Internal Revenue
bulletin

Bulletin No. 2003–19
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HIGHLIGHTS OF THIS ISSUE

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

INCOME TAX

Ct. D. 2077, page 868.
Research and development expenses; accounting. The Supreme Court holds that section 1.861–8(e)(3) is a proper exercise of the Secretary of the Treasury's rulemaking authority. **Boeing Co., et al. v. United States**.

Rev. Rul. 2003–45, page 876.
Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 1274, 1288, and other sections of the Code, tables set forth the rates for May 2003.

Rev. Rul. 2003–47, page 866.
Length of service award plan. This ruling provides an example to eligible employers of a type of length-of-service award program (LOSAP) that would qualify as a valid LOSAP plan described in section 457(e)(11)(A)(ii) of the Code.

Rev. Rul. 2003–48, page 863.
Demutualization. This ruling provides guidance as to the tax consequences when, as described in the specific facts presented, a mutual savings bank converts to a stock savings bank and a holding company structure is created.

Notice 2003–20, page 894.
This notice describes the withholding and reporting requirements applicable to eligible deferred compensation plans described in section 457(b) of the Code for periods after December 31, 2001. Notice 2000–38 modified.

EMPLOYEE PLANS

Rev. Rul. 2003–47, page 866.
Length of service award plan. This ruling provides an example to eligible employers of a type of length-of-service award program (LOSAP) that would qualify as a valid LOSAP plan described in section 457(e)(11)(A)(ii) of the Code.

T.D. 9052, page 879.
Final regulations provide guidance on the notification requirements under section 4980F of the Code and section 204(h) of the Employee Retirement Income Security Act of 1974 (ERISA).

Notice 2003–20, page 894.
This notice describes the withholding and reporting requirements applicable to eligible deferred compensation plans described in section 457(b) of the Code for periods after December 31, 2001. Notice 2000–38 modified.

EXEMPT ORGANIZATIONS

Announcement 2003–28, page 899.
A list is provided of organizations now classified as private foundations.

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Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

EMPLOYMENT TAX

Rev. Rul. 2003–46, page 878.
Federal Insurance Contributions Act (FICA); Medicare. This ruling provides that for the continuing employment exception to the Medicare portion of the Federal Insurance Contributions Act tax to apply to service performed by an employee of a state, political subdivision, or instrumentality thereof, such employee must be a member of a retirement system pursuant to section 3121(b)(7)(F) of the Code. Rev. Ruls. 86–88 and 88–36 supplemented.

Rev. Rul. 2003–47, page 866.
Length of service award plan. This ruling provides an example to eligible employers of a type of length-of-service award program (LOSAP) that would qualify as a valid LOSAP plan described in section 457(e)(11)(A)(ii) of the Code.

Notice 2003–20, page 894.
This notice describes the withholding and reporting requirements applicable to eligible deferred compensation plans described in section 457(b) of the Code for periods after December 31, 2001. Notice 2000–38 modified.

ADMINISTRATIVE

Notice 2003–20, page 894.
This notice describes the withholding and reporting requirements applicable to eligible deferred compensation plans described in section 457(b) of the Code for periods after December 31, 2001. Notice 2000–38 modified.

Notice 2003–27, page 898.
Credit for sales of fuel produced from a nonconventional source, inflation adjustment factor, and reference price. This notice publishes the nonconventional source fuel credit, inflation adjustment factor, and reference price under section 29 of the Code for calendar year 2002. This data is used to determine the credit allowable on sales of fuel produced from a nonconventional source.

The IRS Mission

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

Introduction

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

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

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

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

The Bulletin is divided into four parts as follows:

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

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

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

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

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

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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 May 2003. See Rev. Rul. 2003–45, page 876.

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of May 2003. See Rev. Rul. 2003–45, page 876.

Section 368.—Definitions Relating to Corporate Reorganizations

26 CFR 1.368–1: Purpose and scope of exception of reorganization exchanges.

Demutualization. This ruling provides guidance as to the tax consequences when, as described in the specific facts presented, a mutual savings bank converts to a stock savings bank and a holding company structure is created.

Rev. Rul. 2003–48

ISSUE

What are the tax consequences when, as described in the facts below, a mutual savings bank converts to a stock savings bank?

FACTS

State Y Mutual Bank is a State Y mutual savings bank engaged in banking and banking related activities. State Y Mutual Bank is regulated by State Y, and State Y Mutual Bank's deposits are insured by the FDIC. A membership interest in State Y Mutual Bank arises from the ownership of a bank deposit account in State Y Mutual Bank and is inextricably tied to the bank deposit account from the time of deposit. A membership interest in State Y Mutual Bank entitles the member to vote for the board of directors and to receive assets and other consideration in the event of the liquidation, dissolution, or winding up of State Y Mutual Bank. The rights inherent in each membership interest are created by operation of State Y law solely as a result of the member's ownership of a bank deposit account in State Y Mutual Bank and cannot be transferred separately from that bank deposit account. Further, if a bank deposit account is surrendered by the member, the membership interest ceases to exist, having no continuing value.

Mutual Holding Company is a State Y mutual bank holding company. A membership interest in Mutual Holding Company arises from the ownership of a bank deposit account in a bank that is a direct or indirect, wholly owned subsidiary of Mutual Holding Company. Such a membership interest is inextricably tied to the bank deposit account from the time of deposit. A membership interest in Mutual Holding Company entitles the member to vote for the board of directors of Mutual Holding Company and to receive assets or other consideration in the event of the liquidation, dissolution, or winding up of Mutual Holding Company. The rights inherent in each membership interest are created by operation of State Y law solely as a result of the member's bank deposit account and cannot be transferred separately from that bank deposit account. Further, if a bank deposit account is surrendered by the member, the membership interest ceases to exist, having no continuing value.

Stock Holding Company is a State Y stock company the articles of incorporation and by-laws of which authorize the issuance of capital stock. Stock Holding Company has one class of voting stock outstanding.

Transitory is a transitory State Y stock savings bank.

Each transaction described below is undertaken for a valid business purpose.

Situation 1. Pursuant to State Y law and pursuant to an integrated business plan to convert State Y Mutual Bank from a State Y-chartered mutual savings bank to a State Y-chartered stock savings bank and create a holding company structure, the following events occur. State Y Mutual Bank incorporates Mutual Holding Company for the sole purpose of engaging in the following transactions. Mutual Holding Company initially is organized in stock form. Although Mutual Holding Company is temporarily organized as a stock corporation solely due to regulatory requirements, the parties intend at the time Mutual Holding Company is organized that Mutual Holding Company will operate and function in mutual form. In turn, Mutual Holding Company incorporates two wholly owned subsidiaries, Stock Holding Company and Transitory. Thereafter, the following events occur substantially contemporaneously: State Y Mutual Bank exchanges its State Y mutual bank charter for a State Y stock savings bank charter (which permits the bank to issue equity interests in the form of stock) and changes its name to Stock Bank; Mutual Holding Company cancels its outstanding stock and exchanges its charter for a State Y mutual holding company charter; and Transitory merges with and into Stock Bank with Stock Bank surviving as a wholly owned subsidiary of Mutual Holding Company and State Y Mutual Bank's members receiving Mutual Holding Company membership interests in place of their former State Y Mutual Bank membership interests. Mutual Holding Company then transfers all of its Stock Bank stock to Stock Holding Company in exchange for voting stock of Stock Holding Company. Pursuant to the same plan, Stock Holding Company issues more than 20 percent but less than 50 percent of its common stock to the public in a qualified underwriting transaction as defined in § 1.351–1(a)(3) (the "Stock Offering").

Under State Y law, Stock Bank's corporate existence as a stock savings bank is a continuation of State Y Mutual Bank's corporate existence as a mutual savings bank.

Situation 2. The facts are the same as in Situation 1, except that Stock Holding Company issues no more than 20 percent of its common stock in the Stock Offering.

LAW

Section 351(a) provides that no gain or loss will be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in § 368(c)) of the corporation.

Section 1.351–1(a)(3) of the Income Tax Regulations provides that, for purposes of § 351, if a person acquires stock of a corporation from an underwriter in exchange for cash in a qualified underwriting transaction, the person who acquires stock from the underwriter is treated as transferring cash directly to the corporation in exchange for stock of the corporation and the underwriter is disregarded. A qualified underwriting transaction is a transaction in which a corporation issues stock for cash in an underwriting in which either the underwriter is an agent of the corporation or the underwriter's ownership of the stock is transitory.

Section 354(a) provides that, in general, no gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

Section 368(a)(1)(A) states that the term "reorganization" means a statutory merger or consolidation. Section 368(a)(2)(E) provides that a transaction otherwise qualifying under § 368(a)(1)(A) will not be disqualified by reason of the fact that stock of a corporation (the "controlling corporation") that before the merger was in control of the merged corporation is used in the transaction, if (1) after the transaction, the corporation surviving the merger holds substantially all of its properties and of the properties of the merged corporation (other than stock of the controlling corporation distributed in the transaction), and (2) in the transaction, former shareholders of the surviving corporation exchanged, for an amount of voting stock of the controlling corporation, an amount of stock in the surviving corporation that constitutes control of such corporation (the control-for-voting-stock requirement).

Section 368(a)(1)(B) provides that the term reorganization means the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition).

For purposes of §§ 368(a)(1)(B) and 368(a)(2)(E), control is defined in § 368(c). Section 368(c) defines the term "control" to mean the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

Section 368(a)(1)(E) provides that the term reorganization includes a recapitalization. In *Helvering v. Southwest Consol. Corp.*, 315 U.S. 194, 202 (1942), the Supreme Court defined a recapitalization as a "reshuffling of a capital structure within the framework of an existing corporation."

Section 368(a)(1)(F) provides that the term reorganization means a mere change in identity, form, or place of organization of one corporation, however effected.

Section 368(a)(2)(C) states, in relevant part, that a transaction otherwise qualifying under § 368(a)(1)(A) or 368(a)(1)(B) will not be disqualified by reason of the fact that part or all of the assets or stock which were acquired in the transaction are transferred to a corporation controlled by the corporation acquiring such assets or stock.

Section 1.368–2(k)(1) of the Income Tax Regulations restates the general rule of § 368(a)(2)(C) but permits the assets or stock acquired in certain types of reorganizations, including reorganizations under § 368(a)(1)(A) or (B), to be successively transferred to one or more corporations controlled (as defined in § 368(c)) in each transfer by the transferor corporation without disqualifying the reorganization. Additionally, § 1.368–2(k)(2) provides that a transaction qualifying under §§ 368(a)(1)(A) and 368(a)(2)(E) is not disqualified by reason of the fact that part or all of the stock of the surviving corporation is transferred or successively transferred to one or more corporations controlled in each transfer by the transferor corporation.

Generally, to qualify as a reorganization under § 368(a)(1), a transaction must satisfy the continuity of business enterprise (COBE) requirement. Section 1.368–1(d)(1) provides that COBE requires the issuing corporation (generally the acquiring corporation) in a potential reorganization to either continue the target corporation's historic business or use a significant portion of the target's historic business assets in a business. Pursuant to § 1.368–1(d)(4)(i), the issuing corporation is treated as holding all of the businesses and assets of all members of its qualified group. Section 1.368–1(d)(4)(ii) defines a qualified group as one or more chains of corporations connected through stock ownership with the issuing corporation, but only if the issuing corporation owns directly stock meeting the requirements of § 368(c) in at least one other corporation, and stock meeting the requirements of § 368(c) in each of the corporations (except the issuing corporation) is owned directly by one of the other corporations. Continuity of business enterprise is not required for a recapitalization to qualify as a reorganization under § 368(a)(1)(E). *See* Rev. Rul. 82–34, 1982–1 C.B. 59.

Generally, to qualify as a reorganization under § 368(a)(1), a transaction must satisfy the continuity of interest requirement. Section 1.368–1(e)(1)(i) provides that continuity of interest requires that in substance a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization. All facts and circumstances must be considered in determining whether, in substance, a proprietary interest in the target corporation is preserved. Continuity of interest is not a requirement for reorganizations under § 368(a)(1)(E). *See* Rev. Rul. 77–415, 1977–2 C.B. 311.

In *Paulsen v. Commissioner*, 469 U.S. 131 (1985), a state-chartered stock savings and loan association merged into a federally-chartered non-stock mutual savings and loan association. The stockholders exchanged all of their stock in the state-chartered stock savings and loan association for passbook savings accounts and certificates of deposit in the federally-chartered non-stock mutual savings and loan association. The Supreme Court determined that the passbooks and certificates of deposit in the federally-chartered non-stock mutual savings and loan association had a predominantly cash-equivalent component and an insubstantial equity component. Because the passbooks and certificates of deposit essentially represented cash with an insubstantial equity component, the Court held that the transaction did not satisfy the continuity of interest requirement and, therefore, did not qualify as a tax-free reorganization.

In Rev. Rul. 69–3, 1969–1 C.B. 103, X, a mutual savings and loan association, merged into Y, another mutual savings and loan association. In the merger, Y issued to each share account holder of X a share account equal to the dollar amount evidenced by such holder's passbook. Because the share account holders of X received proprietary interests in Y that were equivalent to their equity interests in X before the exchange, the exchange was solely an equity-for-equity exchange that satisfied the continuity of interest requirement. Accordingly, the Service ruled that the transaction qualified as a tax-free reorganization under § 368(a)(1)(A).

ANALYSIS

Situation 1. Because Stock Bank is a continuation of State Y Mutual Bank under State Y law, the conversion from State Y Mutual Bank to Stock Bank qualifies as a reorganization under § 368(a)(1)(E) as well as a reorganization under § 368(a)(1)(F). Because Stock Bank is a continuation of State Y Mutual Bank, tax attributes of State Y Mutual Bank (such as a bad debt reserve maintained under § 585 and a suspended reserve described in § 593(g)(2)(A)(ii)) continue as tax attributes of Stock Bank. Finally, neither the subsequent transfer of Stock Bank stock to Stock Holding Company nor the Stock Offering prevents the conversion from qualifying as a reorganization under § 368(a)(1)(E) as well as a reorganization under § 368(a)(1)(F). *See* § 1.368–1(e)(1); Rev. Rul. 96–29, 1996–1 C.B. 50; Rev. Rul. 77–415, 1977–2 C.B. 311.

Because the status of Mutual Holding Company as a stock holding company is transitory, the conversion of Mutual Holding Company from a stock holding company to a mutual holding company is disregarded.

Because the former owners of the bank are in control (within the meaning of § 368(c)) of Mutual Holding Company, their transfer of their equity interests in the bank to Mutual Holding Company, in exchange for membership interests in Mutual Holding Company, qualifies as a transfer described in § 351. Furthermore, that transaction qualifies as a transfer described in § 351, even though Mutual Holding Company transfers all of its Stock Bank stock to Stock Holding Company. *See* Rev. Rul. 77–449, 1977–2 C.B. 110; Rev. Rul. 83–34, 1983–1 C.B. 79. However, the same transaction (in which Transitory merges into Stock Bank) does not qualify as a reorganization either under §§ 368(a)(1)(A) and 368(a)(2)(E) or under § 368(a)(1)(B) because at the end of the planned series of transactions Stock Holding Company is not a controlled corporation.

Finally, Mutual Holding Company's contribution of the stock of Stock Bank to Stock Holding Company in exchange for Stock Holding Company's voting stock constitutes a transfer described in § 351. The subsequent Stock Offering by Stock Holding Company does not prevent the transaction from qualifying as a transfer described in § 351 because the persons to whom the stock is issued pursuant to the Stock Offering, together with Mutual Holding Company, are transferors to Stock Holding Company under § 351. *See* § 1.351–1(a)(3).

Situation 2. For the reasons described in the analysis of Situation 1, the conversion from State Y Mutual Bank to Stock Bank qualifies as a reorganization under § 368(a)(1)(E) as well as a reorganization under § 368(a)(1)(F). Because Stock Bank is a continuation of State Y Mutual Bank, tax attributes of State Y Mutual Bank (such as a bad debt reserve maintained under § 585 and a suspended reserve described in § 593(g)(2)(A)(ii)) continue as tax attributes of Stock Bank.

Because the status of Mutual Holding Company as a stock holding company is transitory, the conversion of Mutual Holding Company from a stock holding company to a mutual holding company is disregarded.

For the reasons described in Situation 1, the exchange by the former bank owners of their equity interests in the bank for membership interests in Mutual Holding Company qualifies as a transfer described in § 351.

In addition, each of the membership interests in State Y Mutual Bank and Mutual Holding Company constitutes a proprietary interest in the entities that is treated as voting stock for federal income tax purposes. *See* Rev. Rul. 69–3, 1969–1 C.B. 103. Because Mutual Holding Company acquires, in exchange solely for membership interests in Mutual Holding Company, the actual stock of Stock Bank, and, immediately after that acquisition Mutual Holding Company controls Stock Bank, that acquisition qualifies as a reorganization under § 368(a)(1)(B), provided that the continuity of business enterprise and continuity of interest requirements are satisfied. Because Stock Bank continues to provide the same services as State Y Mutual Bank after the transactions described herein, the continuity of business enterprise requirement is satisfied. *See* § 1.368–1(d)(1). In addition, the acquisition satisfies the continuity of interest requirement because, in the overall transaction, the State Y Mutual Bank members receive Mutual Holding Company membership interests in place of their former Mutual Bank membership interests. *See* Rev. Rul. 69–3; *cf. Paulsen v. Commissioner*, 469 U.S. 131 (1985). Thus, the acquisition qualifies as a reorganization within the meaning of § 368(a)(1)(B). Moreover, neither the subsequent transfer by Mutual Holding Company of Stock Bank stock to Stock Holding Company nor the Stock Offering prevents the acquisition from qualifying as a reorganization under § 368(a)(1)(B). *See* § 368(a)(2)(C); § 1.368–1(d)(4)(i); § 1.368–2(k).

For purposes of § 354, the former State Y Mutual Bank's members' exchange of their ownership interests for Mutual Holding Company's membership interests is pursuant to that reorganization.

In addition, the merger of Transitory into Stock Bank qualifies as a reorganization under §§ 368(a)(1)(A) and 368(a)(2)(E) because the owners of the bank exchanged, for membership interests in Mutual Holding Company, an amount of stock in the bank that constitutes control of Stock Bank. Neither the subsequent transfer by Mutual Holding Company of the Stock Bank stock to Stock Holding Company nor the Stock Offering (of no more than 20 percent of the stock of Stock Holding Company) prevents the merger from so qualifying. *See* § 1.368–2(k).

Furthermore, for the reasons described in Situation 1, Mutual Holding Company's contribution of the stock of Stock Bank to Stock Holding Company in exchange for Stock Holding Company's voting stock constitutes a transfer described in § 351.

