

Example 4. The facts are the same as in example (3) except that A's gross income from his law practice for 1973 is \$40,000. Thus, for 1973, A's deductions (including the net operating loss deduction) exceed his gross income, and his recomputed taxable income is therefore zero. The taxable income subtracted from the net operating loss to determine the carryback to 1974 is \$20,000 (i.e., \$40,000 + \$60,000 - \$50,000 - \$30,000), and thus the net operating loss carryback to 1974 is \$20,000 (i.e., \$40,000 + \$60,000 - \$50,000 - \$30,000), and thus the net operating loss carryback from 1976 to 1974 is \$80,000 (i.e., \$100,000 - \$20,000). Of this amount, \$48,000 ($\$80,000 \times [\$60,000 \text{ (the excess of the expenses paid in 1976 in A's law practice over his gross income from his law practice)} + \$100,000 \text{ (A's net operating loss for 1976)}]$) is properly allocable to or chargeable against earned income, and must be taken into account in recomputing A's taxable income and earned taxable income for 1974.

Example 5. A, an unmarried calendar year taxpayer, receives a salary of \$80,000 from Corporation X in 1975 and also owns and operates a laundry in which both his capital and services are material income producing factors. A incurs no section 62 expenses with respect to the salary income. In 1975 the laundry, a sole proprietorship, has gross income of \$100,000 and business expenses deductible under section 62 of \$80,000. A reasonable allowance as compensation for A's personal services rendered by him in his laundry business would be \$12,000. The net profits of the laundry business were \$20,000.

A's earned income from the laundry business is limited to \$6,000 (30 percent of \$20,000). A's total earned income is \$36,000 ($\$80,000 + \$60,000$). Since the section 62 deductions of the laundry business have already been taken into account in computing net profits, they are not again taken into account in computing earned net income. Accordingly, A's earned net income for 1975 is \$86,000.

Example 6. The facts are the same as example (5) except that the gross income of the laundry is \$130,000 and the net profits from the laundry are \$50,000. A's earned income from the laundry is \$12,000. Even though the 30-percent-of-net profits limitation has not resulted in a reduction of A's earned income from the laundry, the expenses deducted in computing net profits do not reduce earned income. Accordingly, both the earned income and the earned net income of A for 1975 are \$92,000.

Example 7. The facts are the same as example (5) except that the gross income of the laundry is \$60,000 and the laundry has a net loss of \$20,000. A's earned income from the laundry is \$12,000. Since the laundry does not have net profits, the expenses of the laundry have not been taken into account in computing the net profits limitation. Accord-

ingly, a ratable portion of deductible expenses of the laundry must be allocated to the earned income from the laundry in accordance with § 1.1348-2(d)(2); \$16,000 of the expenses are allocated to the earned income ($\$12,000 / \$60,000 \times \$80,000$). A's total earned income for 1975 is \$92,000, and his earned net income is \$76,000 ($\$92,000$ minus \$16,000).

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§ 1.1348-3 Definitions.

(a) *Earned income*—(1) *In general.* (i) For purposes of section 1348 and the regulations thereunder, the term *earned income* means any item of gross income which is earned income within the meaning of section 401(c)(2)(C) or 911(b) unless the item constitutes deferred compensation as defined in paragraph (b) of this section or is otherwise excluded by application of this paragraph. Thus, subject to such exceptions, the term includes:

(A) Wages, salaries, professional fees, bonuses, amounts includible in gross income under section 83, commissions on sales or on insurance premiums, tips, and other amounts received, actually or constructively, as compensation for personal services actually rendered regardless of the medium or basis of payment.

(B) Compensatory payments for personal services made prior to the time such services are actually rendered, provided such advance payments are not made for a purpose of minimizing Federal income taxes by reason of the application of section 1348, and are either customary in the particular profession, trade, or business, or are made for a bona fide business purpose.

(C) Prizes and awards in recognition of personal services includible in gross income under section 74, amounts includible in gross income under section 79 (relating to group-term life insurance purchased for employees), and amounts includible in gross income under section 1379(b) (relating to contributions to qualified pension plans in the case of certain shareholder-employees); and

(D) Gains (other than gain which is treated as capital gain under any provision of chapter 1) and net earnings derived from the sale or other disposition of, the transfer of any interest in,

or the licensing of the use of property (other than good will) by an individual whose personal efforts created such property.

The term does not include such income as dividends (including an amount treated as a dividend by reason of section 1373(b) and § 1.1373-1), other distributions of corporate earnings and profits, gambling gains, or gains which are treated as capital gains under any provision of chapter 1. The term also does not include amounts received for refraining from rendering personal services or engaging in competitive activity or amounts received as consideration for the cancellation of an employment contract.

(ii) In the case of a nonresident alien individual, earned income includes only earned income from sources within the United States which is effectively connected with the conduct of a trade or business within the United States.

