2014 | 86.3467 |
| 2015 | 88.6896 |
| 2016 | 91.2606 |
| 2017 | 94.1745 |
| 2018 and later years | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 87.7819 percent to discount salvage recoverable as of the end of the 2014 taxable year with respect to losses incurred in this line of business in 2004 and prior years.

**Reinsurance C (Nonproportional Assumed Financial Lines)**

| Tax Year | Discount Factors (%) |
|---|---|
| 2004 | 84.4808 |
| 2005 | 85.2596 |
| 2006 | 88.9070 |
| 2007 | 86.2016 |
| 2008 | 89.5553 |
| 2009 | 82.3408 |
| 2010 | 85.6757 |
| 2011 | 92.8358 |
| 2012 | 94.2578 |
| 2013 | 96.3087 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factor to discount salvage recoverable as of the end of the tax year shown with respect to losses incurred in this line of business in the 2004 accident year.

| | |
|---|---|
| 2014 and later years | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 97.6738 percent to discount salvage recoverable as of the end of the 2014 taxable year with respect to losses incurred in this line of business in 2004 and prior years.

**Special Property (Fire, Allied Lines, Inland Marine, Earthquake, Glass, Burglary and Theft)**

| Tax Year | Discount Factors (%) |
|---|---|
| 2004 | 93.6220 |
| 2005 | 95.4281 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factor to discount salvage recoverable as of the end of the tax year shown with respect to losses incurred in this line of business in the 2004 accident year.

| | |
|---|---|
| 2006 and later years | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 97.6738 percent to discount salvage recoverable as of the end of the 2006 taxable year with respect to losses incurred in this line of business in 2004 and prior years.

**Workers' Compensation**

| Tax Year | Discount Factors (%) |
|---|---|
| 2004 | 85.3979 |
| 2005 | 86.7440 |
| 2006 | 87.2113 |
| 2007 | 87.1308 |
| 2008 | 86.4289 |
| 2009 | 87.2964 |
| 2010 | 87.0843 |
| 2011 | 87.2655 |
| 2012 | 88.1306 |
| 2013 | 90.1258 |

Taxpayers that do not use the composite method of Notice 88–100 should use the following factors to discount salvage recoverable as of the end of the tax year shown with respect to losses incurred in this line of business in the 2004 accident year.

| | |
|---|---|
| 2014 | 92.1703 |
| 2015 | 94.2492 |
| 2016 | 96.3002 |
| 2017 and later years | 97.6738 |

Taxpayers that use the composite method of Notice 88–100 should use 93.3819 percent to discount salvage recoverable as of the end of the 2014 taxable year with respect to losses incurred in this line of business in 2004 and prior years.

DRAFTING INFORMATION

The principal author of this revenue procedure is Katherine A. Hossofsky of the Office of the Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue procedure, contact Ms. Hossofsky at (202) 622–8435 (not a toll-free call).

# Part IV. Items of General Interest

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

## Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts

## REG–155608–02

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations under section 403(b) of the Internal Revenue Code and under related provisions of sections 402(b), 402(g), 414(c), and 3121(a)(5)(D). The proposed regulations would provide updated guidance on section 403(b) contracts of public schools and tax-exempt organizations described in section 501(c)(3). These regulations would provide the public with guidance necessary to comply with the law and will affect sponsors of section 403(b) contracts, administrators, participants and beneficiaries. In this issue of the Bulletin, the Treasury Department and IRS are issuing temporary regulations (T.D. 9159) providing employment tax guidance to employers and employees on salary reduction agreements. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by February 14, 2005. Outlines of topics to be discussed at the public hearing scheduled for February 15, 2005, to be held in the IRS Auditorium (7th Floor) must be received by January 25, 2005.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–155608–02), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG–155608–02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically via the IRS Internet site at *www.irs.gov/regs* or via the Federal eRulemaking Portal at *www.regulations.gov* (IRS-REG–155608–02). The public hearing will be held in the IRS Auditorium (7th Floor), Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, R. Lisa Mojiri-Azad or John Tolleris, (202) 622–6060; concerning the proposed regulations as applied to church-related entities, Robert Architect (202) 283–9634; concerning submission of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Sonya Cruse, (202) 622–7180 (not toll–free numbers).

SUPPLEMENTARY INFORMATION:

**Paperwork Reduction Act**

The collection of information contained in this notice of rulemaking has been previously reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1341.

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**

Regulations (T.D. 6783, 1965–1 C.B. 180) under section 403(b) of the Internal Revenue Code (Code) were published in the **Federal Register** (29 FR 18356) on December 24, 1964. These regulations provided guidance for complying with section 403(b) which had been enacted in 1958 in section 23(a) of the Technical Amendments Act of 1958, Public Law 85–866 (1958), relating to tax-sheltered annuity arrangements established for employees by public schools and tax-exempt organizations described in section 501(c)(3). Since 1964, additional regulations have been issued under section 403(b) to reflect rules relating to eligible rollover distributions and minimum distributions under section 401(a)(9).

These proposed regulations would amend the current regulations to conform them to the numerous amendments made to section 403(b) by subsequent legislation, including section 1022(e) of the Employee Retirement Income Security Act of 1974 (ERISA) (88 Stat. 829), Public Law 93–406; section 251 of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) (96 Stat. 324, 529), Public Law 97–248; section 1120 of the Tax Reform Act of 1986 (TRA '86) (100 Stat. 2085, 2463), Public Law 99–514; section 1450(a) of the Small Business Job Protection Act of 1996 (SBJPA) (110 Stat. 1755, 1814), Public Law 104–188; and sections 632, 646, and 647 of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) (115 Stat. 38, 113, 126, 127), Public Law 107–16.

**Explanation of Provisions**

*Overview*

The purposes of these proposed regulations are to update the current regulations under section 403(b) to delete provisions that no longer have legal effect due to changes in law, to include in the regulations a number of items of interpretive

guidance that have been issued under section 403(b) since the 1964 regulations,[1] and generally to reflect the numerous legal changes that have been made in section 403(b). A major effect of the legal changes in section 403(b) has been to diminish the extent to which the rules governing section 403(b) plans differ from the rules governing other arrangements that include salary reduction contributions, *i.e.*, section 401(k) plans and section 457(b) plans for State and local governmental entities. Thus, these regulations will reflect the increasing similarity among these arrangements.

Since the existing regulations were issued in 1964, a number of revenue rulings and other guidance under section 403(b) have become outdated as a result of changes in law. In addition, as a result of the inclusion in these proposed regulations of much of the guidance that the IRS has issued regarding section 403(b), it is anticipated that these regulations, when finalized, will supersede a number of revenue rulings and notices that have been issued under section 403(b). Thus, the IRS anticipates taking action to obsolete many revenue rulings, notices, and other guidance under section 403(b) when these regulations are issued in final form.[2] However, the positions taken in certain rulings and other outstanding guidance are expected to be retained. For example, it is intended that a revenue ruling will be issued that substantially replicates and consolidates the existing rules[3] for determining when employees are performing services for a public school.[4]

The existing regulations include special rules for determining the amount of the contributions made for an employee under a defined benefit plan, based on the employee's pension under the plan. These rules are generally no longer applicable for section 403(b) because the limitations on contributions to a section 403(b) contract are no longer coordinated with accruals under a defined benefit plan. (See also the discussion of defined benefit plans below under the heading *Miscellaneous Provisions*.) However, the rules for determining the amount of contributions made for an employee under a defined benefit plan in the existing regulations under section 403(b) are also used for purposes of section 402(b) (relating to nonqualified plans funded through trusts) and, accordingly, these rules are proposed to be deleted from the regulations under section 403(b). New proposed regulations under section 402(b) would authorize the Commissioner to issue guidance for determining the amount of the contributions made for an employee under a defined benefit plan under section 402(b). See also the request for comments on this guidance under the heading *Comments and Public Hearing*.

The proposed regulations also include controlled group rules under section 414(c) for entities that are tax-exempt under section 501(a).

*Exclusion for Contributions to Section 403(b) Contracts*

Section 403(b) provides an exclusion from gross income for certain contributions made by certain types of employers for their employees to specific types of funding arrangements. There are three categories of funding arrangements to which section 403(b) applies: (1) annuity contracts (as defined in section 401(g)) issued by an insurance company; (2) custodial accounts that are invested solely in mutual funds; and (3) retirement income accounts which are only permitted for church employees. The exclusion applies only if certain general requirements are satisfied. For purposes of most of these requirements, section 403(b)(5) provides that all section 403(b) contracts purchased for an individual by an employer are treated as purchased under a single contract. Other aggregation rules apply for certain specific purposes, including the aggregation rules under section 402(g) for purposes of satisfying the limitations on elective deferrals (which apply both on an individual basis and to all contributions made by an employer) and the controlled group rules of section 414(b) and (c) for purposes of the general nondiscrimination rules and the contribution limitations of section 415 (which generally apply on an employer-by-employer basis).

*Section 403(b) Requirements*

Section 403(b)(1)(C) requires that the contract be nonforfeitable except for the failure to pay future premiums. The proposed regulations define nonforfeitability based on the regulations under section 411(a) and clarify that if an annuity contract issued by an insurance company is purchased that would satisfy section 403(b) except for the failure to satisfy this nonforfeitability requirement, then the contract is treated as a contract to which section 403(c) applies. Section 403(c) provides that the value of a nonqualified contract is included in gross income under the rules of section 83, which generally does not occur before the employee's rights in the contract become substantially vested. Under the proposed regulations, on the date on which the employee's interest in that contract becomes nonforfeitable, the contract may be treated as a section 403(b) contract if the contract has at all prior times satisfied the requirements of section 403(b) other than the nonforfeitability requirement. Solely for this purpose, if a participant's interest in a contract is only partially nonforfeitable in a year, then the portion that is nonforfeitable and the

[1] Since 1964, the existing regulations have been revised for certain specific changes in law, for example, regulations under section 403(b) have been issued in question and answer form to reflect changes relating to eligible rollover distributions (T.D. 8619, 1995–2 C.B. 41, September 15, 1995) and minimum distributions under section 401(a)(9) (T.D. 8987, 2002–1 C.B. 852, April 16, 2002).

[2] It is expected that the following guidance is outdated, or will be superseded, when these regulations are issued in final form: Rev. Rul. 64–333. 1964–2 C.B. 114; Rev. Rul. 65–200, 1965–2 C.B. 141; Rev. Rul. 66–254, 1966–2 C.B. 125; Rev. Rul. 66–312, 1966–2 C.B. 127; Rev. Rul. 67–78, 1967–1 C.B. 94; Rev. Rul. 67–69, 1967–1 C.B. 93; Rev. Rul. 67–361, 1967–2 C.B. 153; Rev. Rul. 67–387, 1967–2 C.B. 153; Rev. Rul. 67–388, 1967–2 C.B. 153; Rev. Rul. 68–179, 1968–1 C.B. 179; Rev. Rul. 68–482, 1968–2 C.B. 186; Rev. Rul. 68–487, 1968–2 C.B. 187; Rev. Rul. 68–488, 1968–2 C.B. 188; Rev. Rul. 69–629, 1969–2 C.B. 101; Rev. Rul. 70–243, 1970–1 C.B. 107; Rev. Rul. 87–114, 1987–2 C.B. 116; Notice 89–23, 1989–1 C.B. 654; Rev. Rul. 90–24, 1990–1 C.B. 97; Notice 90–73, 1990–2 C.B. 353; Notice 92–36, 1992–2 C.B. 364; and Announcement 95–48, 1995–23 I.R.B. 13. It is expected that the following guidance will not be superseded when these regulations are issued in final form: Rev. Rul. 66–254, 1966–2 C.B. 125; Rev. Rul. 68–33, 1968–1 C.B. 175; Rev. Rul 68–58, 1968–1 C.B. 176; Rev. Rul. 68–116, 1968–1 C.B. 177; Rev. Rul. 68–648, 1968–2 C.B. 49; Rev. Rul. 68–488, 1968–2 C.B. 188; and Rev. Rul. 69–146, 1969–1 C.B. 132. Comments are requested on whether any guidance items under section 403(b) should be added to or deleted from either of the preceding lists. See the request for comments below under the heading *Comments and Public Hearing*.

[3] Rev. Rul. 73–607, 1973–2 C.B. 145 and Rev. Rul. 80–139, 1980–1 C.B. 88.

[4] As discussed below (under the heading *Controlled Group Rules For Tax-Exempt Entities*), other guidance that may be reissued includes the controlled group safe harbor rules in paragraph (V)(B)(2)(b) of Notice 89–23.

portion that fails to be nonforfeitable are bifurcated.

Section 403(b)(12) requires a section 403(b) contract to make elective deferrals available to all employees (the universal availability rule) and requires other contributions to satisfy the general nondiscrimination requirements applicable to qualified plans. These rules are discussed further below under the heading *Section 403(b) Nondiscrimination and Universal Availability Rules*.

Section 403(b)(1)(E) requires a section 403(b) contract to satisfy the requirements of section 401(a)(30) relating to limitations on elective deferrals under section 402(g)(1). The proposed regulations provide that a contract only satisfies this requirement if the contract requires all elective deferrals for an employee to satisfy section 402(g)(1), including elective deferrals for the employee under the contract and any other elective deferrals under the plan under which the contract is purchased and under all other plans, contracts, or arrangements of the employer that are subject to the limits of section 402(g). This rule is the same as the rule for section 401(k) arrangements.

A section 403(b) contract is also required to provide that it will satisfy the minimum required distribution requirements of section 401(a)(9), the incidental benefit requirements of section 401(a), and the rollover distribution rules of section 402(c).

The proposed regulations address the requirement that annual additions to the contract not exceed the applicable limitations of section 415(c) (treating contributions as annual additions). In accordance with the last sentence of section 415(a)(2), if an excess annual addition is made to a contract that otherwise satisfies the requirements of section 403(b), then the portion of the contract that includes the excess will fail to be a section 403(b) contract (and instead will be a contract to which section 403(c) applies) and the remaining portion of the contract that includes the contribution that is not in excess of the section 415 limitations is a section 403(b) contract. This rule under which only the excess annual addition is subject to section 403(c) does not apply unless, for the year of the excess and each year thereafter, the issuer of the contract maintains separate accounts for the portion that includes the excess and for the section 403(b) portion, *i.e.*, the portion that includes the amount not in excess of the section 415 limitations.

The proposed regulations require that these conditions for the exclusion be satisfied both in form and operation in the section 403(b) contract. Because several of these requirements are based on plan documents — in particular the requirements that elective deferrals satisfy a universal availability rule and that other contributions satisfy the nondiscrimination rules applicable to qualified plans — the proposed regulations require that the contract be maintained pursuant to a plan. For this purpose, it is intended that the plan would include all of the material provisions regarding eligibility, benefits, applicable limitations, the contracts available under the plan, and the time and form under which benefit distributions would be made. This rule does not require that there be a single plan document. For example, this requirement would be satisfied by complying with the plan document rules applicable to qualified plans.

*Interaction between Title I of ERISA and Section 403(b) of the Code*

The Treasury Department and the IRS have consulted with the Department of Labor concerning the interaction between Title I of the Employee Retirement Income Security Act of 1974 (ERISA) and section 403(b) of the Code. The Department of Labor has advised the Treasury Department and the IRS that Title I of ERISA generally applies to "any plan, fund, or program...established or maintained by an employer or by an employee organization, or by both, to the extent that...such plan, fund, or program...provides retirement income to employees, or...results in a deferral of income by employees for periods extending to the termination of covered employment or beyond." ERISA, section 3(2)(A). However, governmental plans and church plans are generally excluded from coverage under Title I of ERISA. See ERISA, section 4(b)(1) and (2). Therefore, section 403(b) contracts purchased or provided under a program that is either a "governmental plan" under section 3(32) of ERISA or a "church plan" under section 3(33) of ERISA are not generally covered under Title I. However, section 403(b) of the Code is also available with respect to contracts purchased or provided by employers for employees of a section 501(c)(3) organization, and many programs for the purchase of section 403(b) contracts offered by such employers are covered under Title I of ERISA as part of an "employee pension benefit plan" within the meaning of section 3(2)(A) of ERISA. The Department of Labor has promulgated a regulation, 29 CFR 2510.3–2(f), describing circumstances under which an employer's program for the purchase of section 403(b) contracts for its employees, which is not otherwise excluded from coverage under Title I, will not be considered to constitute the establishment or maintenance of an "employee pension benefit plan" under Title I of ERISA.

These proposed regulations are generally limited to the requirements imposed under section 403(b). In this regard, the proposed regulations require that a section 403(b) program be maintained pursuant to a plan, which for this purpose is defined as a written defined contribution plan which, in both form and operation, satisfies the regulatory requirements of section 403(b) and contains all the material terms and conditions for benefits under the plan. The Department of Labor has advised the Treasury Department and the IRS that, although it does not appear that the proposed regulations would mandate the establishment or maintenance of an employee pension benefit plan in order to satisfy its requirements, it leaves open the possibility that an employer may undertake responsibilities that would constitute establishing and maintaining an ERISA-covered plan. The Department of Labor has further advised the Treasury Department and the IRS that whether the manner in which any particular employer decides to satisfy particular responsibilities under these proposed regulations will cause the employer to be considered to have established or to maintain a plan that is covered under Title I of ERISA must be analyzed on a case-by-case basis, applying the criteria set forth in 29 CFR 2510.3–2(f), including the employer's involvement as contemplated by the plan documents and in operation.

To the extent that these proposed regulations may raise questions for employers concerning the scope and application of the regulation at 29 CFR 2510.3–2(f), the Treasury Department and the IRS are re-

questing comments. See below under the heading *Comments and Public Hearing*

All employee pension benefit plans covered under Title I of ERISA, including plans that involve the purchase of section 403(b) contracts, must satisfy a number of requirements, including requirements relating to reporting and disclosure, eligibility, vesting, benefit accrual, advance notice of contribution reductions, qualified joint and survivor annuities, minimum funding, fiduciary standards, fidelity bonds, and claims procedures. Authority to interpret many of the requirements in Parts 2 and 3 of Title I of ERISA (specifically those relating to eligibility, vesting, benefit accrual, minimum funding, and qualified joint and survivor annuities) has been transferred to the Treasury Department and the IRS. See Reorganization Plan No. 4 of 1978, 43 FR 47713, October 17, 1978. As a result, those section 403(b) contracts of a section 501(c)(3) organization that are part of an employee pension benefit plan are subject to requirements parallel to those imposed under sections 401(a)(11) through 401(a)(15), 410, 411, 412, and 417 of the Internal Revenue Code and the regulations promulgated thereunder, since regulations and other guidance issued under those Code sections are applicable for purposes of the parallel requirements in ERISA. Further, although specific references are made to Title I in these proposed regulations, this does not imply that other Title I issues are not applicable.

*Comparison with Section 401(k) Elective Deferrals*

Section 1450(a) of SBJPA provides that the rules applicable to cash or deferred elections under section 401(k) are to apply under section 403(b) for purposes of determining the frequency with which an employee may enter into a salary reduction agreement, the salary to which such an agreement may apply, and the ability to revoke such an agreement. Based in part on this provision, and taking into account the guidance that has been issued since SBJPA,[5] the proposed regulations would clarify the extent to which section 403(b) elective deferrals are like elective deferrals under proposed and final rules under section 401(k). Specifically, the rules are fundamentally similar with respect to the frequency with which a deferral election can be made, changed, or revoked, including automatic enrollment (plan provisions under which elective deferrals are automatically made for employees unless they elect otherwise), the ability for a deferral election that has been made in one year to be carried forward to subsequent periods until modified, the rule under which irrevocable elections are not treated as elective deferrals, and the requirement that employees have an annual effective opportunity to make, revoke, or modify a deferral election. The rules are also fundamentally similar with respect to the compensation with respect to which the election can be made, *e.g.*, allowing a deferral election to be made for compensation up to the day before the compensation is currently available. Likewise, the proposed regulations explicitly provide that, for purposes of sections 402(g) and 403(b), an elective deferral with respect to a section 403(b) contract is limited to contributions made pursuant to a cash or deferred election, as defined in regulations under section 401(k).

These proposed regulations also include a rule comparable to the anti-conditioning rule at section 401(k)(4). Finally, the proposed regulations include rules similar to those for section 401(k) plans regarding plan limitations to comply with section 401(a)(30) and to pay out section 403(b) elective deferrals in excess of the related section 402(g) limitation.

As a result, under the proposed regulations, the three major differences between the rules applicable to section 403(b) elective deferrals and the rules applicable to elective deferrals under section 401(k) are:

- Section 403(b) is limited to certain specific employers and employees (*i.e.*, employees of a State public school, employees of a section 501(c)(3) organization, and certain ministers), whereas section 401(k) is available to all employers, except a State or local government or any political subdivision, agency, or instrumentality thereof.
- Unlike section 401(k), contributions under section 403(b) can only be made to certain funding arrangements, *i.e.*, an insurance annuity contract, custodial account that is limited to mutual fund shares, or church retirement income account, and not to a trust or custodial account that fails to satisfy the custodial account rules at section 403(b)(7) or the retirement income account rules at section 403(b)(9) for churches.
- A universal availability rule applies to section 403(b) elective deferrals, whereas an average deferral percentage rule (the ADP test) and a minimum coverage rule (section 410(b)) apply with respect to elective deferrals under section 401(k).[6]

*Failure to Satisfy Section 403(b)*

The regulations clarify that if the requirements of section 403(b) fail to be satisfied with respect to an employer contribution, then the contribution is subject either to the rules under section 403(c) (relating to nonqualified annuities) if the contribution is for an annuity contract issued by an insurance company, or is subject to the rules under section 61, 83, or 402(b) if the contribution is to a custodial account or retirement income account that fails to satisfy the requirements of section 403(b).

Issues have been raised about the application of section 403(b) to tax-exempt entities that have State or local government features. These proposed regulations do not attempt to address when an entity is a State (treating a local government or other subdivision as a State) and when it is a section 501(c)(3) organization that is not a State.[7] Thus, for example, these regulations do not provide guidance on the con-

[5] See, for example, Rev. Rul. 2000–35, 2000–2 C.B. 138, relating to automatic enrollment in section 403(b) plans.