The analyses in Situations 1 and 2, in general, would also apply if State Y Mutual Bank and Stock Bank were incorporated in different jurisdictions. However, in that case, the conversion would not qualify as a reorganization under § 368(a)(1)(E), but would qualify as a reorganization under § 368(a)(1)(F). In a reorganization under § 368(a)(1)(F), Stock Bank takes into account the items of State Y Mutual Bank as provided in § 381.

HOLDING

This revenue ruling describes the tax consequences that occur when, as described in the facts set forth in this ruling, a mutual savings bank converts to a stock savings bank.

DRAFTING INFORMATION

The principal authors of this revenue ruling are Jeffrey B. Fienberg and Emidio J. Forlini, Jr., of the Office of Associate Chief Counsel (Corporate). For further information regarding this revenue ruling, contact either Mr. Fienberg or Mr. Forlini at (202) 622–7930 (not a toll-free call).

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 May 2003. See Rev. Rul. 2003–45, page 876.

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2003. See Rev. Rul. 2003–45, page 876.

Section 457.—Deferred Compensation Plans of State and Local Governments and Tax Exempt Organizations

Length of service award plan. This ruling provides an example to eligible employers of a type of length-of-service award program (LOSAP) that would qualify as a valid LOSAP plan described in section 457(e)(11)(A)(ii) of the Code.

Rev. Rul. 2003–47

ISSUES:

(1) Is the plan described below a length of service award plan described in § 457(e)(11)(A)(ii) of the Internal Revenue Code?

(2) When are benefits under the plan includible in gross income?

(3) Are benefits paid under the plan wages for purposes of FICA taxes?

FACTS

Pursuant to State S law, the County C Fire Department has adopted a written plan (the "Plan") to implement County C's volunteer fire fighters' and rescue squad workers' service award program. County C and its fire department intend the Plan to be a length of service award plan described in § 457(e)(11)(A)(ii). The County C Fire Department is an agency or instrumentality of County C which is an eligible employer within the meaning of § 457(e)(1) and maintains the plan. The County C Fire Department employs both professional and volunteer fire fighters.

The Plan has been established for the benefit of long-term *bona fide* volunteers who perform fire fighting, prevention, and rescue squad services for the fire department, including related essential services, such as services performed by dispatchers, mechanics, ambulance drivers, and certified instructors. The Plan provides length of service awards to participating volunteers in recognition of their volunteer services to the fire department.

The Plan provides that benefits are only provided to a volunteer who does not receive compensation from the department for performing fire fighting and prevention services, emergency medical and ambulance services, and related essential services, other than reimbursement for (or reasonable allowance for) reasonable expenses incurred in the performance of such services, or reasonable benefits (including length of service awards) and nominal fees for such services, customarily paid by the department in connection with the performance of such services by volunteers.

Under the Plan, a bookkeeping account is established for each participating volunteer and, when a participating volunteer satisfies the Plan's age and service requirements for distribution of benefits, the volunteer automatically receives the balance of the volunteer's account, payable in 60 monthly installments beginning on the tenth day of the first month following the month in which the requirements are satisfied. If a participating volunteer dies prior to satisfying the Plan's age and service requirements, the balance of the volunteer's account is paid to the volunteer's beneficiary in a single sum within 60 days after the date of the volunteer's death. If a participating volunteer dies after payments under the Plan have commenced, but before receiving all monthly installments under the Plan, the balance of the volunteer's account is paid to the volunteer's beneficiary for the remainder of the 60 monthly installments.

Under the Plan, County C and its fire department each periodically provide credits to the accounts of participating volunteers. Each account is also credited with deemed earnings in accordance with the Plan and State S law. The deemed earnings are based on an index that does not exceed a rate of return on a predetermined actual investment or a reasonable rate of return, as defined under § 31.3121(v)(2)–1(d)(2)(i) of the regulations. The Plan provides that the combined amount credited to any account with respect to any participating volunteer, other than deemed earnings, cannot exceed $3,000 for any year of service credit.

The Plan provides that all amounts credited to the bookkeeping accounts, and all deemed earnings attributable to such amounts, remain solely the property of County C and its fire department, and, until paid or made available to a participant or beneficiary, are subject to the claims of County C's and the fire department's general creditors. The Plan also provides that a participating volunteer (or beneficiary) has only an unsecured right to an award under the Plan. The rights of a participating volunteer (or beneficiary) to an award under the Plan cannot be assigned and are nontransferable. If a participating volunteer ceases to provide services to the fire department prior to satisfying the Plan's age and service requirements for distribution of benefits (other than by reason of the volunteer's death or disability), the volunteer's rights to an award under the Plan are forfeited and County C and its fire department cease to have any liability regarding the volunteer's account.

LAW AND ANALYSIS

Section 451(a) and § 1.451–1(a) provide that generally an item of gross income is includible in gross income for the taxable year in which it is actually or constructively received by a cash basis taxpayer. Section 1.451–2(a) provides that income is constructively received in the taxable year during which it is credited to the taxpayer's account, set apart, or otherwise made available so that the taxpayer may draw on it at any time. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

Rev. Rul. 60–31, 1960–1 C.B. 174, holds that a mere promise by the service recipient to pay the service provider, not represented by notes or secured in any way, does not constitute receipt of income within the meaning of the cash receipts and disbursements method of accounting. *See also*, Rev. Rul. 69–650, 1969–2 C.B. 106, and Rev. Rul. 69–649, 1969–2 C.B. 106.

Section 457 governs the taxation of deferred compensation plans of eligible employers. The term "eligible employer" is defined in § 457(e)(1) as a state, political subdivision of a state, and any agency or instrumentality of a state or political subdivision of a state, and any other organization (other than a governmental unit) exempt from tax under subtitle A of the Code. Deferred compensation plans maintained by eligible employers to which § 457 applies are either eligible plans or ineligible plans. An "eligible deferred compensation plan," as defined in § 457(b), must, among other things, provide that the maximum amount which may be deferred under the plan for a taxable year will not exceed the lesser of the applicable dollar amount ($12,000 in 2003) or 100 percent of the participant's includible compensation. Section 457(a)(1) provides that compensation (and income attributable to such compensation) deferred under an eligible deferred compensation plan maintained by a political subdivision of a State is includible in a participant's gross income in the taxable year in which the compensation (and income attributable to such compensation) is paid to the participant.

Section 457(f)(1)(A) provides that generally if a plan of an eligible employer providing for a deferral of compensation is not an eligible deferred compensation plan, compensation deferred under such plan is included in the participant's gross income for the first taxable year in which there is no substantial risk of forfeiture of the rights to such compensation.

Section 457(e)(11)(A)(ii) provides that a plan paying solely length of service awards to *bona fide* volunteers or their beneficiaries on account of qualified services performed by such volunteers is treated as not providing for the deferral of compensation under § 457. Section 457(e)(11)(C) defines qualified services as fire fighting and prevention services, emergency medical services, and ambulance services.

Section 457(e)(11)(B) provides special rules applicable to a length of service award plan. Section 457(e)(11)(B)(i) defines a *bona fide* volunteer to include only persons whose only compensation received for performing qualified services are reimbursements for (or reasonable allowances for) reasonable expenses incurred in performing such services or reasonable benefits (including length of service awards) and nominal fees for such services, customarily paid by eligible employers in connection with the performance of such services by volunteers.

Section 457(e)(11)(B)(ii) provides that a length of service award plan may not provide for an aggregate amount of length of service awards exceeding $3,000 accruing with respect to any year of service by any volunteer.

Section 3121(a)(5)(I) provides that any payment made to, or on behalf of, an employee or his or her beneficiary under a plan described in § 457(e)(11)(A)(ii) and maintained by an eligible employer, as defined in § 457(e)(1), is not treated as "wages" for purposes of Federal Insurance Contributions Act (FICA) taxes.

The Plan established by County C and its fire department satisfies the requirements of § 457(e)(11)(A)(ii). The Plan applies only to volunteers who provide qualified services, *i.e.*, fire fighting and prevention services, emergency medical services, ambulance services, or other related essential services in compliance with § 457(e)(11)(C). The Plan also satisfies § 457(e)(11)(B)(i) by limiting eligible volunteers to persons who receive reimbursements, reasonable expenses, nominal fees, or reasonable benefits customarily paid by eligible employers in connection with the performance of qualified services by volunteers. Finally, the Plan satisfies § 457(e)(11)(B)(ii) by limiting the aggregate amount of awards for any year of service to $3,000.

Since the Plan qualifies as a length of service award plan under § 457(e)(11)(A)(ii), neither § 457(a) nor § 457(f) apply to benefits under the Plan. Instead, amounts distributable under the Plan are includible in gross income under § 451 and the regulations thereunder, when paid or made available without substantial limitation or restriction.

In addition, since the Plan qualifies as a length of service award plan under § 457(e)(11)(A)(ii) maintained by an eligible employer (as defined in § 457(e)(1)), § 3121(a)(5)(I) provides that any payment made to, or on behalf of, a volunteer or his or her beneficiary under the Plan is not treated as "wages" for purposes of determining if FICA taxes apply to such payment.

HOLDINGS

(1) County C's Plan is a length of service award plan described in § 457(e)(11)(A)(ii). The Plan, therefore, is not subject to § 457(a) or § 457(f).

(2) An award under the Plan is includible in a cash basis recipient's gross income under § 451 and the regulations thereunder, in the taxable year when paid or made available without substantial limitation or restriction.

(3) Awards paid under the Plan are not wages for purposes of FICA taxes.

DRAFTING INFORMATION

The principal author of this revenue ruling is John Tolleris of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this revenue ruling, contact John Tolleris at (202) 622–6060 (not a toll-free call).

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 May 2003. See Rev. Rul. 2003–45, page 876.

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 May 2003. See Rev. Rul. 2003–45, page 876.

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 May 2003. See Rev. Rul. 2003–45, page 876.

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 May 2003. See Rev. Rul. 2003–45, page 876.

Section 642.—Special Rules for Credits and Deductions

Federal short-term, mid-term, and long-term rates are set forth for the month of May 2003. See Rev. Rul. 2003–45, page 876.

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 May 2003. See Rev. Rul. 2003–45, page 876.

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 May 2003. See Rev. Rul. 2003–45, page 876.

Section 861.—Income From Sources Within the United States

Ct. D. 2077

SUPREME COURT OF THE UNITED STATES

No. 01–1209 (2003)

BOEING CO., ET AL.
v.
UNITED STATES

CERTIORARI TO THE
UNITED STATES COURT OF
APPEALS FOR
THE NINTH CIRCUIT

March 4, 2003*

Syllabus

Under a 1971 statute providing special tax treatment for export sales made by an American manufacturer through a subsidiary that qualified as a "domestic international sales corporation" (DISC), no tax is payable on the DISC's retained income until it is distributed. See 26 U.S.C. Secs. 991–997. The statute thus provides an incentive to maximize the DISC's share — and to minimize the parent's share — of the parties' aggregate income from export sales. The statute provides three alternative ways for a parent to divert a limited portion of its income to the DISC. See Sec. 994(a)(1)–(3). The alternative that The Boeing Company chose limited the DISC's taxable income to a little over half of the parties "combined taxable income" (CTI). In 1984, the "foreign sales corporation" (FSC) provisions replaced the DISC provisions. As under the DISC regime, it is in the parent's interest to maximize the FSC's share of the taxable income generated by export sales. Because most of the differences between these regimes are immaterial to this suit, the Court's analysis focuses mainly on the DISC provisions. The Treasury Regulation at issue, 26 CFR Sec. 1.861–8(e)(3) (1979), governs the accounting for research and development (R&D) expenses when a taxpayer elects to take a current deduction, telling the taxpaying parent and its DISC "what" must be treated as a cost when calculating CTI, and "how" those costs should be (a) allocated among different products and (b) apportioned between the DISC and its parent. With respect to the "what" question, the regulation includes a list of Standard Industrial Classification (SIC) categories (*e.g.*, transportation equipment) and requires that R&D for any product within the same category as the exported product be taken into account. The regulations use gross receipts from sales as the basis for both "how" questions. Boeing organized its internal operations along product lines (*e.g.*, aircraft model 767) for management and accounting purposes, each of which constituted a separate "program" within the organization; and $3.6 billion of its R&D expenses were spent on "Company Sponsored Product Development," *i.e.*, product-specific research. Boeing's accountants treated all Company Sponsored costs as directly related to a single program and unrelated to any other program. Because nearly half of the Company Sponsored R&D at issue was allocated to programs that had no sales in the year in which the research was conducted, that amount was deducted by Boeing currently in calculating its taxable income for the years at issue, but never affected the calculation of the CTI derived by Boeing and its DISC from export sales. The Internal Revenue Service reallocated Boeing's Company Sponsored R&D costs for 1979 to 1987, thereby decreasing the untaxed profits of its export subsidiaries and increasing its taxable profits on export sales. After paying the additional taxes, Boeing filed this refund suit. In granting Boeing summary judgment, the District Court found Sec. 1.861–8(e)(3) invalid, reasoning that its categorical treatment of R&D conflicted with congressional intent that there be a direct relationship between items of gross income and expenses related thereto, and with a specific DISC regulation giving the taxpayer the right to group and allocate income and costs by product or product line. The Ninth Circuit reversed.

Held: section 1.861–8(e)(3) is a proper exercise of the Secretary of the Treasury's rulemaking authority. Pp. 8–19.

(a) The relevant statutory text does not support Boeing's argument that the statute and certain regulations give it an unqualified right to allocate its Company Sponsored R&D expenses to the specific products to which they are factually

* Together with No. 01–1382, *United States v. Boeing Sales Corp. et al.*, also on certiorari to the same court.

related and to exclude such R&D from treatment as a cost of any other product. The method that Boeing chose to determine an export sale's transfer price allowed the DISC "to derive taxable income attributable to [an export sale] in an amount which *does not exceed* . . . 50 percent of the *combined taxable income* of [the DISC and the parent] which is *attributable* to the qualified export receipts on such property derived as the result of a sale by the DISC plus 10 percent of the export promotion expenses of such DISC attributable to such receipts. . . ." 26 U.S.C. Sec. 994(a)(2) (emphasis added).

The statute does not define "combined taxable income" or specifically mention R&D expenditures. The Secretary's regulation must be treated with deference, see *Cottage Savings Assn. v. Commissioner*, 499 U.S. 554, 560–561, but the statute places some limits on the Secretary's interpretive authority. First, "does not exceed" places an upper limit on the share of the export profits that can be assigned to a DISC and gives three methods of setting the transfer price. Second, "combined taxable income" makes it clear that the domestic parent's taxable income is a part of the CTI equation. Third, "attributable" limits the portion of the domestic parent's taxable income that can be treated as a part of the CTI. The Secretary's classification of all R&D as an indirect cost of all export sales of products in a broadly defined SIC category is not arbitrary. It provides consistent treatment for cost items used in computing the taxpayer's domestic taxable income and CTI, and its allocation of R&D expenditures to all products in a category even when specifically intended to improve only one or a few of those products is no more tenuous than the allocation of a chief executive officer's salary to every product that a company sells, even when he devotes virtually all of his time to the development of the Edsel. Reading Sec. 994 in light of Sec. 861, the more general provision dealing with the distinction between domestic and foreign source income, does not support Boeing's contrary view. If the Secretary reasonably determines that Company Sponsored R&D can be properly apportioned on a categorical basis, the portion of Sec. 861(b) that deducts from gross income "a ratable part of any expenses . . . which cannot definitely be allocated to some item or class of gross income" is inapplicable. Pp. 8–13.

(b) Boeing's arguments based on specific DISC regulations are also unavailing. Language in 26 CFR Sec. 1.994–1(c)(6)(iii), part of the rule describing CTI computation, does not prohibit a ratable allocation of R&D expenditures that can be "definitely related" to particular export sales. Whether such an expense can be "definitely related" is determined by the rules set forth in the very rule that Boeing challenges, Sec. 1.861–8. Moreover, the Secretary could reasonably determine that expenditures on model 767 research conducted in years before any 767's were sold were not "definitely related" to any sales, but should be treated as an indirect cost of producing the gross income derived from the sale of all planes in the transportation equipment category. Nor do Secs. 1.994–1(c)(7)(i) and (ii)(a), which control grouping of transactions for determining the transfer price of sales of export property, and Sec. 1.994–1(c)(6)(iv), which governs the grouping of receipts when the CTI method is used, speak to the questions whether or how research costs should be allocated and apportioned. Pp. 13–17.

(c) What little relevant legislative history there is in this suit weighs in the Government's favor. Pp. 18–19.

258 F.3d 958, affirmed.

STEVENS, J., delivered the opinion of the Court, in which REHNQUIST, C.J., and O'CONNOR, KENNEDY, SOUTER, GINSBURG, and BREYER, JJ., joined. THOMAS, J., filed a dissenting opinion, in which SCALIA, J., joined.

SUPREME COURT OF THE UNITED STATES

Nos. 01–1209 and 01–1382

THE BOEING COMPANY AND CONSOLIDATED SUBSIDIARIES PETITIONERS *v.* UNITED STATES — 01–1209

UNITED STATES PETITIONER *v.* BOEING SALES CORPORATION ET AL. — 01–1382

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

March 4, 2003

JUSTICE STEVENS delivered the opinion of the Court.

This suit concerns tax provisions enacted by Congress in 1971 to provide incentives for domestic manufacturers to increase their exports and in 1984 to limit and modify those incentives. The specific question presented involves the interpretation of a Treasury Regulation (26 CFR Sec. 1.861–8(e)(3) (1979)) promulgated in 1977 that governs the accounting for research and development (R&D) expenses under both statutory schemes.[1] We shall explain the general outlines of the two statutes before we focus on that regulation.

The 1971 statute provided special tax treatment for export sales made by an American manufacturer through a subsidiary that qualified as a "domestic international sales corporation" (DISC).[2] The DISC itself is not a taxpayer; a portion of its income is deemed to have been distributed

[1] In 1996, the provisions of 26 CFR Sec. 1.861–8 were amended, renumbered, and republished as 26 CFR Sec. 1.861–17. See 26 CFR Sec. 1.861–17 (2002); see also 60 Fed. Reg. 66503 (1995).

[2] To qualify as a DISC, at least 95 percent of a corporation's gross receipts must arise from qualified export receipts. See 26 U.S.C. Sec. 992(a)(1)(A). In addition, at least 95 percent of the corporation's assets must be export related. See Sec. 992(a)(1)(B).

to its shareholders, and the shareholders must pay taxes on that portion, but no tax is payable on the DISC's retained income until it is actually distributed. See 26 U.S.C. Secs. 991–997. Typically, "a DISC is a wholly owned subsidiary of a U.S. corporation." 1 Senate Finance Committee, Deficit Reduction Act of 1984, 98th Cong., p. 630, n. 1 (Comm. Print 1984) (hereinafter Committee Print). The statute thus provides an incentive to maximize the DISC's share — and to minimize the parent's share — of the parties' aggregate income from export sales.