(2) *Earned income and employed assistants.* The entire amount received as professional fees shall be treated as earned income if the taxpayer is engaged in a professional occupation, such as a doctor, dentist, lawyer, architect, or accountant, even though he employs assistants to perform part or all of the services, provided the patients or clients are those of the taxpayer and look to the taxpayer as the person responsible for the services performed.

(3) *Earned income from business in which capital is material.* (i) If an individual is engaged in a trade or business (other than in corporate form) in which both personal services and capital are material income-producing factors, a reasonable allowance as compensation for the personal services actually rendered by the individual shall be considered earned income, but the total amount which shall be treated as the earned income of the individual from such a trade or business shall in no case exceed 30 percent of his share of the net profits of such trade or business (which share shall include any guaranteed payment (as defined by § 1.707-1(c)) received from a partnership). For purpose of the preceding sentence, the term *net profits of the trade or business* means the excess of gross in-

come from such trade or business (including income from all sources, whether or not subject to Federal income tax, and without taking into account any deductions which may be allowable under section 1202) over the deductions attributable to such trade or business.

(ii) Whether capital is a material income-producing factor must be determined by reference to all the facts of each case. Capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business, as reflected, for example, by a substantial investment in inventories, plant, machinery, or other equipment. In general, capital is not a material income-producing factor where gross income of the business consists principally of fees, commissions, or other compensation for personal services performed by an individual. Thus, the practice of his profession by a doctor, dentist, lawyer, architect, or accountant will not, as such, be treated as a trade or business in which capital is a material income-producing factor even though the practitioner may have a substantial capital investment in professional equipment or in the physical plant constituting the office from which he conducts his practice since his capital investment is regarded as only incidental to his professional practice.

(iii) This subparagraph does not apply to gains and net earnings derived from the sale or other disposition of, the transfer of any interest in, or the licensing of the use of property by an individual whose personal efforts created such property which are, by reason of subparagraph (1)(i) of this paragraph, treated as earned income. Thus, for example, a research chemist's substantial capital investment in laboratory facilities which he uses to produce patentable chemical processes from which he derives gains within the meaning of this subdivision would not be considered a material income-producing factor.

(4) *Income in respect of a decedent.* An item of gross income in respect of a decedent includible in the gross income of a person described in section described in section 691(a)(1) shall be

treated as earned income in the hands of such person for purposes of subparagraph (1) of this paragraph if such item of gross income would have constituted earned income of the decedent had he lived and received such amount. See § 1.1348-2(d)(3)(vi) for rules relating to attribution of tax preferences by reason of an item of income in respect of a decedent.

(5) *Exceptions to definition of earned income.* For purposes of section 1348 and the regulations thereunder, the term *earned income* does not include:

(i) Any distribution to which section 72(m)(5), relating to certain amounts received by owner-employees from a trust described in section 401(a) or under a plan described in section 403(a), applies,

(ii) Any distribution to which section 402(e), relating to the treatment of certain total distributions from a trust described in section 401(a) or under a plan described in section 403(a), applies,

(iii) Any distribution to which section 402(a)(2), relating to capital gains treatment of certain total distributions from a trust described in section 401(a), applies,

(iv) Any distribution to which section 403(a)(2)(A), relating to capital gains treatment for certain distributions under a plan described in section 404(a)(2), applies, or

(v) Any deferred compensation within the meaning of paragraph (b) of this section.

(6) *Examples.* The application of this paragraph may be illustrated by the following examples:

Example 1. A owns and operates an unincorporated laundering and dry cleaning business. A, assisted by his employees, devotes his entire time and attention to this business. Substantial capital is invested in the plant and equipment utilized in the laundering and dry cleaning of clothing for A's customers. Although personal services performed by A and his employees are a material income-producing factor in A's business, the capital investment in plant and equipment is not merely incidental to the performance of such services but is, as such, material to the production of business income. Therefore, A's laundering and dry cleaning business is one in which both personal services and capital are material income-producing factors within the meaning of paragraph (a)(3) of this section. A may

treat as earned income for a taxable year a reasonable allowance as compensation for the personal services rendered by him in his business, but the amount so treated shall not exceed 30% of the net profits of his business for such year.

Example 2. In his unincorporated business as a real estate broker, which he conducts on a full-time basis, A performs substantial personal services, including solicitation of home buyers and sellers, escorting prospective buyers on house visits, arranging appraisal, financing, and legal services, and other related tasks. In the course of conducting such business, A often finances sales of real estate with his own capital, makes all the necessary arrangements incident to such financing, and a substantial portion of the gross income of the business consists of interest income from such financing. Under these facts and circumstances, both personal services and capital are material income-producing factors in A's real estate business within the meaning of paragraph (a)(3) of this section since the financing of real estate sales is an integral part of the entire business. Accordingly, A's earned income from his real estate business is limited to a reasonable allowance as compensation for the personal services A actually renders, but not in excess of 30% of the net profits from the business, including the interest income derived from financing sales of real estate.