[6] Other differences between the rules applicable to elective deferrals under section 403(b) and elective deferrals under section 401(k) include the following: the consequences of failing to satisfy the rules of section 403(b) (described below under the heading *Failure to satisfy section 403(b)*); the definition of compensation (including the five-year rule) at section 403(b)(3); the special section 403(b) catch-up elective deferral at section 402(g)(7); the section 415 aggregation rules; and the general inapplicability of stock ownership for State entities (and some nonprofit entities), including the related inapplicability of employee stock ownership plans and the use of stock ownership to determine common control. An additional difference is discussed below, under the heading *Severance From Employment*.

[7] Similarly, the proposed regulations do not address the conditions under which a plan is a governmental plan under section 414(d).

ditions under which a tax-exempt charter school is, or is not, a State entity.

Based on the wording of section 401(k)(4)(B)(i) and (ii), an entity that is both a section 501(c)(3) organization and an instrumentality of a State cannot have a section 401(k) plan. Under sections 457(b)(6) and 457(g), an entity that is both an instrumentality of a State and a section 501(c)(3) organization can have an eligible plan under section 457(b) only if it is funded. However, under section 403(b)(1)(A)(i) and (ii), an entity that is both an instrumentality of a State and a section 501(c)(3) organization could cover any of its employees, regardless of whether they are performing services for a public school.

*Maximum Contribution Limitations*

The exclusion provided under section 403(b) applies only to the extent that all amounts contributed by the employer for the purchase of an annuity contract for the participant do not exceed the applicable limit under section 415 and, with respect to section 403(b) elective deferrals, only if the contract is purchased under a plan that includes the limits under section 402(g), including aggregation under all plans of the employer. The proposed regulations require a section 403(b) contract to include this limit on section 403(b) elective deferrals, as imposed by section 402(g).

*Catch-up Contributions*

A section 403(b) contract may provide for additional catch-up contributions for a participant who is age 50 by the end of the year, provided that those age 50 catch-up contributions do not exceed the catch-up limit under section 414(v) for the taxable year (which is $3,000 for 2004). In addition, an employee of a qualified organization who has at least 15 years of service (disregarding any period during which an individual is not an employee of the eligible employer) is entitled to a special section 403(b) catch-up limit. Under the special section 403(b) catch-up limit, the section 402(g) limit is increased by the lowest of the following three amounts: (i) $3,000; (ii) the excess of $15,000 over the total special section 403(b) catch-up elective deferrals made for the qualified employee by the qualified organization for prior taxable years; or (iii) the excess of (A) $5,000 multiplied by the number of years of service of the employee with the qualified organization, over (B) the total elective deferrals made for the qualified employee by the qualified organization for prior taxable years. For this purpose, a qualified organization is an eligible employer that is a school, hospital, health and welfare service agency (including a home health service agency), or a church-related organization. In the case of a church-related organization, all entities that are in such a church-related organization are treated as a single qualified organization, so that years of service and any section 403(b) catch-up elective deferrals previously made for a qualified employee for any such church are taken into account for purposes of determining the amount of section 403(b) catch-up elective deferrals to which an employee is entitled under any section 403(b) plan maintained by another entity in the same church-related organization. A health and welfare service agency is defined as either an organization whose primary activity is to provide medical care as defined in section 213(d)(1) (such as a hospice), or a section 501(c)(3) organization whose primary activity is the prevention of cruelty to individuals or animals, or which provides substantial personal services to the needy as part of its primary activity (such as a section 501(c)(3) organization that provides meals to needy individuals).

The proposed regulations provide that any catch-up contribution for an employee who is eligible for both an age 50 catch-up and the special section 403(b) catch-up is treated first as a special section 403(b) catch-up to the extent a special section 403(b) catch-up is permitted, and then as an amount contributed as an age 50 catch-up (to the extent the age 50 catch-up amount exceeds the maximum special section 403(b) catch-up).

Any contribution made for a participant to a section 403(b) contract for a taxable year that exceeds either the section 415 maximum annual contribution limit or the section 402(g) elective deferral limit constitutes an excess contribution that is included in gross income for that taxable year (or, if later, the taxable year in which the contract becomes nonforfeitable). The proposed regulations provide that a section 403(b) contract or the section 403(b) plan may provide that any excess deferral as a result of a failure to comply with the section 402(g) elective deferral limit for the taxable year with respect to any section 403(b) elective deferral made for a participant by the employer will be distributed to the participant, with allocable net income, no later than April 15 or otherwise in accordance with section 402(g).

*Determination of Years of Service under Section 403(b)*

For purposes of determining a participant's includible compensation and years of service — used both for the special section 403(b) catch-up contributions and for employer contributions for former employees — an employee's number of years of service include each full year during which the individual is a full-time employee of the eligible employer plus a fraction of a year for each part of a year during which the individual is a full-time or part-time employee of the eligible employer. A year of service is based on the employer's annual work period, not the employee's taxable year. Thus, in determining whether a university professor is employed full-time, the annual work period is the school's academic year. In determining whether an individual is employed full-time, the amount of work actually performed is compared with the amount of work that is normally required of individuals performing similar services from which substantially all of their annual compensation is derived. An individual is treated as performing a fraction of a year of service for each annual work period during which he or she is a full-time employee for part of the annual work period or for each annual work period during which he or she is a part-time employee either for the entire annual work period or for a part of the annual work period.

In measuring the amount of work of an individual performing particular services, the work performed is determined based on the individual's hours of service (as defined under section 410(a)(3)(C)), except that a plan may use a different measure of work if appropriate under the facts and circumstances. For example, a plan may provide for a university professor's work to be measured by the number of courses taught during an annual work period if that individual's work assignment is generally

based on a specified number of courses to be taught.

In determining years of service, any period during which an individual is not an employee of the eligible employer is disregarded, except that, for a section 403(b) contract of an eligible employer that is a church-related organization, any period during which an individual is an employee of that eligible employer and any other eligible employer that is within the same church-related organization with that eligible employer is taken into account on an aggregated basis. In the case of a part-time employee or a full-time employee who is employed for only part of the year, the employee's most recent periods of service are aggregated to determine his or her most recent one-year period of service, as follows: the employee's service during the annual work period for which the last year of service's includible compensation is being determined is taken into account first; then the employee's service during the next preceding annual work period based on whole months is taken into account; and so forth, until the employee's service equals, in the aggregate, one year of service.

*Special Rule for Former Employees*

Under section 403(b)(3), a former employee is deemed to have monthly includible compensation for the period through the end of the taxable year of the employee in which he or she ceases to be an employee and through the end of each of the next five taxable years of the employee. The amount of the monthly includible compensation is equal to 1/12 of the former employee's includible compensation during the former employee's most recent year of service. Accordingly, a plan may provide that nonelective employer contributions are continued for up to five years for a former employee, up to the lesser of the dollar amount in section 415(c)(1)(A) or the former employee's annual includible compensation based on the former employee's compensation during his or her most recent year of service.

*Other Contributions for Former Employees*

The proposed regulations do not address the extent, if any, to which the exclusion from gross income provided by section 403(b) applies to contributions made for former employees (*e.g.*, whether a contribution may be made for a former employee if the contribution is with respect to compensation that would otherwise be paid for a payroll period that begins after severance from employment) other than as provided under the five-year rule at section 403(b)(3), described above under the heading *Special Rule for Former Employees*. The Treasury Department and the IRS expect to issue separate guidance on this issue, potentially addressing this question with respect to not only section 403(b), but also sections 401(k), 457(b) (for eligible governmental plans), and 415(c).

*Section 403(b) Nondiscrimination and Universal Availability Rules*

*Nondiscrimination*

Section 403(b)(12)(A)(i) requires that employer contributions and employee after-tax contributions made under a section 403(b) contract satisfy a specified series of requirements (the nondiscrimination requirements) in the same manner as a qualified plan under section 401(a). These proposed regulations do not adopt the good faith reasonable standard of Notice 89–23 for purposes of satisfying the nondiscrimination requirements of section 403(b)(12)(A)(i). These nondiscrimination requirements include rules relating to nondiscrimination in contributions, benefits, and coverage (sections 401(a)(4) and 410(b)), a limitation on the amount of compensation that can be taken into account (section 401(a)(17)), and the average contribution percentage rules of section 401(m) (relating to matching and after-tax contributions). The nondiscrimination requirements are generally tested using compensation as defined in section 414(s) and are applied on an aggregated basis taking into account all plans of the employer. See the discussion below under the heading *Controlled Group Rules For Tax-Exempt Entities*.

The nondiscrimination requirements do not apply to section 403(b) elective deferrals. In addition, the only nondiscrimination requirement that applies to a governmental plan, within the meaning of section 414(d), is the limitation on compensation (section 401(a)(17)).

*Universal Availability*

Under section 403(b)(12)(A)(ii), a universal availability requirement applies under which all employees of the eligible employer must be permitted to elect to have section 403(b) elective deferrals contributed on their behalf if any employee of the eligible employer may elect to have the organization make section 403(b) elective deferrals. Under the proposed regulations, the universal availability requirement is not satisfied unless the contributions are made pursuant to a plan and the plan permits elective deferrals that satisfy the universal availability requirement. The proposed regulations generally provide that the universal availability requirement applies separately to each common law entity, *i.e.*, to each section 501(c)(3) organization, or, in the case of a section 403(b) plan that covers the employees of more than one State entity, to each entity that is not part of a common payroll. The proposed regulations allow an employer that historically has treated one or more of its various geographically distinct units as separate for employee benefit purposes to treat each unit as a separate organization if the unit is operated independently on a day-to-day basis.

The proposed regulations include the statutory categories that are exceptions to the universal availability rule, and provide that, if any employee listed in any excludable category has the right to have section 403(b) elective deferrals made on his or her behalf, then no employees in that category may be excluded. The categories generally are: employees who are eligible to participate in an eligible governmental plan under section 457(b) which permits contributions or deferrals at the election of the employee or a plan of the employer offering a qualified cash or deferred election under section 401(k); employees who are non-resident aliens; employees who are students performing services described in section 3121(b)(10); and employees who normally work fewer than 20 hours per week. Additionally, Notice 89–23 included transition rules for certain other exclusions that are not in the statute: employees who make a one-time election to participate in a governmental plan instead of a section 403(b) plan; employees covered by a collective bargaining agreement; visiting professors for up to one year

under certain circumstances; and employees affiliated with a religious order who have taken a vow of poverty. The proposed regulations do not adopt these transition rules. See the reference to these exclusions below under the heading *Comments and Public Hearing*.

The nondiscrimination and the universal availability requirements do not apply to a section 403(b) contract purchased by a church, which is specially defined for this purpose, and generally does not include a university, hospital, or nursing home.

The nondiscrimination and universal availability requirements are in addition to other applicable legal requirements. Specifically, these requirements do not reflect the requirements of Title I of ERISA that may apply with respect to a section 403(b) plan, such as the ERISA vesting requirements. Another example is that, while employees who normally work fewer than 20 hours per week may be excluded under the universal availability rule, employers who maintain plans that are subject to Title I of ERISA should be aware that Title I of ERISA includes limitations on the conditions under which employees can be excluded from a plan on account of not working full time and that these limitations would generally not permit an exclusion for employees who normally work fewer than 20 hours per week. See section 202(a)(1) of ERISA and regulations under section 410(a) of the Code (which interpret section 202 of ERISA).

*Timing of Distributions and Benefits*

The proposed regulations reflect the statutory rules regarding when distributions can be made from a section 403(b) contract. Thus, amounts held in a custodial contract attributable to employer contributions (that are not section 403(b) elective deferrals) may not be paid to a participant before the participant has a severance from employment, becomes disabled (within the meaning of section 72(m)(7)), or attains age 59½. This rule also applies to amounts transferred out of a custodial account (*i.e.*, to an annuity contract or retirement income account), including earnings thereon. In addition, distributions of amounts attributable to section 403(b) elective deferrals may not be paid to a participant earlier than when the participant has a severance from employment, has a hardship, becomes disabled (within the meaning of section 72(m)(7)), or attains age 59½. Hardship is generally defined under regulations issued under section 401(k).

The proposed regulations would reflect the requirements of section 402(f) relating to the written explanation requirements for distributions that qualify as eligible rollover distributions, including conforming the timing rule to the rule for qualified plans.

Where the distribution restrictions do not apply, a section 403(b) contract is permitted to distribute retirement benefits to the participant after severance from employment or upon the prior occurrence of an event, such as after a fixed number of years, the attainment of a stated age, or disability. The proposed regulations include a number of exceptions to the timing restrictions, *e.g.*, the rule for elective deferrals does not apply to distributions of section 403(b) elective deferrals (not including earnings thereon) that were contributed before January 1, 1989.

*Severance From Employment*

The proposed regulations define severance from employment in a manner that is generally the same as the proposed regulations under section 401(k),[8] but provide that a severance from employment occurs on any date on which the employee ceases to be employed by an eligible employer that maintains the section 403(b) plan. Thus, a severance from employment would occur when an employee ceases to be employed by an eligible employer even though the employee may continue to be employed by an entity that is part of the same controlled group but that is not an eligible employer, or on any date on which the employee works in a capacity that is not employment with an eligible employer. Examples of the situations that constitute a severance from employment include: an employee transferring from a section 501(c)(3) organization to a for-profit subsidiary of the section 501(c)(3) organization; an employee ceasing to work for a public school, but continuing to be employed by the same State; and an individual employed as a minister for an entity that is neither a State nor a section 501(c)(3) organization ceasing to perform services as a minister, but continuing to be employed by the same entity.

*Section 401(a)(9)*

The proposed regulations include rules similar to those in the existing regulations relating to the minimum distribution requirements of section 401(a)(9), but with some minor changes (for example, omitting the special rules for 5-percent owners). Thus, section 403(b) contracts must satisfy the incidental benefit rules. Existing revenue rulings provide guidance with respect to the application of the incidental benefit requirements to permissible nonretirement benefits such as life, accident, or health benefits.[9]

*Loans*

The proposed regulations include rules reflecting that loans can be made to participants from a section 403(b) contract.

*QDROs*

The proposed regulations include limited rules relating to qualified domestic relations orders (QDROs) under section 414(p). Section 414(p)(9) provides that the QDRO rules only apply to plans that are subject to the anti-alienation provisions of section 401(a)(13), except that section 414(p)(9) also provides that, except to the extent set forth in regulations — there are currently no regulations under section 414(p) — the section 414(p) QDRO rules apply to a section 403(b) contract. These proposed section 403(b) regulations clarify that the section 414(p) QDRO rules apply to section 403(b) contracts for purposes of applying section 403(b).

*Taxation of Distributions and Benefits From a Section 403(b) Contract*

The proposed regulations include a number of rules regarding the taxation of distributions and benefits from sec-

[8] See proposed §1.401(k)–1(d)(2), REG–108639–99, 2003–2 C.B. 431 [68 FR 42476] (July 17, 2003).

[9] See, for example, Rev. Rul. 61–121, 1961–2 C.B. 65; Rev. Rul. 68–304, 1968–1 C.B. 179; Rev. Rul. 72–240, 1972–1 C.B. 108; Rev. Rul. 72–241, 1972–1 C.B. 108; Rev. Rul. 73–239, 1973–1 C.B. 201; and Rev. Rul. 74–115, 1974–1 C.B. 100. (see §601.601(d)(2)(ii)(*b*) of this chapter).

tion 403(b) contracts, including the statutory provision that only amounts actually distributed from a section 403(b) contract are generally includible in the gross income of the recipient for the year in which distributed under section 72, relating to annuities. The regulations also reflect the rule that any payment that constitutes an eligible rollover distribution is not taxed in the year distributed to the extent the payment is directly rolled over or transferred to an eligible retirement plan. The payor must withhold 20 percent Federal income tax, however, if an eligible rollover distribution is not rolled over in a direct rollover. Another provision requires the payor to give proper written notice to the section 403(b) participant or beneficiary concerning the eligible rollover distribution provision. Notice 2002–3, 2002–1 C.B. 289, provides a sample of the safe-harbor notice that the payor may furnish to satisfy this requirement.

*Funding of Section 403(b) Arrangements*

*Annuity Contracts*

As described above, section 403(b) only applies to contributions made to certain funding arrangements, namely: amounts held in an annuity contract, in a custodial account that is treated as an annuity contract under section 403(b)(7), or in a church retirement income account that is treated as an annuity contract under section 403(b)(9). The proposed regulations require that contributions to a section 403(b) plan be transferred to the insurance company issuing the annuity contract (or the entity holding assets of any custodial or retirement income account that is treated as an annuity contract) within a period that is not longer than is reasonable for the proper administration of the plan, such as transferring elective deferrals within 15 business days following the month in which these amounts would otherwise have been paid to the participant.

The proposed regulations provide that, except where a custodial or retirement income account is treated as an annuity contract, an annuity contract means a contract that is issued by an insurance company qualified to issue annuities in a State and that includes payment in the form of an annuity, but does not include a contract that is a life insurance contract, as defined in section 7702, an endowment contract, a heath or accident insurance contract, or a property, casualty, or liability insurance contract. The regulations include a special transition rule relating to life insurance contracts issued before the effective date.

Rev. Rul. 67–361, 1967–2 C.B. 153, and Rev. Rul. 67–387, 1967–2 C.B. 153, provided for certain State plans to be treated as qualifying as annuities under section 403(b). Rev. Rul. 82–102, 1982–1 C.B. 62, revoked this interpretation (in connection with the 1974 enactment of section 403(b)(7) which allowed custodial accounts), but provides section 7805(b) relief for arrangements established in reliance on these rulings, *i.e.*, for arrangements established on or before May 17, 1982. The proposed regulations contemplate that the section 7805(b) relief provided by these rulings would be continued. This relief would be limited to State section 403(b) plans established on or before May 17, 1982 satisfying either of the following requirements: (i) benefits under the contract are provided from a separately funded retirement reserve that is subject to supervision of the State insurance department or (ii) benefits under the contract are provided from a fund that is separate from the fund used to provide statutory benefits payable under a State retirement system and that is part of a State teachers retirement system to purchase benefits that are unrelated to the basic benefits provided under the retirement system, and the death benefit provided under the contract cannot at any time exceed the larger of the reserve or the contribution made for the employee.

*Custodial Accounts*

The proposed regulations define a custodial account as a plan, or a separate account under a plan, in which an amount attributable to section 403(b) contributions (or amounts rolled over to a section 403(b) contract) is held by a bank or a person who satisfies the conditions in section 401(f)(2), if amounts held in the account are invested in stock of a regulated investment company (as defined in section 851(a) relating to mutual funds), the special restrictions on distributions with respect to a custodial account are satisfied, the assets held in the account cannot be used for, or diverted to, purposes other than for the exclusive benefit of plan participants or their beneficiaries, and the account is not part of a retirement income account, as described below. This requirement limiting investments to mutual funds is not satisfied if the account includes any assets other than stock of a regulated investment company.

*Special Rules for Church Plans*

*Retirement Income Accounts*

The proposed regulations include a number of special rules for church plans. Under section 403(b)(9), a retirement income account for employees of a church-related organization is treated as an annuity contract for purposes of section 403(b) and these regulations. Under the proposed regulations, the rules for a retirement income account are based largely on the legislative history to TEFRA. The proposed regulations define a retirement income account as a defined contribution program established or maintained by a church-related organization under which (i) there is separate accounting for the retirement income account's interest in the underlying assets (*i.e.*, it must be possible at all times to determine the retirement income account's interest in the underlying assets and distinguish that interest from any interest that is not part of the retirement income account), (ii) investment performance is based on gains and losses on those assets, and (iii) the assets held in the account cannot be used for, or diverted to, purposes other than for the exclusive benefit of plan participants or their beneficiaries. For this purpose, assets are treated as diverted to the employer if the employer borrows assets from the account. A retirement income account must be maintained pursuant to a program which is a plan and the plan document must state (or otherwise evidence in a similarly clear manner) the intent to constitute a retirement income account.

If any asset of a retirement income account is owned or used by a participant or beneficiary, then that ownership or use is treated as a distribution to that participant or beneficiary. The proposed regulations provide that a retirement income account that is treated as an annuity contract is not a custodial account (even if it is invested in stock of a regulated investment company).

A life annuity can generally only be provided from an individual account by the purchase of an insurance annuity contract. However, in light of the special rules applicable to church retirement income accounts, the proposed regulations permit a life annuity to be paid from such an account if certain conditions are satisfied. The conditions are that the amount of the distribution form have an actuarial present value, at the annuity starting date, that is equal to the participant's or beneficiary's accumulated benefit, based on reasonable actuarial assumptions, including assumptions regarding interest and mortality, and that the plan sponsor guarantee benefits in the event that a payment is due that exceeds the participant's or beneficiary's accumulated benefit.

*Commingling Assets*

Under these proposed regulations, both custodial accounts and retirement income accounts would be subject to an exclusive benefit requirement similar to the exclusive benefit requirement applicable to qualified plans. Section 403(b)(7)(B) provides for a custodial account to be treated as a tax exempt organization.

When these regulations are issued as final regulations, to the extent permitted by the Commissioner in future guidance, assets held under a custodial account or a retirement income account may be pooled with trust assets held under qualified plans.

*Controlled Group Rules For Tax-Exempt Entities*

The proposed regulations include controlled group rules under section 414(c) for entities that are tax-exempt under section 501(a). Under these rules, the employer for a plan maintained by a section 501(c)(3) organization (or any other tax-exempt organization under section 501(a)) includes not only the organization whose employees participate in the plan, but also any other exempt organization that is under common control with such organization, based on 80 percent of the directors or trustees being either representatives of or directly or indirectly controlled by an exempt organization. The proposed regulations include an anti-abuse rule and would also allow tax exempt organizations to choose to be aggregated if they maintain a single plan covering one or more employees from each organization and the organizations regularly coordinate their day to day exempt activities. For a section 501(c)(3) organization that makes contributions to a section 403(b) contract, these rules would be generally relevant for purposes of the nondiscrimination requirements, as well as the section 415 contribution limitations, the special section 403(b) catch-up contributions, and the section 401(a)(9) minimum distribution rules.