The DISC statute does not, however, allow the parent simply to assign all of the profits on its export sales to the DISC. Rather, "to avoid granting undue tax advantages,"[3] the statute provides three alternative ways in which the parties may divert a limited portion of taxable income from the parent to the DISC. See 26 U.S.C. Secs. 994(a)(1)–(3). Each of the alternatives assumes that the parent has sold the product to the DISC at a hypothetical "transfer price" that produced a profit for both seller and buyer when the product was resold to the foreign customer. The alternative used by Boeing in this suit limited the DISC's taxable income to a little over half of the parties' "combined taxable income" (CTI).[4]

Soon after its enactment, the DISC statute became "the subject of an ongoing dispute between the United States and certain other signatories of the General Agreement on Tariffs and Trade (GATT)" regarding whether the DISC provisions were impermissible subsidies that violated our treaty obligations. Committee Print 634. "To remove the DISC as a contentious issue and to avoid further disputes over retaliation, the United States made a commitment to the GATT Council on October 1, 1982, to propose legislation that would address the concerns of other GATT members." *Id.* at 634–635. This ultimately resulted in the replacement of the DISC provisions in 1984 with the "foreign sales corporation" (FSC) provisions of the Code. See Deficit Reduction Act of 1984, Pub. L. 98–369, Secs. 801–805, 98 Stat. 985.[5]

Unlike a DISC, an FSC is a foreign corporation, and a portion of its income is taxable by the United States. See *ibid.*; see also B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶17.14 (5th ed. 1987). Whereas a portion of a DISC's income was tax deferred, a portion of an FSC's income is exempted from taxation. Compare 26 U.S.C. Secs. 991–997 with 26 U.S.C. Secs. 921, 923 (1988 ed.). Hence, under the FSC regime, as under the DISC regime, it is in the parent's interest to maximize the FSC's share of the taxable income generated by export sales. Because the differences between the DISC and FSC regimes for the most part are immaterial to this suit, the analysis in this opinion will focus mainly on the DISC provisions.[6]

The Internal Revenue Code gives the taxpayer an election either to capitalize and amortize the costs of R&D over a period of years or to deduct such expenses currently. See 26 U.S.C. Sec. 174. The regulation at issue here, 26 CFR Sec. 1.861–8(e)(3) (1979), deals with R&D expenditures for which the taxpayer has taken a current deduction. It tells the taxpaying parent and its DISC "what" must be treated as a cost when calculating CTI, and "how" those costs should be (a) allocated among different products and (b) apportioned between the DISC and its parent.[7]

With respect to the "what" question, the Treasury might have adopted a broad approach defining the relevant R&D as including all of the parent's products, or, a narrow approach defining the relevant R&D as all R&D directly related to a particular product being exported. Instead, the regulation includes a list of two-digit Standard Industrial Classification (SIC) categories (examples are "chemicals and allied products" and "transportation equipment"), and it requires that R&D for any product within the same category as the exported product be taken into account.[8] See *ibid*. The regulation explains that R&D on any product "is an inherently speculative activity" that sometimes contributes unexpected benefits on other products, and "that the gross income derived from successful research and development must bear the cost of unsuccessful research and development." *Ibid*.

With respect to the two "how" questions, the regulations use gross receipts from sales as the basis both for allocating the costs among the products within the broad R&D categories and also for apportioning those costs between the parent and the DISC. Thus, if the exported product constitutes 20 percent of the parties' total sales of all products within an R&D category, 20 percent of the R&D cost is allocated to that product. And if export sales represent 70 percent of the total sales of that product, 70 percent of that amount, or 14 percent of the R&D, is apportioned to the DISC.

I

Petitioners (and cross-respondents) are The Boeing Company and subsidiaries that include a DISC and an FSC. For over 40 years, Boeing has been a world leader in commercial aircraft development and a major exporter of commercial aircraft. During the period at issue in this litigation, the dollar volume of its sales amounted to about $64 billion, 67 percent of which were DISC-eligible export sales. The amount that Boeing spent on R&D during that period amounted to approximately $4.6 billion.

During the tax years at issue here, Boeing organized its internal operations along

[3] S. Rep. No. 92–437, p. 13 (1971) (hereinafter S. Rep.).

[4] To be more precise, it allowed the DISC "to derive taxable income attributable to [an export sale] in an amount which does not exceed . . . 50 percent of the combined taxable income of [the DISC and the parent] plus 10 percent of the export promotion expenses of such DISC attributable to such receipts. . . . 26 U.S.C. Sec. 994(a)(2).

A hypothetical example in both the House and Senate Committee Reports illustrated the computation of a transfer price of $816 based on a DISC's selling price of $1,000 and the parent's cost of goods sold of $650. The gross margin of $350 was reduced by $180 (including the DISC's promotion expenses of $90, the parent's directly related selling and administrative expenses of $60, and the parent's prorated indirect expenses of $30), to produce a CTI of $170. Half of that amount ($85) plus 10 percent of the DISC's promotion expenses ($9) gave the DISC its allowable taxable income of $94, leaving only $76 of income immediately taxable to the parent. The $184 aggregate of the two amounts attributed to the DISC (promotion expenses of $90 plus its $94 share of CTI) subtracted from the $1,000 gross receipt produced the "transfer price" of $816. See S. Rep. at 108, n. 7; H.R. Rep. No. 92–533, p. 74, n. 7 (1971) (hereinafter H.R. Rep.).

[5] In 2000, Congress repealed and replaced the FSC provisions with the "extraterritorial income" exclusion of 26 U.S.C. Sec. 114.

[6] Two aspects of the 1984 statute that do have special significance to this suit are discussed in Part IV, *infra.*

[7] Treasury Regulation Sec. 1.861–8 (1979) also specifies how other specific items of expense should be treated. See, *e.g.*, 26 CFR Sec. 1.861–8(e)(2) (1979) (interest fees); Sec. 1.861–8(e)(5) (legal and accounting fees); Sec. 1.861–8(e)(6) (income taxes).

[8] The original regulation used two-digit SIC categories. See Sec. 1.861–8(e)(3). The current regulation uses narrower three-digit SIC categories, See 26 CFR Sec. 1.861–17(a)(2)(ii) (2002), but the change is not relevant to this suit.

product lines (*e.g.*, aircraft models 727, 737, 747, 757, 767) for management and accounting purposes, each of which constituted a separate "program" within the Boeing organization. For those purposes, it divided its R&D expenses into two broad categories: "Blue Sky" and "Company Sponsored Product Development." The former includes the cost of broad-based research aimed at generally advancing the state of aviation technology and developing alternative designs of new commercial planes. The latter includes product-specific research pertaining to a specific program after the board of directors has given its approval for the production of a new model. With respect to its $1 billion of "Blue Sky" R&D, Boeing's accounting was essentially consistent with 26 CFR Sec. 1.861–8(e)(3) (1979).[9] Its method of accounting for $3.6 billion of "Company Sponsored" R&D gave rise to this litigation.

Boeing's accountants treated all of the Company Sponsored research costs as directly related to a single program, and as totally unrelated to any other program. Thus, for DISC purposes, the cost of Company Sponsored R&D directly related to the 767 model, for example, had no effect on the calculation of the "combined taxable income" produced by export sales of any other models. Moreover, because immense Company Sponsored research costs were routinely incurred while a particular model was being completed and before any sales of that model occurred, those costs effectively "disappeared" in the calculation of the CTI even for the model to which the R&D was most directly related.[10] Almost half of the $3.6 billion of Company Sponsored R&D at issue in this suit was allocated to programs that had no sales in the year in which the research was conducted. That amount (approximately $1.75 billion) was deducted by Boeing currently in the calculation of its taxable income for the years at issue, but never affected the calculation of the CTI derived by Boeing and its DISC from export sales.

Pursuant to an audit, the Internal Revenue Service reallocated Boeing's Company Sponsored R&D costs for the years 1979 to 1987, thereby decreasing the untaxed profits of its export subsidiaries and increasing the parent's taxable profits from export sales. Boeing paid the additional tax obligation of $419 million and filed this suit seeking a refund. Relying on the decision of the Eighth Circuit in *St. Jude Medical, Inc. v. Commissioner*, 34 F.3d 1394 (1994), the District Court entered summary judgment in favor of Boeing. It held that 26 CFR Sec. 1.861–8(e)(3) (1979) is invalid as applied to DISC and FSC transactions because the regulation's categorical treatment of R&D conflicted with congressional intent that there be a "direct" relationship between items of gross income and expenses "related thereto," and with a specific DISC regulation giving the taxpayer the right to group and allocate income and costs by product or product line. The Court of Appeals for the Ninth Circuit reversed, 258 F.3d 958 (2001), and we granted certiorari to resolve the conflict between the Circuits, 535 U.S. 1094 (2002). We now affirm.

II

Section 861 of the Internal Revenue Code distinguishes between United States and foreign source income for several different purposes. See 26 U.S.C. Sec. 861. The regulation at issue in this suit, 26 CFR Sec. 1.861–8(e)(3) (1979), was promulgated pursuant to that general statute. Separate regulations promulgated under the DISC statute, 26 U.S.C. Secs. 991–997, incorporate 26 CFR Sec. 1.861–8(e)(3) (1979) by specific reference. See Sec. 1.994–1(c)(6)(iii) (citing and incorporating the cost allocation rules of Sec. 1.861–8). Boeing does not claim that its method of accounting for Company Sponsored R&D complied with Sec. 1.861–8(e)(3). Rather, it argues that Sec. 1.861–8(e)(3) is so plainly inconsistent with congressional intent and with other provisions of the DISC regulations that it cannot be validly applied to its computation of CTI for DISC purposes.

Boeing argues, in essence, that the statute and certain specific regulations promulgated pursuant to 26 U.S.C. Sec. 994 give it an unqualified right to allocate its Company Sponsored R&D expenses to the specific products to which they are "factually related" and to exclude any allocated R&D from being treated as a cost of any other product. The relevant statutory text does not support its argument.

As we have already mentioned, the DISC statute gives the taxpayer a choice of three methods of determining the transfer price for an exported good. Boeing elected to use only the second method described in the following text:

"Inter-company pricing rules"

(a) In general

"In the case of a sale of export property to a DISC by a person described in section 482, the taxable income of such DISC and such person shall be based upon a transfer price which would allow such DISC to derive taxable income attributable to such sale (regardless of the sales price actually charged) in an amount *which does not exceed the greatest of* —

(1) 4 percent of the qualified export receipts on the sale of such property by the DISC plus 10 percent of the export promotion expenses of such DISC attributable to such receipts,

(2) 50 percent of the *combined taxable income* of such DISC and such person which is *attributable* to the qualified export receipts on such property derived as the result of a sale by the DISC plus 10 percent of the export promotion expenses of such DISC attributable to such receipts, or

(3) taxable income based upon the sale price actually charged (but subject to the rules provided in section 482)."

(b) Rules for commissions, rentals, and marginal costing

The Secretary shall prescribe regulations setting forth

* * * *

"(2) *rules for the allocation of expenditures in computing combined taxable income under subsection (a)(2)* in those cases where a DISC is seeking to establish or maintain a market for export property." 26 U.S.C. Secs. 994(a)(1)–(3), (b)(2) (emphasis added).

The statute does not define the term "combined taxable income," nor does it spe-

[9] Because all of Boeing's commercial aircraft were "transportation equipment" within the meaning of the Treasury Regulation, it properly allocated all of its Blue Sky research among all of its programs, and then apportioned those costs between the parent and the DISC. However, according to the Government, it erroneously did so on the basis of hours of direct labor rather than sales. See Brief for United States 10.

[10] When Boeing charged R&D costs to programs that had no sales in the year the research was conducted, the R&D costs effectively "disappeared" in the sense that they were not accounted for by Boeing in computing its CTI.

cifically mention expenditures for R&D. Congress did grant the Secretary express authority to prescribe regulations for determining the proper allocation of expenditures in computing CTI in certain specific contexts. See, *e.g.*, Secs. 994(b)(1)–(2). Yet in promulgating 26 CFR Sec. 1.861–8 (1979), the Secretary of the Treasury exercised his rulemaking authority under 26 U.S.C. Sec. 7805(a), which gives the Secretary general authority to "prescribe all needful rules and regulations for the enforcement" of the Internal Revenue Code. See 41 Fed. Reg. 49160 (1976) ("The proposed regulations are to be issued under the authority contained in section 7805 of the Internal Revenue Code"). Even if we regard the challenged regulation as interpretive because it was promulgated under Sec. 7805(a)'s general rulemaking grant rather than pursuant to a specific grant of authority, we must still treat the regulation with deference. See *Cottage Savings Assn. v. Commissioner*, 499 U.S. 554, 560–561 (1991).

The words that we have emphasized in the statutory text do place some limits on the Secretary's interpretive authority. First, the "does not exceed" phrase places an upper limit on the share of the export profits that can be assigned to a DISC and also gives the taxpayer an unfettered right to select any of the three methods of setting a "transfer price." Second, the use of the term "combined taxable income" in subsection (a)(2) makes it clear that the taxable income of the domestic parent is a part of the equation that should produce the CTI. As Boeing recognizes, even a charitable contribution to the Seattle Symphony that reduces its domestic earnings from sales of 767's must be treated as a cost that is not definitely related to any particular category of income and thus must be apportioned among all categories of income, including income from export sales. See Brief for Petitioners 8, n. 7. Third, the word "attributable" places a limit on the portion of the domestic parent's taxable income that can be treated as a part of the CTI. It is this word that provides the statutory basis for Boeing's position.

Under Boeing's reading of the statute, a calculation of the domestic income "attributable" to the export sale of a 767 may include both the direct and indirect costs of manufacturing and selling 767's, but it may not include the direct costs of selling anything else. Moreover, if Boeing's accountants classify a particular cost as directly related to the 767, that classification is conclusive. Thus, while the Secretary asserts that Boeing's R&D expenses are definitely related to all income in the relevant SIC category, Boeing claims the right to divide its R&D in a way that effectively creates three segments: (1) Blue Sky; (2) Company Sponsored R&D on products that have no sales in the current year; and (3) Company Sponsored R&D on products that are being sold currently. Boeing, like the Secretary, essentially treats Blue Sky R&D as an indirect cost in computing both its domestic taxable income and its CTI. With respect to the second segment, Boeing uses the R&D to reduce its domestic taxable earnings on every product it sells, but eliminates it entirely from the calculation of CTI on any product by charging the R&D costs to programs without any sales. The third segment is used for both domestic and CTI purposes, but with respect to CTI only for the export sales to which it is "factually related."

The Secretary's classification of all R&D as an indirect cost of all export sales of products in a broadly defined SIC category — in other words, as "attributable" to such sales is surely not arbitrary. It has the virtue of providing consistent treatment for cost items used in computing the taxpayer's domestic taxable income and its CTI. Moreover, its allocation of R&D expenditures to all products in a category even when specifically intended to improve only one or a few of those products is no more tenuous than the allocation of a chief executive officer's salary to every product that a company sells even when he devotes virtually all of his time to the development of an Edsel.

On the other hand, even if Boeing's method of accounting for R&D is fully justified for management purposes, it certainly produces anomalies for tax purposes. Most obvious is the fact that it enabled Boeing to deduct some $1.75 billion of expenditures from its domestic taxable earnings under 26 U.S.C. Sec. 174 and never deduct a penny of those expenditures from its "combined taxable earnings" under the DISC statute. See Brief for Petitioners 11. Less obvious, but nevertheless significant, is that Boeing's method assumed that Blue Sky research produces benefits for airplane models that are producing current income and — at the same time — assumed that Company Sponsored research related to a specific product, such as the 727, is not likely to produce benefits for other airplane models, such as the 737 or 767.[11]

In all events, the mere use of the word "attributable" in the text of Sec. 994 surely does not qualify the Secretary's authority to decide whether a particular tax deductible expenditure made by the parent of a DISC is sufficiently related to its export sales to qualify as an indirect cost in the computation of the parties' CTI. Boeing argues, however, that the text of Sec. 994 should be read in light of Sec. 861, the more general provision dealing with the distinction between domestic and foreign source income.

Title 26 U.S.C. Sec. 861(b) contains the following two sentences:

> "Taxable income from sources within United States"
>
> "From the items of gross income specified in subsection (a) as being income from sources within the United States there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto *and a ratable part* of any expenses, losses, or other deductions *which cannot definitely be allocated to some item or class of gross income*. The remainder, if any, shall be included in full as taxable income from sources within the United States". (Emphasis added.)

Focusing on the emphasized words, Boeing interprets this section as having created a background rule dividing all expenses into two categories: those that can be allocated to specific income and those that cannot. "Ratable" allocation is permissible for the second category, but not for the first, according to Boeing. Moreover, in Boeing's view, any expense in the first category cannot be ratably apportioned across all classes of income.

There are at least two flaws in this argument. First, although the emphasized words authorize ratable apportionment of

[11] This assumption, of course, runs contrary to the Secretary's determination that R&D "is an inherently speculative activity" that sometimes contributes unexpected benefits on other products. 26 CFR Sec. 1.861–8(e)(3)(i)(A) (1979).

costs that cannot definitely be allocated to some item or class of income, the sentence as a whole does not prohibit ratable apportionment of expenses that could be, but perhaps in fairness should not be, treated as direct costs. Second, the Secretary has the authority to prescribe regulations determining whether an expense can be properly apportioned to an item of gross income in the calculation of CTI. See 26 U.S.C. Sec. 7805(a). Thus, as in this suit, if the Secretary reasonably determines that Company Sponsored R&D can be properly apportioned on a categorical basis, the italicized portion of Sec. 861 is simply inapplicable.

In sum, Boeing's arguments based on statutory text are plainly insufficient to overcome the deference to which the Secretary's interpretation is entitled.

III

Boeing also advances two arguments based on the text of specific DISC regulations. The first resembles its argument based on the text of Sec. 861 and the second relies on regulations providing that certain accounting decisions made by the taxpayer shall be controlling.

The regulations included in 26 CFR Sec. 1.994–1 (1979) set forth intercompany pricing rules for DISCs. They generally describe the three methods of determining a transfer price, noting that the taxpayer may choose the most favorable method, and may group transactions to use one method for some export sales and another method for others. See *ibid*. With respect to the CTI method used by Boeing, there is a rule, Sec. 1.994–1(c)(6), that describes the computation of CTI. The rule broadly defines the CTI of a DISC and its related supplier from a sale of export property as the excess of gross receipts over their total costs "which relate to such gross receipts."[12] Subdivision (iii) of that rule, on which Boeing relies, provides:

"Costs (other than cost of goods sold) which shall be treated as relating to gross receipts from sales of export property are (*a*) the expenses, losses, and other deductions *definitely related*, and therefore allocated and apportioned, thereto, and (*b*) a ratable part of any other expenses, losses, or other deductions *which are* not definitely related to a class of gross income, determined in a manner consistent with the rules set forth in Sec. 1.861–8." Sec. 1.994–1(c)(6)(iii) (emphasis added).