Example 3. For his taxable year ending on December 31, 1973, A, a radiologist, reports fees of \$100x for professional services rendered to his own patients during 1973. Since 1970, A has maintained his own office in a small building that he purchased for \$60x. In addition, A owns X-ray equipment with an original cost of \$300x which he uses in his professional practice. The entire \$100x of professional fees earned by A during 1973 is treated as earned income, notwithstanding that A has a substantial capital investment in professional equipment and the office from which he conducts his medical practice, because such capital investment is only incidental to the rendition of personal services in A's professional practice.

(b) *Deferred compensation*—(1) *In general.* For purposes of section 1348 and the regulations thereunder, the term *deferred compensation* means, except as otherwise provided in subparagraph (2) of this paragraph, any compensation which is deferred within the meaning of that concept in section 404, including any deferred compensation to which the provisions of section 404 and the regulations thereunder apply and any other compensation taxation of which is deferred in a manner similar to the treatment applicable to deferred

compensation to which such provisions apply. Thus, the term includes any amounts includable in gross income as compensation for personal services pursuant to a plan, or method having the effect of a plan, deferring the taxation of such payment to a taxable year later than that in which such services were rendered. For purposes of section 1348, the term *deferred compensation* is not limited to payments to common-law employees but also includes payments to self-employed individuals: nor is it material that no deduction is allowable in respect of all or part of such payments or that a deduction in respect thereof is allowable under some provision of the Code other than section 404. For example, amounts received by a retired partner pursuant to a written plan of the partnership of the kind described in section 1402(a)(10) constitute deferred compensation except as otherwise provided in subparagraph (2) of this paragraph. The term *deferred compensation*, as defined in this paragraph, shall have no application to a determination of the deductibility of any amount under section 162, 404, or any other provision of the Code.

(2) *Amounts not treated as deferred compensation.* Notwithstanding the provisions of subparagraph (1) of this paragraph, any amount includable in gross income as compensation before the end of the taxable year following the first taxable year of the taxpayer in which his right to receive such amount is not subject to any requirement or condition which would be treated as resulting in a substantial risk of forfeiture within the meaning of section 83 and the regulations thereunder does not constitute deferred compensation for purposes of section 1348 and the regulations thereunder. For purposes of this subparagraph, a fractional part of a year which is a taxable year under sections 441(b) and 7701(a)(23) shall be treated as a taxable year.

(3) *Application to certain compensation*—(i) *In general.* This subparagraph provides rules for the application of the principles of subparagraphs (1) and (2) of this paragraph to certain types of compensation.

(ii) *Pension, etc., plans.* (A) In accordance with subparagraph (1) of this paragraph, the taxable portion of dis-

tributions under a pension, annuity, profit-sharing, or stock bonus plan, whether or not such plan meets the requirements of section 401(a), or pursuant to a method having the effect of such a plan, generally constitutes deferred compensation. However, under subparagraph (2) of this paragraph, such portion constitutes earned income if includable in gross income before the end of the taxable year following the first taxable year of the taxpayer in which his right to receive such amount is not subject to a substantial risk of forfeiture. In the case of a distribution under a contributory plan, the preceding sentence applies only to that part of the taxable portion of the distribution which is attributable to employer contributions to the plan. For purposes of the preceding sentence, that part of the taxable portion of a distribution which is attributable to employer contributions is the amount of such part, multiplied by a fraction, the numerator of which is the employer contributions to the plan on behalf of the employee (determined in accordance with the principles of §1.402(a)-2), and the denominator of which is the sum of such employer contributions and the net employee contributions to the plan (as defined in paragraph (a)(2) of §1.402(a)-2). Thus, if the employer does not contribute to the plan, no part of any distribution thereunder constitutes earned income. Amounts included in gross income under section 402(b), 403(c), or 1379(b)(1) in respect of employer contributions to a plan described in this subdivision do not constitute deferred compensation.

(B) If a recipient's rights to receive amounts pursuant to a plan cease to be subject to a substantial risk of forfeiture in more than one of his taxable years, each payment pursuant to such plan shall be considered to consist of a ratable portion of all of the amounts which are not subject to a substantial risk of forfeiture at the time of such payment. Thus, for example, if an employment contract provides in part that an employee or his estate is to receive in each of the fifteen years after the year in which he attains or would have attained age 65 an amount equal to \$2,000 times his years of service with the employer and if he had eighteen

years of service with the employer, each \$36,000 payment would be considered to consist of 18 payments of \$2,000, his right to receive one of which ceased to be subject to a substantial risk of forfeiture upon completing his first year of service with the employer, his right to receive another of which ceased to be subject to a substantial risk of forfeiture upon completing his second year of service with the employer, etc. Therefore, if the employee's last year of service with the employer was completed in the year in which he attained age 65, \$2,000 of the first payment in the next year would not be deferred compensation under subparagraph (2) of this paragraph, and the remaining \$34,000 of that payment and all of the other fourteen payments of \$36,000 would be deferred compensation. If the employee's last year of service was completed in an earlier year, all fifteen payments would constitute deferred compensation in full.

iii) *Income attributable to options.* (A) Ordinary income realized by a taxpayer upon a disqualifying disposition of stock acquired pursuant to the exercise of a statutory option (as defined in §1.421-7(b)) is not deferred compensation for purposes of subparagraph (1) of this paragraph and, therefore, constitutes earned income.