These controlled group rules for tax-exempt entities generally do not apply to certain church entities. Comments are requested below under the heading *Comment and Public Hearing* on whether these rules should be extended to such church entities.

The proposed regulations do not include controlled group rules for public schools. As noted above (under the heading *Overview*), it is anticipated that, when these regulations are issued as final regulations, guidance may be issued providing controlled group safe harbors for public schools taking into account the existing safe harbors in Notice 89–23.

*Miscellaneous Provisions*

The proposed regulations include a number of rules that address the circumstances under which a section 403(b) plan may be terminated or assets may be exchanged or transferred.

*Plan Termination*

The proposed regulations, if adopted as final regulations, would not only permit an employer to amend its section 403(b) plan to eliminate future contributions for existing participants, but would allow plan provisions that permit plan termination with a resulting distribution of accumulated benefits. In general, the distribution of accumulated benefits would be permitted only if the employer (taking into account all entities that are treated as the employer under section 414 on the date of the termination) does not make contributions to another section 403(b) contract that is not part of the plan (based generally on contributions made to a section 403(b) contract during the 12 months before and after the date of plan termination). In order for a section 403(b) plan to be considered terminated, all accumulated benefits under the plan must be distributed to all participants and beneficiaries as soon as administratively practicable after termination of the plan. A distribution includes delivery of a fully paid individual insurance annuity contract. Eligible rollover distributions would not be subject to current income inclusion if rolled over to an eligible retirement plan.

The proposed regulations prohibit an employer that ceases to be an eligible employer from making any further contributions to the section 403(b) contract for subsequent periods. In this event, the contract can be held under a frozen plan or the plan could be terminated in accordance with the rules regarding plan termination.

*Exchanges and Transfers*

Under certain conditions, the proposed regulations permit the following exchanges or transfers:

- A section 403(b) contract is permitted to be exchanged for another section 403(b) contract held under the same section 403(b) plan if the following conditions are satisfied: (1) the plan provides for the exchange, (2) the participant or beneficiary has an accumulated benefit immediately after the exchange at least equal to the accumulated benefit of that participant or beneficiary immediately before the exchange (taking into account the accumulated benefit of that participant or beneficiary under both section 403(b) contracts immediately before the exchange), and (3) the contract received in the exchange provides that, to the extent a contract that is exchanged is subject to any section 403(b) distribution restrictions, the contract received in the exchange imposes restrictions on distributions to the participant or beneficiary that are not less stringent than those imposed on the contract being exchanged.

- A section 403(b) contract is permitted to be transferred to another section 403(b) plan (*i.e.*, the section 403(b) contracts held thereunder, including any assets held in a custodial account or retirement income account that are treated as section 403(b) contracts)

if the following conditions are satisfied: (1) the participant or beneficiary whose assets are being transferred is an employee of the employer providing the receiving plan, (2) the transferor plan provides for transfers, (3) the receiving plan provides for the receipt of transfers, (4) the participant or beneficiary whose assets are being transferred has an accumulated benefit immediately after the transfer at least equal to the accumulated benefit with respect to that participant or beneficiary immediately before the transfer, and (5) the receiving plan provides that, to the extent any amount transferred is subject to any section 403(b) distribution restrictions, the receiving plan imposes restrictions on distributions to the participant or beneficiary whose assets are being transferred that are not less stringent than those imposed on the transferor plan. In addition, if a plan-to-plan transfer does not constitute a complete transfer of the participant's or beneficiary's interest in the section 403(b) plan, then the transferee plan must treat the amount transferred as a continuation of a *pro rata* portion of the participant's or beneficiary's interest in the transferor section 403(b) plan (*e.g.*, a *pro rata* portion of the participant's or beneficiary's interest in any after-tax employee contributions).

- A section 403(b) plan may provide for the transfer of its assets to a qualified plan under section 401(a) to purchase permissive service credit under a defined benefit governmental plan or to make a repayment to a defined benefit governmental plan.

However, neither a qualified plan nor an eligible plan under section 457 may transfer assets to a section 403(b) plan, and a section 403(b) plan may not accept such a transfer. In addition, a section 403(b) contract may not be exchanged for an annuity contract that is not a section 403(b) contract. Neither a plan-to-plan transfer nor a contract exchange permitted under the proposed regulations is treated as a distribution for purposes of the section 403(b) distribution restrictions (so that such a transfer or exchange may be made before severance from employment or another distribution event).

Additional plan-to-plan transfer rules may apply in the event that a plan-to-plan transfer is made to or from a section 403(b) arrangement that is subject to Title I of ERISA. See section 208 of ERISA and regulations under section 414(l) of the Internal Revenue Code (which are the regulations interpreting section 208 of ERISA).

*Defined Benefit Plans*

These proposed regulations generally require a section 403(b) plan to be a defined contribution plan. This requirement would not apply to certain church plans. Specifically, section 251(e)(5) of TEFRA permits a church arrangement in effect on September 3, 1982 (the date TEFRA was enacted) to not be treated as failing to satisfy the exclusion allowance limitations of section 403(b)(2) merely because it is a defined benefit plan and these regulations would allow such a plan to be continued. Any other defined benefit plan in existence on the effective date of these regulations that has taken the position, based on a reasonable interpretation of the statute, that it satisfies section 403(b) would not be subject to the requirement in these regulations that the plan be a defined contribution plan for pre-effective date accruals, and such a plan might seek to take the position that it satisfies the section 401 qualified plan rules for subsequent accruals (assuming it satisfies those rules with respect to those accruals).

*Section 3121(a)(5)(D)*

These proposed regulations also include proposed amendments to regulations under section 3121(a)(5)(D), defining salary reduction agreement for purposes of the Federal Insurance Contributions Act (FICA). The text of the proposed amendments is the same as that of temporary regulations being issued under section 3121(a)(5)(D) in this same issue of the Bulletin. The proposed regulations under section 3121(a)(5)(D) would be applicable on November 16, 2004.

**Proposed Effective date**

These regulations (other than the proposed amendments to regulations under section 3121(a)(5)(D)) are proposed to be generally applicable for taxable years beginning after December 31, 2005. However, there are certain transition rules. Under one transition rule, for a section 403(b) contract maintained pursuant to a collective bargaining agreement that is ratified and in effect when the final regulations are issued, the regulations would not apply until the collective bargaining agreement terminates (determined without regard to any extension thereof after the date of publication of final regulations). Under another transition rule, for a section 403(b) contract maintained by a church-related organization for which the authority to amend the contract is held by a church convention (within the meaning of section 414(e)), the regulations would not apply before the earlier of (i) January 1, 2007, or (ii) 60 days following the earliest church convention that occurs after the date of publication of final regulations. These proposed regulations cannot be relied upon until adopted in final form.

**Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations.

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 upon the determination that respondents will need to spend minimal time (an average of 1/2 hour per year) giving the statutorily required notice to departing employees. Therefore, a Regulatory Flexibility Analysis is not required under the Regulatory Flexibility Act (5 U.S.C. chapter 6).

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 their 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) or electronic comments that are submitted timely to the IRS. Comments are requested on all aspects of the proposed regulations. In addition, comments are specifically requested on the clarity of the proposed regulations and how they can be revised to be more easily understood. All comments will be available for public inspection and copying.

Comments are also requested on the following:

- As indicated above, the IRS expects to obsolete a number of revenue rulings, notices, and other guidance when these regulations are issued in final form, including guidance that is now outdated as a result of changes in the law, and guidance that will become outdated by final regulations. Other previously issued guidance is expected to continue in effect. Comments are requested as to whether any previously issued guidance should be added or deleted from either list, with respect to the scope of this obsolescence, and also with respect to whether there are any aspects that should be preserved in the guidance that is expected to be obsolete.

- The Treasury Department and the IRS are requesting comments describing the issues and suggesting methods of clarifying the interaction between the employer activities required under these proposed regulations for an arrangement to satisfy section 403(b) and the employer conduct that will give rise to the establishment and maintenance of an employee pension benefit plan covered under Title I of ERISA. The Treasury Department and the IRS will forward a copy of the comments on this issue to the Department of Labor.

- These proposed regulations authorize the Commissioner to issue rules to determine the amount of contributions for a participant in a defined benefit plan under section 402(b) (relating to the tax treatment of contributions to nonqualified plans). Comments are requested on the methodology and assumptions that should be used for this purpose, including specifically whether the methodology and assumptions should be the same as those currently in the regulations under section 403(b), whether revisions should be made to reflect the possibility that a nonqualified plan might include an early retirement subsidy, and whether the assumptions currently applicable under the section 403(b) regulations should be updated (for example, to match the assumptions in Rev. Proc. 2004–37, 2004–26 I.R.B. 1099, relating to determining the extent to which certain pension payments made to a nonresident alien are not U.S. source income).

- With respect to includible compensation, comments are requested on whether the Treasury Department and IRS have the authority to permit 403(b) plans to use compensation, as defined in section 415(c)(3) without regard to section 415(c)(3)(E), in lieu of the definition of includible compensation under section 403(b)(3) and, if so, whether this should be done.

- With respect to the universal availability rule, comments are requested on whether the requirement should apply separately to employees covered by a collective bargaining unit. Comments are also requested on whether plans that exclude any of the following additional types of employees (as has been permitted under Notice 89–23) should be permitted to continue to exclude these types of employees for at least some period of time: employees who make a one-time election to participate in a governmental plan described in section 414(d) instead of a section 403(b) plan; professors who are providing services on a temporary basis to another public school for up to one year and for whom section 403(b) contributions are being made at a rate no greater than the rate each such professor would receive under the section 403(b) plan of the original public school; employees who are affiliated with a religious order and who have taken a vow of poverty where the religious order provides for the support of such employees in their retirement; and employees who are covered by a collective bargaining agreement.

- The controlled group rules in these proposed regulations for tax-exempt entities generally do not apply to certain church entities. Comments are requested on whether these rules should be extended to such church entities.

A public hearing has been scheduled for February 15, 2005, at 10 a.m. in the IRS Auditorium (7th Floor), Internal Revenue Service Building, 1111 Constitution Avenue, NW, Washington DC. All visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area at the Constitution Avenue entrance more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit electronic or written comments and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by January 25, 2005. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

**Drafting Information**

The principal authors of these regulations are R. Lisa Mojiri-Azad and John Tolleris, Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities), IRS. However, other personnel from the IRS and the Treasury Department participated in their development.

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**Proposed Amendments to the Regulations**

Accordingly, 26 CFR parts 1 and 31 are proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entry for §1.403(b)–3 and adding entries in numerical order to read, in part, as follows:

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

§1.403(b)–6 also issued under 26 U.S.C. 403(b)(10). * * *

§1.414(c)–5 also issued under 26 U.S.C. 414(b), (c), and (o). * * *

Par. 2. Section 1.402(b)–1 is amended by revising paragraphs (a)(2) and (b)(2)(ii) to read as follows:

*§1.402(b)–1 Treatment of beneficiary of a trust not exempt under section 501(a).*

(a) * * *

(2) *Determination of amount of employer contributions*. If, for an employee, the actual amount of employer contributions referred to in paragraph (a)(1) of this section for any taxable year of the employee is not determinable or for any other reason is not known, such amount shall be the amount applicable under rules prescribed by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter).

(b) * * *

(2) * * *

(ii) If a separate account in a trust for the benefit of two or more employees is not maintained for each employee, the value of the employee's interest in such trust is determined in accordance with rules prescribed by the Commissioner under the authority in paragraph (a)(2) of this section.

* * * * *

Par. 3. Section 1.402(g)(3)–1 is added to read as follows:

*§1.402(g)(3)–1 Employer contributions to purchase a section 403(b) contract under a salary reduction agreement.*

(a) *General rule*. With respect to an annuity contract under section 403(b), except as provided in paragraph (b) of this section, an elective deferral means an employer contribution to purchase an annuity contract under section 403(b) under a salary reduction agreement within the meaning of §31.3121(a)(5)–2(a) of this chapter.

(b) *Special rule*. Notwithstanding paragraph (a) of this section, for purposes of section 402(g)(3)(C), an elective deferral only includes a contribution that is made pursuant to a cash or deferred election (as defined at §1.401(k)–1(a)(3)). Thus, for purposes of section 402(g)(3)(C), an elective deferral does not include a contribution that is made pursuant to an employee's one-time irrevocable election made on or before the employee's first becoming eligible to participate under the employer's plan or a contribution made as a condition of employment that reduces the employee's compensation.

(c) *Effective date*. This section is applicable for taxable years beginning after December 31, 2005.

Par. 4. Section 1.403(b)–0 is added to read as follows:

*§1.403(b)–0 Taxability under an annuity purchased by a section 501(c)(3) organization or a public school.*

§1.403(b)–1 General overview of taxability under an annuity contract purchased by a section 501(c)(3) organization or a public school.
§1.403(b)–2 Definitions.
§1.403(b)–3 Exclusion for contributions to purchase section 403(b) contracts.
§1.403(b)–4 Contribution limitations.
§1.403(b)–5 Nondiscrimination rules.
§1.403(b)–6 Timing of distributions and benefits.
§1. 403(b)–7 Taxation of distributions and benefits.
§1.403(b)–8 Funding.
§1.403(b)–9 Special rules for church plans.
§1.403(b)–10 Miscellaneous provisions.
§1.403(b)–11 Effective date.

Par. 5. Sections 1.403(b)–1, 1.403(b)–2 and 1.403(b)–3 are revised to read as follows:

*§1.403(b)–1 General overview of taxability under an annuity contract purchased by a section 501(c)(3) organization or a public school.*

Section 403(b) and §§1.403(b)–2 through 1.403(b)–10 provide rules for the Federal income tax treatment of an annuity purchased for an employee by an employer that is either a tax-exempt entity under section 501(c)(3) (relating to certain religious, charitable, scientific, or other types of organizations) or a public school, or for a minister described in section 414(e)(5)(A). See section 403(a) (relating to qualified annuities) for rules regarding the taxation of an annuity purchased under a qualified annuity plan that meets the requirements of section 404(a)(2), and see section 403(c) (relating to nonqualified annuities) for rules regarding the taxation of other types of annuities.

*§1.403(b)–2 Definitions.*

(a) This section sets forth the definitions that are applicable for purposes of §§1.403(b)–1 through 1.403(b)–11.

(1) *Accumulated benefit* means the total benefit to which a participant or beneficiary is entitled under a section 403(b) contract, including all contributions made to the contract and all earnings thereon.

(2) *Annuity contract* means a contract that is issued by an insurance company qualified to issue annuities in a State and that includes payment in the form of an annuity. See §1.401(f)–1(d)(2) and (e) for the definition of an annuity, and see §1.403(b)–8(c)(3) for a special rule for certain State plans. See also §§1.403(b)–8(d) and 1.403(b)–9(a) for additional rules regarding the treatment of custodial accounts and retirement income accounts as annuity contracts.

(3) *Beneficiary* means a person who is entitled to benefits in respect of a participant following the participant's death or an alternate payee pursuant to a qualified domestic relations order, as described in §1.403(b)–10(c).

(4) *Catch-up* amount or *catch-up* limitation for a participant for a taxable year means a section 403(b) elective deferral permitted under section 414(v) (as described in §1.403(b)–4(c)(2)), or section 402(g)(7) (as described in §1.403(b)–4(c)(3)).

(5) *Church* means a church as defined in section 3121(w)(3)(A) and a qualified church-controlled organization as defined in section 3121(w)(3)(B).

(6) *Church-related organization* means a church or convention or association of churches as described in section 414(e)(3)(A).

(7) *Elective deferral* means an elective deferral under §1.402(g)(3)–1 (with respect to an employer contribution to a section 403(b) contract) and any other amount that constitutes an elective deferral under section 402(g)(3).

(8) (i) *Eligible employer* means—

(A) A State, but only with respect to an employee of the State performing services for a public school;

(B) A section 501(c)(3) organization with respect to any employee of the section 501(c)(3) organization;

(C) Any employer of a minister described in section 414(e)(5)(A), but only with respect to the minister; or

(D) A minister described in section 414(e)(5)(A), but only with respect to a retirement income account established for the minister.

(ii) An entity is not an eligible employer under paragraph (a)(8)(i)(A) of this section if it treats itself as not being a State for any other purpose of the Internal Revenue Code, and a subsidiary or other affiliate of an eligible employer is not an eligible employer under paragraph (a)(8)(i) of this section if the subsidiary or other affiliate is not an entity described in paragraph (a)(8)(i) of this section.

(9) *Employee* means a common-law employee performing services for the employer, and does not include a former employee or an independent contractor. Subject to any rules in §§1.403(b)–1 through 1.403(b)–11 that are specifically applicable to ministers, an employee also includes a minister described in section 414(e)(5)(A) when performing services in the exercise of his or her ministry.

(10) *Employee performing services for a public school* means an employee performing services as an employee for a public school of a State. This definition is not applicable unless the employee's compensation for performing services for a public school is paid by the State. Further, a person occupying an elective or appointive public office is not an employee performing services for a public school unless such office is one to which an individual is elected or appointed only if the individual has received training, or is experienced, in the field of education. The term *public office* includes any elective or appointive office of a State.

(11) *Includible compensation* means the employee's compensation received from an eligible employer that is includible in the participant's gross income for Federal income tax purposes (computed without regard to section 911) for the most recent period that is a year of service. Includible compensation for a minister who is self-employed means the minister's earned income as defined in section 401(c)(2) (computed without regard to section 911) for the most recent period that is a year of service. Includible compensation does not include any compensation received during a period when the employer is not an eligible employer. Includible compensation also includes any elective deferral and any amount contributed or deferred by the eligible employer at the election of the employee that is not includible in the gross income of the employee by reason of section 125, 132(f)(4), or 457. The amount of includible compensation is determined without regard to any community property laws. See §1.403(b)–4(d) for a special rule regarding former employees.

(12) *Participant* means an employee for whom a section 403(b) contract is currently being purchased, or an employee or former employee for whom a section 403(b) contract has previously been purchased and who has not received a distribution of his or her entire benefit under the contract.

(13) *Plan* means a plan as described in §1.403(b)–3(b)(3).

(14) *Public school* means a State-sponsored educational organization described in section 170(b)(1)(A)(ii) (relating to educational organizations that normally maintain a regular faculty and curriculum and normally have a regularly enrolled body of pupils or students in attendance at the place where educational activities are regularly carried on).

(15) *Retirement income account* means a defined contribution program established or maintained by a church-related organization to provide benefits under section 403(b) for its employees or their beneficiaries as described in §1.403(b)–9.

(16) *Section 403(b) contract; section 403(b) plan*—(i) *Section 403(b) contract* means a contract described in §1.403(b)–3. If for any taxable year an employer contributes to more than one section 403(b) contract for a participant or beneficiary, then, under section 403(b)(5), all such contracts are treated as one contract for purposes of section 403(b) and §§1.403(b)–2 through 1.403(b)–10. See also §1.403(b)–3(b)(1).

(ii) *Section 403(b) plan* means the plan of the employer under which the section 403(b) contracts for its employees are maintained.

(17) *Section 403(b) elective deferral* means an elective deferral that is an employer contribution to a section 403(b) contract for an employee. See §1.403(b)–5(b) for additional rules with respect to a section 403(b) elective deferral.

(18) *Section 501(c)(3) organization* means an organization that is described in section 501(c)(3) (relating to certain religious, charitable, scientific, or other types of organizations) and exempt from tax under section 501(a).

(19) *Severance from employment* means that the employee ceases to be employed by the employer maintaining the plan. See regulations under section 401(k) for additional guidance concerning severance from employment. See also §1.403(b)–6(h) for a special rule under which severance from employment is determined by reference to employment with the eligible employer.

(20) *State* means a State, a political subdivision of a State, or any agency or instrumentality of a State. For this purpose, the District of Columbia is treated as a State, as provided under section 7701(a)(10). In addition, for purposes of determining whether an individual is an employee performing services for a public school, an Indian tribal government is treated as a State, as provided under section 7871(a)(6)(B). See also section 1450(b) of the Small Business Job Protection Act of 1996 (110 Stat. 1755, 1814) for special rules treating certain contracts purchased in a plan year beginning before January 1, 1995, that include contributions by an Indian tribal government as section 403(b) contracts, whether or not those contributions are for employees performing services for a public school.

(21) *Years of service* means each full year during which an individual is a full-time employee of an eligible employer, plus fractional credit for each part of a year during which the individual is either a full-time employee of an eligible employer for a part of the year or a part-time employee of an eligible employer. See §1.403(b)–4(e) for rules for determining years of service.

(b) [Reserved].

*§1.403(b)–3 Exclusion for contributions to purchase section 403(b) contracts.*

(a) *Exclusion for section 403(b) contracts.* Amounts contributed by an eligible employer for the purchase of an annuity contract for an employee are excluded from the gross income of the employee under section 403(b) only if each of the requirements in paragraphs (a)(1) through (9) of this section is satisfied. In addition, amounts contributed by an eligible employer for the purchase of an annuity contract for an employee pursuant to a cash or deferred election are not includible in an employee's gross income at the time the cash would have been includible in the employee's gross income (but for the cash or deferred election) if each of the requirements in paragraphs (a)(1) through (9) of this section is satisfied.

(1) *Not a contract issued under qualified plan or eligible governmental plan.* The contract is not purchased under a qualified plan (under section 401(a) or 404(a)(2)) or an eligible governmental plan under section 457(b).

(2) *Nonforfeitability.* The rights of the employee under the contract (disregarding rights to future premiums) are nonforfeitable. An employee's rights under a contract fail to be nonforfeitable unless the participant for whom the contract is purchased has at all times a fully vested and nonforfeitable right (as defined under §1.411(a)–4) to all benefits provided under the contract. See paragraph (c) of this section for additional rules regarding the nonforfeitability requirement of this paragraph (a)(2).

(3) *Nondiscrimination and universal availability.* In the case of a contract purchased by an eligible employer other than a church, the contract is purchased under a plan that satisfies section 403(b)(12) (relating to nondiscrimination and universal availability requirements). See §1.403(b)–5.