Boeing interprets the emphasized words as prohibiting a ratable allocation of R&D expenditures that can be "definitely related" to particular export sales. The obvious response to this argument is provided by the final words in the paragraph. Whether such an expense can be "definitely related" is determined by the rules set forth in the very regulation that Boeing challenges, Sec. 1.861–8. Moreover, it seems quite clear that the Secretary could reasonably determine that expenditures on 767 research conducted in years before any 767's were sold were not "definitely related" to any sales, but should be treated as an indirect cost of producing the gross income derived from the sale of all planes in the transportation equipment category.

Boeing also argues that the regulations expressly allow it to allocate and apportion R&D expenses to groups of export sales that are based on industry usage rather than SIC categories. The regulations providing the strongest support for this argument are Secs. 1.994–1(c)(7)(i) and (ii)(a), which control the grouping of transactions for the purpose of determining the transfer price of sales of export property, and Sec. 1.994–1(c)(6)(iv), which governs the grouping of receipts when the CTI method of transfer pricing is used.[13] Treasury Regulation Sec. 1.994–1(c)(7) reads, in part, as follows:

"*Grouping transactions.* (i) Generally, the determinations under this section are to be made on a transaction-by-transaction basis. However, at the annual choice of the taxpayer some or all of these determinations may be made on the basis of groups consisting of products or product lines."

"(ii) A determination by a taxpayer as to a product or a product line will be accepted by a district director if such determination conforms to any one of the following standards: (*a*) A recognized industry or trade usage, or (*b*) the 2-digit major groups . . . of the Standard Industrial Classification. . . ."

As we understand the statutory and regulatory scheme, it gives controlling effect to three important choices by the taxpayer. First, the taxpayer may elect to deduct R&D expenses on an annual basis instead of capitalizing and amortizing those costs. See 26 U.S.C. Sec. 174(a)(1). Second, when engaging in export transactions with a DISC, the taxpayer may choose any one of the three methods of determining the transfer price. See Sec. 994(a). Third, the taxpayer may decide how best to group those transactions for purposes of applying the transfer pricing methods. See 26 CFR Sec. 1.994–1(c)(7) (1979). Conceivably the taxpayer could account for each sale separately, by product lines, or by grouping all of its export sales together. These regulations confirm the finality of the third type of choice (*i.e.*, which groups of sales will be evaluated under one of the three alternative transfer pricing methods), but do not speak to the questions answered by the regulation at issue in this suit — namely, whether or how a particular research cost should be allocated and apportioned.

Nor does Sec. 1.994–1(c)(6)(iv) support Boeing's argument. It provides that a "taxpayer's choice in accordance with subparagraph (7) of this paragraph as to the grouping of transactions shall be control-

[12] Treasury Regulation Sec. 1.994–1(c)(6), 26 CFR Sec. 1.994–1(c)(6) (1979), provides in part:

"*Combined taxable income*." For purposes of this section, the combined taxable income of a DISC and its related supplier from a sale of export property is the excess of the gross receipts (as defined in section 993(f)) of the DISC from such sale over the total costs of the DISC and related supplier which relate to such gross receipts. Gross receipts from a sale do not include interest with respect to the sale. Combined taxable income under this paragraph shall be determined after taking into account under paragraph (e)(2) of this section all adjustments required by section 482 with respect to transactions to which such section is applicable. In determining the gross receipts of the DISC and the total costs of the DISC and related supplier which relate to such gross receipts, the following rules shall be applied:

"(i) Subject to subdivisions (ii) through (v) of this subparagraph, the taxpayer's method of accounting used in computing taxable income will be accepted for purposes of determining amounts and the taxable year for which items of income and expense (including depreciation) are taken into account. See Sec. 1.991–1(b)(2) with respect to the method of accounting which may be used by a DISC."

[13] In support of its argument that Secs. 1.994–1(c) and 1.861–8(e)(3) conflict, Boeing also points to various proposed regulations, including example 1 of proposed regulation Sec. 1.861–8(g). See Brief for Petitioners 22–26. Unlike Boeing and the dissent, See *post* at 2–3, we find these proposed regulations to be of little consequence given that they were nothing more than mere proposals. In 1972 — when regulations governing DISCs were first proposed — the Secretary made clear that the proposed regulations were suggestions only and that whatever final regulations were ultimately adopted would govern. See Technical Memorandum accompanying Notice of Proposed Rulemaking, 1972 T. M. Lexis 14, pp. *8–*9 (June 29, 1972) (providing that in determining deductible expenses, "the rules of section 861(b) and Sec. 1.861–8 are to be applied in whatever form they ultimately take in a new notice to be prepared").

ling, and costs deductible in a taxable year shall be allocated and apportioned to the items or classes of gross income of such taxable year resulting from such grouping." The regulation makes clear that if the taxpayer selects the CTI method of transfer pricing (as Boeing did), then the taxpayer may choose to group export receipts according to product lines, two-digit SIC codes, or on a transaction-by-transaction basis. *Ibid*. The regulation also establishes that there shall be an allocation and apportionment of all relevant costs deducted in the taxable year. *Ibid*. Notably, however, the regulation simply does not speak to how costs should be allocated among different items or classes of gross income and apportioned between the DISC and its parent once the taxpayer (pursuant to Sec. 1.994–1(c)(6)) groups its gross receipts. Treasury Regulation Sec. 1.861–8(e)(3) fills this gap by providing that R&D expenditures that are related to all income reasonably connected with the taxpayer's relevant two-digit SIC category or categories are "*allocable to all items of gross income as a class* . . . related to such product category (or categories)." 26 CFR Sec. 1.861–8(e)(3) (1979) (emphasis added).

IV

Boeing also relies heavily on legislative history, particularly on statements in Reports prepared by the tax-writing committees of the House and the Senate on the DISC statute. Those Reports are virtually identical in terms of their discussion of the DISC provisions. See H.R. Rep. at 58–95; S. Rep. at 90–129. Neither says anything about R&D costs. They both contain statements supporting the proposition that in determining how to calculate income that qualifies for a tax benefit, the expenses to be deducted from gross income are those expenses that are "directly related" to the income. See H.R. Rep., at 74, S. Rep., at 107. Those statements are not, however, inconsistent with the proposition that particular R&D expenses may be factually related to more than one item of income, or with the proposition that the Secretary has broad authority to promulgate regulations determining which expenses are directly or indirectly related to particular items of income.

If anything, what little relevant legislative history there is in this suit weighs in favor of the Government's position in two important respects. First, whereas the DISC transfer price could be set at a level that attributed over half of the CTI to the DISC, when Congress enacted the FSC provisions in 1984, it lowered the maximum allowable share of CTI attributable to an FSC to 23 percent. Compare 26 U.S.C. Sec. 994(a)(2) with 26 U.S.C. Sec. 925(a)(2) (1988 ed.). This dramatizes the point that even though the purpose of the DISC and FSC statutes was to provide American firms with a tax incentive to increase their exports, Congress did not intend to grant "undue tax advantages" to firms. S. Rep., at 13. Rather, the statutory formulas were designed to place ceilings on the amount of those special tax benefits. See Committee Print 636 ("[T]he income of the foreign sales corporation must be determined according to transfer prices specified in the bill: either actual prices for sales between unrelated, independent parties or, if the sales are between related parties, formula prices which are intended to comply with GATT's requirement of arm's-length prices").

Second, the 1977 R&D regulation at issue in this suit had been in effect for seven years when Congress enacted the FSC provisions. Yet Congress did not legislatively override 26 CFR Sec. 1.861–8(e)(3) (1979) in enacting the FSC provisions. In fact, although a moratorium was placed on the application of Sec. 1.861–8(e)(3) for purposes of the sourcing of income in 1981,[14] a 1984 conference agreement specified that the moratorium would "not apply for other purposes, such as the computation of combined taxable income of a DISC (or FSC) and its related supplier." H.R. Conf. Rep. No. 98–861, p. 1263 (1984). The fact that Congress did not legislatively override 26 CFR Sec. 1.861–8(e)(3) (1979) in enacting the FSC provisions in 1984 serves as persuasive evidence that Congress regarded that regulation as a correct implementation of its intent. See *Lorillard v. Pons*, 434 U.S. 575, 580–581 (1978).

The judgment of the Court of Appeals is affirmed.

It is so ordered.

SUPREME COURT OF THE UNITED STATES

Nos. 01–1209 and 01–1382

THE BOEING COMPANY AND CONSOLIDATED SUBSIDIARIES PETITIONERS *v.* UNITED STATES — 01–1209

UNITED STATES PETITIONER *v.* BOEING SALES CORPORATION ET AL. — 01–1382

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

JUSTICE THOMAS, with whom JUSTICE SCALIA joins, dissenting.

Before placing its hand in the taxpayer's pocket, the Government must place its finger on the law authorizing its action. *United Dominion Industries, Inc. v. United States*, 532 U.S. 822, 839 (2001) (THOMAS, J., concurring) (citing *Leavell v. Blades*, 237 Mo. 695, 700–701, 141 S.W. 893, 894 (1911)). Despite the Government's failure to do so here, the Court holds in its favor; I respectfully dissent.

To read the majority opinion, one would think that the Court has before it a perfectly clear statutory and regulatory scheme and that the position of petitioners/cross-respondents (hereinafter Boeing) is utterly without support. Nothing could be further from the facts of this suit. Indeed, the Internal Revenue Service (IRS) itself initially read the statutory and regulatory provisions at issue here to permit precisely what Boeing asserts it is allowed to do.[1]

When regulations governing DISCs were first proposed in 1972, the IRS received public comments recommending that the regulations be amplified to include rules and examples on how expenses should be treated for purposes of determining the combined taxable income of the DISC and a related supplier. The IRS, however, declined to incorporate the recommendations in the

[14] In 1981, Congress imposed a temporary moratorium on the application of the cost allocation rules of 26 CFR Sec. 1.861–8(e)(3) (1979) solely for the geographic sourcing of income. See Economic Recovery Tax Act of 1981, Pub. L. 97–34, Sec. 223, 95 Stat. 249. As a result, research expenditures made for research conducted in the United States were allocated against United States source gross income only — not between United States source income and foreign source income. See H.R. Conf. Rep. No. 98–861, p. 1262 (1984).

[1] Because, as the Court notes, ante at 4, differences in the rules governing domestic international sales corporations (DISCs) and foreign sales corporations do not affect the outcome of this suit, I too focus only on the relevant DISC provisions.

final regulations, explaining that proposed regulation Sec. 1.861–8, which had been published in 1973, provided ample guidance on the subject. Technical Memorandum accompanying T.D. 7364, 1974, T. M. Lexis 30, pp. *20–21 (Oct. 29, 1974).

Proposed regulation Sec. 1.861–8(e)(3), in turn, explained that where "research and development . . . is intended or is reasonably expected to result in the improvement of specific properties or processes, deductions in connection with such research and development shall be considered definitely related and therefore allocable to the class of gross income to which the properties or processes give rise or are reasonably *expected* to give rise." 38 Fed. Reg. 15843 (1973). The regulations went on to note that in "other cases, as in the case of most basic research, research and development shall generally be considered definitely related and therefore allocable to all gross income of the current taxable year which is likely to benefit from the research and development."

Ibid. Example 1 in Sec. 1.8618(g) illustrated this principle by considering the research and development (R&D) expenditures of a corporation manufacturing four-, six-, and eight-cylinder gasoline engines. The corporation conducted both general and engine-specific research. The example made clear that, while general R&D expenses were "definitely related" to gross income resulting from sales of all three types of engines, R&D expenses in connection with a specific type of engine were to be allocated only to gross income arising from sales of that type of engine. *Id*., at 15846 ("X's deductions for its research and development expenses in connection with the 4 cylinder engine are definitely related to the gross income to which the 4 cylinder engine gives rise, *i.e.*, gross income from the sales of 4 cylinder engines . . . ").

Indeed, the IRS' 1974 position on the proper allocation of R&D expenses incurred in connection with separate lines of products is the only one that makes sense under the relevant DISC regulations. See, *e.g.*, 26 CFR Secs. 1.994–1(c)(6), (7) (1979). As the Court explains, *ante*, at 2, 26 U.S.C. Sec. 994 was designed to provide special tax treatment for American companies engaged in export activities. To that end, Sec. 994 permits a DISC and its related supplier to compute their relevant transfer price (and, relatedly, their income tax liability) based on one of three methods. See Sec. 994 (providing that the transfer price for sales between a DISC and a related supplier can be computed based on (1) the gross income method, (2) the combined taxable income method, and (3) the usual transfer-pricing rules set forth in Sec. 482).

The Treasury Department has promulgated regulations explaining how the statutory framework must be applied. Section 1.994–1(c)(7) of those regulations explains that, as a general rule, a determination of the transfer price under Sec. 994 is to be made on a transaction-by-transaction basis. Section 1.994–1(c)(7), however, provides that, instead of following the transaction-by-transaction rule, taxpayers may make Sec. 994 transfer price determinations based on groups consisting of products or product lines. Sec. 1.994–1(c)(7)(i). Specifically, the regulation states that

> "A determination by a taxpayer as to a product or a product line will be accepted by a district director if such determination conforms to any one of the following standards: (*a*) A recognized industry or trade usage, or (*b*) the 2-digit major groups (or any inferior classifications or combinations thereof, within a major group) of the Standard Industrial Classification [SIC] as prepared by the [Office of Management and Budget]." Sec. 1.994–1(c)(7)(ii).

Section 1.994–1(c)(6)(iv), in turn, provides that, in connection with the computation of combined taxable income, "[t]he taxpayer's choice in accordance with [Sec. 1.994–1(c)(7)] as to the grouping of transactions shall be controlling, and *costs deductible in a taxable year shall be allocated and apportioned to the items or classes of gross income of such taxable year resulting from such grouping*." (Emphasis added.) Thus, in tandem, Secs. 1.994–1(c)(6)(iv) and 1.994–1(c)(7) give a taxpayer the choice of allocating and apportioning costs to items or classes of gross income resulting from (1) case-by-case transactions, (2) products or product lines grouped together based on industry or trade usage, and (3) products or product lines grouped together based on 2-digit SIC codes or lesser included subgroups.

Although under Sec. 1.991–1(c)(7) taxpayers are given three choices with respect to the proper grouping of export income (*and* the related allocation of *expenses*), and although Sec. 1.994–1(c)(6)(iv) provides that the taxpayer's selection under Sec. 1.991–1(c)(7) shall be "controlling," Sec. 1.861–8(e)(3) takes away the very choices Sec. 1.991–1 provides. Under Sec. 1.861–8(e)(3), the taxpayer is told that R&D expenses may be allocated *solely* to items or classes of gross income resulting from products that are within the same 2-digit SIC group — which happens to be only one of the three options given under Sec. 1.991–1(c)(7). In my view, the rule set forth in Sec. 1.861–8(e)(3) entirely eviscerates the options given in Sec. 1.991–1. Thus, despite the Court's efforts to show that the two regulations complement, rather than contradict, each other, *ante*, at 15–17, the conflict is irreconcilable.[2] On these facts, a taxpayer should be permitted to compute its tax liability under Sec. 1.991–1, rather than under Sec. 1.861–8(e)(3), based on the principle that a specific rule governs a general one.[3] See *Morales v. Trans World Airlines, Inc.*, 504 U.S. 374, 384 (1992); *Crawford Fitting Co. v. J. T. Gibbons, Inc.*, 482 U.S. 437, 445 (1987); see also *St. Jude Medical, Inc. v. Commissioner*, 34 F.3d 1394 (CA8 1994).

The Court disapproves of Boeing's method of allocating R&D because, as the Court sees it, Boeing's approach results in the "disappear[ance]" of relevant costs, *ante*, at 6, in "the sense that [R&D costs] were not accounted for by Boeing in computing its [combined taxable income]," *ante*, at 7, n. 10. The Court is troubled by the fact that this computation method has enabled Boeing "to deduct some $1.75 billion of expenditures from its domestic taxable earnings under 26 U.S.C. Sec. 174 and never deduct a penny of those expenditures from its 'combined taxable earnings' under the

[2] A taxpayer wishing to (1) group its sales based on an accepted industry practice, for example based on different models, *and* (2) allocate its R&D expenses with respect to a specific model to the items or classes of gross income resulting from that model is not, on the Government's view, permitted to do so. Rather, the taxpayer must first allocate R&D expenses incurred in connection with the relevant model to items or classes of gross income resulting from all models falling within the same 2-digit SIC group and only after doing so can the taxpayer deduct a portion of that model's R&D expenses from the income earned by sales of that model.

[3] With respect to a DISC, Sec. 1.991–1 provides the more specific rules because it applies only to DISCs, while Sec. 1.861–8(e)(3) sets forth more general rules because it applies to all taxpayers that have foreign source income.

DISC statute." *Ante*, at 11–12. But the "disappearance" of Boeing's R&D expenses is the direct result of Congress' decision to encourage such expenditures by making them immediately deductible under 26 U.S.C. Sec. 174(a)(1). Moreover, the approach adopted in the regulations, and approved by the Court, does not remedy the alleged problem of disappearing R&D expenses. A company that decides to enter the export market with a product unrelated to its existing business remains free to deduct in the current tax period all R&D expenses incurred in connection with the new product, even though those expenses would not be used to offset DISC income resulting from the sale of existing products.[4] Finally, neither the Court nor the Government provide a satisfactory explanation for why Sec. 861 can be read to permit the "disappearance" of most expenses, see, *e.g.*, 26 CFR Sec. 1.861–8(d)(1) (1979) ("Each deduction which bears a definite relationship to a class of gross income shall be allocated to that class . . . even though, for the taxable year, no gross income in such class is received or accrued. . . . In apportioning deductions, it may be that, for the taxable year, there is no gross income in the statutory grouping (or residual grouping), or that deductions exceed the amount of gross income in the statutory grouping (or residual grouping)"); see also 1 J. Isenbergh, International Taxation: U.S. Taxation of Foreign Persons and Foreign Income ¶21.10 (3d ed. 2003) ("[I]f an expense incurred in one year is properly allocable to income arising in another, the expense will be allocated to the class to which the income belongs and may therefore produce a loss in that class for the year"), but to disallow the "disappearance" of R&D expenses.