(B) Ordinary income realized by a taxpayer upon the transfer of property pursuant to the exercise, or sale or other disposition, of an option which is not a statutory option (as defined in §1.421-7(b)) and which was granted on or before December 15, 1971, is not deferred compensation for purposes of subparagraph (1) of this paragraph and, therefore, constitutes earned income. Ordinary income realized by a taxpayer upon the transfer of property pursuant to the exercise, or sale or other disposition, of an option which is not a statutory option (as defined in §1.421-7(b)) and which is granted after December 15, 1971 constitutes earned income rather than deferred compensation if such option cannot, by its terms, be exercised more than three months after termination (for any reason other than death) of the grantee's employment by the grantor of the option. If the terms of such an option granted after December 15, 1971 permit the exercise of the

option more than three months after termination (for any reason other than death) of the grantee's employment by the grantor, ordinary income realized by a taxpayer upon the transfer of property pursuant to exercise, or sale or other disposition, of the option constitutes earned income rather than deferred compensation only if such income is realized in a taxable year no later than that following the taxable year in which the option was granted. In the case of the grantee's death within a period during which ordinary income realized upon the transfer of property pursuant to his exercise, or sale or other disposition, of an option described in this subdivision would have constituted earned income as provided in this subdivision had the grantee lived, ordinary income realized subsequently upon the transfer of property pursuant to exercise, or sale or other disposition, of an option described in this subdivision, by the grantee's legal representatives or beneficiary constitutes earned income only if such exercise or sale or other disposition, occurs on a date no later than the date twelve months following that of the grantee's death. For purposes of this subdivision, the term *employment by the grantor* includes employment by a related corporation as defined in §1.421-7(i), and by a corporation which is considered a related corporation under §1.421-7(h)(3). Therefore, the transfer of an employee from the grantor corporation to such a related corporation or from one related corporation to another related corporation or to the grantor corporation will not be treated as a termination of employment by the grantor.

(C) For purposes of (B) of this subdivision, if an option described therein and granted after December 15, 1971 is exercisable only following completion of a specified period of employment, the taxable year in which such period of employment is completed shall be treated as the taxable year in which the option was granted. Further, if the terms of an option described in (B) of this subdivision and granted after December 15, 1971 are modified, such modification shall not be considered as

the granting of a new option for purposes of (B) in determining the taxable year in which such option was granted.

(D) For purposes of (B) of this subdivision, an option will not be considered exercisable by its terms more than three months following termination (for any reason other than death) of the grantee's employment by the grantor solely because the terms of such option permit, in the event of such grantee's death within three months following termination of such employment, exercise of the option by the grantee's legal representative or beneficiary during or following such three-month period.

(4) *Examples.* The application of this paragraph may be illustrated by the following examples, in each of which it is assumed that any amounts paid as described therein constitute salaries or other compensation for personal services actually rendered rather than a distribution of earnings and profits:

Example 1. (i) On January 1, 1965, Corporation X and E, an individual, execute an employment contract under which E is to be employed by X for a period of 10 years. Under the contract, E is entitled to a stated annual salary and to additional compensation of \$10x for each year. This additional compensation is to be credited as of December 31 of each year to a bookkeeping reserve account and will be deferred, accumulated, and paid only upon termination of the employment contract, E's becoming a part-time employee of X, or E's becoming partially or totally incapacitated. Under the terms of the contract, X is merely under a contractual obligation to make the payments when due, and neither X nor E intends that the amounts in the reserve be held by X in trust for E. The contract provides that if E shall fall or refuse to perform his duties, X will be relieved of any obligation to make further credits to the reserve but not of the obligation to distribute amounts previously credited to the reserve. In the event E should die prior to his receipt in full of the balance in the account, the remaining balance is distributed to his personal representative.

(ii) Having completed the terms of his employment contract, E retires from the employment of X on December 31, 1974, and on January 15, 1975, receives a total distribution of \$100x from his reserve account. Of this distribution of \$100x to E, only \$10x, representing the credit made to E's reserve account in 1974, constitutes earned income. No other credits to E's reserve account are taken into account for this purpose because they were made to the reserve account and

became nonforfeitable in a year earlier than the year preceding that in which the \$100x distribution was made to E.

Example 2. (i) Corporation X follows a policy of permitting employees to elect before the beginning of any calendar year to defer the receipt of either 5 percent or 10 percent of their stated annual salary to be earned in that year. E, an employee, elects for each of 10 years of employment to defer receipt of \$5x of his stated annual salary. The total so deferred, or \$50x, is paid to E on January 15, 1974.