(4) *Limitations on elective deferrals.* In the case of an elective deferral, the contract satisfies section 401(a)(30) (relating to limitations on elective deferrals). A contract does not satisfy section 401(a)(30) as required under this paragraph (a)(4) unless the contract requires all elective deferrals for an employee to not exceed the limits of section 402(g)(1), including elective deferrals for the employee under the contract and any other elective deferrals under the plan under which the contract is purchased and under all other plans, contracts, or arrangements of the employer.

(5) *Nontransferability.* The contract is not transferable. This paragraph (a)(5) does not apply to a contract issued before January 1, 1963. See section 401(g).

(6) *Minimum required distributions.* The contract satisfies the requirements of section 401(a)(9) (relating to minimum required distributions). See §1.403(b)–6(e).

(7) *Rollover distributions.* The contract provides that, if the distributee of an eligible rollover distribution elects to have the distribution paid directly to an eligible retirement plan, as defined in section 402(c)(8)(B), and specifies the eligible retirement plan to which the distribution is to be paid, then the distribution will be paid to that eligible retirement plan in a direct rollover. See §1.403(b)–7(b)(2).

(8) *Limitation on incidental benefits.* The contract satisfies the incidental benefit requirements of section 401(a). See §1.403(b)–6(g).

(9) *Maximum annual additions.* The annual additions to the contract do not exceed the applicable limitations of section 415(c) (treating contributions and other additions as annual additions). See paragraph (b) of this section and §1.403(b)–4(b).

(b) *Application of requirements*—(1) *Aggregation of contracts.* In accordance with section 403(b)(5), for purposes of determining whether this section is satisfied, all section 403(b) contracts purchased for an individual by an employer are treated as purchased under a single contract. Additional aggregation rules apply under section 402(g) for purposes of satisfying paragraph (a)(4) of this section and under section 415 for purposes of satisfying paragraph (a)(9) of this section.

(2) *Disaggregation for excess annual additions.* In accordance with the last sentence of section 415(a)(2), if an excess annual addition is made to a contract that otherwise satisfies the requirements of this section, then the portion of the contract that includes such excess annual addition fails to be a section 403(b) contract (and instead is a contract to which section 403(c) applies, as further described in paragraph (c)(1) of this section) and the remaining portion of the contract is a section 403(b) contract. This paragraph (b)(2) does not apply unless, for the year of the excess and each year thereafter, the issuer of the contract maintains separate accounts for each such portion. Thus, the entire contract fails to be a section 403(b) contract if an excess annual addition is made and a separate account is not maintained with respect to the excess.

(3) *Plan in form and operation.* A contract does not satisfy paragraph (a) of this section unless it is maintained pursuant to a plan. For this purpose, a plan is a written defined contribution plan, which, in both form and operation, satisfies the requirements of this section and §§1.403(b)–4 through 1.403(b)–10. For purposes of this section and §§1.403(b)–4 through 1.403(b)–10, the plan must contain all the material terms and conditions for eligibility, benefits, applicable limitations, the contracts available under the plan, and the time and form under which benefit distributions would be made. For purposes of this section and §§1.403(b)–4 through 1.403(b)–10, a plan may contain certain optional features not required under section 403(b), such as hardship withdrawal distributions, loans, plan-to-plan or annuity contract-to-annuity contract transfers, and acceptance of rollovers to the plan. However, if a plan contains any optional provisions, the optional provisions must meet, in both form and operation, the relevant requirements under section 403(b), this section, and §§1.403(b)–4 through 1.403(b)–10. This paragraph (b)(3) applies to contributions to an annuity contract by a church only if the annuity is part of a retirement income account, as defined in §1.403(b)–9.

(4) *Exclusion limited to former employees*—(i) *General rule.* Except as provided in paragraph (b)(4)(ii) of this section and in §1.403(b)–4(d), the exclusion from gross income provided by section 403(b) does not apply to contributions made for former employees. For this purpose, a contribution is not made for a former employee if the contribution is with respect to compensation that would otherwise be paid for a payroll period that begins before severance from employment.

(ii) *Exceptions.* [Reserved].

(c) *Effect of failure*—(1) *General rule.* See section 403(c) (relating to nonqualified annuities) for the treatment of a nonqualified annuity contract issued by an insurance company that is not a section

403(b) contract. See section 61, 83, or 402(b) for the treatment of a custodial account or retirement income account that fails to be treated as a section 403(b) contract.

(2) *Failure to satisfy nonforfeitability requirement*. If an annuity contract issued by an insurance company would qualify as a section 403(b) contract but for the failure to satisfy the nonforfeitability requirement of paragraph (a)(2) of this section, then the contract is treated as a contract to which section 403(c) applies. However, on or after the date on which the participant's interest in that contract becomes nonforfeitable, the contract may be treated as a section 403(b) contract if no election has been made under section 83(b) with respect to the contract, the participant's interest in the contract has been subject to a substantial risk of forfeiture before becoming nonforfeitable, and the contract has at all times satisfied the requirements of paragraph (a) of this section other than the nonforfeitability requirement of paragraph (a)(2) of this section. Thus, for example, for the current year and each prior year, no contribution can have been made to the contract that would cause the contract to fail to be a section 403(b) contract as a result of contributions exceeding the limitations of section 415 (except to the extent permitted under paragraph (b)(2) of this section) or to fail to satisfy the nondiscrimination rules described in §1.403(b)–5.

(3) *Treatment of partial vesting and separate accounts*. For purposes of applying this paragraph (c), if a participant's interest in a contract becomes nonforfeitable to any extent in a year but the participant's entire interest in the contract is not nonforfeitable, then the portion that is nonforfeitable and the portion that fails to be nonforfeitable are each treated as separate contracts. In addition, for purposes of applying this paragraph (c), if a contribution is made to an annuity contract in excess of the limitations of section 415(c) and the excess is maintained in a separate account, then the portion of the contract that includes the excess contributions account and the remainder are each treated as separate contracts. Thus, if an annuity contract that includes an excess contributions account changes from forfeitable to nonforfeitable during a year, then the portion that is not attributable to the excess contributions account constitutes a section 403(b) contract (assuming it otherwise satisfies the requirements to be a section 403(b) contract) and is not included in gross income, and the portion that is attributable to the excess contributions account is included in gross income in accordance with section 403(c).

Par. 5a. Sections 1.403(b)–4 through 1.403(b)–11 are added to read as follows:

*§1.403(b)–4 Contribution limitations.*

(a) *Treatment of contributions in excess of limitations*. The exclusion provided under §1.403(b)–3(a) applies to a participant only if the amounts contributed by the employer for the purchase of an annuity contract for the participant do not exceed the applicable limit under sections 415 and 402(g), as described in this section. Under §1.403(b)–3(a)(4), a section 403(b) contract is required to include the limits on elective deferrals imposed by section 402(g), as described in paragraph (c) of this section. See paragraph (f) of this section for special rules concerning correction of excess contributions and deferrals. The limits imposed by section 415, §1.403(b)–3(a)(9), section 402(g), §1.403(b)–3(a)(4), and this section do not apply with respect to rollover contributions made to a section 403(b) contract, as described in §1.403(b)–10(d), but after-tax contributions are taken into account under section 415, §1.403(b)–3(a)(9), and this section.

(b) *Maximum annual contribution*—(1) *General rule*. In accordance with section 415(a)(2) and §1.403(b)–3(b)(2), the contributions for any participant under a section 403(b) contract (*i.e.*, employer nonelective contributions (including matching contributions), section 403(b) elective deferrals, and after-tax contributions) are not permitted to exceed the limitations imposed by section 415. For this purpose, contributions made for a participant are aggregated to the extent applicable under sections 414(b), (c), (m), (n), and (o). For purposes of section 415(a)(2) and §1.403(b)–1 through §1.403(b)–11, a contribution means any annual addition, as defined in section 415(c).

(2) *Special rules*. See section 415(k)(4) for a special rule under which contributions to section 403(b) contracts are generally aggregated with contributions under other arrangements in applying section 415. For purposes of applying section 415(c)(1)(B) with respect to a section 403(b) contract, except as provided in section 415(c)(3)(C), a participant's includible compensation (as defined in §1.403(b)–2) is substituted for the participant's compensation, as described in section 415(c)(3)(E). Any age 50 catch-up contributions under paragraph (c)(2) of this section are disregarded in applying section 415.

(c) *Section 403(b) elective deferrals*—(1) *Basic limit under section 402(g)(1)*. In accordance with section 402(g)(1)(A), the section 403(b) elective deferrals for any individual are included in the individual's gross income to the extent the amount of such deferrals, plus all other elective deferrals for the individual, for the taxable year exceeds the applicable dollar amount under section 402(g)(1)(B). The applicable annual dollar amount under section 402(g)(1)(B) is: $11,000 for 2002; $12,000 for 2003; $13,000 for 2004; $14,000 for 2005; and $15,000 for 2006 and thereafter. After 2006, the $15,000 amount is adjusted for cost-of-living in the manner described in section 402(g)(4). See §1.403(b)–5(b) for a universal availability rule that applies if any employee is permitted to have any section 403(b) elective deferrals made on his or her behalf.

(2) *Age 50 catch-up*—(i) *In general*. In accordance with section 414(v) and the regulations thereunder, a section 403(b) contract may provide for additional catch-up contributions for a participant who is age 50 by the end of the year, provided that such age 50 catch-up contributions do not exceed the catch-up limit under section 414(v)(2) for the taxable year. The maximum amount of additional age 50 catch-up contributions for a taxable year under section 414(v) is as follows: $1,000 for 2002; $2,000 for 2003; $3,000 for 2004; $4,000 for 2005; and $5,000 for 2006 and thereafter. After 2006, the $5,000 amount is adjusted for cost-of-living in the manner described in section 414(v)(2)(C). For additional requirements, see regulations under section 414(v).

(ii) *Coordination with special section 403(b) catch-up*. In accordance with sections 414(v)(6)(A)(ii) and 402(g)(7)(A), the age 50 catch-up described in this paragraph (c)(2) may apply for any taxable year in which a participant also qualifies

for the special section 403(b) catch-up under paragraph (c)(3) of this section.

(3) *Special section 403(b) catch-up for certain organizations*—(i) *Amount of the special section 403(b) catch-up*. In the case of a qualified employee of a qualified organization for whom the basic section 403(b) elective deferrals for any year are not less than the applicable dollar amount under section 402(g)(1)(B), the section 403(b) elective deferral limitation of section 402(g)(1) for the taxable year of the qualified employee is increased by the least of—

(A) $3,000;

(B) The excess of—

(*1*) $15,000; over

(*2*) The total special section 403(b) catch-up elective deferrals made for the qualified employee by the qualified organization for prior years; or

(C) The excess of—

(*1*) $5,000 multiplied by the number of years of service of the employee with the qualified organization; over

(*2*) The total elective deferrals (as defined at §1.403(b)–2) made for the qualified employee by the qualified organization for prior years.

(ii) *Qualified organization*. (A) For purposes of this paragraph (c)(3), *qualified organization* means an eligible employer that is either—

(*1*) An educational organization described in section 170(b)(1)(A)(ii);

(*2*) A hospital;

(*3*) A health and welfare service agency (including a home health service agency); or

(*4*) A church-related organization. All entities that are in a church-related organization are treated as a single qualified organization (so that years of service and any special section 403(b) catch-up elective deferrals previously made for a qualified employee for a church within a church-related organization are taken into account for purposes of applying this paragraph (c)(3) to the employee with respect to any other entity within the same church-related organization).

(B) For purposes of this paragraph (c)(3)(ii), a *health and welfare service agency* means either an organization whose primary activity is to provide services that constitute medical care as defined in section 213(d)(1) (such as a hospice) or a section 501(c)(3) organization whose primary activity is the prevention of cruelty to individuals or animals, or which provides substantial personal services to the needy as part of its primary activity (such as a section 501(c)(3) organization that provides meals to needy individuals).

(iii) *Qualified employee*. For purposes of this paragraph (c)(3), *qualified employee* means an employee who has completed at least 15 years of service (as defined under paragraph (e) of this section) taking into account only employment with the qualified organization.

(iv) *Coordination with age 50 catch-up*. In accordance with sections 402(g)(1)(C) and 402(g)(7), any catch-up amount contributed by an employee who is eligible for both an age 50 catch-up and a special section 403(b) catch-up is treated first as an amount contributed as a special section 403(b) catch-up to the extent a special section 403(b) catch-up is permitted, and then as an amount contributed as an age 50 catch-up (to the extent the catch-up amount exceeds the maximum special section 403(b) catch-up after taking into account sections 402(g) and 415(c), this paragraph (c)(3), and any limitations on the special section 403(b) catch-up that are imposed by the terms of the plan).

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

*Example 1*. (i) *Facts illustrating application of the basic dollar limit*. Participant B, who is 45, is eligible to participate in a State university section 403(b) plan in 2006. B is not a qualified employee, as defined in paragraph (c)(3)(iii) of this section. The plan permits section 403(b) elective deferrals, but no other employer contributions are made under the plan. The plan provides limitations on section 403(b) elective deferrals up to the maximum permitted under paragraphs (c)(1) and (3) of this section and the additional age 50 catch-up amount described in paragraph (c)(2) of this section. For 2006, B will receive includible compensation of $42,000 from the eligible employer. B desires to elect to have the maximum section 403(b) elective deferral possible contributed in 2006. For 2006, the basic dollar limit for section 403(b) elective deferrals under paragraph (c)(1) of this section is $15,000 and the additional dollar amount permitted under the age 50 catch-up is $5,000.

(ii) *Conclusion*. B is not eligible for the age 50 catch-up in 2006 because B is 45 in 2006, or the special section 403(b) catch-up under paragraph (c)(3) of this section because B is not a qualified employee. Accordingly, the maximum section 403(b) elective deferral that B may elect for 2006 is $15,000.

*Example 2*. (i) *Facts illustrating application of the includible compensation limitation*. The facts are the same as in *Example 1*, except B's includible compensation is $14,000.

(ii) *Conclusion*. Under section 415(c), contributions may not exceed 100 percent of includible compensation. Accordingly, the maximum section 403(b) elective deferral that B may elect for 2006 is $14,000.

*Example 3*. (i) *Facts illustrating application of the age 50 catch-up*. Participant C, who is 55, is eligible to participate in a State university section 403(b) plan in 2006. The plan permits section 403(b) elective deferrals, but no other employer contributions are made under the plan. The plan provides limitations on section 403(b) elective deferrals up to the maximum permitted under paragraphs (c)(1) and (3) of this section and the additional age 50 catch-up amount described in paragraph (c)(2) of this section. For 2006, C will receive includible compensation of $48,000 from the eligible employer. C desires to elect to have the maximum section 403(b) elective deferral possible contributed in 2006. For 2006, the basic dollar limit for section 403(b) elective deferrals under paragraph (c)(1) of this section is $15,000 and the additional dollar amount permitted under the age 50 catch-up is $5,000. C does not have 15 years of service and thus is not a qualified employee, as defined in paragraph (c)(3)(iii) of this section.

(ii) *Conclusion*. C is eligible for the age 50 catch-up in 2006 because C is 55 in 2006. C is not eligible for the special section 403(b) catch-up under paragraph (c)(3) of this section because C is not a qualified employee (as defined in paragraph (c)(3)(iii) of this section). Accordingly, the maximum section 403(b) elective deferral that C may elect for 2006 is $20,000 ($15,000 plus $5,000).

*Example 4*. (i) *Facts illustrating application of both the age 50 and the special section 403(b) catch-up*. The facts are the same as in *Example 3*, except that C is a qualified employee for purposes of the special section 403(b) catch-up provisions in paragraph (c)(3) of this section. For 2006, the maximum additional section 403(b) elective deferral for which C qualifies under the special section 403(b) catch-up under paragraph (c)(3) of this section is $3,000.

(ii) *Conclusion*. The maximum section 403(b) elective deferrals that C may elect for 2006 is $23,000. This is the sum of the basic limit on section 403(b) elective deferrals under paragraph (c)(1) of this section equal to $15,000, plus the $3,000 additional special section 403(b) catch-up amount for which C qualifies under paragraph (c)(3) of this section, plus the additional age 50 catch-up amount of $5,000.

*Example 5*. (i) *Facts illustrating calculation of years of service with a predecessor organization for purposes of the special section 403(b) catch-up*. The facts are the same as in *Example 4*, except that C has previously made special section 403(b) catch-up deferrals to a section 403(b) plan maintained by a hospital which was acquired by C's current eligible employer which is a hospital.

(ii) *Conclusion*. The special section 403(b) catch-up amount for which C qualifies under paragraph (c)(3) of this section must be calculated taking into account C's prior years of service and special section 403(b) catch-up deferrals with the predecessor hospital if and only if C did not have any severance from service in connection with the acquisition.

*Example 6*. (i) *Facts illustrating application of the age 50 catch-up and the section 415(c) dollar limitation*. The facts are the same as in *Example 4*, except

that the employer makes a nonelective contribution for each employee equal to 20 percent of C's compensation (which is $48,000). Thus, the employer makes a nonelective contribution for C for 2006 equal to $9,600. The plan provides that a participant is not permitted to make section 403(b) elective deferrals to the extent the section 403(b) elective deferrals would result in contributions in excess of the maximum permitted under section 415 and provides that contributions are reduced in the following order: the special section 403(b) catch-up elective deferrals under paragraph (c)(3) of this section are reduced first; the age 50 catch-up elective deferrals under paragraph (c)(2) of this section are reduced second; and then the basic section 403(b) elective deferrals under paragraph (c)(1) of this section are reduced. For 2006, it is assumed that the applicable dollar limit under section 415(c)(1)(A) is $44,000.

(ii) *Conclusion*. The maximum section 403(b) elective deferral that C may elect for 2006 is $23,000. This is the sum of the basic limit on section 403(b) elective deferrals under paragraph (c)(1) of this section equal to $15,000, plus the $3,000 additional special section 403(b) catch-up amount for which C qualifies under paragraph (c)(3) of this section, plus the additional age 50 catch-up amount of $5,000. The limit in paragraph (b) of this section would not be exceeded because the sum of the $9,600 nonelective contribution and the $23,000 section 403(b) elective deferrals does not exceed the lesser of $49,000 (which is the sum of $44,000 plus the $5,000 additional age 50 catch-up amount) or $53,000 (which is the sum of C's includible compensation for 2006 ($48,000) plus the $5,000 additional age 50 catch-up amount).

*Example 7*. (i) *Facts further illustrating application of the age 50 catch-up and the section 415(c) dollar limitation*. The facts are the same as in *Example 6*, except that C's includible compensation for 2006 is $56,000 and the plan provides for a nonelective contribution equal to 50 percent of includible compensation, so that the employer nonelective contribution for C for 2006 is $28,000 (50 percent of $56,000).

(ii) *Conclusion*. The maximum section 403(b) elective deferral that C may elect for 2006 is $21,000. A section 403(b) elective deferral in excess of this amount would exceed the sum of the limit in section 415(c)(1)(A) plus the additional age 50 catch-up amount, because the sum of the employer's nonelective contribution of $28,000 plus a section 403(b) elective deferral in excess of $21,000 would exceed $49,000 (the sum of the $44,000 limit in section 415(c)(1)(A) plus the $5,000 additional age 50 catch-up amount).

*Example 8*. (i) *Facts further illustrating application of the age 50 catch-up and the section 415(c) dollar limitation*. The facts are the same as in *Example 7*, except that the plan provides for a nonelective contribution for C equal to $44,000 (which is the limit in section 415(c)(1)(A)).

(ii) *Conclusion*. The maximum section 403(b) elective deferral that C may elect for 2006 is $5,000. A section 403(b) elective deferral in excess of this amount would exceed the sum of the limit in section 415(c)(1)(A) plus the additional age 50 catch-up amount ($5,000), because the sum of the employer's nonelective contribution of $44,000 plus a section 403(b) elective deferral in excess of $5,000 would exceed $49,000 (the sum of the $44,000 limit in section 415(c)(1)(A) plus the $5,000 additional age 50 catch-up amount).

*Example 9*. (i) *Facts illustrating application of the age 50 catch-up and the section 415(c) includible compensation limitation*. The facts are the same as in *Example 7*, except that C's includible compensation for 2006 is $28,000, so that the employer nonelective contribution for C for 2006 is $14,000 (50 percent of $28,000).

(ii) *Conclusion*. The maximum section 403(b) elective deferral that C may elect for 2006 is $19,000. A section 403(b) elective deferral in excess of this amount would exceed the sum of the limit in section 415(c)(1)(B) plus the additional age 50 catch-up amount, because C's includible compensation is $28,000 and the sum of the employer's nonelective contribution of $14,000 plus a section 403(b) elective deferral in excess of $19,000 would exceed $33,000 (which is the sum of 100 percent of C's includible compensation plus the $5,000 additional age 50 catch-up amount).

*Example 10*. (i) *Facts illustrating that section 403(b) elective deferrals cannot exceed compensation otherwise payable*. Employee D is age 60, has includible compensation of $14,000, and wishes to contribute section 403(b) elective deferrals of $20,000 for the year. No nonelective contributions are made for Employee D.

(ii) *Conclusion*. The maximum limit on section 403(b) elective deferrals for a participant with compensation less than the maximum dollar limit in section 415(c) is 100 percent of includible compensation, plus the $5,000 additional age 50 catch-up amount. However, because a contribution is a section 403(b) elective deferral only if it is a result of a compensation reduction, D cannot make section 403(b) elective deferrals in excess of D's actual compensation.

*Example 11*. (i) *Facts illustrating calculation of the special section 403(b) catch-up*. For 2006, employee E, who is age 50, is eligible to participate in a section 403(b) plan of hospital H, which is a section 501(c)(3) organization. H's plan permits section 403(b) elective deferrals and provides for an employer contribution of 10 percent of a participant's compensation with that employer for the taxable year. The plan provides limitations on section 403(b) elective deferrals up to the maximum permitted under paragraphs (c)(1), (2), and (3) of this section. For 2006, E's includible compensation is $50,000. E wishes to elect to have the maximum section 403(b) elective deferral possible contributed in 2006. E has previously made $62,000 of section 403(b) elective deferrals under the plan, but has never made an election for a special section 403(b) catch-up elective deferral. For 2006, the basic dollar limit for section 403(b) elective deferrals under paragraph (c)(1) of this section is $15,000, the additional dollar amount permitted under the age 50 catch-up is $5,000, E's employer will make a nonelective contribution of $5,000 (10% of $50,000 compensation), and E is a qualified employee of a qualified employer as defined in paragraph (c)(3) of this section.