Because I believe that Sec. 1.861–8(e)(3) does not apply to a DISC, I need not decide here whether Sec. 1.861–8(e)(3) is consistent with the text of Sec. 861(b) and may be properly applied in other contexts. I am puzzled, however, by the Court's assertion that the Secretary is free to determine that certain expenses "can be properly apportioned on a categorical basis," *ante*, at 13, and the implication that the Secretary has authority to require "ratable apportionment of expenses that could be, but perhaps in fairness should not be, treated as direct costs." *Ibid.* By its terms, Sec. 861(b) appears to contemplate two types of expenses: (1) those that can definitely be allocated to some item or class of gross income and (2) those that *cannot*. 26 U.S.C. Sec. 861(b) (providing for the deduction of "*the* expenses, losses, and other deductions properly apportioned or allocated thereto *and a ratable part* of any expenses, losses, or other deductions *which cannot definitely be allocated to some item or class of gross income*" (emphasis added)). Moreover, on its face, the statute does not appear to permit expenses to be "deemed" related to an item or class of gross income, even though in actual fact they are not so related. Yet, Sec. 1.861–8(e)(3) relies on the notion of "deemed relationships." The regulation states that the methods of allocation and apportionment established there "recognize that research and development is an inherently speculative activity, that findings may contribute unexpected benefits, and that the gross income derived from successful research and development must bear the cost of unsuccessful research and development. 26 CFR Sec. 1.861–8(e)(3)(i)(A) (1979). The regulation then proceeds to require the allocation of R&D expenses based on 2-digit SIC groups. But neither the regulation nor the Court attempt to reconcile the statutory text with the regulation's determination to allocate certain R&D expenses to items or classes of gross income that admittedly did not benefit from that research.

* * * *

In short, I conclude that Boeing properly computed its tax liability for the years at issue here. I would therefore reverse the judgment of the Court of Appeals. Because the Court concludes otherwise, I respectfully dissent.

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, 1274, 1288, and other sections of the Code, tables set forth the rates for May 2003.

Rev. Rul. 2003–45

This revenue ruling provides various prescribed rates for federal income tax purposes for May 2003 (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. Finally, Table 5 contains the federal rate for determining the present value of annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

[4] Boeing illustrates this point with the following example: Suppose a company that produces and exports athletic clothing (SIC Code 23) decides to invest the proceeds of its clothing sales in research to develop a line of athletic equipment (SIC Code 39). The company has current DISC sales of $1 million from the athletic clothing, no current sales of athletic equipment, and $500,000 in athletic equipment R&D expenses. Under the regulations, the $500,000 of equipment-related R&D will be allocated to the athletic equipment SIC Code, which has no income. It will not be allocated to the athletic clothing SIC Code to reduce the income eligible for the DISC benefit related to the clothing. Thus, in the words of the Court, the expense will simply "disappear." Brief for Petitioners 37, n. 17.

REV. RUL. 2003–45 TABLE 1

Applicable Federal Rates (AFR) for May 2003

Period for Compounding

	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	1.53%	1.52%	1.52%	1.52%
110% AFR	1.68%	1.67%	1.67%	1.66%
120% AFR	1.83%	1.82%	1.82%	1.81%
130% AFR	1.99%	1.98%	1.98%	1.97%
Mid-Term				
AFR	3.17%	3.15%	3.14%	3.13%
110% AFR	3.50%	3.47%	3.46%	3.45%
120% AFR	3.82%	3.78%	3.76%	3.75%
130% AFR	4.14%	4.10%	4.08%	4.07%
150% AFR	4.79%	4.73%	4.70%	4.68%
175% AFR	5.59%	5.51%	5.47%	5.45%
Long-Term				
AFR	4.79%	4.73%	4.70%	4.68%
110% AFR	5.27%	5.20%	5.17%	5.14%
120% AFR	5.76%	5.68%	5.64%	5.61%
130% AFR	6.24%	6.15%	6.10%	6.07%

REV. RUL. 2003–45 TABLE 2

Adjusted AFR for May 2003

Period for Compounding

	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	1.34%	1.34%	1.34%	1.34%
Mid-term adjusted AFR	2.72%	2.70%	2.69%	2.68%
Long-term adjusted AFR	4.45%	4.40%	4.38%	4.36%

REV. RUL. 2003–45 TABLE 3

Rates Under Section 382 for May 2003

Adjusted federal long-term rate for the current month	4.45%
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.)	4.58%

REV. RUL. 2003–45 TABLE 4	
Appropriate Percentages Under Section 42(b)(2) for May 2003	
Appropriate percentage for the 70% present value low-income housing credit	7.92%
Appropriate percentage for the 30% present value low-income housing credit	3.40%

REV. RUL. 2003–45 TABLE 5	
Rate Under Section 7520 for May 2003	
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	3.8%

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

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2003. See Rev. Rul. 2003–45, page 876.

Section 3121.—Definitions

Federal Insurance Contributions Act (FICA); Medicare. This ruling provides that for the continuing employment exception to the Medicare portion of the Federal Insurance Contributions Act tax to apply to service performed by an employee of a state, political subdivision, or instrumentality thereof, such employee must be a member of a retirement system pursuant to Internal Revenue Code section 3121(b)(7)(F). Rev. Ruls. 86–88 and 88–36 supplemented.

Rev. Rul. 2003–46

The Federal Insurance Contributions Act (FICA) tax consists of an old age, survivors, and disability insurance ("OASDI") portion and a hospital insurance ("Medicare") portion. This revenue ruling provides guidance concerning the applicability of the Medicare portion of FICA tax under Internal Revenue Code § 3121(u)(2) to employees of state and local governments. Specifically, this revenue ruling considers the interaction between §§ 3121(u)(2)(C) and 3121(b)(7)(F) in the context of the continuing employment exception. Section 3121(u)(2) generally extends the Medicare portion of FICA tax to wages for service performed by employees of states, political subdivisions, and wholly owned instrumentalities thereof hired after March 31, 1986. Section 3121(b)(7)(F), enacted by section 11332(b) of the Omnibus Budget Reconciliation Act of 1990 (OBRA '90), Pub. L. 101–508, 104 Stat. 1388, expands the definition of employment for FICA tax purposes to include service performed after July 1, 1991, by state or local government employees who are not members of a retirement system.

This revenue ruling supplements Rev. Rul. 86–88, 1986–2 C.B. 172, and Rev. Rul. 88–36, 1988–1 C.B. 343, both of which provide guidelines concerning the application of § 3121(u)(2) in a question and answer format. This revenue ruling also provides guidelines in a question and answer format. In this revenue ruling, the terms "state," "political subdivision," "state employer," "political subdivision employer," and "continuing employment exception" have the same meanings as in Rev. Rul. 86–88.

SERVICE ELIGIBLE FOR THE CONTINUING EMPLOYMENT EXCEPTION

Q1. Is the continuing employment exception to the Medicare portion of FICA tax available for service performed by an employee for a state employer or political subdivision employer who is not a member of a retirement system within the meaning of § 3121(b)(7)(F)?

A1. No. Under § 3121(u)(2)(C)(i), the continuing employment exception applies only to service that is otherwise excluded from employment under § 3121(b)(7). Section 3121(b)(7) excepts from employment service in the employ of a state employer or political subdivision employer for FICA tax purposes. However, § 3121(b)(7)(F) expands the definition of employment for FICA tax purposes to include service by an employee who is not a member of a retirement system. *See* § 31.3121(b)(7)–2 of the Employment Tax Regulations. The House-Senate Conference Report to OBRA '90 provides that "[t]he conference agreement extends Medicare coverage to, and applies the HI [(Medicare)] tax with respect to wages of, those employees (otherwise not already subject to the HI tax) who become subject to OASDI by reason of this provision." H.R. Rep. No. 101–964, at 1105 (1990). Consequently, wages paid for service performed by an employee who is not a member of a retirement system for the state employer or political subdivision employer are subject to the OASDI and Medicare portions of FICA tax regardless of when the employee became employed.

Q2. Is the continuing employment exception available for service performed by an employee for a state employer or political subdivision employer who is subject to the Medicare portion of FICA tax solely because the employee is not a member of a retirement system (*i.e.*, the employee meets all the requirements of § 3121(u)(2)(C), and the employee's service is not covered by a voluntary agreement with the Secretary of Health and Human Services pursuant to § 218 of the Social Security Act, 42 U.S.C. § 418), but who becomes a member of a retirement system after July 1, 1991?

A2. Yes. If an employee's wages are subject to FICA tax solely because the employee is not a member of a retirement system within the meaning of § 3121(b)(7)(F), and the employee subsequently becomes a member of a retirement system, then the employee's wages will cease to be subject to the OASDI and Medicare portions of FICA tax.

EFFECT ON OTHER REVENUE RULINGS:

This revenue ruling supplements Rev. Rul. 86–88, 1986–2 C.B. 172, and Rev. Rul. 88–36, 1988–1 C.B. 343.

DRAFTING INFORMATION

The principal author of this revenue ruling is Patricia P. Holdsworth of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this revenue ruling, contact Ms. Holdsworth at (202) 622–6040 (not a toll-free call).

Section 4980F.—Failure of Applicable Plans Reducing Benefit Accruals to Satisfy Notice Requirements

26 CFR 54.4980F–1: Notice requirements for certain pension plan amendments significantly reducing the rate of future benefit accrual.

T.D. 9052

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1, 54, and 602

Notice of Significant Reduction in the Rate of Future Benefit Accrual

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY:This document contains final regulations providing guidance on the notification requirements under section 4980F of the Internal Revenue Code (Code) and section 204(h) of the Employee Retirement Income Security Act of 1974 (ERISA). Under these final regulations, a plan administrator must give notice of a plan amendment to certain plan participants and beneficiaries when the plan amendment provides for a significant reduction in the rate of future benefit accrual or the elimination or significant reduction in an early retirement benefit or retirement-type subsidy. These final regulations affect retirement plan sponsors and administrators, participants in and beneficiaries of retirement plans, and employee organizations representing retirement plan participants.

DATES: *Effective date:* These regulations are effective on April 9, 2003.

Applicability date: For dates of applicability of these regulations, see §54.4980F–1, Q&A–18, of these regulations.

FOR FURTHER INFORMATION CONTACT: Pamela R. Kinard at (202) 622–6060 or Diane S. Bloom at (202) 283–9888 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1780. Responses to this collection of information are required to obtain a benefit for a taxpayer who wants to amend a plan with an amendment that significantly reduces the rate of future benefit accrual or eliminates or significantly reduces an early retirement benefit or retirement-type subsidy.

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

The estimated annual burden per respondent varies from 1 hour to 80 hours, depending on individual circumstances, with an estimated average of 10 hours.

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

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

Background

This document contains amendments to 26 CFR parts 1, 54, and 602 under section 4980F of the Code and section 204(h) of ERISA. Prior to 2001, section 204(h) of ERISA had no analogous section in the Code, but pursuant to section 101(a) of the Reorganization Plan No. 4 of 1978, 29 U.S.C. 1001nt, the Secretary of the Treasury has authority to issue regulations under parts 2 and 3 of subtitle B of title I of ERISA, including section 204(h) of ERISA. Under section 104 of the Reorganization Plan No. 4, the Secretary of Labor retains enforcement authority with respect to parts 2 and 3 of subtitle B of title 1 of ERISA, but, in exercising that authority, is bound by the regulations issued by the Secretary of Treasury. On December 15, 1995, temporary regulations (T.D. 8631, 1996–1 C.B. 54 [60 FR 64320]), under section 411(d)(6) of the Code were published in the **Federal Register**, providing guidance on section 204(h) of ERISA. A notice of proposed rulemaking (EE–34–95, 1996–1 C.B. 761 [60 FR 64401]), cross-referencing the temporary regulations was published in the **Federal Register** on the same day. On December 14, 1998, final regulations (T.D. 8795, 1999–1 C.B. 459 [63 FR 68678]) addressing the notice requirements under section 204(h) of ERISA were published in the **Federal Register** and were codified in §1.411(d)–6. The final regulations in this Treasury decision remove Treasury regulation §1.411(d)–6.

Section 659 of the Economic Growth and Tax Relief Reconciliation Act of 2001, Public Law 107–16 (115 Stat. 38) (EGTRRA) added section 4980F of the Code. Section 4980F imposes an excise tax when a plan administrator fails to provide timely notice of plan amendments that provide for a significant reduction in the rate of future benefit accrual. A reduction of an early retirement benefit or a retirement-type subsidy is also treated, for purposes of section 4980F of the Code, as a reduction in the rate of future benefit accrual. Section 659(b) of EGTRRA also amended section 204(h) of ERISA to treat the elimination of an early retirement benefit or a retirement-type subsidy as a reduction in the rate of future benefit accrual. The Job Creation and Worker Assistance Act of 2002, Public Law 107–147 (116 Stat. 21) included certain technical corrections to section 659 of EGTRRA.

On April 23, 2002, proposed regulations (REG–136193–01, 2002–1 C.B. 995 [67 FR 19713]) under section 4980F of the Code and section 204(h) of ERISA were published in the **Federal Register**. On August 15, 2002, the IRS held a public hearing on the proposed regulations. Written comments responding to the notice of proposed rulemaking were also received. After consideration of all the comments, the proposed regulations are adopted, as amended by this Treasury decision, and the regulations under §1.411(d)–6 are removed. The revisions are discussed below.

The regulations retain the overall structure of the proposed regulations and, like the proposed regulations, include a number of examples illustrating applicable rules. Some of the examples show the information required to be furnished in a section 204(h) notice, both as to amendments that result in a simple reduction in the future rate of benefit accrual and as to those that result in more complex reductions. The most complex are examples in which a defined benefit plan is amended to change prospectively the plan's benefit accrual formula from a traditional formula to a formula that bases future benefits on an account balance — commonly called a conversion to a cash balance pension plan — with the result that, for purposes of the notice requirements of section 4980F and section 204(h), the future rate of benefit accrual may be reduced for some participants and increased for others, including a separate but similarly complex effect on future early retirement benefits.

None of the examples illustrates rules in any other regulation or positions of Treasury or the IRS regarding provisions of the Internal Revenue Code other than the notice requirements of section 4980F and section 204(h). Thus, the examples do not indicate any possible outcome regarding proposed regulations that were published in the Federal Register (67 FR 76123) on December 11, 2002, relating to sections 411(b)(1)(H) and 411(b)(2) of the Internal Revenue Code, which require that accruals or allocations under certain retirement plans not cease or be reduced because of the attainment of any age. Specifically, Treasury and the IRS are still considering comments received in connection with those proposed regulations, including comments relating to cash balance pension plans, and will only address the application of section 411(b)(1)(H) to cash balance plans as part of the process to issue regulations under sections 411(b)(1)(H).

Explanation of Revisions and Summary of Comments

A. *Overview*

Section 4980F of the Code and section 204(h) of ERISA require notice of an amendment to an applicable pension plan that either provides for a significant reduction in the rate of future benefit accrual or eliminates or significantly reduces an early retirement benefit or retirement-type subsidy. An applicable pension plan is a defined benefit plan and any individual account plan that is subject to the funding requirements of section 412 of the Code. The notice is required to be provided to participants and alternate payees for whom the amendment is reasonably expected to reduce significantly the rate of future benefit accrual and to employee organizations representing those participants. The statute generally requires the plan administrator to provide the notice within a reasonable time before the effective date of the plan amendment.

A plan amendment that is subject to the notice requirements of section 4980F of the Code and section 204(h) of ERISA (section 204(h) amendment) may be subject to additional reporting and disclosure requirements under title I of ERISA, such as the requirement to provide a summary of material modifications (SMM) describing the amendment. Notice under section 4980F of the Code and section 204(h) of ERISA (section 204(h) notice) must be provided in accordance with the provisions of these regulations even though sections 102(a) and 104(b) of ERISA also may require that an SMM describing the plan amendment be furnished to participants covered under the plan and beneficiaries receiving benefits under the plan. The Department of Labor has advised the IRS that a plan administrator who provides a section 204(h) notice to applicable individuals in accordance with this final rule will be treated as having furnished those individuals with an SMM regarding the section 204(h) amendment. The Department of Labor has also advised the IRS that furnishing the notice to the last known address of an individual would be sufficient for this purpose where the plan utilizes a method of delivery described in 29 CFR 2520.104b–1 and the fiduciaries of the plan have taken reasonable steps to keep plan records up-to-date and to locate lost or missing participants. Finally, the Department of Labor noted that the plan administrator is required to satisfy any other requirements regarding the furnishing of SMMs or updated summary plan descriptions, including, for example, satisfaction of the requirement to furnish an SMM to any other participants covered under the plan, and to beneficiaries receiving benefits under the plan, who are entitled to an SMM regarding the amendment.

B. *Conversion of a Money Purchase Pension Plan into an Individual Account Plan That is Not Subject to Section 412*

Rev. Rul. 2002–42, 2002–28 I.R.B. 76, provides that a conversion of a money purchase pension plan into a profit-sharing plan is considered a significant reduction in the rate of future benefit accrual under the money purchase pension plan, thus requiring notice under section 4980F of the Code and section 204(h) of ERISA. As stated in the revenue ruling, allocations under the profit-sharing plan are not benefit accruals under the money purchase pension plan for purposes of determining whether there is a reduction in the rate of future benefit accrual. Accordingly, the final regulations clarify that a plan amendment to convert a money purchase pension plan into a profit-sharing or any other individual account plan that is not subject to section 412 of the Code (including a merger, consolidation, or transfer) is deemed to be a plan amendment that provides for a significant reduction in the rate of future benefit accrual for purposes of section 4980F of the Code and section 204(h) of ERISA.

C. *Rate of Future Benefit Accrual Determined Annually*

A commentator questioned the provisions of the proposed regulations under which the determination of whether there is a reduction in the rate of future benefit accrual would be based on whether the amendment is reasonably expected to reduce "the benefits accruing for a year." The commentator objected on the grounds that this could require section 204(h) notice for an amendment that increases benefits in one year and then reduces them in the next, even though the aggregate benefit over the two years might not be reduced or might even be increased in the aggregate. The final regulations retain this rule, but clarify in an example that where a reduction occurs at the same time as an immediate increase in accrued benefits such that the participant's aggregate benefit can never be less than what it would have been had the amendment not been adopted, the reduction is not significant.

D. *Reduction in the Rate of Future Benefit Accrual for Individual Account Plans*

A commentator suggested that the regulations be revised to clarify that only contributions or forfeitures that are allocated to a participant's account be considered in determining whether a plan amendment to an individual account plan reduces the rate of future benefit accrual. The commentator recommended this revision to clarify that an amendment reducing a contribution formula is not considered insignificant solely because expected future investment returns might offset a portion of the reduction in the contribution formula. A clarification that reflects this suggestion has been adopted in the final regulations.

E. *Determination of Applicable Individuals*

A commentator suggested that the regulations be revised to clarify the date as of which applicable individuals should be identified. The commentator argued that the lack of a clear determination date would make it difficult, from an administrative standpoint, for plans to identify applicable individuals due to turnover among participants. The final regulations provide that whether a plan participant or an alternate payee is an applicable individual is determined on a typical business day that is reasonably proximate to the time the section 204(h) notice is provided (or at the latest date for providing section 204(h) notice, if earlier), based on all relevant facts and circumstances. An example to this effect has been added to the final regulations.