(ii) Since the salary which E elects to defer is includible in his gross income only in the taxable year in which actually received by him, then to the extent E receives any such deferred salary payment after the end of the taxable year following the taxable year from which such payment was deferred, such payment does not constitute earned income since such payment is deferred compensation under this paragraph (b). Accordingly, of the \$50x distribution to E, only \$5x, representing the salary deferral from 1973, constitutes earned income.

Example 3. (i) E is an officer of Corporation X, which has a plan for making future payments of additional compensation for current services to certain employees. The plan provides that a fixed percentage of the annual net earnings in excess of \$400x is to be designated for division among the participants. This amount is not currently paid to the participants; but X has set up on its books a separate account for each participant, including E, and each year it credits thereto the dollar amount of his participation for the year. Distributions are to be made from the account when the employee reaches the age of 60, is no longer employed by X, including cessation of employment due to death, or becomes totally unable to perform his duties, whichever occurs first. X's liability to make these distributions is contingent upon the employee's refraining from engaging in any business competitive to that of X, making himself available to X for consultation and advice after retirement or termination of his services, unless disabled, and retaining unencumbered any interest or benefit under the plan. In the event of his death, either before or after the beginning of payments, amounts in an employee's account are distributable to his designated beneficiaries of heirs-at-law. Under the facts and circumstances, E's rights to distributions from his account pursuant to the terms of the plan are not subject to a substantial risk of forfeiture within the meaning of section 83(c)(1). Under the terms of the compensation plan, X is under a merely contractual obligation to make the payments when due, and the parties did not intend that the amounts in each account be held by X in trust for the participants.

(ii) Cash or property includable in gross income by E which is attributable to a credit to his account in a taxable year earlier than the year immediately preceding the year on conclusion does not constitute earned income since it is deferred compensation within the meaning of this paragraph (b). See subparagraph (3) of this paragraph (b) for rules for determining that portion of distributions from E's account which are attributable to credits to his account in a taxable year immediately preceding the year in which such distributions are made.

Example 4. (i) Corporation X has an annual incentive bonus plan for its employees. Under this plan, X has the sole discretion to defer all or any part of any employee's incentive bonus award. In addition, no employee has any right to receive any incentive bonus for any year (whether to be paid currently or to be deferred) until such time, if any, as X makes an award to him. No employee has any election as to the amount or time of payment of his award for any year. Furthermore, the last of any payments under an award must be paid no later than 10 years from the normal retirement date of the employee. In addition, the obligations of X under the plan are merely contractual and are not funded or secured. The awards are nonassignable. However, in the case of death the awards are payable to the employee's designated beneficiary. Once made, a bonus award under the plan is not subject to any substantial risk of forfeiture.

(ii) In each of the years 1967, 1968, 1969, and 1970, X awards E a deferred bonus of \$100x. E retires on June 30, 1971. Beginning in 1971, X pays to E the total of \$400x of deferred bonus awards in 5 annual installments of \$80x each. With respect to the \$80x payment made to E in 1971, \$20x, representing the ratable portion of the payment ($\$100x/\$400x \times \$80x$) allocable to the 1970 bonus award, is earned income because it was received in a year no later than the year following that (1970) in which E's right to receive such amount was no longer subject to a substantial risk of forfeiture. The balance of the \$80x payment made in 1971 and all payments made subsequently constitute deferred compensation.

Example 5. (i) Under the terms of a non-qualified bonus plan for its executive employees, Corporation M contributes each year to a bonus reserve a given percentage of its net earnings for the year. M makes bonus awards each year from the reserve in cash or stock of M, or a combination of both, to such executive employees, and in such amounts, as M may determine. The bonus award so determined to be made to a beneficiary is paid to him in installments: 20 percent of the award at the time that the award is made and the remaining installments in January of each succeeding year (until the full amount of the award is paid). Such amounts are payable in succeeding years but only if earned out by

the employee by continuing service to M, at the rate of $\frac{1}{12}$ th of the amount of the first installment for each complete month of service beginning with the year of determination. If the beneficiary voluntarily terminates his employment, is discharged for cause, or conducts himself in a manner inimical to the best interests of M, he forfeits the rights to receive any portion of his bonus award previously earned out but undelivered to him and to continue earning out his bonus award. Upon retirement a beneficiary retains the right to earn out an unearned bonus award but forfeits the right to continue earning out the award if he conducts himself in a manner inimical to M's best interests or engages in an activity which is in competition with an activity of M. If a beneficiary dies while earning out a bonus award, any unpaid and undelivered portion of his award is paid and delivered to his estate or heirs at such time and in such manner as if the beneficiary were living.

(ii) On January 1, 1971, M makes a cash bonus award to A of \$100x. On January 15, 1971, \$20x, representing the first installment of the award, is paid to A. On January 15, 1972, \$20x, representing the portion of the award earned out by A during the calendar year 1971 is paid to him. On January 1, 1972, A retires from employment with M and, having satisfied the conditions to continue earning out his bonus award, receives \$20x on January 15, 1975.