(ii) *Conclusion*. The maximum section 403(b) elective deferrals that E may elect for 2006 is $23,000. This is the sum of the basic limit on section 403(b) elective deferrals for 2006 under paragraph (c)(1) of this section equal to $15,000, plus the $3,000 maximum additional special section 403(b) catch-up amount for which D qualifies in 2006 under paragraph (c)(3) of this section, plus the additional age 50 catch-up amount of $5,000. The limitation on the additional special section 403(b) catch-up amount is not less than $3,000 because the limitation at paragraph (c)(3)(i)(B) of this section is $15,000 ($15,000 minus zero) and the limitation at paragraph (c)(3)(i)(C) of this section is $13,000 ($5,000 times 15, minus $62,000 of total deferrals in prior years).

*Example 12*. (i) *Facts illustrating calculation of the special section 403(b) catch-up in the next calendar year*. The facts are the same as in *Example 11*, except that, for 2007, E has includible compensation of $60,000. For 2007, E now has previously made $85,000 of section 403(b) elective deferrals ($62,000 deferred before 2006, plus the $15,000 in basic section 403(b) elective deferrals in 2006, the $3,000 maximum additional special section 403(b) catch-up amount in 2006, plus the $5,000 age 50 catch-up amount in 2006). However, the $5,000 age 50 catch-up amount deferred in 2006 is disregarded for purposes of applying the limitation at paragraph (c)(3)(i)(B) of this section to determine the special section 403(b) catch-up amount. Thus, for 2007, only $80,000 of section 403(b) elective deferrals are taken into account in applying the limitation at paragraph (c)(3)(i)(B) of this section. For 2007, the basic dollar limit for section 403(b) elective deferrals under paragraph (c)(1) of this section is assumed to be $16,000, the additional dollar amount permitted under the age 50 catch-up is assumed to be $5,000, and E's employer contributes $6,000 (10% of $60,000 compensation) as a non-elective contribution.

(ii) *Conclusion*. The maximum section 403(b) elective deferral that D may elect for 2007 is $21,000. This is the sum of the basic limit on section 403(b) elective deferrals under paragraph (c)(1) of this section equal to $16,000, plus the additional age 50 catch-up amount of $5,000. E is not entitled to any additional special section 403(b) catch-up amount for 2007 under paragraph (c)(3) due to the limitation at paragraph (c)(3)(i)(C) of this section (16 times $5,000 equals $80,000, minus D's total prior section 403(b) elective deferrals of $80,000 equals zero).

(d) *Employer contributions for former employees*—(1) *Includible compensation deemed to continue for nonelective contributions*. For purposes of applying paragraph (b) of this section, a former employee is deemed to have monthly includible compensation for the period through the end of the taxable year of the employee in which he or she ceases to be an employee and through the end of each of the next five taxable years. The amount of the monthly includible compensation is equal to one twelfth of the former employee's includible compensation during the former employee's most recent year of service. Accordingly, nonelective employer contributions for a former employee must not exceed the limitation of section 415(c)(1) up to the lesser of the dollar amount in section 415(c)(1)(A) or the former employee's annual includible compensation based on the former employee's average monthly com-

pensation during his or her most recent year of service.

(2) *Examples*. The provisions of paragraph (d)(1) of this section are illustrated by the following examples:

*Example 1*. (i) *Facts*. College M is a section 501(c)(3) organization operated on the basis of a June 30 fiscal year that maintains a section 403(b) plan for its employees. In 2004, M amends the plan to provide for a temporary early retirement incentive under which the college will make a nonelective contribution for any participant who satisfies certain minimum age and service conditions and who retires before June 30, 2006. The contribution will equal 110 percent of the participant's rate of pay for one year and will be payable over a period ending no later than the end of the fifth fiscal year that begins after retirement. It is assumed for purposes of this *Example 1* that, in accordance with § 1.401(a)(4)–10(b) and under the facts and circumstances, the post-retirement contributions made for participants who satisfy the minimum age and service conditions and retire before June 30, 2006 do not discriminate in favor of former employees who are highly compensated employees. Employee A retires under the early retirement incentive on March 12, 2006, and A's annual includible compensation for the period from March 1, 2005, through February 28, 2006 (which is A's most recent one year of service), is $30,000. The applicable dollar limit under section 415(c)(1)(A) is assumed to be $44,000 for 2006 and $45,000 for 2007. The college contributes $30,000 for A for 2006 and $3,000 for A for 2007 (totaling $33,000 or 110 percent of $30,000). No other contributions are made to a section 403(b) contract for A for those years.

(ii) *Conclusion*. The contributions made for A do not exceed A's includible compensation for 2006 or 2007.

*Example 2*. (i) *Facts*. College N is a section 501(c)(3) organization that maintains a section 403(b) plan for its employees. The plan provides for N to make monthly nonelective contributions equal to 20 percent of the monthly includible compensation for each eligible employee. In addition, the plan provides for contributions to continue for 5 years following the retirement of any employee after age 64 and completion of at least 20 years of service (based on the employee's average annual rate of base salary in the preceding 3 calendar years ended before the date of retirement). It is assumed for purposes of this *Example 2* that, in accordance with § 1.401(a)(4)–10(b) and under the facts and circumstances, the post-retirement contributions made for participants who satisfy the minimum age and service conditions do not discriminate in favor of former employees who are highly compensated employees. Employee B retires on July 1, 2006, at age 64 after completion of 20 or more years of service. At that date, B's annual includible compensation for the most recently ended fiscal year of N is $72,000 and B's average monthly rate of base salary for 2003 through 2005 is $5,000. N contributes $1,200 per month (20 percent of 1/12th of $72,000) from January of 2006 through June of 2006 and contributes $1,000 (20 percent of $5,000) per month for B from July of 2006 through June of 2011. The applicable dollar limit under section 415(c)(1)(A) is assumed to be at least $44,000 for 2006 through 2011. No other contributions are made to a section 403(b) contract for B for those years.

(ii) *Conclusion*. The contributions made for B do not exceed B's includible compensation for any of the years from 2006 through 2010.

(3) *Disabled employees*. See also section 415(c)(3)(C) which sets forth a special rule under which compensation may be treated as continuing for purposes of section 415 for certain former employees who are disabled.

(e) *Special rules for determining years of service*—(1) *In general*. For purposes of determining a participant's includible compensation under paragraph (b)(2) of this section and a participant's years of service under paragraphs (c)(3) (special section 403(b) catch-up for qualified employees of certain organizations) and (d) (employer contributions for former employees) of this section, an employee's number of years of service depend on whether the employee has a full year during which the individual is a full-time employee of the eligible employer, and any fraction of a year for each part of a year during which the individual is a full-time or part-time employee of the eligible employer. An individual's number of years of service equals the aggregate of the annual work periods during which the individual is employed by the eligible employer.

(2) *Work period*. A year of service is based on the employer's annual work period, not the employee's taxable year. For example, in determining whether a university professor is employed full time, the annual work period is the school's academic year. However, in no case may an employee accumulate more than one year of service in a twelve-month period.

(3) *Service with more than one eligible employer*—(i) *General rule*. With respect to any section 403(b) contract of an eligible employer, except as provided in paragraph (e)(3)(ii) of this section, any period during which an individual is not an employee of that eligible employer is disregarded for purposes of this paragraph (e).

(ii) *Special rule for church employees*. With respect to any section 403(b) contract of an eligible employer that is a church-related organization, any period during which an individual is an employee of that eligible employer and any other eligible employer that is a church-related organization that has an association (as defined in section 414(e)(3)(D)) with that eligible employer is taken into account on an aggregated basis, but any period during which an individual is not an employee of a church-related organization or is an employee of a church-related organization that does not have an association with that eligible employer is disregarded for purposes of this paragraph (e).

(4) *Full-time employee for full year*. Each annual work period during which an individual is employed full time by the eligible employer constitutes one year of service. In determining whether an individual is employed full-time, the amount of work which he or she actually performs is compared with the amount of work that is normally required of individuals performing similar services from which substantially all of their annual compensation is derived.

(5) *Other employees*. (i) An individual is treated as performing a fraction of a year of service for each annual work period during which he or she is a full-time employee for part of the annual work period and for each annual work period during which he or she is a part-time employee either for the entire annual work period or for a part of the annual work period.

(ii) In determining the fraction that represents the fractional year of service for an individual employed full time for part of an annual work period, the numerator is the period of time (*e.g.*, weeks or months) during which the individual is a full-time employee during that annual work period, and the denominator is the period of time that is the annual work period.

(iii) In determining the fraction that represents the fractional year of service of an individual who is employed part time for the entire annual work period, the numerator is the amount of work performed by the individual, and the denominator is the amount of work normally required of individuals who perform similar services and who are employed full time for the entire annual work period.

(iv) In determining the fraction representing the fractional year of service of an individual who is employed part time for part of an annual work period, the fractional year of service that would apply if the individual were a part-time employee for a full annual work period is multiplied times the fractional year of service that would apply if the individual were a full-time employee for the part of an annual work period.

(6) *Work performed*. For purposes of this paragraph (e), in measuring the amount of work of an individual performing particular services, the work performed is determined based on the individual's hours of service (as defined under section 410(a)(3)(C)), except that a plan may use a different measure of work if appropriate under the facts and circumstances. For example, a plan may provide for a university professor's work to be measured by the number of courses taught during an annual work period in any case in which that individual's work assignment is generally based on a specified number of courses to be taught.

(7) *Most recent one-year period of service*. For purposes of paragraph (d) of this section, in the case of a part-time employee or a full-time employee who is employed for only part of the year determined on the basis of the employer's annual work period, the employee's most recent periods of service are aggregated to determine his or her most recent one-year period of service. In such a case, there is first taken into account his or her service during the annual work period for which the last year of service's includible compensation is being determined; then there is taken into account his or her service during his next preceding annual work period based on whole months; and so forth, until the employee's service equals, in the aggregate, one year of service.

(8) *Less than one year of service considered as one year*. If, at the close of a taxable year, an employee has, after application of all of the other rules in this paragraph (e), some portion of one year of service (but has accumulated less than one year of service), the employee is deemed to have one year of service. Except as provided in this paragraph (e)(8), fractional years of service are not rounded up.

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

*Example 1*. (i) *Facts*. Individual C is employed half-time in 2004 and 2005 as a clerk by H, a hospital which is a section 501(c)(3) organization. C earns $20,000 from H in each of those years, and retires on December 31, 2005.

(ii) *Conclusion*. For purposes of determining C's includible compensation during C's last year of service under paragraph (d) of this section, C's most recent periods of service are aggregated to determine C's most recent one-year period of service. In this case, since C worked half-time in 2004 and 2005, the compensation C earned in those two years are aggregated to produce C's includible compensation for C's last full year in service. Thus, in this case, the $20,000 that C earned in 2004 and 2005 for C's half-time work are aggregated, so that C has $40,000 of includible compensation for C's most recent one-year of service for purposes of applying paragraphs (b)(2), (c)(3), and (d) of this section.

*Example 2*. (i) *Facts*. Individual A is employed as a part-time professor by public University U during the first semester of its two-semester 2004–2005 academic year. While A teaches one course generally for 3 hours a week during the first semester of the academic year, U's full-time faculty members generally teach for 9 hours a week during the full academic year.

(ii) *Conclusion*. For purposes of calculating how much of a year of service A performs in the 2004–05 academic year (before application of the special rules of paragraphs (e)(7) and (8) of this section concerning less than one year of service), paragraph (e)(5)(iv) of this section is applied as follows: since A teaches one course at U for 3 hours per week for 1 semester and other faculty members at U teach 9 hours per week for 2 semesters, A is considered to have completed $3/18$ or $1/6$ of a year of service during the 2004–05 academic year, determined as follows:

(A) The fractional year of service if A were a part-time employee for a full year is $3/9$ (number of hours employed divided by the usual number of hours of work required for that position).

(B) The fractional year of service if A were a full-time employee for half of a year is $1/2$ (one semester, divided by the usual 2-semester annual work period).

(C) These fractions are multiplied to obtain the fractional year of service: $3/9$ times $1/2$, or $3/18$, equals $1/6$ of a year of service.

(f) *Excess contributions or deferrals*—(1) *In general*. Any contribution made for a participant to a section 403(b) contract for the taxable year that exceeds either the maximum annual contribution limit set forth in paragraph (b) of this section or the maximum annual section 403(b) elective deferral limit set forth in paragraph (c) of this section constitutes an excess contribution that is included in gross income for that taxable year. A contract does not fail to satisfy the requirements of §1.403(b)–3, the distribution rules of §§1.403(b)–6 or 1.403(b)–9, or the funding rules of §1.403(b)–8 solely by reason of a distribution made under this paragraph (f). See also section 4973 for an excise tax applicable with respect to excess contributions to a custodial account.

(2) *Excess section 403(b) elective deferrals*. A section 403(b) contract may provide that any excess deferral as a result of a failure to comply with the limitation under paragraph (c) of this section for a taxable year with respect to any section 403(b) elective deferral made for a participant by the employer will be distributed to the participant, with allocable net income, no later than April 15 of the following taxable year or otherwise in accordance with section 402(g). See section 402(g)(2)(A) for rules permitting the participant to allocate excess deferrals among the plans in which the participant has made elective deferrals, and see section 402(g)(2)(C) for special rules to determine the tax treatment of such a distribution.

(3) *Special rule for small excess amount*. See section 4979(f)(2)(B) for a special rule applicable if excess matching contributions, excess after-tax contributions, and excess section 403(b) elective deferrals do not exceed $100.

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

*Example*. (i) *Facts*. Individual D makes section 403(b) elective deferrals totaling $15,500 for 2006, when D is age 45 and the applicable limit on section 403(b) elective deferrals is $15,000. On April 14, 2007, the plan refunds the $500 excess along with applicable earnings of $65.

(ii) *Conclusion*. The $565 payment constitutes a distribution of an excess deferral under paragraph (f)(2) of this section. Under section 402(g), the $500 excess deferral is included in D's gross income for 2006. The additional $65 is included in D's gross income for 2007 and, because the distribution is made by April 15, 2007 (as provided in section 402(g)(2)), the $65 is not subject to the additional 10 percent income tax on early distributions under section 72(t).

### *§1.403(b)–5 Nondiscrimination rules.*

(a) *Nondiscrimination rules for contributions other than section 403(b) elective deferrals*—(1) *General rule*. Under section 403(b)(12)(A)(i), employer contributions and employee after-tax contributions must satisfy all of the following requirements (the nondiscrimination requirements) in the same manner as a qualified plan under section 401(a):

(i) Section 401(a)(4) (relating to nondiscrimination in contributions and benefits), taking section 401(a)(5) into account.

(ii) Section 401(a)(17) (limiting the amount of compensation that can be taken into account).

(iii) Section 401(m) (relating to matching and after-tax contributions).

(iv) Section 410(b) (relating to minimum coverage).

(2) *Nonapplication to section 403(b) elective deferrals*. The requirements of this paragraph (a) do not apply to section 403(b) elective deferrals.

(3) *Compensation for testing*. Except as may otherwise be specifically permitted under the sections referenced in paragraph (a)(1) of this section, compliance with those provisions is tested using compensation as defined in section 414(s) (and without regard to section 415(c)(3)(E)).

(4) *Employer aggregation rules*. See regulations under section 414 for rules treating entities as a single employer for purposes of the nondiscrimination requirements.

(5) *Special rules for governmental plans*. Paragraphs (a)(1)(i), (iii), and (iv) of this section do not apply to a governmental plan as defined in section 414(d) (but contributions to a governmental plan must comply with paragraphs (a)(1)(ii) and (b) of this section).

(b) *Universal availability required for section 403(b) elective deferrals*—(1) *General rule*. Under section 403(b)(12)(A)(ii), all employees of the eligible employer must be permitted to have section 403(b) elective deferrals contributed on their behalf if any employee of the eligible employer may elect to have the organization make section 403(b) elective deferrals. The employee's right to have section 403(b) elective deferrals made on his or her behalf includes the right to section 403(b) elective deferrals up to the lesser of the applicable limits in §1.403(b)–4(c) (including any permissible catch-up elective deferrals under §1.403(b)–4(c)(2) and (3)) or the applicable limits under the contract with the largest limitation, and applies to part-time employees as well as full-time employees.

(2) *Effective opportunity required*. A section 403(b) plan satisfies this paragraph (b) only if the plan provides an employee with an effective opportunity to make (or change) a cash or deferred election (as defined at §1.401(k)–1(a)(3)) at least once during each plan year. Whether an employee has an effective opportunity is determined based on all the relevant facts and circumstances, including notice of the availability of the election, the period of time during which an election may be made, and any other conditions on elections. An effective opportunity is not considered to exist if there are any other rights or benefits that are conditioned (directly or indirectly) upon a participant making or failing to make a cash or deferred election with respect to a contribution to a section 403(b) contract.

(3) *Special rules*. (i) In the case of a section 403(b) plan that covers the employees of more than one section 501(c)(3) organization, the universal availability requirement of this paragraph (b) applies separately to each common law entity, *i.e.*, to each section 501(c)(3) organization. In the case of a section 403(b) plan that covers the employees of more than one State entity, this requirement applies separately to each entity that is not part of a common payroll. An employer may condition the employee's right to have section 403(b) elective deferrals made on his or her behalf on the employee electing a section 403(b) elective deferral of more than $200 for a year.

(ii) For purposes of this paragraph (b)(3), an employer that historically has treated one or more of its various geographically distinct units as separate for employee benefit purposes may treat each unit as a separate organization if the unit is operated independently on a day-to-day basis. Units are not geographically distinct if such units are located within the same Standard Metropolitan Statistical Area (SMSA).

(4) *Special exclusions*—(i) *Exclusions for special types of employees*. A plan does not fail to satisfy the universal availability requirement of this paragraph (b) merely because it excludes one or more of the types of employees listed in paragraph (b)(4)(ii) of this section. If any employee listed in paragraph (b)(4)(ii)(A) through (E) of this section has the right to have section 403(b) elective deferrals made on his or her behalf, then no employees listed in that subparagraph may be excluded under this paragraph (b)(4).

(ii) *List of special types of excludible employees*. The following types of employees are listed in this paragraph (b)(4)(ii):

(A) Employees who are eligible under a section 457(b) eligible governmental plan of the employer which permits an amount to be contributed or deferred at the election of the employee.

(B) Employees who are eligible to make a cash or deferred election (as defined at §1.401(k)–1(a)(3)) under a section 401(k) plan of the employer.

(C) Employees who are non-resident aliens described in section 410(b)(3)(C).

(D) Subject to the conditions applicable under section 410(b)(4) (including section 410(b)(4)(B) permitting separate testing for employees not meeting minimum age and service requirements), employees who are students performing services described in section 3121(b)(10).

(E) Subject to the conditions applicable under section 410(b)(4), employees who normally work fewer than 20 hours per week. For this purpose, an employee normally works fewer than 20 hours per week if and only if—

(*1*) For the 12-month period beginning on the date the employee's employment commenced, the employer reasonably expects the employee to work fewer than 1,000 hours of service (as defined in section 410(a)(3)(C)) in such period; and

(*2*) For each plan year ending after the close of the 12-month period beginning on the date the employee's employment commenced (or, if the plan so provides, each subsequent 12-month period), the employee worked fewer than 1,000 hours of service in the preceding 12-month period. (*See*, however, section 202(a)(1) of the Employee Retirement Income Security Act of 1974 (ERISA) (88 Stat. 829) Public Law 93–406, and regulations under section 410(a) of the Internal Revenue Code applicable with respect to plans that are subject to Title I of ERISA.)

(c) *Plan required*. Contributions to an annuity contract do not satisfy the requirements of this section unless the contributions are made pursuant to a plan, as defined in §1.403(b)–3(b)(3), and the terms of the plan satisfy this section.

(d) *Certain requirements not applicable to a church plan*. This section does not apply to a section 403(b) contract purchased by a church (as defined in §1.403(b)–2).

(e) *Other rules*. This section only reflects requirements of the Internal Revenue Code applicable for purposes of section 403(b) and does not include other requirements. Specifically, this section does not reflect the requirements of the ERISA that may apply with respect to section 403(b), such as the vesting requirements at 29 U.S.C. 1053.

*§1.403(b)–6 Timing of distributions and benefits.*

(a) *Distributions generally*. This section includes special rules regarding the

timing of distributions from, and the benefits that may be provided under, a section 403(b) contract, including limitations on when early distributions can be made (in paragraphs (b) through (d) of this section), required minimum distributions (in paragraph (e) of this section), and special rules relating to loans (in paragraph (f) of this section) and incidental benefits (in paragraph (g) of this section).

(b) *Distributions from contracts other than custodial accounts or amounts attributable to section 403(b) elective deferrals*. Except as provided in paragraph (c) of this section relating to distributions from custodial accounts, paragraph (d) of this section relating to distributions attributable to section 403(b) elective deferrals, §1.403(b)–4(f) (relating to correction of excess deferrals), or §1.403(b)–10(a) (relating to plan termination), a section 403(b) contract is permitted to distribute retirement benefits to the participant no earlier than upon the earliest of the participant's severance from employment or upon the prior occurrence of some event, such as after a fixed number of years, the attainment of a stated age, or disability. See §1.401–1(b)(1)(ii) for additional guidance.

(c) *Distributions from custodial accounts that are not attributable to section 403(b) elective deferrals*. Except as provided in §1.403(b)–4(f) (relating to correction of excess deferrals) or §1.403(b)–10(a) (relating to plan termination), distributions from a custodial account, as defined in §1.403(b)–8(d)(2), may not be paid to a participant before the participant has a severance from employment, dies, becomes disabled (within the meaning of section 72(m)(7)), or attains age 59½. Any amounts transferred out of a custodial account to an annuity contract or retirement income account, including earnings thereon, continue to be subject to this paragraph (c). This paragraph (c) does not apply to distributions that are attributable to section 403(b) elective deferrals.