F. *Definition of Early Retirement Benefits and Retirement-Type Subsidies*

A commentator stated that Treasury and IRS should issue regulations defining the terms *early retirement benefits* and *retirement-type subsidies*. The commentator noted that there are numerous references to the terms *early retirement benefit* or *retirement-type subsidy* in both the Code (section 4980F(f)(3) and section 411(d)(6)(B)(i)), ERISA (sections 204(g)(2)(A) and 204(h)(9)) and the regulations (§1.411(d)–4 and Proposed §54.4980F–1), but the terms are not defined. The commentator expressed concern that adverse consequences might result from an egregious failure to identify a significant reduction in early retirement benefit or a retirement-type subsidy and guidance has not been issued to clarify the meaning of those terms. The definitions of *early retirement benefits* and *retirement-type subsidies* affect more than determining whether an amendment requires a section 204(h) notice and, therefore, are beyond the scope of these final regulations. Treasury and IRS anticipate issuing proposed regulations under section 411(d)(6), including general guidance concerning early retirement benefits and retirement-type subsidies. Comments regarding the anticipated proposed regulations were requested, including comments on the guidance that should be provided regarding early retirement benefits and retirement-type subsidies, in Notice 2002–46, 2002–28 I.R.B. 96, and Notice 2003–10, 2003–5 I.R.B. 369.

G. *Timing of Notice*

A number of comments addressed what constitutes a reasonable period for providing a section 204(h) notice. The proposed regulations included a generally applicable 45-day advance notice rule with exceptions for amendments in connection with certain business transactions and small plans. Some comments recommended that notice generally be required to be provided more than 45 days in advance of the effective date of the section 204(h) amendment and others recommended that notice generally be allowed to be provided less than 45 days in advance of the effective date of the section 204(h) amendment. The approach in the proposed regulations was designed to strike a balance between providing participants with sufficient time to understand and consider the information in the notice and allowing employers to effect changes in their plans for business reasons within a reasonable time, and has been retained in the final regulations.

A commentator requested clarification that section 204(h) notice may be provided before the adoption date of the amendment. The commentator noted that neither section 4980F of the Code nor section 204(h) of ERISA prevents a plan administrator from providing section 204(h) notice before the adoption date of the amendment. The regulations have not been revised to reflect this suggestion because the statute is already sufficiently clear that section 204(h) notice may be provided before the adoption of the amendment.

H. *Certification of Accuracy by Senior Officer*

A commentator suggested that the regulations be revised to require that a senior officer of the plan sponsor or the plan administrator certify to employees of the plan sponsor and the IRS that the disclosures in the section 204(h) notice accurately describe the effects of the amendment and that the notice is presented in a manner that is understandable to the average applicable individual. The commentator also suggested that the senior officer should certify that the section 204(h) notice provided to applicable individuals does not contain any false or misleading information. The commentator argued that this certification would not be burdensome to plan sponsors if they have exercised due diligence concerning the content of the section 204(h) notice. Because of concerns about the usefulness of such a rule as well as whether there is statutory authority for such a rule, this suggestion has not been adopted.

I. *Determination and Effects of Egregious Failures*

A commentator suggested that the regulations revise the definition of an egregious violation to distinguish between intentional and negligent acts of failure. The commentator stated that it is possible that a trustee or plan sponsor may make a decision not to provide section 204(h) notice that the trustee or plan sponsor thought was prudent at the time but later determined was a mistake. The commentator argued that these types of decisions, which may be negligent but not intentional, should not be considered egregious failures. The commentator suggested that the final regulations be revised to provide that an egregious failure is an action resulting from a deliberate choice by the plan sponsor, in which the plan sponsor knew or reasonably should have known that a section 204(h) notice would be required. The commentator also suggested that the final regulations be revised to provide that only applicable individuals who were adversely affected by the egregious failure be entitled to the greater of the old or new benefit formulas.

Section 204(h)(6)(B) of ERISA generally defines an egregious failure as a failure within the control of the plan sponsor that is either an intentional failure or a failure to provide most of the individuals with most of the information they are entitled to receive. Further, section 204(h)(6)(A) of ERISA provides that, in the case of any egregious failure to meet any requirement of section 204(h) with respect to any plan amendment, the provisions are applied so that all applicable individuals are entitled to the greater of the benefits to which they would have been entitled without regard to the amendment, or the benefits under the plan with regard to the amendment. Accordingly, these suggestions were not adopted in the final regulations because they would conflict with the plain language of section 204(h) of ERISA.

J. *Content of Section 204(h) Notice*

Section 4980F of the Code and section 204(h) of ERISA require that section 204(h) notice be written in a manner calculated to be understood by the average plan participant and that it provide sufficient information to allow applicable individuals to understand the effect of the amendment. Q&A–11 of these final regulations sets forth the content requirements for section 204(h) notice. The final regulations retain the basic structure of Q&A–11 in the proposed regulations, but include a number of clarifications, including clarifying that the content must permit the applicable individual to determine the approximate magnitude of the reduction applicable to that individual. The regulations provide that this requirement is deemed to be satisfied if the notice includes illustrative examples satisfying certain conditions. At the request of a commentator, the final regulations clarify that individualized benefit statements may be used in lieu of illustrative examples if the statements include the same information as illustrative examples, such as showing the approximate range of the reductions for the individual if the reductions vary over time and identification of the assumptions used in the projections.

K. *Benefit Changes Made by Collective Bargaining Agreements*

A commentator suggested that the final regulations be revised to distinguish between a reduction in the rate of future benefit accrual by collective bargaining agreements and a reduction in the rate of future benefit accrual by plan amendments. Multiemployer plans often incorporate the provisions of related collective bargaining agreements by reference. The commentator argued that when the rate of future benefit accrual is being reduced by a change to a collective bargaining agreement, section 204(h) notice is not required because there is no plan amendment relating to the reduction. The commentator suggested that the final regulations include an example clarifying that in situations where there is an automatic benefit change that is linked to a collective bargaining agreement, section 204(h) notice is not required, or at a minimum that some relief be provided to allow the amendment to go into effect quickly. The IRS and Treasury believe that when a benefit formula in a plan document incorporates provisions of the collective bargaining agreement by reference, those provisions are part of the plan. Accordingly, the final regulations provide a rule in Q&A–7(a)(2) that if all or a part of a plan's rate of future benefit accrual, or an early retirement benefit or retirement-type subsidy provided under the plan, depends on provisions in another document that are referenced in the plan document, a change in the provisions of the other document is an amendment of the plan. An example illustrating this rule has been added to the final regulations.

The IRS and Treasury recognize that multiemployer plans may need additional time to comply with the requirements of Q&A–7(a)(2) of these final regulations, therefore the effective date of this rule has been delayed until January 1, 2004. In addition, because of the special characteristics of multiemployer plans (*e.g.*, participating employers are often small businesses with fewer than 100 employees), the final regulations provide that, for a multiemployer plan, section 204(h) notice must be provided at least 15 days before the effective date of any section 204(h) amendment.

Effective Date

Except with respect to Q&A–7(a)(2), these regulations are applicable to amendments with an effective date that is on or after September 1, 2003.

The provisions of Q&A–7(a)(2) of these regulations are applicable to amendments with an effective date that is on or after January 1, 2004.

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) 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 final regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that small entities generally do not have very complex benefit structures in their plans, or many different classes of participants who will be differently affected by an amendment reducing the rate of future benefit accrual. Small entities also have fewer employees, and thus they are required to provide section 204(h) notice to fewer individuals. Accordingly, the time required for them to prepare and provide section 204(h) notice will usually be modest. Furthermore, because most small entities will only be affected when they amend the retirement plans they sponsor to reduce or eliminate benefits, and most small entities will not so amend their retirement plans frequently, it is generally expected that most small entities would be required to provide section 204(h) notice only once over the course of several years. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required.

Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these final regulations was submitted to the Chief Counsel for Advocacy of the

Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Pamela R. Kinard, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities), Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1, 54, and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows: Authority: 26 U.S.C. 7805 ***

§1.411(d)–6 [Removed]

Par. 2. Section 1.411(d)–6 is removed.

PART 54—PENSION EXCISE TAXES

Par. 3. The authority citation for part 54 is amended by adding the following citation in numerical order to read as follows:

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

Section 54.4980F–1 also issued under 26 U.S.C. 4980F.* * *

Par. 4. Section 54.4980F–1 is added to read as follows:

§54.4980F–1 Notice requirements for certain pension plan amendments significantly reducing the rate of future benefit accrual.

The following questions and answers concern the notification requirements imposed by 4980F of the Internal Revenue Code and section 204(h) of ERISA relating to a plan amendment of an applicable pension plan that significantly reduces the rate of future benefit accrual or that eliminates or significantly reduces an early retirement benefit or retirement-type subsidy.

List of Questions

Q–1. What are the notice requirements of section 4980F(e) of the Internal Revenue Code and section 204(h) of ERISA?

Q–2. What are the differences between section 4980F and section 204(h)?

Q–3. What is an "applicable pension plan" to which section 4980F and section 204(h) apply?

Q–4. What is "section 204(h) notice" and what is a "section 204(h) amendment"?

Q–5. For which amendments is section 204(h) notice required?

Q–6. What is an amendment that reduces the rate of future benefit accrual or reduces an early retirement benefit or retirement-type subsidy for purposes of determining whether section 204(h) notice is required?

Q–7. What plan provisions are taken into account in determining whether an amendment is a section 204(h) amendment?

Q–8. What is the basic principle used in determining whether a reduction in the rate of future benefit accrual or a reduction in an early retirement benefit or retirement-type subsidy is significant for purposes of section 4980F and section 204(h)?

Q–9. When must section 204(h) notice be provided?

Q–10. To whom must section 204(h) notice be provided?

Q–11. What information is required to be provided in a section 204(h) notice?

Q–12. What special rules apply if participants can choose between the old and new benefit formulas?

Q–13. How may section 204(h) notice be provided?

Q–14. What are the consequences if a plan administrator fails to provide section 204(h) notice?

Q–15. What are some of the rules that apply with respect to the excise tax under section 4980F?

Q–16. How do section 4980F and section 204(h) apply when a business is sold?

Q–17. How are amendments to cease accruals and terminate a plan treated under section 4980F and section 204(h)?

Q–18. What are the effective dates of section 4980F, section 204(h), as amended by EGTRRA, and these regulations?

Questions and Answers

Q–1. What are the notice requirements of section 4980F(e) of the Internal Revenue Code and section 204(h) of ERISA?

A–1. (a) *Requirements of Internal Revenue Code section 4980F(e) and ERISA section 204(h)*. Section 4980F of the Internal Revenue Code (section 4980F) and section 204(h) of the Employee Retirement Income Security Act of 1974, as amended (ERISA), 29 U.S.C. 1054(h) (section 204(h)) each generally requires notice of an amendment to an applicable pension plan that either provides for a significant reduction in the rate of future benefit accrual or that eliminates or significantly reduces an early retirement benefit or retirement-type subsidy. The notice is required to be provided to plan participants and alternate payees who are applicable individuals (as defined in Q&A–10 of this section) and to certain employee organizations. The plan administrator must generally provide the notice before the effective date of the plan amendment. Q&A–9 of this section sets forth the time frames for providing notice, Q&A–11 of this section sets forth the content requirements for the notice, and Q&A–12 of this section contains special rules for cases in which participants can choose between the old and new benefit formulas.

(b) *Other notice requirements*. Other provisions of law may require that certain parties be notified of a plan amendment. See, for example, sections 102 and 104 of ERISA, and the regulations thereunder, for requirements relating to summary plan descriptions and summaries of material modifications.

Q–2. What are the differences between section 4980F and section 204(h)?

A–2. The notice requirements of section 4980F generally are parallel to the notice requirements of section 204(h), as amended by the Economic Growth and Tax Relief Reconciliation Act of 2001, Public Law 107–16 (115 Stat. 38) (2001) (EGTRRA). However, the consequences of the failure to satisfy the requirements of the two provisions differ: section 4980F imposes an excise tax on a failure to satisfy the notice requirements, while section 204(h)(6), as amended by EGTRRA, contains a special rule with respect to an egregious failure to satisfy the notice requirements. See Q&A–14 and Q&A–15 of this section. Except to the extent specifically indicated, these regulations apply both to section 4980F and to section 204(h).

Q–3. What is an "applicable pension plan" to which section 4980F and section 204(h) apply?

A–3. (a) *In general*. Section 4980F and section 204(h) apply to an applicable pension plan. For purposes of section 4980F, an *applicable pension plan* means a defined benefit plan qualifying under section 401(a) or 403(a) of the Internal Revenue Code, or an individual account plan that is subject to the funding standards of section 412 of the Internal Revenue Code. For purposes of section 204(h), an *applicable pension plan* means a defined benefit plan that is subject to part 2 of subtitle B of title I of ERISA, or an individual account plan that is subject to such part 2 and to the funding standards of section 412 of the Internal Revenue Code. Accordingly, individual account plans that are not subject to the funding standards of section 412 of the Internal Revenue Code, such as profit-sharing and stock bonus plans and contracts under section 403(b) of the Internal Revenue Code, are not applicable pension plans to which section 4980F or section 204(h) apply. Similarly, a defined benefit plan that neither qualifies under section 401(a) or 403(a) of the Internal Revenue Code nor is subject to part 2 of subtitle B of title I of ERISA is not an applicable pension plan. Further, neither a governmental plan (within the meaning of section 414(d) of the Internal Revenue Code), nor a church plan (within the meaning of section 414(e) of the Internal Revenue Code) with respect to which no election has been made under section 410(d) of the Internal Revenue Code is an applicable pension plan.

(b) *Section 204(h) notice not required for small plans covering no employees*. Section 204(h) notice is not required for a plan under which no employees are participants covered under the plan, as described in §2510.3–3(b) of the Department of Labor regulations, and which has fewer than 100 participants.

Q–4. What is "section 204(h) notice" and what is a "section 204(h) amendment"?

A–4. (a) *Section 204(h) notice* is notice that complies with section 4980F(e) of the Internal Revenue Code, section 204(h)(1) of ERISA, and this section.

(b) A *section 204(h) amendment* is an amendment for which section 204(h) notice is required under this section.

Q–5. For which amendments is section 204(h) notice required?

A–5. (a) *Significant reduction in the rate of future benefit accrual*. Section 204(h) notice is required for an amendment to an applicable pension plan that provides for a significant reduction in the rate of future benefit accrual.

(b) *Early retirement benefits and retirement-type subsidies*. Section 204(h) notice is also required for an amendment to an applicable pension plan that provides for the significant reduction of an early retirement benefit or retirement-type subsidy. For purposes of this section, *early retirement benefit* and *retirement-type subsidy* mean early retirement benefits and retirement-type subsidies within the meaning of section 411(d)(6)(B)(i).

(c) *Elimination or cessation of benefits*. For purposes of this section, the terms *reduce* or *reduction* include eliminate or cease or elimination or cessation.

(d) *Delegation of authority to Commissioner*. The Commissioner may provide in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter) that section 204(h) notice need not be provided for plan amendments otherwise described in paragraph (a) or (b) of this Q&A–5 that the Commissioner determines to be necessary or appropriate, as a result of changes in the law, to maintain compliance with the requirements of the Internal Revenue Code (including requirements for tax qualification), ERISA, or other applicable federal law.

Q–6. What is an amendment that reduces the rate of future benefit accrual or reduces an early retirement benefit or retirement-type subsidy for purposes of determining whether section 204(h) notice is required?

A–6. (a) *In general*. For purposes of determining whether section 204(h) notice is required, an amendment reduces the rate of future benefit accrual or reduces an early retirement benefit or retirement-type subsidy only as provided in paragraph (b) or (c) of this Q&A–6.

(b) *Reduction in rate of future benefit accrual*—(1) *Defined benefit plans*. For purposes of section 4980F and section 204(h), an amendment to a defined benefit plan reduces the rate of future benefit accrual only if it is reasonably expected that the amendment will reduce the amount of the future annual benefit commencing at normal retirement age (or at actual retirement age, if later) for benefits accruing for a year. For this purpose, the annual benefit commencing at normal retirement age is the benefit payable in the form in which the terms of the plan express the accrued benefit (or, in the case of a plan in which the accrued benefit is not expressed in the form of an annual benefit commencing at normal retirement age, the benefit payable in the form of a single life annuity commencing at normal retirement age that is the actuarial equivalent of the accrued benefit expressed under the terms of the plan, as determined in accordance with section 411(c)(3) of the Internal Revenue Code).

(2) *Individual account plans*. For purposes of section 4980F and section 204(h), an amendment to an individual account plan reduces the rate of future benefit accrual only if it is reasonably expected that the amendment will reduce the amount of contributions or forfeitures allocated for any future year. Changes in the investments or investment options under an individual account plan are not taken into account for this purpose.

(3) *Determination of rate of future benefit accrual*. The rate of future benefit accrual for purposes of this paragraph (b) is determined without regard to optional forms of benefit within the meaning of §1.411(d)–4, Q&A–1(b) of this chapter (other than the annual benefit described in paragraph (b)(1) of this Q&A–6). The rate of future benefit accrual is also determined without regard to ancillary benefits and other rights or features as defined in §1.401(a)(4)–4(e) of this chapter.

(c) *Reduction of early retirement benefits or retirement-type subsidies*. For purposes of section 4980F and section 204(h), an amendment reduces an early retirement benefit or retirement-type subsidy only if it is reasonably expected that the amendment will eliminate or reduce an early retirement benefit or retirement-type subsidy.

Q–7. What plan provisions are taken into account in determining whether an amendment is a section 204(h) amendment?

A–7. (a) *Plan provisions taken into account*—(1) *In general*. All plan provisions that may affect the rate of future benefit accrual, early retirement benefits, or retirement-type subsidies of participants or alternate payees must be taken into account in determining whether an amendment is a section 204(h) amendment. For example, plan provisions that may affect the rate of future benefit accrual include the dollar amount or percentage of compensation on which benefit accruals are based;

the definition of service or compensation taken into account in determining an employee's benefit accrual; the method of determining average compensation for calculating benefit accruals; the definition of normal retirement age in a defined benefit plan; the exclusion of current participants from future participation; benefit offset provisions; minimum benefit provisions; the formula for determining the amount of contributions and forfeitures allocated to participants' accounts in an individual account plan; in the case of a plan using permitted disparity under section 401(l) of the Internal Revenue Code, the amount of disparity between the excess benefit percentage or excess contribution percentage and the base benefit percentage or base contribution percentage (all as defined in section 401(l) of the Internal Revenue Code); and the actuarial assumptions used to determine contributions under a target benefit plan (as defined in §1.401(a)(4)–8(b)(3)(i) of this chapter). Plan provisions that may affect early retirement benefits or retirement-type subsidies include the right to receive payment of benefits after severance from employment and before normal retirement age and actuarial factors used in determining optional forms for distribution of retirement benefits.