(iii) Under the facts and circumstances, the conditions that A not conduct himself in a manner inimical to the best interests of M and refrain from activity competitive to that of M are not considered to result in a substantial risk of forfeiture of the bonus award. The total installments of \$40x paid to A in 1971 and 1972 constitute earned income. The installment of \$20x earned out by A in 1972 and paid to him in 1973 also constitutes earned income for the taxable year 1973 because it was includible in gross income by A before the end of the taxable year of A following the first taxable year (the year of his retirement, i.e., 1972) in which his right to receive the installment was not subject to a substantial risk of forfeiture. The installments paid to A in 1974 and 1975, however, do not constitute earned income because they were paid in a year later than the year following the year of A's retirement. Had the conditions that A not conduct himself in a manner inimical to the best interests of M and refrain from activity competitive to that of M constituted a substantial risk of forfeiture, the installments paid to A in 1974 and 1975 would have constituted earned income.

Example 6. On January 15, 1968, Corporation M, under the terms of a nonqualified bonus plan for its employees, grants to A, an employee, 5,000 *dividend units*, which entitle A to receive, for the period during which the

award remains in effect, a cash payment equal to the dividends declared and paid by M on the equivalent of 5,000 shares of its capital stock. The award remains in effect for A's lifetime but is subject to forfeiture if A is dismissed or leaves the service of M for any reason other than his death or retirement, or if A, following his retirement, engages in any activity which is harmful to the interests of M. Under the particular facts and circumstances, the condition that A not engage in any harmful activity is not considered to amount to a substantial risk of forfeiture within the meaning of section 83(c)(1). A retires on January 1, 1971. In each of the calendar years 1971, 1972, 1973, and 1974, A receives cash payments of \$5x under his bonus award. The payments totaling \$10x to A in the years 1971 and 1972 constitute earned income because A received them before the end of the taxable year following the first taxable year (i.e., 1971, the year in which A retired) in which his right to receive such payments was not subject to a substantial risk of forfeiture. Payments totaling \$10x to A in 1973 and 1974, however, constitute deferred compensation under paragraph (b) of this section.

Example 7. Corporation M maintains an employees' profit sharing trust which is not exempt from tax under section 501(a). Under the terms of the trust agreement, the interest of the trust beneficiaries in each contribution made to the trust by M is subject to a substantial risk of forfeiture for a period of 2 years from the date on which the particular contribution is made, except that upon a beneficiary's retirement, his entire interest in the trust vests immediately. Contributions are made on December 30 of each year. As of August 1, 1969, the total interest, forfeitable and nonforfeitable, of A, an employee of M, in the trust is \$320x. On December 30 in each of the years 1969, 1970, and 1971, M makes a further contribution to the trust allocable to A's account equal to \$60x. A retires on December 31, 1971, and becomes entitled to a total distribution from the trust of \$500x, of which \$320x represents M's contributions made prior to August 1, 1969, and \$180x represents contributions made subsequent to such date. Beginning in 1972, the trust distributes to A \$500x in 5 equal annual installments. Because M's contributions to A's account for the years subsequent to August 1, 1969, totaling \$180x vested as of his retirement date, such contributions of \$180x constitute earned income of A for the year 1971 by reason of § 1.402(b)-1(b). No portion of any annual installment of \$100x which is includible in A's gross income constitutes earned income since it is attributable to the \$320x, in all of which A's rights became nonforfeitable no later than December 30, 1970.

Example 8. Corporation M maintains a qualified noncontributory pension plan for the benefit of its employees. Under the terms

of the plan, no employee has a vested right to receive any distribution under the plan prior to his retirement from the employment of M upon reaching the age of 65. A, an employee of M, reaches age 65 on June 15, 1972, and retires on June 30, 1972. Under the terms of the pension plan, A becomes entitled to receive a monthly pension of \$5x, beginning on July 1, 1972. A receives pension payments totalling \$30x in 1972, \$60x in 1973, \$60x in 1974, \$60x in 1975, and \$60x in 1976. The pension payments received by A in 1972 and 1973 constitute earned income within paragraph (b)(3)(ii) of this section. The pension payments received by A in 1974, 1975, and 1976 constitute deferred compensation.