(d) *Distribution of section 403(b) elective deferrals*—(1) *Limitation on distributions*—(i) *General rule*. Except as provided in paragraph (d)(2) of this section (relating to distributions on account of hardship), §1.403(b)–4(f) (relating to correction of excess deferrals), or §1.403(b)–10(a) (relating to plan termination), distributions of amounts attributable to section 403(b) elective deferrals may not be paid to a participant earlier than the earliest of the date on which the participant has a severance from employment, dies, has a hardship, becomes disabled (within the meaning of section 72(m)(7)), or attains age 59½.

(ii) *Special rule for pre–1989 section 403(b) elective deferrals*. For special rules relating to amounts held as of the close of the taxable year beginning before January 1, 1989 (which does not apply to earnings thereon), see section 1123(e)(3) of the Tax Reform Act of 1986 (100 Stat. 2085, 2475) Public Law 99–514, and section 1011A(c)(11) of the Technical and Miscellaneous Revenue Act of 1988 (102 Stat. 3342, 3476) Public Law 100–647.

(2) *Hardship rules*. A hardship distribution under this paragraph (d) is defined as, and is subject to the rules in, §1.401(k)–1(d)(3) (including limiting the amount of a distribution in the case of hardship to the amount necessary to satisfy the hardship). In addition, a hardship distribution is limited to the aggregate dollar amount of the participant's section 403(b) elective deferrals under the contract (and may not include any income thereon), reduced by the aggregate dollar amount of the distributions previously made to the participant from the contract.

(3) *Failure to keep separate accounts*. If a section 403(b) contract includes both section 403(b) elective deferrals and other contributions and the section 403(b) elective deferrals are not maintained in a separate account, then distributions may not be made earlier than the later of:

(i) Any date permitted under this paragraph (d) with respect to 403(b) elective deferrals; and

(ii) Any date permitted under paragraph (b) or (c) of this section with respect to contributions that are not section 403(b) elective deferrals (whichever applies to the contributions that are not section 403(b) elective deferrals).

(e) *Minimum required distributions for eligible plans*—(1) *In general*. Under section 403(b)(10), a section 403(b) contract must meet the minimum distribution requirements of section 401(a)(9) (in both form and operation). See section 401(a)(9) and the regulations thereunder for these requirements.

(2) *Treatment as IRAs*. For purposes of applying the distribution rules of section 401(a)(9) to section 403(b) contracts, section 403(b) contracts are treated as individual retirement annuities described in section 408(b) and individual retirement accounts described in section 408(a) (IRAs). Consequently, except as otherwise provided in paragraphs (e)(3) through (e)(5) of this section, the distribution rules in section 401(a)(9) are applied to section 403(b) contracts in accordance with the provisions in §1.408–8 for purposes of determining required minimum distributions.

(3) *Required beginning date*. The required beginning date for purposes of section 403(b)(10) is April 1 of the calendar year following the later of the calendar year in which the employee attains 70½ or the calendar year in which the employee retires from employment with the employer maintaining the plan. However, for any section 403(b) contract that is not part of a government plan or church plan, the required beginning date for a 5–percent owner is April 1 of the calendar year following the earlier of the calendar year in which the employee attains 70½ or the calendar year in which the employee retires from employment with the employer maintaining the plan.

(4) *Surviving spouse rule does not apply*. The special rule in §1.408–8, A–5 (relating to spousal beneficiaries), does not apply to a section 403(b) contract. Thus, the surviving spouse of a participant is not permitted to treat a section 403(b) contract as the spouse's own section 403(b) contract, even if the spouse is the sole beneficiary.

(5) *Retirement income accounts*. For purposes of §1.401(a)(9)–6, A–4 (relating to annuity contracts), annuity payments provided with respect to retirement income accounts do not fail to satisfy the requirements of section 401(a)(9) merely because the payments are not made under an annuity contract purchased from an insurance company, provided that the relationship between the annuity payments and the retirement income accounts is not inconsistent with any rules prescribed by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter). See §1.403(b)–9(a)(5).

(6) *Special rules for benefits accruing before December 31, 1986*. (i) The distri-

bution rules provided in section 401(a)(9) do not apply to the undistributed portion of the account balance under the section 403(b) contract valued as of December 31, 1986, exclusive of subsequent earnings (pre-'87 account balance). The distribution rules provided in section 401(a)(9) apply to all benefits under section 403(b) contracts accruing after December 31, 1986 (post-'86 account balance), including earnings after December 31, 1986. Consequently, the post-'86 account balance includes earnings after December 31, 1986, on contributions made before January 1, 1987, in addition to the contributions made after December 31, 1986, and earnings thereon.

(ii) The issuer or custodian of the section 403(b) contract must keep records that enable it to identify the pre-'87 account balance and subsequent changes as set forth in paragraph (d)(6)(iii) of this section and provide such information upon request to the relevant employee or beneficiaries with respect to the contract. If the issuer or custodian does not keep such records, the entire account balance is treated as subject to section 401(a)(9).

(iii) In applying the distribution rules in section 401(a)(9), only the post-'86 account balance is used to calculate the required minimum distribution for a calendar year. The amount of any distribution from a contract is treated as being paid from the post-'86 account balance to the extent the distribution is required to satisfy the minimum distribution requirement with respect to that contract for a calendar year. Any amount distributed in a calendar year from a contract in excess of the required minimum distribution for a calendar year with respect to that contract is treated as paid from the pre-'87 account balance, if any, of that contract.

(iv) If an amount is distributed from the pre-'87 account balance and rolled over to another section 403(b) contract, the amount is treated as part of the post-'86 account balance in that second contract. However, if the pre-'87 account balance under a section 403(b) contract is directly transferred to another section 403(b) contract (as permitted under §1.403(b)–10(b)), the amount transferred retains its character as a pre-'87 account balance, provided the issuer of the transferee contract satisfies the recordkeeping requirements of paragraph (e)(6)(ii) of this section.

(v) The distinction between the pre-'87 account balance and the post-'86 account balance provided for under this paragraph (e)(6) of this section has no relevance for purposes of determining the portion of a distribution that is includible in income under section 72.

(vi) The pre-'87 account balance must be distributed in accordance with the incidental benefit requirement of §1.401–1(b)(1)(i). Distributions attributable to the pre-'87 account balance are treated as satisfying this requirement if all distributions from the section 403(b) contract (including distributions attributable to the post-'86 account balance) satisfy the requirements of §1.401–1(b)(1)(i) without regard to this section, and distributions attributable to the post-'86 account balance satisfy the rules of this paragraph (e). Distributions attributable to the pre-'87 account balance are treated as satisfying the incidental benefit requirement if all distributions from the section 403(b) contract (including distributions attributable to both the pre-'87 account balance and the post-'86 account balance) satisfy the rules of this paragraph (e).

(7) *Application to multiple contracts for an employee*. The required minimum distribution must be separately determined for each section 403(b) contract of an employee. However, because, as provided in paragraph (e)(2) of this section, the distribution rules in section 401(a)(9) apply to section 403(b) contracts in accordance with the provisions in §1.408–8, the required minimum distribution from one section 403(b) contract of an employee is permitted to be distributed from another section 403(b) contract in order to satisfy section 401(a)(9). Thus, as provided in §1.408–8, A–9, with respect to IRAs, the required minimum distribution amount from each contract is then totaled and the total minimum distribution taken from any one or more of the individual section 403(b) contracts. However, consistent with the rules in §1.408–8, A–9, only amounts in section 403(b) contracts that an individual holds as an employee may be aggregated. Amounts in section 403(b) contracts that an individual holds as a beneficiary of the same decedent may be aggregated, but such amounts may not be aggregated with amounts held in section 403(b) contracts that the individual holds as the employee or as the beneficiary of another decedent. Distributions from section 403(b) contracts do not satisfy the minimum distribution requirements for IRAs, nor do distributions from IRAs satisfy the minimum distribution requirements for section 403(b) contracts.

(f) *Loans*. The determination of whether the availability of a loan, the making of a loan, or a failure to repay a loan made from an issuer of a section 403(b) contract to a participant or beneficiary is treated as a distribution (directly or indirectly) for purposes of this section, and the determination of whether the availability of the loan, the making of the loan, or a failure to repay the loan is in any other respect a violation of the requirements of section 403(b) and these regulations, depends on the facts and circumstances. Among the facts and circumstances are whether the loan has a fixed repayment schedule and bears a reasonable rate of interest, and whether there are repayment safeguards to which a prudent lender would adhere. Thus, for example, a loan must bear a reasonable rate of interest in order to be treated as not being a distribution. However, a plan loan offset is a distribution for purposes of this section. See §1.72(p)–1, Q&A–13. See also §1.403(b)–7(d) relating to the application of section 72(p) with respect to the taxation of a loan made under a section 403(b) contract. (Further, see 29 CFR 2550.408b–1 of the Department of Labor regulations concerning additional requirements applicable with respect to plans that are subject to Title I of ERISA.)

(g) *Death benefits and other incidental benefits*. An annuity is not a section 403(b) contract if it fails to satisfy the incidental benefit requirement of §1.401–1(b)(1)(i). For this purpose, to the extent the incidental benefit requirement of §1.401–1(b)(1)(i) requires a distribution of the participant's or beneficiary's accumulated benefit, that requirement is deemed to be satisfied if distributions satisfy the minimum distribution requirements of section 401(a)(9).

(h) *Special rule regarding severance from employment*. For purposes of this section, severance from employment occurs on any date on which an employee ceases to be an employee of an eligible employer (*e.g.*, by the section 501(c)(3)

organization that maintains the plan, assuming that only one section 501(c)(3) organization maintains the plan), even though the employee may continue to be employed either by another entity that is treated as the same employer where either that other entity is not an entity that can be an eligible employer (such as transferring from a section 501(c)(3) organization to a for-profit subsidiary of the section 501(c)(3) organization) or in a capacity that is not employment with an eligible employer (*e.g.*, ceasing to be an employee performing services for a public school but continuing to work for the same State employer).

(i) *Certain limitations do not apply to rollover contributions*. The limitations on distributions in paragraphs (b) through (d) of this section do not apply to amounts held in a separate account for eligible rollover distributions as described in §1.403(b)–10(d).

*§1.403(b)–7 Taxation of distributions and benefits.*

(a) *General rules for when amounts are included in gross income*. Except as provided in this section (or in §1.403(b)–10(c) relating to payments pursuant to a qualified domestic relations order), amounts actually distributed from a section 403(b) contract are includible in the gross income of the recipient participant or beneficiary (in the year in which so distributed) under section 72 (relating to annuities). For an additional income tax that may apply to certain early distributions that are includible in gross income, see section 72(t).

(b) *Rollovers to individual retirement arrangements and other eligible retirement plans*—(1) *Timing of taxation of rollovers*. In accordance with sections 402(c), 403(b)(8), and 403(b)(10), a direct transfer in accordance with section 401(a)(31) (generally referred to as a direct rollover) is not includible in the gross income of a participant or beneficiary in the year transferred. In addition, any payment made in the form of an eligible rollover distribution (as defined in section 402(c)(4)) is not includible in gross income in the year paid to the extent the payment is transferred to an eligible retirement plan (as defined in section 402(c)(8)(B)) within 60 days, including the transfer to the eligible retirement plan of any property distributed. For this purpose, the rules of section 402(c)(2) through (7) and (c)(9) apply. Any direct rollover under this paragraph (b)(1) is a distribution that is subject to the distribution requirements of §1.403(b)–6.

(2) *Requirement that contract provide rollover options for eligible rollover distributions*. As required in §1.403(b)–3(a)(7), an annuity contract is not a section 403(b) contract unless the contract provides that if the distributee of an eligible rollover distribution elects to have the distribution paid directly to an eligible retirement plan (as defined in section 402(c)(8)(B)) and specifies the eligible retirement plan to which the distribution is to be paid, then the distribution will be paid to that eligible retirement plan in a direct rollover. For purposes of determining whether a contract satisfies this requirement, the provisions of section 401(a)(31) apply to the annuity as though it were a plan qualified under section 401(a) unless otherwise provided in section 401(a)(31). In applying the provisions of this paragraph (b)(2), the payor of the eligible rollover distribution from the contract is treated as the plan administrator.

(3) *Requirement that contract payor provide notice of rollover option to distributees*. To ensure that the distributee of an eligible rollover distribution from a section 403(b) contract has a meaningful right to elect a direct rollover, section 402(f) requires that the distributee be informed of the option. Thus, within a reasonable time period before making the initial eligible rollover distribution, the payor must provide an explanation to the distributee of his or her right to elect a direct rollover and the income tax withholding consequences of not electing a direct rollover. For purposes of satisfying the reasonable time period requirement, the plan timing rule provided in section 402(f)(1) and the regulations thereunder applies to section 403(b) contracts.

(4) *Mandatory withholding upon certain eligible rollover distributions from contracts*. If a distributee of an eligible rollover distribution from a section 403(b) contract does not elect to have the eligible rollover distribution paid directly to an eligible retirement plan in a direct rollover, the eligible rollover distribution is subject to 20-percent income tax withholding imposed under section 3405(c). See section 3405(c) and the regulations thereunder for provisions regarding the withholding requirements relating to eligible rollover distributions.

(5) *Automatic rollover for certain mandatory distributions under section 401(a)(31)(B)*. [Reserved].

(c) *Special rules for certain corrective distributions*. See section 402(g)(2)(C) for special rules to determine the tax treatment of a distribution of excess deferrals, and see §1.401(m)–1(e)(3)(v) for the tax treatment of corrective distributions of after-tax and matching contributions to comply with section 401(m).

(d) *Amounts taxable under section 72(p)(1)*. In accordance with section 72(p), the amount of any loan from a section 403(b) contract to a participant or beneficiary (including any pledge or assignment treated as a loan under section 72(p)(1)(B)) is treated as having been received as a distribution from the contract under section 72(p)(1), except to the extent set forth in section 72(p)(2) (relating to loans that do not exceed a maximum amount and that are repayable in accordance with certain terms) and §1.72(p)–1. Thus, except to the extent a loan satisfies section 72(p)(2), any amount loaned from a section 403(b) contract to a participant or beneficiary (including any pledge or assignment treated as a loan under section 72(p)(1)(B)) is includible in the gross income of the participant or beneficiary for the taxable year in which the loan is made. See generally §1.72(p)–1.

*§1.403(b)–8 Funding.*

(a) *Investments permitted*. Section 403(b) and §1.403(b)–3 only apply to amounts held in an annuity contract (as defined in §1.403(b)–2), including a custodial account that is treated as an annuity contract under this section or a retirement income account that is treated as an annuity contract under §1.403(b)–9.

(b) *Contributions to the plan*. Contributions to a section 403(b) plan must be transferred to the insurance company issuing the annuity contract (or the entity holding assets of any custodial or retirement income account that is treated as an annuity contract) within a period that is not longer than is reasonable for the proper administration of the plan. For purposes of this requirement, the plan may provide for sec-

tion 403(b) elective deferrals for a participant under the plan to be transferred to the annuity contract within a specified period after the date the amounts would otherwise have been paid to the participant. For example, the plan could provide for section 403(b) elective deferrals under the plan to be contributed within 15 business days following the month in which these amounts would otherwise have been paid to the participant.

(c) *Annuity contracts*—(1) *Generally*. As defined in §1.403(b)–2, and except as otherwise permitted under this section, an annuity contract means a contract that is issued by an insurance company qualified to issue annuities in a State and that includes payment in the form of an annuity. This paragraph (c) sets forth additional rules regarding annuity contracts.

(2) *Certain insurance contracts*. Neither a life insurance contract, as defined in section 7702, an endowment contract, a health or accident insurance contract, nor a property, casualty, or liability insurance contract meets the definition of an annuity contract. See §1.401(f)–4(e). Also see §1.403(b)–11(d) for a transition rule.

(3) *Special rule for certain contracts*. This paragraph (c)(3) applies in the case of a contract issued under a State section 403(b) plan established on or before May 17, 1982, or for an employee who becomes covered for the first time under the plan after May 17, 1982, unless the Commissioner had before that date issued any written communication (either to the employer or financial institution) to the effect that the arrangement under which the contract was issued did not meet the requirements of section 403(b). The requirement that the contract be issued by an insurance company qualified to issue annuities in a State does not apply to that contract if one of the following two conditions is satisfied and that condition has been satisfied continuously since May 17, 1982—

(i) Benefits under the contract are provided from a separately funded retirement reserve that is subject to supervision of the State insurance department; or

(ii) Benefits under the contract are provided from a fund that is separate from the fund used to provide statutory benefits payable under a State retirement system and that is part of a State teachers retirement system to purchase benefits that are unrelated to the basic benefits provided under the retirement system, and the death benefit provided under the contract does not at any time exceed the larger of the reserve or the contribution made for the employee.

(d) *Custodial accounts*—(1) *Treatment as a section 403(b) contract*. Under section 403(b)(7), a custodial account is treated as an annuity contract for purposes of §§1.403(b)–1 through 1.403(b)–11. See section 403(b)(7)(B) for special rules regarding the tax treatment of custodial accounts and section 4973(c) for an excise tax that applies to excess contributions to a custodial account.

(2) *Custodial account defined*. A custodial account means a plan, or a separate account under a plan, in which an amount attributable to section 403(b) contributions (or amounts rolled over to a section 403(b) contract, as described in §1.403(b)–10(d)) is held by a bank or a person who satisfies the conditions in section 401(f)(2), if—

(i) All of the amounts held in the account are invested in stock of a regulated investment company (as defined in section 851(a) relating to mutual funds);

(ii) The requirements of §1.403(b)–6(c) (imposing restrictions on distributions with respect to a custodial account) and §1.403(b)–6(d) are satisfied with respect to the amounts held in the account;

(iii) The assets held in the account cannot be used for, or diverted to, purposes other than for the exclusive benefit of plan participants or their beneficiaries (for which purpose, assets are treated as diverted to the employer if the employer borrows assets from the account); and

(iv) The account is not part of a retirement income account.

(3) *Effect of definition*. The requirement in paragraph (d)(2)(i) of this section is not satisfied if the account includes any assets that other than stock of a regulated investment company.

(e) *Retirement income accounts*. See §1.403(b)–9 for special rules under which a retirement income account for employees of a church-related organization is treated as a section 403(b) contract for purposes of §§1.403(b)–1 through 1.403(b)–11.

(f) *Combining assets*. To the extent permitted by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter), trust assets held under a custodial account and trust assets held under a retirement income account, as described in §1.403(b)–9(a)(6), may be invested in a group trust with trust assets held under a qualified plan or individual retirement plan. For this purpose, a trust includes a custodial account that is treated as a trust under section 401(f).

*§1.403(b)–9 Special rules for church plans.*

(a) *Retirement income accounts*—(1) *Treatment as a section 403(b) contract*. Under section 403(b)(9), a retirement income account for employees of a church-related organization (as defined in §1.403(b)–2) is treated as an annuity contract for purposes of §§1.403(b)–1 through 1.403(b)–11.

(2) *Retirement income account defined*—(i) *In general*. A retirement income account means a defined contribution program established or maintained by a church-related organization under which—

(A) There is separate accounting for the retirement income account's interest in the underlying assets (*i.e.*, there must be sufficient separate accounting for it to be possible at all times to determine the retirement income account's interest in the underlying assets and to distinguish that interest from any interest that is not part of the retirement income account);

(B) Investment performance is based on gains and losses on those assets; and

(C) The assets held in the account cannot be used for, or diverted to, purposes other than for the exclusive benefit of plan participants or their beneficiaries. For this purpose, assets are treated as diverted to the employer if the employer borrows assets from the account.

(ii) *Plan required*. A retirement income account must be maintained pursuant to a program which is a plan (as defined in §1.403(b)–3(b)(3)) and the plan document must state (or otherwise evidence in a similarly clear manner) the intent to constitute a retirement income account.

(3) *Ownership or use constitutes distribution*. Any asset of a retirement income account that is owned or used by a participant or beneficiary is treated as having been distributed to that participant or ben-

eficiary. See §§1.403(b)–6 and 1.403(b)–7 for rules relating to distributions.

(4) *Coordination of retirement income account with custodial account rules*. A retirement income account that is treated as an annuity contract is not a custodial account (defined in §1.403(b)–8(d)(2)), even if it is invested solely in stock of a regulated investment company.

(5) *Life annuities*. A retirement income account may distribute benefits in a form that includes a life annuity only if—

(i) The amount of the distribution form has an actuarial present value, at the annuity starting date, equal to the participant's or beneficiary's accumulated benefit, based on reasonable actuarial assumptions, including regarding interest and mortality; and

(ii) The plan sponsor guarantees benefits in the event that a payment is due that exceeds the participant's or beneficiary's accumulated benefit.

(6) *Combining retirement income account assets with other assets*. For purposes of §1.403(b)–8(f) relating to combining assets, retirement income account assets held in trust (including a custodial account that is treated as a trust under section 401(f)) are subject to the same rules regarding combining of assets as custodial account assets. In addition, retirement income account assets are permitted to be commingled in a common fund with amounts devoted exclusively to church purposes (such as a fund from which unfunded pension payments are made to former employees of the church). However, unless otherwise permitted by the Commissioner, no assets of the plan sponsor, other than retirement income account assets, may be combined with custodial account assets or any other assets permitted to be combined under §1.403(b)–8(f). This paragraph (a)(6) is subject to any additional rules issued by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter).

(7) *Trust treated as tax exempt*. A trust (including a custodial account that is treated as a trust under section 401(f)) that includes no assets other than assets of a retirement income account is treated as an organization that is exempt from taxation under section 501(a).

(b) *No compensation limitation up to $10,000*. See section 415(c)(7) for special rules regarding certain employer contributions not exceeding $10,000.

(c) *Special deduction rule for self-employed ministers*. See section 404(a)(10) for a special rule regarding the deductibility of a contribution made by a self-employed minister.