(2) *Provisions incorporated by reference in plan*. If all or a part of a plan's rate of future benefit accrual, or an early retirement benefit or retirement-type subsidy provided under the plan, depends on provisions in another document that are referenced in the plan document, a change in the provisions of the other document is an amendment of the plan.

(b) *Plan provisions not taken into account*. Plan provisions that do not affect the rate of future benefit accrual of participants or alternate payees are not taken into account in determining whether there has been a reduction in the rate of future benefit accrual. Further, any benefit that is not a section 411(d)(6) protected benefit as described in §1.411(d)–4, Q&A–1(d) of this chapter, or that is a section 411(d)(6) protected benefit that may be eliminated or reduced as permitted under §1.411(d)–4, Q&A–2(a) or (b) of this chapter, is not taken into account in determining whether an amendment is a section 204(h) amendment. Thus, for example, provisions relating to vesting schedules or the right to make after-tax contributions or elective deferrals are not taken into account.

(c) *Examples*. The following examples illustrate the rules in this Q&A–7:

Example 1. (i) *Facts*. A defined benefit plan provides a normal retirement benefit equal to 50% of highest 5-year average pay multiplied by a fraction (not in excess of one), the numerator of which equals the number of years of participation in the plan and the denominator of which is 20. A plan amendment is adopted that changes the numerator or denominator of that fraction.

(ii) *Conclusion*. The plan amendment must be taken into account in determining whether there has been a reduction in the rate of future benefit accrual.

Example 2. (i) *Facts*. Plan C is a multiemployer defined benefit plan subject to several collective bargaining agreements. The specific benefit formula under Plan C that applies to an employee depends on the hourly rate of contribution of the employee's employer, which is set forth in the provisions of the collective bargaining agreements that are referenced in the Plan C document. Collective Bargaining Agreement A between Employer B and the union representing employees of Employer B is renegotiated to provide that the hourly contribution rate for an employee of B who is subject to the Collective Bargaining Agreement A will decrease. That decrease will result in a decrease in the rate of future benefit accrual for employees of B.

(ii) *Conclusion*. Under paragraph (a)(2) of this Q&A–7, the change to Collective Bargaining Agreement A is a plan amendment that is a section 204(h) amendment if the reduction in the rate of future benefit accrual is significant.

Q–8. What is the basic principle used in determining whether a reduction in the rate of future benefit accrual or a reduction in an early retirement benefit or retirement-type subsidy is significant for purposes of section 4980F and section 204(h)?

A–8. (a) *General rule*. Whether an amendment reducing the rate of future benefit accrual or reducing an early retirement benefit or retirement-type subsidy provides for a reduction that is significant for purposes of section 4980F and section 204(h) is determined based on reasonable expectations taking into account the relevant facts and circumstances at the time the amendment is adopted.

(b) *Application for determining significant reduction in the rate of future benefit accrual*. For a defined benefit plan, the determination of whether an amendment provides for a significant reduction in the rate of future benefit accrual is made by comparing the amount of the annual benefit commencing at normal retirement age (or at actual retirement age, if later), as determined under Q&A–6(b)(1) of this section, under the terms of the plan as amended with the amount of the annual benefit commencing at normal retirement age (or at actual retirement age, if later), as determined under Q&A–6(b)(1) of this section, under the terms of the plan prior to amendment. For an individual account plan, the determination of whether an amendment provides for a significant reduction in the rate of future benefit accrual is made in accordance with Q&A–6(b)(2) of this section by comparing the amounts to be allocated in the future to participants' accounts under the terms of the plan as amended with the amounts to be allocated in the future to participants' accounts under the terms of the plan prior to amendment. An amendment to convert a money purchase pension plan to a profit-sharing or other individual account plan that is not subject to section 412 of the Internal Revenue Code is, in all cases, deemed to be an amendment that provides for a significant reduction in the rate of future benefit accrual.

(c) *Application to certain amendments reducing early retirement benefits or retirement-type subsidies*. Because section 204(h) notice is required only for reductions that are significant, section 204(h) notice is not required for an amendment that reduces an early retirement benefit or retirement-type subsidy if the amendment is permitted under the third sentence of section 411(d)(6)(B) of the Internal Revenue Code and regulations thereunder (relating to the elimination or reduction of benefits or subsidies which create significant burdens or complexities for the plan and plan participants unless the amendment adversely affects the rights of any participant in a more than *de minimis* manner).

(d) *Example*. The following example illustrates the rules in this Q&A–8:

Example. (i) *Facts*. Pension Plan A is a defined benefit plan that provides a rate of benefit accrual of 1% of highest-five years' pay multiplied by years of service, payable annually for life commencing at normal retirement age (or at actual retirement age, if later). Plan A is amended, effective January 1, 2008, to provide that any participant who separates from service after December 31, 2007, and before January 1, 2013, will have the same number of years of service he or she would have had if his or her service continued to December 31, 2012.

(ii) *Conclusion*. While the amendment will result in a reduction in the annual rate of future benefit accrual from 2009 through 2012 (because under the amendment, benefits based upon an additional five years of service accrue on January 1, 2008, and no additional service is credited after January 1, 2008, until January 1, 2013), the amendment does not result in a reduction that is significant because the amount of the annual benefit commencing at normal retirement age (or at actual retirement age, if later) under the terms of the plan as amended is not under any conditions less than the amount of the annual benefit commencing at normal retirement age (or at actual retirement age, if later) to which any participant would have been entitled under the terms of the plan had the amendment not been made.

Q–9. When must section 204(h) notice be provided?

A–9. (a) *45-day general rule*. Except as described in paragraphs (b), (c), and (d) of this Q&A–9, section 204(h) notice must be provided at least 45 days before the effective date of any section 204(h) amendment. See paragraph (e) of this Q&A–9 for special rules for amendments permitting participant choice.

(b) *15-day rule for small plans*. Except for amendments described in paragraph (d)(2) of this Q&A–9, section 204(h) notice must be provided at least 15 days before the effective date of any section 204(h) amendment in the case of a small plan. For purposes of this section, a small plan is a plan that the plan administrator reasonably expects to have, on the effective date of the section 204(h) amendment, fewer than 100 participants who have an accrued benefit under the plan.

(c) *15-day rule for multiemployer plans*. Except for amendments described in paragraph (d)(2) of this Q&A–9, section 204(h) notice must be provided at least 15 days before the effective date of any section 204(h) amendment in the case of a multiemployer plan. For purposes of this section, a multiemployer plan means a multiemployer plan as defined in section 414(f) of the Internal Revenue Code.

(d) *Special timing rule for business transactions*—(1) *15-day rule for section 204(h) amendment in connection with an acquisition or disposition*. Except for amendments described in paragraph (d)(2) of this Q&A–9, if a section 204(h) amendment is adopted in connection with an acquisition or disposition, section 204(h) notice must be provided at least 15 days before the effective date of the section 204(h) amendment.

(2) *Later notice permitted for a section 204(h) amendment significantly reducing early retirement benefit or retirement-type subsidies in connection with certain plan transfers, mergers, or consolidations*. If a section 204(h) amendment is adopted with respect to liabilities that are transferred to another plan in connection with a transfer, merger, or consolidation of assets or liabilities as described in section 414(l) of the Internal Revenue Code and §1.414(l)–1 of this chapter, the amendment is adopted in connection with an acquisition or disposition, and the amendment significantly reduces an early retirement benefit or retirement-type subsidy, but does not significantly reduce the rate of future benefit accrual, then section 204(h) notice must be provided no later than 30 days after the effective date of the section 204(h) amendment.

(3) *Definition of acquisition or disposition*. For purposes of this paragraph (d), see §1.410(b)–2(f) of this chapter for the definition of acquisition or disposition.

(e) *Timing rule for amendments permitting participant choice*. In general, section 204(h) notice of a section 204(h) amendment that provides applicable individuals with a choice between the old and the new benefit formulas (as described in Q&A–12 of this section) must be provided in accordance with the time period applicable under paragraphs (a) through (d) of this Q&A–9. See Q&A–12 of this section for additional guidance regarding section 204(h) notice in connection with participant choice.

Q–10. To whom must section 204(h) notice be provided?

A–10. (a) *In general*. Section 204(h) notice must be provided to each applicable individual and to each employee organization representing participants who are applicable individuals. A special rule is provided in paragraph (d) of this Q&A–10.

(b) *Applicable individual*. Applicable individual means each participant in the plan, and any alternate payee, whose rate of future benefit accrual under the plan is reasonably expected to be significantly reduced, or for whom an early retirement benefit or retirement-type subsidy under the plan may reasonably be expected to be significantly reduced, by the section 204(h) amendment. The determination is made with respect to individuals who are reasonably expected to be participants or alternate payees in the plan at the effective date of the section 204(h) amendment.

(c) *Alternate payee*. Alternate payee means a beneficiary who is an alternate payee (within the meaning of section 414(p)(8) of the Internal Revenue Code) under an applicable qualified domestic relations order (within the meaning of section 414(p)(1)(A) of the Internal Revenue Code).

(d) *Designees*. Section 204(h) notice may be provided to a person designated in writing by an applicable individual or by an employee organization representing participants who are applicable individuals, instead of being provided to that applicable individual or employee organization. Any designation of a representative made through an electronic method that satisfies standards similar to those of Q&A–13(c)(1) of this section satisfies the requirement that a designation be in writing.

(e) *Facts and circumstances test*. Whether a participant or alternate payee is an applicable individual is determined on a typical business day that is reasonably proximate to the time the section 204(h) notice is provided (or at the latest date for providing section 204(h) notice, if earlier), based on all relevant facts and circumstances.

(f) *Examples*. The following examples illustrate the rules in this Q&A–10:

Example 1. (i) *Facts*. A defined benefit plan requires an individual to complete 1 year of service to become a participant who can accrue benefits, and participants cease to accrue benefits under the plan at severance from employment with the employer. There are no alternate payees and employees are not represented by an employee organization. On November 18, 2004, the plan is amended effective as of January 1, 2005, to reduce significantly the rate of future benefit accrual. Section 204(h) notice is provided on November 1, 2004.

(ii) *Conclusion*. Section 204(h) notice is only required to be provided to individuals who, based on the facts and circumstances on November 1, 2004, are reasonably expected to have completed at least 1 year of service and to be employed by the employer on January 1, 2005.

Example 2. (i) *Facts*. The facts are the same as in *Example 1*, except that the sole effect of the plan amendment is to alter the pre-amendment plan provisions under which benefits payable to an employee who retires after 20 or more years of service are unreduced for commencement before normal retirement age. The amendment requires 30 or more years of service in order for benefits commencing before normal retirement age to be unreduced, but the amendment only applies for future benefit accruals.

(ii) *Conclusion*. Section 204(h) notice is only required to be provided to individuals who, on January 1, 2005, have completed at least 1 year of service but less than 30 years of service, are employed by the employer, have not attained normal retirement age, and will have completed 20 or more years of service before normal retirement age if their employment continues to normal retirement age.

Example 3. (i) *Facts*. A plan is amended to reduce significantly the rate of future benefit accrual for all current employees who are participants. Based on the facts and circumstances, it is reasonable to expect that the amendment will not reduce the rate of future benefit accrual of former employees who are currently receiving benefits or of former employees who are entitled to deferred vested benefits.

(ii) *Conclusion*. The plan administrator is not required to provide section 204(h) notice to any former employees.

Example 4. (i) *Facts*. The facts are the same as in *Example 3*, except that the plan covers two groups of alternate payees. The alternate payees in the first group are entitled to a certain percentage or portion of the former spouse's accrued benefit and, for this purpose, the accrued benefit is determined at the time the former spouse begins receiving retirement benefits under the plan. The alternate payees in the second group are entitled to a certain percentage or portion of the former spouse's accrued benefit and, for this purpose, the accrued benefit was determined at the time the qualified domestic relations order was issued by the court.

(ii) *Conclusion*. It is reasonable to expect that the benefits to be received by the second group of alternate payees will not be affected by any reduction in a former spouse's rate of future benefit accrual. Accordingly, the plan administrator is not required to provide section 204(h) notice to the alternate payees in the second group.

Example 5. (i) *Facts*. A plan covers hourly employees and salaried employees. The plan provides the same rate of benefit accrual for both groups. The employer amends the plan to reduce significantly the rate of future benefit accrual of the salaried employees only. At that time, it is reasonable to expect that only a small percentage of hourly employees will become salaried in the future.

(ii) *Conclusion*. The plan administrator is not required to provide section 204(h) notice to the participants who are currently hourly employees.

Example 6. (i) *Facts*. A plan covers employees in Division M and employees in Division N. The plan provides the same rate of benefit accrual for both groups. The employer amends the plan to reduce significantly the rate of future benefit accrual of employees in Division M. At that time, it is reasonable to expect that in the future only a small percentage of employees in Division N will be transferred to Division M.

(ii) *Conclusion*. The plan administrator is not required to provide section 204(h) notice to the participants who are employees in Division N.

Example 7. (i) *Facts*. The facts are the same facts as in *Example 6*, except that at the time the amendment is adopted, it is expected that thereafter Division N will be merged into Division M in connection with a corporate reorganization (and the employees in Division N will become subject to the plan's amended benefit formula applicable to the employees in Division M).

(ii) *Conclusion*. In this case, the plan administrator must provide section 204(h) notice to the participants who are employees in Division M and to the participants who are employees in Division N.

Example 8. (i) *Facts*. A plan is amended to reduce significantly the rate of future benefit accrual for all current employees who are participants. The plan amendment will be effective on January 1, 2004. The plan will provide the notice to applicable individuals on October 31, 2003. In determining which current employees are applicable individuals, the plan administrator determines that October 1, 2003, is a typical business day that is reasonably proximate to the time the section 204(h) notice is provided.

(ii) *Conclusion*. In this case, October 1, 2003, is a typical business day that satisfies the requirements of Q&A–10(e) of this section.

Q–11. What information is required to be provided in a section 204(h) notice?

A–11. (a) *Explanation of notice requirements*—(1) *In general*. Section 204(h) notice must include sufficient information to allow applicable individuals to understand the effect of the plan amendment. In order to satisfy this rule, a plan administrator providing section 204(h) notice must satisfy each of the following requirements of this paragraph (a).

(2) *Information in section 204(h) notice*. The information in a section 204(h) notice must be written in a manner calculated to be understood by the average plan participant and to apprise the applicable individual of the significance of the notice.

(3) *Required narrative description of amendment*—(i) *Reduction in rate of future benefit accrual*. In the case of an amendment reducing the rate of future benefit accrual, the notice must include a description of the benefit or allocation formula prior to the amendment, a description of the benefit or allocation formula under the plan as amended, and the effective date of the amendment.

(ii) *Reduction in early retirement benefit or retirement-type subsidy*. In the case of an amendment that reduces an early retirement benefit or retirement-type subsidy (other than as a result of an amendment reducing the rate of future benefit accrual), the notice must describe how the early retirement benefit or retirement-type subsidy is calculated from the accrued benefit before the amendment, how the early retirement benefit or retirement-type subsidy is calculated from the accrued benefit after the amendment, and the effective date of the amendment. For example, if, for a plan with a normal retirement age of 65, the change is from an unreduced normal retirement benefit at age 55 to an unreduced normal retirement benefit at age 60 for benefits accrued in the future, with an actuarial reduction to apply for benefits accrued in the future to the extent that the early retirement benefit begins before age 60, the notice must state the change and specify the factors that apply in calculating the actuarial reduction (for example, a 5% per year reduction applies for early retirement before age 60).

(4) *Sufficient information to determine the approximate magnitude of reduction*—(i) *General rule*. (A) Section 204(h) notice must include sufficient information for each applicable individual to determine the approximate magnitude of the expected reduction for that individual. Thus, in any case in which it is not reasonable to expect that the approximate magnitude of the reduction for each applicable individual will be reasonably apparent from the description of the amendment provided in accordance with paragraph (a)(3) of this Q&A–11, further information is required. The further information may be provided by furnishing additional narrative information or in other information that satisfies this paragraph of this section.

(B) To the extent any expected reduction is not uniformly applicable to all participants, the notice must either identify the general classes of participants to whom the reduction is expected to apply, or by some other method include sufficient information to allow each applicable individual receiving the notice to determine which reductions are expected to apply to that individual.

(ii) *Illustrative examples*—(A) *Requirement generally*. The requirement to include sufficient information for each applicable individual to determine the approximate magnitude of the expected reduction for that individual under (a)(4)(i)(A) of this Q&A–11 is deemed satisfied if the notice includes one or more illustrative examples showing the approximate magnitude of the reduction in the examples, as provided in this paragraph (a)(4)(ii). Illustrative examples are in any event required to be provided for any change from a traditional defined benefit formula to a cash balance formula or a change that results in a period of time during which there are no accruals (or minimal accruals) with regard to normal retirement benefits or an early retirement subsidy (a wear-away period).

(B) *Examples must bound the range of reductions*. Where an amendment results in reductions that vary (either among participants, as would occur for an amendment converting a traditional defined benefit formula to a cash balance formula, or over time as to any individual participant, as would occur for an amendment that results in a wear-away period), the illustrative example(s) provided in accordance with this paragraph (a)(4)(ii) must show the approximate range of the reductions. However, any reductions that are likely to occur in only a *de minimis* number of cases are not required to be taken into account in determining the range of the reductions if a narrative statement is included to that effect and examples are provided that show the approximate range of the reductions in other cases. Amendments for which the maximum reduction occurs under identifiable circumstances, with proportionately smaller reductions in other cases, may be illustrated by one example illustrating the maximum reduction, with a statement that smaller reductions also occur. Further, assuming that the reduction varies from small to large depending on service or other factors, two illustrative examples may be provided showing the smallest likely reduction and the largest likely reduction.

(C) *Assumptions used in examples*. The examples provided under this paragraph (a)(4)(ii) are not required to be based on any particular form of payment (such as a life annuity or a single sum), but may be based on whatever form appropriately illustrates the reduction. The examples generally may be based on any reasonable assumptions (for example, assumptions relating to the representative participant's age, years of service, and compensation, along with any interest rate and mortality table used in the illustrations, as well as salary scale assumptions used in the illustrations for amendments that alter the compensation taken into account under the plan), but the section 204(h) notice must identify those assumptions. However, if a plan's benefit provisions include a factor that varies over time (such as a variable interest rate), the determination of whether an amendment is reasonably expected to result in a wear-away period must be based on the value of the factor applicable under the plan at a time that is reasonably close to the date section 204(h) notice is provided, and any wear-away period that is solely a result of a future change in the variable factor may be disregarded. For example, to determine whether a wear-away occurs as a result of a section 204(h) amendment that converts a defined benefit plan to a cash balance pension plan that will credit interest based on a variable interest factor specified in the plan, the future interest credits must be projected based on the interest rate applicable under the variable factor at the time section 204(h) notice is provided.