Example 9. (i) A is a participant in X Corporation's noncontributory qualified pension plan. The plan provides an annual benefit upon attaining age 65 of 2 percent of average compensation for each calendar year of participation in the plan. Average compensation is defined as the average of an employee's annual compensation over the last 5 calendar years of service. The plan provides that an employee's rights in his accrued benefit are nonforfeitable after 15 years of participation in the plan. A attains age 65 on June 20, 1975 and begins to receive a pension on July 1, 1975. A's pension is based upon 30 years of participation in the plan. A's annual compensation for the period 1969 through 1974, is as follows:

Year	Annual Compensation
1969	\$75,000
1970	80,000
1971	80,000
1972	85,000
1973	85,000
1974	90,000

(ii) Under the terms of the plan, A's accrued benefit as of December 31, 1974, and his pension are \$50,400 ($0.02 \times 30 \times 1/5$ (\$80,000 + \$80,000 + \$85,000 + \$90,000)). A's accrued benefit as of December 31, 1973, is \$46,980 ($0.02 \times 29 \times 1/5$ \$85,000)). Since A's rights in \$46,980 of his accrued benefit had ceased to be subject to a substantial risk of forfeiture before 1974, only \$285 ($1/12 \times ($50,400 - $46,980)$) of each payment received during 1975 does not constitute deferred compensation. The balance of the amounts received during 1975 and all amounts received in 1976 constitute deferred compensation since they are paid after the end of the taxable year following A's first taxable year in which his right to receive any such amount was not subject to a substantial risk of forfeiture.

Example 10. On January 15, 1971, Corporation M grants to A, an employee, an option to purchase 100 shares of stock of M at a price of \$10x per share. Such option constitutes a qualified stock option and constitutes a qualified stock option as defined in section

422(b). On August 1, 1971, A exercises his option, at which time the fair market value of the 100 shares of M Stock is \$15x per share. On April 24, 1972, A sells the 100 shares of M stock acquired pursuant to exercise of his option at a price of \$25x per share. Because the sale constitutes a disqualifying disposition within the meaning of section 421(b), A realizes ordinary income of \$500x and a capital gain of \$1,000x in the taxable year 1972. The \$500x of ordinary income so realized by A constitutes earned income.

Example 11. On November 30, 1972, Corporation M grants to A, an employee, a non-qualified stock option to which section 421 does not apply and which has no readily ascertainable fair market value on that date. The option may, by its terms, be exercised by A at any time during, or following termination of, his employment. On March 30, 1974, A, while still employed by M, exercises his option and realizes compensation income at that time. Such compensation does not constitute earned income because the option is exercisable within a period that may extend beyond three months after A's termination of employment (other than by reason of death). See paragraph (b)(3)(iii)(B) of this section. Had A exercised his option at any time prior to January 1, 1974, the compensation realized by him by reason of such exercise would have constituted earned income.

Example 12. On November 30, 1972, Corporation N grants to B, an employee, a non-qualified stock option to which section 421 does not apply and which has no readily ascertainable fair market value on that date. The option may by its terms, be exercised only within the period during which B is employed by N or within three months thereafter. On March 30, 1974, B exercises his option and realizes compensation at that time. Such compensation so realized by B constitutes earned income. See paragraph (b)(3)(iii)(B) of this section.

Example 13. On May 9, 1973, and in connection with the performance of services by E, an employee, Corporation X transfers to E 100 shares of X stock. Under the terms of the transfer, E is subject to a binding commitment to return the stock to X if E leaves X's employment for any reason prior to the expiration of a 3-year period beginning on the date of transfer. Since E must perform substantial services for X before he may keep the X stock, E's rights in the stock are subject to a substantial risk of forfeiture under section 83(c)(1). Consequently, if such restriction lapses on May 9, 1976, the compensation realized at such time constitutes earned income. Had E elected to include an amount in his gross income in 1973 pursuant to section 83(b) and the regulations thereunder, the amount so included would also have constituted earned income.

Example 14. On October 1, 1971, A, an author, and Corporation M, a publisher, exe-

cuted an agreement under which A granted to M the exclusive right to print, publish and sell a book he had written. The agreement provides that M will pay to A specified royalties based on the actual cash received from the sale of the published work, render semi-annual statements of the sales, and at the time of rendering each statement make settlement for the amount due. On the same day, another agreement was signed by A and M, mutually agreeing that, in consideration of, and notwithstanding, any contrary provisions contained in the first contract, M shall not pay A more than \$100x in any one calendar year. Under this supplemental contract, sums in excess of \$100x accruing in any one calendar year are to be carried over by M into succeeding years. For the calendar year 1971, royalties payable to A under the basic agreement amount to \$100x and this sum is paid to A. For the calendar year 1972, royalties of \$120x are payable to A under the basic agreement, but by reason of the supplemental agreement, only \$100x of this sum is actually paid to A. For each of the calendar years 1973 and 1974, royalties of \$100x are payable to A under the basic agreement, and this sum is paid to A. For the calendar year 1975, royalties of \$80x are payable to A under the basic agreement, and this sum, plus \$20x carried over from 1972, or \$100x, is paid to A. The \$100x paid to A in each of the years 1971, 1972, 1973, and 1974, and \$80x of the \$100x paid to A in 1975 constitute earned income. The additional \$20x carried over from 1972 and paid to A in 1975 constitutes deferred compensation under this paragraph (b) because it was paid to A later than the end of the year following the year (i.e., 1972) in which A's right to receive the amount was not subject to a substantial risk of forfeiture.