*§1.403(b)–10 Miscellaneous provisions.*

(a) *Plan terminations and frozen plans*—(1) *In general*. An employer may amend its section 403(b) plan to eliminate future contributions for existing participants. Alternatively, an employer may amend its section 403(b) plan to limit participation to existing participants and employees (to the extent consistent with §1.403(b)–5). A section 403(b) plan may contain provisions that permit plan termination and permit accumulated benefits to be distributed on termination. However, in the case of a section 403(b) contract that is subject to the distribution restrictions in §1.403(b)–6(c) or (d) (relating to custodial accounts and section 403(b) elective deferrals), termination of the plan and the distribution of accumulated benefits is permitted only if the employer (taking into account all entities that are treated as the employer under section 414 on the date of the termination) does not make contributions to an alternative section 403(b) contract that is not part of the plan. For purposes of this rule, contributions are made to an alternative section 403(b) contract if and only if contributions are made to a section 403(b) contract during the period beginning on the date of plan termination and ending 12 months after distribution of all assets from the terminated plan. However, if at all times during the period beginning 12 months before the termination and ending 12 months after distribution of all assets from the terminated plan, fewer than 2 percent of the employees who were eligible under the section 403(b) plan as of the date of plan termination are eligible under the alternative section 403(b) contract, the alternative section 403(b) contract is disregarded. In order for a section 403(b) plan to be considered terminated, all accumulated benefits under the plan must be distributed to all participants and beneficiaries as soon as administratively practicable after termination of the plan. A distribution includes delivery of a fully paid individual insurance annuity contract. The mere provision for, and making of, distributions to participants or beneficiaries upon plan termination does not cause a contract to cease to be a section 403(b) contract. See §1.403(b)–7 for rules regarding the tax treatment of distributions.

(2) *Employers that cease to be eligible employers*. An employer that ceases to be an eligible employer may no longer contribute to a section 403(b) contract for any subsequent period, and the contract will fail to satisfy §1.403(b)–3(a) if any further contributions are made with respect to a period after the employer ceases to be an eligible employer.

(b) *Contract exchanges and plan-to-plan transfers*—(1) *Contract exchanges and transfers*—(i) *General rule*. If the conditions in paragraph (b)(2) of this section are met, a section 403(b) contract held under a section 403(b) plan may be exchanged for another section 403(b) contract held under that section 403(b) plan. Further, if the conditions in paragraph (b)(3) of this section are met, a section 403(b) plan may provide for the transfer of its assets (*i.e.*, the section 403(b) contracts held thereunder, including any assets held in a custodial account or retirement income account that are treated as section 403(b) contracts) to another section 403(b) plan. In addition, if the conditions in paragraph (b)(4) of this section (relating to permissive service credit and repayments under section 415) are met, a section 403(b) plan may provide for the transfer of its assets to a qualified plan under section 401(a). However, neither a qualified plan nor an eligible plan under section 457(b) may transfer assets to a section 403(b) plan, and a section 403(b) plan may not accept such a transfer. In addition, a section 403(b) contract may not be exchanged for an annuity contract that is not a section 403(b) contract. Neither a plan-to-plan transfer nor a contract exchange permitted under this paragraph (b) is treated as a distribution for purposes of the distribution restrictions at §1.403(b)–6. Therefore, such a transfer or exchange may be made before severance from employment or another distribution event. Further, no amount is includible in gross income by reason of such a transfer or exchange.

(ii) *ERISA rules*. See §1.414(l)–1 for other rules that are applicable to section 403(b) plans that are subject to section 208 of the Employee Retirement Income Security Act of 1974 (88 Stat. 829, 865).

(2) *Requirements for contract exchange within the same plan*. A section 403(b) contract of a participant or beneficiary may be exchanged under paragraph (b)(1) of this section for another section 403(b) contract of that participant or beneficiary under the same section 403(b) plan if the following conditions are met—

(i) The plan under which the contract is issued provides for the exchange;

(ii) The participant or beneficiary has an accumulated benefit immediately after the transfer at least equal to the accumulated benefit of that participant or beneficiary immediately before the exchange (taking into account the accumulated benefit of that participant or beneficiary under both section 403(b) contracts immediately before the exchange); and

(iii) The other contract provides that, to the extent a contract that is exchanged is subject to any distribution restrictions under §1.403(b)–6, the other contract imposes restrictions on distributions to the participant or beneficiary that are not less stringent than those imposed on the contract being exchanged.

(3) *Requirements for plan-to-plan transfers*. A plan-to-plan transfer under paragraph (b)(1) of this section from a section 403(b) plan to another section 403(b) plan is permitted if the following conditions are met—

(i) The participant or beneficiary whose assets are being transferred is an employee of the employer providing the receiving plan;

(ii) The transferor plan provides for transfers;

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

(iv) The participant or beneficiary whose assets are being transferred has an accumulated benefit immediately after the transfer at least equal to the accumulated benefit with respect to that participant or beneficiary immediately before the transfer.

(v) The receiving plan provides that, to the extent any amount transferred is subject to any distribution restrictions under §1.403(b)–6, the receiving plan imposes restrictions on distributions to the participant or beneficiary whose assets are being transferred that are not less stringent than those imposed on the transferor plan.

(vi) If a plan-to-plan transfer does not constitute a complete transfer of the participant's or beneficiary's interest in the section 403(b) plan, the transferee plan treats the amount transferred as a continuation of a *pro rata* portion of the participant's or beneficiary's interest in the section 403(b) plan (*e.g.*, a *pro rata* portion of the participant's or beneficiary's interest in any after-tax employee contributions).

(4) *Purchase of permissive service credit by contract-to-plan transfers from a section 403(b) contract to a qualified plan*—(i) *General rule*. If the conditions in paragraph (b)(4)(ii) of this section are met, a section 403(b) plan may provide for the transfer of assets held thereunder to a qualified defined benefit governmental plan (as defined in section 414(d)).

(ii) *Conditions for plan-to-plan transfers*. A transfer may be made under this paragraph (b)(4) only if the transfer is either—

(A) For the purchase of permissive service credit (as defined in section 415(n)(3)(A)) under the receiving defined benefit governmental plan; or

(B) A repayment to which section 415 does not apply by reason of section 415(k)(3).

(c) *Qualified domestic relations orders*. In accordance with the second sentence of section 414(p)(9), any distribution from an annuity contract under section 403(b) (including a distribution from a custodial account or retirement income account that, under section 403(b)(7) or (9), is treated as a section 403(b) contract) pursuant to a qualified domestic relations order is treated in the same manner as a distribution from a plan to which section 401(a)(13) applies. Thus, for example, a section 403(b) plan does not fail to satisfy the distribution restrictions set forth in §1.403(b)–6(b), (c), or (d) merely as a result of distribution made pursuant to a qualified domestic relations order under section 414(p), so that such a distribution is permitted without regard to whether the employee from whose contract the distribution is made has had a severance from employment or other event permitting a distribution to be made under section 403(b).

(d) *Rollovers to a section 403(b) contract*. A section 403(b) contract may accept contributions that are eligible rollover distributions (as defined in section 402(c)(4)) made from another eligible retirement plan (as defined in section 402(c)(8)(B)). Amounts contributed to a section 403(b) contract as eligible rollover distributions are not taken into account for purposes of the limits in §1.403(b)–4, but, except as otherwise specifically provided (for example, at §1.403(b)–6(i)), are otherwise treated in the same manner as amounts held under a section 403(b) contract for purposes of §§1.403(b)–3 through 1.403(b)–9 and this section.

(e) *Deemed IRAs*. See regulations under section 408(q) for special rules relating to deemed IRAs.

(f) *Defined benefit plans*—(1) *TEFRA church defined benefit plans*. See section 251(e)(5) of the Tax Equity and Fiscal Responsibility Act of 1982, Public Law 97–248, for a provision permitting certain arrangements established by a church-related organization and in effect on September 3, 1982 (a TEFRA church defined benefit plan), to be treated as section 403(b) contract even though it is a defined benefit arrangement. In accordance with section 403(b)(1), for purposes of applying section 415 to a TEFRA church defined benefit plan, the accruals under the plan are limited to the maximum amount permitted under section 415(c) when expressed as an annual addition, and, for this purpose, the rules at §1.402(b)–1(a)(2) for determining the present value of an accrual under a nonqualified defined benefit plan also apply for purposes of converting the accrual under a TEFRA church defined benefit plan to an annual addition. See section 415(b) for additional limits for TEFRA church defined benefit plans.

(2) *Other defined benefit plans*. Except for a TEFRA church defined benefit plan, section 403(b) does not apply to any contributions or accrual under a defined benefit plan.

(g) *Other rules relating to section 501(c)(3) organizations*. See section 501(c)(3) and regulations thereunder for the substantive standards for tax-exemption under that section, including the requirement that no part of the organization's net earnings inure to the benefit of any private shareholder or individual. See also sections 4941 (self dealing), 4945

(taxable expenditures), and 4958 (excess benefit transactions), and the regulations thereunder, for rules relating to excise taxes imposed on certain transactions involving organizations described in section 501(c)(3).

*§1.403(b)–11 Effective dates.*

(a) Except as otherwise provided in this section, §§1.403(b)–1 through 1.403(b)–10 apply for taxable years beginning after December 31, 2005.

(b) In the case of a section 403(b) contract maintained pursuant to a collective bargaining agreement that is ratified and in effect on the date of publication of final regulations in the **Federal Register**, §§1.403(b)–1 through 1.403(b)–10 do not apply before the date on which the collective bargaining agreement terminates (determined without regard to any extension thereof after the date of publication of final regulations in the **Federal Register**).

(c) In the case of a section 403(b) contract maintained by a church-related organization for which the authority to amend the contract is held by a church convention (within the meaning of section 414(e)), §§1.403(b)–1 through 1.403(b)–10 do not apply before the earlier of—

(1) January 1, 2007; or

(2) 60 days following the earliest church convention that occurs after the date of publication of final regulations in the **Federal Register**.

(d) Section 1.403(b)–8(c)(2) does not apply to a contract issued before February 14, 2005.

Par. 6. Section 1.414(c)–5 is redesignated as §1.414(c)–6 and new §1.414(c)–5 is added to read as follows:

*§1.414(c)–5 Certain tax-exempt organizations.*

(a) *Application*. This section applies to an organization that is exempt from tax under section 501(a). The rules of this section are in addition to the rules otherwise applicable under section 414(b) and 414(c). Except to the extent set forth in paragraphs (d), (e), and (f) of this section, this section does not apply to any church, as defined in section 3121(w)(3)(A), or any qualified church-controlled organization, as defined in section 3121(w)(3)(B).

(b) *General rule*. In the case of an organization that is exempt from tax under section 501(a) (an exempt organization) whose employees participate in a plan, the employer with respect to that plan includes the exempt organization and any other organization that is under common control with the exempt organization whose employees participate in the plan. For this purpose, common control exists between exempt organizations if at least 80 percent of the directors or trustees of one organization are either representatives of, or directly or indirectly controlled by, the other organization. A trustee or director is treated as a representative of another exempt organization if he or she also is a trustee, director, agent, or employee of the other exempt organization. Existence of control is determined based on the facts and circumstances. A trustee or director is controlled by another organization if the other organization has the power to remove such trustee or director and designate a new trustee or director. For example, if exempt organization A appoints at least 80 percent of the trustees of exempt organization B (which is the owner of the outstanding shares of corporation C, which is not an exempt organization) and has the power to control at least 80 percent of the directors of exempt organization D, then, under this paragraph (b) and §1.414(b)–1, entities A, B, C, and D are treated as the same employer with respect to any plan maintained by A, B, C, or D for purposes of the sections referenced in sections 414(b), 414(c), and 414(t).

(c) *Permissive aggregation with entities having a common exempt purpose*. For purposes of this section, exempt organizations that maintain a single plan covering one or more employees from each organization may treat themselves as under common control for purposes of section 414(c) if each of the organizations regularly coordinate their day-to-day exempt activities. For example, an entity that provides a type of emergency relief within one geographic region and another exempt organization that provides that type of emergency relief within another geographic region may treat themselves as under common control if they have a single plan covering employees of both entities and regularly coordinate their day-to-day exempt activities. Similarly, a hospital that is an exempt organization and another exempt organization with which it coordinates the delivery of medical services or medical research may treat themselves as under common control if there is a single plan covering employees of the hospital and employees of the other exempt organization and the coordination is a regular part of their day-to-day exempt activities.

(d) *Permissive disaggregation between qualified church controlled organizations and other entities*. In the case of a church plan (as defined in section 414(e)) to which contributions are made by more than one common law entity, any employer may apply paragraphs (b) and (c) of this section to those entities that are not a church (as defined in section 403(b)(12)(B) and §1.403(b)–2) separately from those entities that are churches. For example, in the case of a group of entities consisting of a church (as defined in section 3121(w)(3)(A)), a secondary school (that is treated as a church under §1.403(b)–2), and a nursing home that receives more than 25 percent of its support from fees paid by residents (so that it is not treated as a qualified church-controlled organization under §1.403(b)–2 and section 3121(w)(3)(B)), the nursing home may treat itself as not being under common control with the church and the school, even though the nursing home may be under common control with the school and the church under paragraph (b) of this section.

(e) *Application to certain church entities*. [Reserved].

(f) *Anti-abuse rule*. In any case in which the Commissioner determines that the structure of one or more exempt organizations (including an exempt organization and an entity that is not exempt from income tax) or the positions taken by those organizations has the effect of avoiding or evading §1.403(b)–5(a) or another requirement imposed under section 401(a), 403(b), or 457(b), or any applicable section (as defined in section 414(t)), the Commissioner may treat an entity as under common control with the exempt organization.

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

*Example 1*. (i) *Facts*. Organization A is a tax-exempt organization under section 501(c)(3) which owns 80% or more of the total value of all classes of stock of corporation B, which is a for profit organization.

(ii) *Conclusion*. Under paragraph (a) of this section, this section does not alter the rules of section

414(b) and (c), so that organization A and corporation B are under common control under §1.414(c)–2(b).

*Example 2*. (i) *Facts*. Organization M is a hospital which is a tax-exempt organization under section 501(c)(3) and organization N is a medical clinic which is also a tax-exempt organization under section 501(c)(3). N is located in a city and M is located in a nearby suburb. There is a history of regular coordination of day-to-day activities between M and N, including periodic transfers of staff, coordination of staff training, common sources of income, and coordination of budget and operational goals. A single section 403(b) plan covers professional and staff employees of both the hospital and the medical clinic. While a number of members of the board of directors of M are also on the board of directors of N, there is less than 80% overlap in board membership. Both organizations have approximately the same percentage of employees who are highly compensated and have appropriate business reasons for being maintained in separate entities.

(ii) *Conclusion*. M and N are not under common control under this section, but, under paragraph (c) of this section, may chose to treat themselves as under common control, assuming both of them act in a manner that is consistent with that choice for purposes of §1.403(b)–5(a), sections 401(a), 403(b), and 457(b), and any other applicable section (as defined in section 414(t)).

(h) *Effective date*. This section applies for taxable years beginning after December 31, 2005.

PART 31—EMPLOYMENT TAXES

Par. 7. The authority citation for part 31 continues to read, in part, as follows:

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

Par. 8. Section 31.3121(a)(5)–2 is added to read as follows:

*§31.3121(a)(5)–2 Payments under or to an annuity contract described in section 403(b).*

[The text of proposed §31.3121(a)(5)–2 is the same as the text of §31.3121(a)(5)–2T(a) through (b)(1) published elsewhere in this issue of the Bulletin].

Nancy Jardini,
*Acting Deputy Commissioner for Services and Enforcement.*

(Filed by the Office of the Federal Register on November 15, 2004, 8:45 a.m., and published in the issue of the Federal Register for November 16, 2004, 69 F.R. 67075)

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

## Announcement 2004-95

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

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

# Consent Suspensions From Practice Before the Internal Revenue Service

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

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

| Name | Address | Designation | Date of Suspension |
| --- | --- | --- | --- |
| Sanchez, Wayne L. | Derby, KS | Attorney | Indefinite from July 12, 2004 |
| Gatti, John T. | Orlando, FL | Enrolled Agent | Indefinite from July 16, 2004 |
| Hall, Beverly J. | Newberg, OR | Enrolled Agent | Indefinite from July 26, 2004 |
| Spencer, Robert E. | Wilmington, NC | Enrolled Agent | Indefinite from August 11, 2004 |
| Lebaron, Betty J. | Mesa, AZ | Enrolled Agent | Indefinite from August 17, 2004 |
| Worrell, Douglas | Streamwood, IL | Attorney | Indefinite from August 23, 2004 |
| Singleton, Stan R. | Derby, KS | Attorney | Indefinite from August 30, 2004 |
| Halpern, Barbara | Weston, CT | CPA | Indefinite from September 15, 2004 |
| Johnson, Jeanne M. | Hoquiam, WA | Enrolled Agent | Indefinite from September 27, 2004 |
| Fisher, Robert | Holbrook, AZ | Enrolled Agent | Indefinite from October 5, 2004 |
| Valdez II, Arthur | Albuquerque, NM | CPA | Indefinite from October 19, 2004 |

| Name | Address | Designation | Date of Suspension |
|---|---|---|---|
| Wilshire Jr., Raymond B. | Fort Worth, TX | Enrolled Agent | Indefinite from December 1, 2004 |

# Expedited Suspensions From Practice Before the Internal Revenue Service

Under Title 31, Code of Federal Regulations, Part 10, the Director, Office of Professional Responsibility, is authorized to immediately suspend from practice before the Internal Revenue Service any practitioner who, within five years from the date the expedited proceeding is instituted (1) has had a license to practice as an attorney, certified public accountant, or actuary suspended or revoked for cause or (2) has been convicted of certain crimes.

The following individuals have been placed under suspension from practice before the Internal Revenue Service by virtue of the expedited proceeding provisions:

| Name | Address | Designation | Date of Suspension |
|---|---|---|---|
| Daly, Thomas J. | Elmsford, NY | CPA | Indefinite from August 20, 2004 |
| Jewett, Jerry A. | Fremont, OH | Attorney | Indefinite from September 8, 2004 |
| Kyllo, Harry N. | Portland, OR | CPA | Indefinite from September 9, 2004 |
| Pearl, David S. | Reisterstown, MD | Attorney | Indefinite from September 21, 2004 |
| Graugnard, Paul E. | Alexandria, LA | Attorney | Indefinite from September 21, 2004 |
| Thomas, Robert C. | Natchitoches, LA | Attorney | Indefinite from September 21, 2004 |
| Culver Jr., Allan J. | Bel Air, MD | Attorney | Indefinite from September 21, 2004 |
| Christovich, Michael | New Orleans, LA | Attorney | Indefinite from September 27, 2004 |
| Turner, Haiden W. | Farmers Branch, TX | CPA | Indefinite from September 27, 2004 |
| Tuttle, Heidi | Unionville, CT | Attorney | Indefinite from September 27, 2004 |

| Name | Address | Designation | Date of Suspension |
|---|---|---|---|
| Oberhauser Jr., Louis | Wayzata, MN | Attorney | Indefinite from September 27, 2004 |
| Nelson, John A. | Wilmar, MN | Attorney | Indefinite from September 27, 2004 |
| Judd Jr., John K. | Taft, CA | CPA | Indefinite from September 30, 2004 |
| McGrady, Michael S. | Hankins, NY | Attorney | Indefinite from October 1, 2004 |
| Wahl-Taylor, Kimberly | Council Bluffs, IA | Attorney | Indefinite from October 4, 2004 |
| Haneberg III, Elmer C.W. | Chicago, IL | Attorney | Indefinite from October 6, 2004 |
| McDonald, Michael G. | Methuen, MA | Attorney | Indefinite from October 6, 2004 |
| Mason Jr., Maurice | Dracut, MA | Attorney | Indefinite from October 6, 2004 |
| Aaron, Stanley R. | Baton Rouge, LA | Attorney | Indefinite from October 6, 2004 |
| McFarland, Sheila E. | Chicago, IL | Attorney | Indefinite from October 6, 2004 |
| Deutchman, Murray L. | Barnesville, MD | Attorney | Indefinite from October 6, 2004 |
| Wolfert, Marvin L. | Foxboro, MA | Attorney | Indefinite from October 6, 2004 |
| Andricopoulos, Maureen | Chelmsford, MA | Attorney | Indefinite from October 6, 2004 |
| Ezuruike, Maurice | Austin, TX | Attorney | Indefinite from October 6, 2004 |
| Jones, Thomas C. | Dekalb, IL | Attorney | Indefinite from October 6, 2004 |

| Name | Address | Designation | Date of Suspension |
|---|---|---|---|
| Yopp, L. Gregory | Louisville, KY | Attorney | Indefinite from October 6, 2004 |
| Waples, Alan N. | Burlington, IA | Attorney | Indefinite from October 6, 2004 |
| Ghitelman, Gayle S. | Brookline, MA | Attorney | Indefinite from October 6, 2004 |
| Bulas Jr., Luis | Hollywood, FL | Enrolled Agent | Indefinite from October 15, 2004 |
| Earl, Thomas J. | Moses Lake, WA | Attorney | Indefinite from October 8, 2004 |
| George, Gary R. | Milwaukee, WI | Attorney | Indefinite from October 8, 2004 |
| Jordan, David M. | San Antonio, TX | Attorney | Indefinite from October 8, 2004 |
| Young III, George G. | Havertown, PA | Attorney | Indefinite from October 8, 2004 |
| Tanner, Martin | Salt Lake City, UT | Attorney | Indefinite from October 8, 2004 |
| Jensen, Georg | Cheyenne, WY | Attorney | Indefinite from October 8, 2004 |
| Slowiaczek, Peter A. | Lakewood, WA | Attorney | Indefinite from October 8, 2004 |
| Fennell, David E. | New Castle, WA | Attorney | Indefinite from October 8, 2004 |
| Gish, Robert | Basin, WY | Attorney | Indefinite from October 8, 2004 |
| Ramirez, Silverio | Roselle, NJ | Attorney | Indefinite from October 8, 2004 |
| Flaherty, Patrick J. | Traverse City, MI | CPA | Indefinite from October 19, 2004 |
| Vanden Berg, Steven | Mason City, IA | Attorney | Indefinite from October 25, 2004 |

| Name | Address | Designation | Date of Suspension |
|---|---|---|---|
| Johnson, Jamis M. | Salt Lake City, UT | Attorney | Indefinite from October 25, 2004 |
| Braskey, James F. | Frostburg, MD | Attorney | Indefinite from October 25, 2004 |
| Mills, Laurence A. | Wellesley, MA | Attorney | Indefinite from October 26, 2004 |

# Censure Issued by Consent

Under Title 31, Code of Federal Regulations, Part 10, in lieu of a proceeding being instituted or continued, an attorney, certified public accountant, enrolled agent, or enrolled actuary, may offer his or her consent to the issuance of a censure. Censure is a public reprimand.