Example 15. Corporation M is the producer and owner of a feature length motion picture which is distributed to exhibitors by Corporation N pursuant to a distribution agreement between M and N providing for current payments to M of a given percentage of the current net profits derived by N from the exhibition and exploitation of the picture. A was employed by M as the leading actor in the picture for fixed compensation payable at the rate of \$10x per week during the production period plus additional compensation equal to a given percentage of the net profits derived from the exhibition and exploitation of the picture. A's additional compensation is payable at the time that M receives payments from N under the terms of the distribution agreement. The additional compensation paid to A does not constitute deferred compensation since it is attributable to and measured by current net profits derived from the use of property created in part by A's efforts.

Example 16. A, a boxer entered into an agreement with M boxing club to fight a particular opponent on June 19, 1971. The agreement provided in part, that for his performance A was to receive 16 percent of the gross receipts derived from the match. Simultaneously, A and M executed a separate agreement providing for payment of A's share of the receipts from the match as follows: 25 percent thereof not later than August 15, 1971, and 25 percent thereof during each of the years 1972, 1973, and 1974 in equal semi-annual installments. A's share of the gross receipts derived from the match was \$100x, of which 25 percent was paid to him in 1971 and a total of \$25x in each of the years 1972, 1973, and 1974. Under the particular facts and circumstances, A and M are not acting as partners or joint venturers. Thus, A is taxable upon his share of such gross receipts only in the years in which such share is actually paid to him under the terms of the separate agreement. The payments of \$25x in each of the years 1971 and 1972 constitute earned income. The payments of \$25x in each of the years 1973 and 1974 would not constitute earned income because they constitute deferred compensation received later than the end of the first taxable year (i.e., 1972) following the year in which A's right to receive such amounts was not subject to a substantial risk of forfeiture.

[T.D. 7446, 41 FR 55339, Dec. 20, 1976]

SMALL BUSINESS CORPORATIONS AND THEIR SHAREHOLDERS

§ 1.1361-0 Table of contents.

This section lists captions contained in §§ 1.1361-1, 1.1361-2, 1.1361-3, 1.1361-4, 1.1361-5, and 1.1361-6.

§ 1.1361-1 S Corporation defined.

- (a) In general.
- (b) Small business corporation defined.
 - (1) In general.
 - (2) Estate in bankruptcy.
 - (3) Treatment of restricted stock.
 - (4) Treatment of deferred compensation plans.
 - (5) Treatment of straight debt.
 - (6) Effective date provisions.
- (c) Domestic corporation.
- (d) Ineligible corporation.
 - (1) General rule.
 - (2) Exceptions.
- (e) Number of shareholders.
 - (1) General rule.
 - (2) Special rules relating to stock owned by husband and wife.
- (f) Shareholder must be an individual or estate.
 - (g) No nonresident alien shareholder.
 - (1) General rule.
 - (2) Special rule for dual residents.

- (h) Special rules relating to trusts.
 - (1) General rule.
 - (2) Foreign trust.
 - (3) Determination of shareholders.
 - (i) [Reserved]
 - (j) Qualified subchapter S trust.
 - (1) Definition.
 - (2) Special rules.
 - (3) Separate and independent shares of a trust.
 - (4) Qualified terminable interest property trust.
 - (5) Ceasing to meet the QSST requirements.
 - (6) Qualified subchapter S trust election.
 - (7) Treatment as shareholder.
 - (8) Coordination with grantor trust rules.
 - (9) Successive income beneficiary.
 - (10) Affirmative refusal to consent.
 - (11) Revocation of QSST election.
 - (k)(1) Examples.
 - (2) Effective date.
 - (1) Classes of stock.
 - (1) General rule.
 - (2) Determination of whether stock confers identical rights to distribution and liquidation proceeds.
 - (3) Stock taken into account.
 - (4) Other instruments, obligations, or arrangements treated as a second class of stock.
 - (5) Straight debt safe harbor.
 - (6) Inadvertent terminations.
 - (7) Effective date

§ 1.1361-2 Definitions relating to S corporation subsidiaries.

- (a) In general.
- (b) Stock treated as held by S corporation.
- (c) Straight debt safe harbor.
- (d) Examples.

§ 1.1361-3 QSub election.

- (a) Time and manner of making election.
 - (1) In general.
 - (2) Manner of making election.
 - (3) Time of making election.
 - (4) Effective date of election.
 - (5) Example.
 - (6) Extension of time for making a QSub election.
 - (b) Revocation of QSub election.
 - (1) Manner of revoking QSub election.
 - (2) Effective date of revocation.
 - (3) Revocation after termination.
 - (4) Revocation before QSub election effective.

§ 1.1361-4 Effect of QSub election.

- (a) Separate existence ignored.
 - (1) In general.
 - (2) Liquidation of subsidiary.
 - (i) In general.
 - (ii) Examples
 - (iii) Adoption of plan of liquidation.
 - (iv) Example.