The following individuals have consented to the issuance of a Censure:

| Name | Address | Designation | Date of Censure |
|---|---|---|---|
| Dayandayan, Angel Y. | Irvine, CA | Enrolled Agent | July 27, 2004 |
| Summers, Todd W. | Stockton, CA | Enrolled Agent | August 10, 2004 |
| Barrett Sr., Jeffrey J. | Catskill, NY | CPA | August 31, 2004 |
| Davis, Charles W. | San Francisco, CA | Enrolled Agent | September 28, 2004 |
| Giles, Benjamin M. | Wichita, KS | CPA | September 30, 2004 |

# Suspensions From Practice Before the Internal Revenue Service After Notice and an Opportunity for a Proceeding

Under Title 31, Code of Federal Regulations, Part 10, after notice and an opportunity for a proceeding before an administrative law judge, the following individuals have been placed under suspension from practice before the Internal Revenue Service:

| Name | Address | Designation | Effective Date |
|---|---|---|---|
| Lim, Edgar E. | St. Louis, MO | Attorney | August 2, 2004 to July 31, 2007 |

# Resignations of Enrolled Agents

Under Title 31, Code of Federal Regulations, Part 10, an enrolled agent, in order to avoid the institution or conclusion of a proceeding for his or her disbarment or suspension from practice before the Internal Revenue Service, may offer his or her resignation as an enrolled agent. The Director, Office of Professional Responsibility, in his discretion, may accept the offered resignation.

The Director, Office of Professional Responsibility, has accepted offers of resignation as an enrolled agent from the following individuals:

| Name | Address | Date of Resignation |
|---|---|---|
| Gleason, Daniel J. | Franklin, TN | September 30, 2004 |

# Consent Disbarment From Practice Before the Internal Revenue Service

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

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

| Name | Address | Designation | Date of Disbarment |
|---|---|---|---|
| Fort, Gala J. | Las Vegas, NV | CPA | Indefinite from October 19, 2004 |

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## Regulated Investment Company (RIC); Correction

## Announcement 2004–97

PURPOSE

This document contains a correction to Rev. Rul. 2003–84, 2003–32 I.R.B. 289, and 2003–2 C.B. 289. As published, Rev. Rul. 2003–84 contains an error that may prove to be misleading and is in need of clarification.

CORRECTION

On page 290 of I.R.B. 2003–32 and C.B. 2003–2, under HOLDING, on the second line of the paragraph, the reference to § 851(g)(3) should read "§ 851(b)(3)".

FOR FURTHER INFORMATON CONTACT:

Susan Thompson Baker at (202) 622–3930 (not a toll-free number).

# Definition of Terms

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

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

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

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

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

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

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

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

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

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

# Abbreviations

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

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

## Numerical Finding List[1]

Bulletins 2004–27 through 2004–49

### Announcements:


2004-55, 2004-27 I.R.B. *15*
2004-56, 2004-28 I.R.B. *41*
2004-57, 2004-27 I.R.B. *15*
2004-58, 2004-29 I.R.B. *66*
2004-59, 2004-30 I.R.B. *94*
2004-60, 2004-29 I.R.B. *43*
2004-61, 2004-29 I.R.B. *67*
2004-62, 2004-30 I.R.B. *103*
2004-63, 2004-31 I.R.B. *149*
2004-64, 2004-35 I.R.B. *402*
2004-65, 2004-33 I.R.B. *300*
2004-66, 2004-35 I.R.B. *402*
2004-67, 2004-36 I.R.B. *459*
2004-68, 2004-38 I.R.B. *508*
2004-69, 2004-39 I.R.B. *542*
2004-70, 2004-39 I.R.B. *543*
2004-71, 2004-40 I.R.B. *569*
2004-72, 2004-41 I.R.B. *650*
2004-73, 2004-39 I.R.B. *543*
2004-74, 2004-40 I.R.B. *579*
2004-75, 2004-40 I.R.B. *580*
2004-76, 2004-40 I.R.B. *588*
2004-77, 2004-41 I.R.B. *662*
2004-78, 2004-40 I.R.B. *592*
2004-79, 2004-41 I.R.B. *662*
2004-80, 2004-41 I.R.B. *663*
2004-81, 2004-42 I.R.B. *675*
2004-82, 2004-45 I.R.B. *834*
2004-83, 2004-43 I.R.B. *712*
2004-84, 2004-43 I.R.B. *712*
2004-85, 2004-43 I.R.B. *712*
2004-86, 2004-46 I.R.B. *842*
2004-87, 2004-45 I.R.B. *834*
2004-88, 2004-44 I.R.B. *779*
2004-89, 2004-45 I.R.B. *835*
2004-90, 2004-45 I.R.B. *835*
2004-91, 2004-45 I.R.B. *835*
2004-92, 2004-45 I.R.B. *835*
2004-93, 2004-48 I.R.B. *882*
2004-94, 2004-46 I.R.B. *842*
2004-95, 2004-46 I.R.B. *845*
2004-96, 2004-47 I.R.B. *872*
2004-97, 2004-49 I.R.B. *957*


### Notices:


2004-41, 2004-28 I.R.B. *31*
2004-43, 2004-27 I.R.B. *10*
2004-44, 2004-28 I.R.B. *32*
2004-45, 2004-28 I.R.B. *33*
2004-46, 2004-29 I.R.B. *46*
2004-47, 2004-29 I.R.B. *48*


**Notices— Continued:**


2004-48, 2004-30 I.R.B. *88*
2004-49, 2004-30 I.R.B. *88*
2004-50, 2004-33 I.R.B. *196*
2004-51, 2004-30 I.R.B. *89*
2004-52, 2004-32 I.R.B. *168*
2004-53, 2004-33 I.R.B. *209*
2004-54, 2004-33 I.R.B. *209*
2004-55, 2004-34 I.R.B. *319*
2004-56, 2004-35 I.R.B. *375*
2004-57, 2004-35 I.R.B. *376*
2004-58, 2004-39 I.R.B. *520*
2004-59, 2004-36 I.R.B. *447*
2004-60, 2004-40 I.R.B. *564*
2004-61, 2004-41 I.R.B. *596*
2004-62, 2004-40 I.R.B. *565*
2004-63, 2004-41 I.R.B. *597*
2004-64, 2004-41 I.R.B. *598*
2004-65, 2004-41 I.R.B. *599*
2004-66, 2004-42 I.R.B. *677*
2004-67, 2004-41 I.R.B. *600*
2004-68, 2004-43 I.R.B. *706*
2004-69, 2004-43 I.R.B. *706*
2004-70, 2004-44 I.R.B. *724*
2004-71, 2004-45 I.R.B. *793*
2004-72, 2004-46 I.R.B. *840*
2004-73, 2004-46 I.R.B. *841*
2004-74, 2004-48 I.R.B. *875*
2004-75, 2004-48 I.R.B. *876*
2004-76, 2004-48 I.R.B. *878*
2004-77, 2004-47 I.R.B. *855*
2004-78, 2004-48 I.R.B. *879*
2004-79, 2004-49 I.R.B. *898*


### Proposed Regulations:


REG-208246-90, 2004-36 I.R.B. *450*
REG-138176-02, 2004-43 I.R.B. *710*
REG-153841-02, 2004-31 I.R.B. *145*
REG-155608-02, 2004-49 I.R.B. *924*
REG-163679-02, 2004-35 I.R.B. *390*
REG-163909-02, 2004-38 I.R.B. *499*
REG-108637-03, 2004-37 I.R.B. *472*
REG-120616-03, 2004-37 I.R.B. *474*
REG-124405-03, 2004-35 I.R.B. *394*
REG-131486-03, 2004-28 I.R.B. *36*
REG-131786-03, 2004-38 I.R.B. *500*
REG-145987-03, 2004-39 I.R.B. *523*
REG-145988-03, 2004-42 I.R.B. *693*
REG-149524-03, 2004-39 I.R.B. *528*
REG-150562-03, 2004-32 I.R.B. *175*
REG-152549-03, 2004-36 I.R.B. *451*
REG-154077-03, 2004-37 I.R.B. *476*
REG-169135-03, 2004-42 I.R.B. *697*
REG-171386-03, 2004-37 I.R.B. *477*
REG-101282-04, 2004-42 I.R.B. *698*
REG-101447-04, 2004-34 I.R.B. *344*


**Proposed Regulations— Continued:**


REG-106889-04, 2004-38 I.R.B. *501*
REG-114726-04, 2004-47 I.R.B. *857*
REG-116265-04, 2004-38 I.R.B. *505*
REG-117307-04, 2004-28 I.R.B. *39*
REG-124872-04, 2004-39 I.R.B. *533*
REG-128767-04, 2004-39 I.R.B. *534*
REG-129274-04, 2004-40 I.R.B. *567*
REG-129706-04, 2004-37 I.R.B. *478*
REG-129771-04, 2004-36 I.R.B. *453*
REG-130863-04, 2004-39 I.R.B. *538*
REG-131264-04, 2004-38 I.R.B. *506*
REG-135898-04, 2004-40 I.R.B. *568*
REG-136481-04, 2004-37 I.R.B. *480*


### Revenue Procedures:


2004-38, 2004-27 I.R.B. *10*
2004-39, 2004-29 I.R.B. *49*
2004-40, 2004-29 I.R.B. *50*
2004-41, 2004-30 I.R.B. *90*
2004-42, 2004-31 I.R.B. *121*
2004-43, 2004-31 I.R.B. *124*
2004-44, 2004-31 I.R.B. *134*
2004-45, 2004-31 I.R.B. *140*
2004-46, 2004-31 I.R.B. *142*
2004-47, 2004-32 I.R.B. *169*
2004-48, 2004-32 I.R.B. *172*
2004-49, 2004-33 I.R.B. *210*
2004-50, 2004-33 I.R.B. *211*
2004-51, 2004-33 I.R.B. *294*
2004-52, 2004-34 I.R.B. *319*
2004-53, 2004-34 I.R.B. *320*
2004-54, 2004-34 I.R.B. *325*
2004-55, 2004-34 I.R.B. *343*
2004-56, 2004-35 I.R.B. *376*
2004-57, 2004-38 I.R.B. *498*
2004-58, 2004-41 I.R.B. *602*
2004-59, 2004-42 I.R.B. *678*
2004-60, 2004-42 I.R.B. *682*
2004-61, 2004-43 I.R.B. *707*
2004-62, 2004-44 I.R.B. *728*
2004-63, 2004-45 I.R.B. *795*
2004-64, 2004-49 I.R.B. *898*
2004-69, 2004-49 I.R.B. *906*
2004-70, 2004-49 I.R.B. *918*


### Revenue Rulings:


2004-63, 2004-27 I.R.B. *6*
2004-64, 2004-27 I.R.B. *7*
2004-65, 2004-27 I.R.B. *1*
2004-66, 2004-27 I.R.B. *4*
2004-67, 2004-28 I.R.B. *28*
2004-68, 2004-31 I.R.B. *118*
2004-69, 2004-36 I.R.B. *445*
2004-70, 2004-37 I.R.B. *460*
2004-71, 2004-30 I.R.B. *74*


[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2004–1 through 2004–26 is in Internal Revenue Bulletin 2004–26, dated June 28, 2004.

**Revenue Rulings— Continued:**

2004-72, 2004-30 I.R.B. *77*
2004-73, 2004-30 I.R.B. *80*
2004-74, 2004-30 I.R.B. *84*
2004-75, 2004-31 I.R.B. *109*
2004-76, 2004-31 I.R.B. *111*
2004-77, 2004-31 I.R.B. *119*
2004-78, 2004-31 I.R.B. *108*
2004-79, 2004-31 I.R.B. *106*
2004-80, 2004-32 I.R.B. *164*
2004-81, 2004-32 I.R.B. *161*
2004-82, 2004-35 I.R.B. *350*
2004-83, 2004-32 I.R.B. *157*
2004-84, 2004-32 I.R.B. *163*
2004-85, 2004-33 I.R.B. *189*
2004-86, 2004-33 I.R.B. *191*
2004-87, 2004-32 I.R.B. *154*
2004-88, 2004-32 I.R.B. *165*
2004-89, 2004-34 I.R.B. *301*
2004-90, 2004-34 I.R.B. *317*
2004-91, 2004-35 I.R.B. *357*
2004-92, 2004-37 I.R.B. *466*
2004-93, 2004-37 I.R.B. *462*
2004-94, 2004-38 I.R.B. *491*
2004-95, 2004-38 I.R.B. *492*
2004-96, 2004-41 I.R.B. *593*
2004-97, 2004-39 I.R.B. *516*
2004-98, 2004-42 I.R.B. *664*
2004-99, 2004-44 I.R.B. *720*
2004-100, 2004-44 I.R.B. *718*
2004-101, 2004-44 I.R.B. *719*
2004-102, 2004-45 I.R.B. *784*
2004-103, 2004-45 I.R.B. *783*
2004-104, 2004-46 I.R.B. *837*
2004-105, 2004-48 I.R.B. *873*
2004-106, 2004-49 I.R.B. *893*
2004-107, 2004-47 I.R.B. *852*
2004-108, 2004-47 I.R.B. *853*

**Tax Conventions:**

2004-60, 2004-29 I.R.B. *43*
2004-81, 2004-42 I.R.B. *675*

**Treasury Decisions:**

9131, 2004-27 I.R.B. *2*
9132, 2004-28 I.R.B. *16*
9133, 2004-28 I.R.B. *25*
9134, 2004-30 I.R.B. *70*
9135, 2004-30 I.R.B. *69*
9136, 2004-31 I.R.B. *112*
9137, 2004-34 I.R.B. *308*
9138, 2004-32 I.R.B. *160*
9139, 2004-38 I.R.B. *495*
9140, 2004-32 I.R.B. *159*
9141, 2004-35 I.R.B. *359*
9142, 2004-34 I.R.B. *302*
9143, 2004-36 I.R.B. *442*
9144, 2004-36 I.R.B. *413*

**Treasury Decisions— Continued:**

9145, 2004-37 I.R.B. *464*
9146, 2004-36 I.R.B. *408*
9147, 2004-37 I.R.B. *461*
9148, 2004-37 I.R.B. *460*
9149, 2004-38 I.R.B. *494*
9150, 2004-39 I.R.B. *514*
9151, 2004-38 I.R.B. *489*
9152, 2004-39 I.R.B. *509*
9153, 2004-39 I.R.B. *517*
9154, 2004-40 I.R.B. *560*
9155, 2004-40 I.R.B. *562*
9156, 2004-42 I.R.B. *669*
9157, 2004-40 I.R.B. *545*
9158, 2004-42 I.R.B. *665*
9159, 2004-49 I.R.B. *895*
9160, 2004-45 I.R.B. *785*
9161, 2004-43 I.R.B. *704*

## Findings List of Current Actions on Previously Published Items[1]

Bulletins 2004–27 through 2004–49

### Announcements:

**99-76**
Obsoleted by
T.D. 9157, 2004-40 I.R.B. *545*

**2003-54**
Updated and superseded by
Ann. 2004-72, 2004-41 I.R.B. *650*

**2004-70**
Amended by
Ann. 2004-77, 2004-41 I.R.B. *662*

### Notices:

**88-128**
Supplemented by
Notice 2004-61, 2004-41 I.R.B. *596*

**98-65**
Superseded by
Rev. Proc. 2004-40, 2004-29 I.R.B. *50*

**2001-50**
Modified by
Rev. Proc. 2004-46, 2004-31 I.R.B. *142*

**2002-70**
Modified by
Notice 2004-65, 2004-41 I.R.B. *599*

**2003-76**
Supplemented and superseded by
Notice 2004-67, 2004-41 I.R.B. *600*
Modified by
Notice 2004-65, 2004-41 I.R.B. *599*

**2004-2**
Modified by
Notice 2004-50, 2004-33 I.R.B. *196*
2004-2,
Corrected by
Ann. 2004-67, 2004-36 I.R.B. *459*

**2004-66**
Amplified and superseded by
Notice 2004-76, 2004-48 I.R.B. *878*

### Proposed Regulations:

**INTL-116-90**
Withdrawn by
REG-208246-90, 2004-36 I.R.B. *450*

**REG-208254-90**
Withdrawn by
REG-136481-04, 2004-37 I.R.B. *480*

**REG-104683-00**
Partially withdrawn by
Ann. 2004-64, 2004-35 I.R.B. *402*

**Proposed Regulations— Continued:**

**REG-165579-02**
Withdrawn by
Ann. 2004-69, 2004-39 I.R.B. *542*

**REG-150562-03**
Corrected by
Ann. 2004-68, 2004-38 I.R.B. *508*
Ann. 2004-73, 2004-39 I.R.B. *543*

### Revenue Procedures:

**79-61**
Superseded by
Rev. Proc. 2004-44, 2004-31 I.R.B. *134*

**89-37**
Obsoleted by
Rev. Rul. 2004-90, 2004-34 I.R.B. *317*

**94-64**
Superseded by
Rev. Proc. 2004-38, 2004-27 I.R.B. *10*

**96-18**
Obsoleted by
Rev. Rul. 2004-90, 2004-34 I.R.B. *317*

**96-53**
Superseded by
Rev. Proc. 2004-40, 2004-29 I.R.B. *50*

**96-60**
Superseded by
Rev. Proc. 2004-53, 2004-34 I.R.B. *320*

**98-41**
Superseded by
Rev. Proc. 2004-56, 2004-35 I.R.B. *376*

**2000-37**
Modified by
Rev. Proc. 2004-51, 2004-33 I.R.B. *294*

**2002-9**
Modified and amplified by
Rev. Proc. 2004-41, 2004-30 I.R.B. *90*

**2003-28**
Superseded by
Rev. Proc. 2004-58, 2004-41 I.R.B. *602*

**2003-30**
Superseded by
Rev. Proc. 2004-54, 2004-34 I.R.B. *325*

**2003-52**
Superseded by
Rev. Proc. 2004-50, 2004-33 I.R.B. *211*

**2003-73**
Superseded by
Rev. Proc. 2004-62, 2004-44 I.R.B. *728*

**2003-76**
Superseded by
Rev. Proc. 2004-64, 2004-49 I.R.B. *898*

**Revenue Procedures— Continued:**

**2003-80**
Superseded by
Rev. Proc. 2004-60, 2004-42 I.R.B. *682*

**2003-83**
Superseded by
Rev. Proc. 2004-63, 2004-45 I.R.B. *795*

**2004-4**
Modified by
Rev. Proc. 2004-44, 2004-31 I.R.B. *134*

**2004-23**
Modified by
Rev. Proc. 2004-57, 2004-38 I.R.B. *498*

### Revenue Rulings:

**54-379**
Superseded by
Rev. Rul. 2004-68, 2004-31 I.R.B. *118*

**58-120**
Obsoleted by
Rev. Rul. 2004-90, 2004-34 I.R.B. *317*

**62-60**
Amplified by
Rev. Proc. 2004-53, 2004-34 I.R.B. *320*

**70-58**
Obsoleted by
Rev. Rul. 2004-90, 2004-34 I.R.B. *317*

**73-354**
Obsoleted by
Rev. Rul. 2004-76, 2004-31 I.R.B. *111*

**78-371**
Distinguished by
Rev. Rul. 2004-86, 2004-33 I.R.B. *191*

**79-64**
Obsoleted by
Rev. Rul. 2004-90, 2004-34 I.R.B. *317*

**80-7**
Amplified and clarified by
Rev. Rul. 2004-71, 2004-30 I.R.B. *74*
Rev. Rul. 2004-72, 2004-30 I.R.B. *77*
Rev. Rul. 2004-73, 2004-30 I.R.B. *80*
Rev. Rul. 2004-74, 2004-30 I.R.B. *84*

**80-366**
Obsoleted by
Rev. Rul. 2004-90, 2004-34 I.R.B. *317*

**81-100**
Clarified and modified by
Rev. Rul. 2004-67, 2004-28 I.R.B. *28*

[1] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2004–1 through 2004–26 is in Internal Revenue Bulletin 2004–26, dated June 28, 2004.

**Revenue Rulings— Continued:**

**85-70**

Amplified and clarified by

Rev. Rul. 2004-71, 2004-30 I.R.B. *74*

Rev. Rul. 2004-72, 2004-30 I.R.B. *77*

Rev. Rul. 2004-73, 2004-30 I.R.B. *80*

Rev. Rul. 2004-74, 2004-30 I.R.B. *84*

**92-105**

Distinguished by

Rev. Rul. 2004-86, 2004-33 I.R.B. *191*

**95-63**

Modified by

Rev. Rul. 2004-103, 2004-45 I.R.B. *783*

**2003-84**

Corrected by

Ann. 2004-97, 2004-49 I.R.B. *957*

**2003-118**

Supplemented and superseded by

Rev. Rul. 2004-108, 2004-47 I.R.B. *853*

**2003-119**

Supplemented and superseded by

Rev. Rul. 2004-107, 2004-47 I.R.B. *852*

**2004-75**

Amplified by

Rev. Rul. 2004-97, 2004-39 I.R.B. *516*

### Treasury Decisions:

**9031**

Removed by

T.D. 9152, 2004-39 I.R.B. *509*

**9141**

Corrected by

Ann. 2004-86, 2004-46 I.R.B. *842*



*U.S. G.P.O.: 2004—310–365/60164