(D) *Individual statements*. This paragraph (a)(4)(ii) may be satisfied by providing a statement to each applicable individual projecting what that individual's future benefits are reasonably expected to be at various future dates and what that individual's future benefits would have been under the terms of the plan as in effect before the section 204(h) amendment, provided that the statement includes the same information required for examples under paragraphs (a)(4)(ii)(A) through (C) of this Q&A–11, including showing the approximate range of the reductions for the individual if the reductions vary over time and identification of the assumptions used in the projections.

(5) *No false or misleading information*. A section 204(h) notice may not include materially false or misleading information (or omit information so as to cause the information provided to be misleading).

(6) *Additional information when reduction not uniform*—(i) *In general*. If an amendment by its terms affects different classes of participants differently (*e.g.*, one new benefit formula will apply to Division A and another to Division B), then the requirements of paragraph (a) of this Q&A–11 apply separately with respect to each such general class of participants. In addition, the notice must include sufficient information to enable an applicable individual who is a participant to understand which class he or she is a member of.

(ii) *Option for different section 204(h) notices*. If a section 204(h) amendment affects different classes of applicable individuals differently, the plan administrator may provide to differently affected classes of applicable individuals a section 204(h) notice appropriate to those individuals. Such section 204(h) notice may omit information that does not apply to the applicable individuals to whom it is furnished, but must identify the class or classes of applicable individuals to whom it is provided.

(b) *Examples*. The following examples illustrate the requirements of paragraph (a) of this Q&A–11. In each example, it is assumed that the actual notice provided is written in a manner calculated to be understood by the average plan participant and to apprise the applicable individual of the significance of the notice in accordance with paragraph (a)(2) of this Q&A–11. The examples are as follows:

Example 1. (i) *Facts*. Plan A provides that a participant is entitled to a normal retirement benefit of 2% of the participant's average pay over the 3 consecutive years for which the average is the highest (highest average pay) multiplied by years of service. Plan A is amended to provide that, effective January 1, 2004, the normal retirement benefit will be 2% of the participant's highest average pay multiplied by years of service before the effective date, plus 1% of the participant's highest average pay multiplied by years of service after the effective date. The plan administrator provides notice that states: "Under the Plan's current benefit formula, a participant's normal retirement benefit is 2% of the participant's average pay over the 3 consecutive years for which the average is the highest multiplied by the participant's years of service. This formula is being changed by a plan amendment. Under the Plan as amended, a participant's normal retirement benefit will be the sum of 2% of the participant's average pay over the 3 consecutive years for which the average is the highest multiplied by years of service before the January 1, 2004, effective date, plus 1% of the participant's average pay over the 3 consecutive years for which the average is the highest multiplied by the participant's years of service after December 31, 2003. This change is effective on January 1, 2004." The notice does not contain any additional information.

(ii) *Conclusion*. The notice satisfies the requirements of paragraph (a) of this Q&A–11.

Example 2. (i) *Facts*. Plan B provides that a participant is entitled to a normal retirement benefit at age 64 of 2.2% of the participant's career average pay multiplied by years of service. Plan B is amended to cease all accruals, effective January 1, 2004. The plan administrator provides notice that includes a description of the old benefit formula, a statement that, after December 31, 2003, no participant will earn any further accruals, and the effective date of the amendment. The notice does not contain any additional information.

(ii) *Conclusion*. The notice satisfies the requirements of paragraph (a) of this Q&A–11.

Example 3. (i) *Facts*. Plan C provides that a participant is entitled to a normal retirement benefit at age 65 of 2% of career average compensation multiplied by years of service. Plan C is amended to provide that the normal retirement benefit will be 1% of average pay over the 3 consecutive years for which the average is the highest multiplied by years of service. The amendment only applies to accruals for years of service after the amendment, so that each employee's accrued benefit is equal to the sum of the benefit accrued as of the effective date of the amendment plus the accrued benefit equal to the new formula applied to years of service beginning on or after the effective date. The plan administrator provides notice that describes the old and new benefit formulas and also explains that for an individual whose compensation increases over the individual's career such that the individual's highest 3-year average exceeds the individual's career average, the reduction will be less or there may be no reduction. The notice does not contain any additional information.

(ii) *Conclusion*. The notice satisfies the requirements of paragraph (a) of this Q&A–11.

Example 4. (i) *Facts*. (A) Plan D is a defined benefit pension plan under which each participant accrues a normal retirement benefit, as a life annuity beginning at the normal retirement age of 65, equal to the participant's number of years of service multiplied by 1.5 percent multiplied by the participant's average pay over the 3 consecutive years for which the average is the highest. Plan D provides early retirement benefits for former employees beginning at or after age 55 in the form of an early retirement annuity that is actuarially equivalent to the normal retirement benefit, with the reduction for early commencement based on reasonable actuarial assumptions that are specified in Plan D. Plan D provides for the suspension of benefits of participants who continue in employment beyond normal retirement age, in accordance with section 203(a)(3)(B) of ERISA and regulations thereunder issued by the Department of Labor. The pension of a participant who retires after age 65 is calculated under the same normal retirement benefit formula, but is based on the participant's service credit and highest 3-year pay at the time of late retirement with any appropriate actuarial increases.

(B) Plan D is amended, effective July 1, 2005, to change the formula for all future accruals to a cash balance formula under which the opening account balance for each participant on July 1, 2005, is zero, hypothetical pay credits equal to 5 percent of pay are credited to the account thereafter, and hypothetical interest is credited monthly based on the applicable interest rate under section 417(e)(3) of the Internal Revenue Code at the beginning of the quarter. Any participant who terminates employment with vested benefits can receive an actuarially equivalent annuity (based on the same reasonable actuarial assumptions that are specified in Plan D) commencing at any time after termination of employment and before the plan's normal retirement age of 65. The benefit resulting from the hypothetical account balance is in addition to the benefit accrued before July 1, 2005 (taking into account only service and highest 3-year pay before July 1, 2005), so that it is reasonably expected that no wear-away period will result from the amendment. The plan administrator expects that, as a general rule, depending on future pay increases and future interest rates, the rate of future benefit accrual after the conversion is higher for participants who accrue benefits before approximately age 50 and after approximately age 70, but is lower for participants who accrue benefits between approximately age 50 and age 70.

(C) The plan administrator of Plan D announces the conversion to a cash balance formula on May 16, 2005. The announcement is delivered to all participants and includes a written notice that describes the old formula, the new formula, and the effective date.

(D) In addition, the notice states that the Plan D formula before the conversion provided a normal retirement benefit equal to the product of a participant's number of years of service multiplied by 1.5 percent multiplied by the participant's average pay over the 3 years for which the average is the highest (highest 3-year pay). The notice includes an example showing the normal retirement benefit that will be accrued after June 30, 2005, for a participant who is age 49 with 10 years of service at the time of the conversion. The plan administrator reasonably believes that such a participant is representative of the participants whose rate of future benefit accrual will be reduced as a result of the amendment. The example estimates that, if the participant continues employment to age 65, the participant's normal retirement benefit for service from age 49 to age 65 will be $657 per month for life. The example assumes that the participant's pay is $50,000 at age 49. The example states that the estimated $657 monthly pension accrues over the 16-year period from age 49 to age 65 and that, based on assumed future pay increases, this amount annually would be 9.1 percent of the participant's highest 3-year pay at age 65, which over the 16 years from age 49 to age 65 averages 0.57 percent per year multiplied by the participant's highest 3-year pay. The example also states that the sum of the monthly annuity accrued before the conversion in the 10-year period from age 39 to age 49 plus the $657 monthly annuity estimated to be accrued over the 16-year period from age 49 to age 65 is $1,235 and that, based on assumed future increases in pay, this would be 17.1 percent of the participant's highest 3-year pay at age 65, which over the employee's career from age 39 to age 65 averages 0.66 percent per year multiplied by the participant's highest 3-year pay. The notice also includes two other examples with similar information, one of which is intended to show the circumstances in which a small reduction may occur and the other of which shows the largest reduction that the plan administrator thinks is likely to occur. The notice states that the estimates are based on the assumption that pay increases annually after June 30, 2005, at a 4 percent rate. The notice also specifies that the applicable interest rate under section 417(e) for hypothetical interest credits after June 30, 2005, is assumed to be 6 percent, which is the section 417(e) of the Internal Revenue Code applicable interest rate under the plan for 2005.

(ii) *Conclusion*. The information in the notice, as described in paragraph (i)(C) and (i)(D) of this *Example 4*, satisfies the requirements of paragraph (a)(3) of this Q&A–11 with respect to applicable individuals who are participants. The requirements of paragraph (a)(4) of this Q&A–11 are satisfied because, as noted in paragraph (i)(D) of this *Example 4*, the notice describes the old formula and describes the estimated future accruals under the new formula in terms that can be readily compared to the old formula, *i.e.*, the notice states that the estimated $657 monthly pension accrued over the 16-year period from age 49 to age 65 averages 0.57 percent of the participant's highest 3-year pay at age 65. The requirement in paragraph (a)(4)(ii) of this Q&A–11 that the examples include sufficient information to be able to determine the approximate magnitude of the reduction would also be satisfied if the notice instead directly stated the amount of the monthly pension that would have accrued over the 16-year period from age 49 to age 65 under the old formula.

Example 5. (i) *Facts*. The facts are the same as in *Example 4*, except that, under the plan as in effect before the amendment, the early retirement pension for a participant who terminates employment after age 55 with at least 20 years of service is equal to the normal retirement benefit without reduction from age 65 to age 62 and reduced by only 5 percent per year for each year before age 62. As a result, early retirement benefits for such a participant constitute a retirement-type subsidy. The plan as in effect after the amendment provides an early retirement benefit equal to the sum of the early retirement benefit payable under the plan as in effect before the amendment taking into account only service and highest 3-year pay before July 1, 2005, plus an early retirement annuity that is actuarially equivalent to the account balance for service after June 30, 2005. The notice provided by the plan administrator describes the old early retirement annuity, the new early retirement annuity, and the effective date. The notice includes an estimate of the early retirement annuity payable to the illustrated participant for service after the conversion if the participant were to retire at age 59 (which the plan administrator believes is a typical early retirement age) and elect to begin receiving an immediate early retirement annuity. The example states that the normal retirement benefit expected to be payable at age 65 as a result of service from age 49 to age 59 is $434 per month for life beginning at age 65 and that the early retirement annuity expected to be payable as a result of service from age 49 to age 59 is $270 per month for life beginning at age 59. The example states that the monthly early retirement annuity of $270 is 38 percent less than the monthly normal retirement benefit of $434, whereas a 15 percent reduction would have applied under the plan as in effect before the amendment. The notice also includes similar information for examples that show the smallest and largest reduction that the plan administrator thinks is likely to occur in the early retirement benefit. The notice also specifies the applicable interest rate, mortality table, and salary scale used in the example to calculate the early retirement reductions.

(ii) *Conclusion*. The information in the notice, as described in paragraphs (i)(C) and (D) of *Example 4* and paragraph (i) of this *Example 5*, satisfies the requirements of paragraph (a)(3) of this Q&A–11 with respect to applicable individuals who are participants. The requirements of paragraph (a)(4) of this Q&A–11 are satisfied because, as noted in paragraph (i) of this *Example 5*, the notice describes the early retirement subsidy under the old formula and describes the estimated early retirement pension under the new formula in terms that can be readily compared to the old formula, *i.e.*, the notice states that the monthly early retirement pension of $270 is 38 percent less than the monthly normal retirement benefit of $434, whereas a 15 percent reduction would have applied under the plan as in effect before the amendment. The requirements of paragraph (a)(4)(ii) of this Q&A–11 that the examples include sufficient information to be able to determine the approximate magnitude of the reduction would also be satisfied if the notice instead directly stated the amount of the monthly early retirement pension that would be payable at age 59 under the old formula.

Q–12. What special rules apply if participants can choose between the old and new benefit formulas?

A–12. In any case in which an applicable individual can choose between the benefit formula (including any early retirement benefit or retirement-type subsidy) in effect before the section 204(h) amendment (old formula) or the benefit formula in effect after the section 204(h) amendment (new formula), section 204(h) notice has not been provided unless the applicable individual has been provided the information required under Q&A–11 of this section, and has also been provided sufficient information to enable the individual to make an informed choice between the old and new benefit formulas. The information required under Q&A–11 of this section must be provided by the date otherwise required under Q&A–9 of this section. The information sufficient to enable the individual to make an informed choice must be provided within a period that is reasonably contemporaneous with the date by which the individual is required to make his or her choice and that allows sufficient advance notice to enable the individual to understand and consider the additional information before making that choice.

Q–13. How may section 204(h) notice be provided?

A–13. (a) *Delivering section 204(h) notice*. A plan administrator (including a person acting on behalf of the plan administrator, such as the employer or plan trustee) must provide section 204(h) notice through a method that results in actual receipt of the notice or the plan administrator must take appropriate and necessary measures reasonably calculated to ensure that the method for providing section 204(h) notice results in actual receipt of the notice. Section 204(h) notice must be provided either in the form of a paper document or in an electronic form that satisfies the requirements of paragraph (c) of this Q&A–13. First class mail to the last known address of the party is an acceptable delivery method. Likewise, hand delivery is acceptable. However, the posting of notice is not considered provision of section 204(h) notice. Section 204(h) notice may be enclosed with or combined with other notice provided by the employer or plan administrator (for example, a notice of intent to terminate under title IV of ERISA). Except as provided in paragraph (c) of this Q&A–13, a section 204(h) notice is deemed to have been provided on a date if it has been provided by the end of that day. When notice is delivered by first class mail, the notice is considered provided as of the date of the United States postmark stamped on the cover in which the document is mailed.

(b) *Example*. The following example illustrates the provisions of paragraph (a) of this Q&A–13:

Example. (i) *Facts*. Plan A is amended to reduce significantly the rate of future benefit accrual effective January 1, 2005. Under Q&A–9 of this section, section 204(h) notice is required to be provided at least 45 days before the effective date of the amendment. The plan administrator causes section 204(h) notice to be mailed to all affected participants. The mailing is postmarked November 16, 2004.

(ii) *Conclusion*. Because section 204(h) notice is given 45 days before the effective date of the plan amendment, it satisfies the timing requirement of Q&A–9 of this section.

(c) *New technologies*—(1) *General rule*. A section 204(h) notice may be provided to an applicable individual through an electronic method (other than an oral communication or a recording of an oral communication), provided that all of the following requirements are satisfied:

(i) Either the notice is actually received by the applicable individual or the plan administrator takes appropriate and necessary measures reasonably calculated to ensure that the method for providing section 204(h) notice results in actual receipt of the notice by the applicable individual.

(ii) The plan administrator provides the applicable individual with a clear and conspicuous statement, in electronic or non-electronic form, that the applicable individual has a right to request and obtain a paper version of the section 204(h) notice without charge and, if such request is made, the applicable individual is furnished with the paper version without charge.

(iii) The requirements of this section must otherwise be satisfied. Thus, for example, a section 204(h) notice provided through an electronic method must be delivered on or before the date required under Q&A–9 of this section and must satisfy the requirements set forth in Q&A–11 of this section, including the content requirements and the requirements that it be written in a manner calculated to be understood by the average plan participant and to apprise the applicable individual of the significance of the notice. Accordingly, when it is not otherwise reasonably evident, the recipient should be apprised (either in electronic or in non-electronic form), at the time the notice is furnished electronically, of the significance of the notice.

(2) *Examples*. The following examples illustrate the requirement in paragraph (c)(1)(i) of this Q&A–13. In these examples, it is assumed that the notice satisfies the requirements in paragraphs (c)(1)(ii) and (iii) of this section. The examples are as follows:

Example 1. (i) *Facts*. On July 1, 2003, M, a plan administrator of Company N's plan, sends notice intended to constitute section 204(h) notice to A, an employee of Company N and a participant in the plan. The notice is sent through e-mail to A's e-mail address on Company N's electronic information system. Accessing Company N's electronic information system is not an integral part of A's duties. M sends the e-mail with a request for a computer-generated notification that the message was received and opened. M receives notification indicating that the e-mail was received and opened by A on July 9, 2003.

(ii) *Conclusion*. With respect to A, although M has failed to take appropriate and necessary measures reasonably calculated to ensure that the method for providing section 204(h) notice results in actual receipt of the notice, M satisfies the requirement of paragraph (c)(1)(i) of this Q&A–13 on July 9, 2003, which is when A actually receives the notice.

Example 2. (i) *Facts*. On August 1, 2003, O, a plan administrator of Company P's plan, sends a notice intended to constitute section 204(h) notice of ERISA to B, who is an employee of Company P and a participant in Company P's plan. The notice is sent through e-mail to B's e-mail address on Company P's electronic information system. B has the ability to effectively access electronic documents from B's e-mail address on Company P's electronic information system and accessing the system is an integral part of B's duties.

(ii) *Conclusion*. Because access to the system is an integral part of B's duties, O has taken appropriate and necessary measures reasonably calculated to ensure that the method for providing section 204(h) notice results in actual receipt of the notice. Thus, regardless of whether B actually accesses B's email on that date, O satisfies the requirement of paragraph (c)(1)(i) of this Q&A–13 on August 1, 2003, with respect to B.

(3) *Safe harbor in case of consent*. The requirement of paragraph (c)(1)(i) of this Q&A–13 is deemed to be satisfied with respect to an applicable individual if the section 204(h) notice is provided electronically to an applicable individual, and—

(i) The applicable individual has affirmatively consented electronically, or confirmed consent electronically, in a manner that reasonably demonstrates the applicable individual's ability to access the information in the electronic form in which the notice will be provided, to receiving section 204(h) notice electronically and has not withdrawn such consent;

(ii) The applicable individual has provided, if applicable, in electronic or non-electronic form, an address for the receipt of electronically furnished documents;

(iii) Prior to consenting, the applicable individual has been provided, in electronic or non-electronic form, a clear and conspicuous statement indicating—

(A) That the consent can be withdrawn at any time without charge;

(B) The procedures for withdrawing consent and for updating the address or other information needed to contact the applicable individual;

(C) Any hardware and software requirements for accessing and retaining the documents; and

(D) The information required by paragraph (c)(1)(ii) of this Q&A–13; and

(iv) After consenting, if a change in hardware or software requirements needed to access or retain electronic records creates a material risk that the applicable individual will be unable to access or retain the section 204(h) notice—

(A) The applicable individual is provided with a statement of the revised hardware and software requirements for access to and retention of the section 204(h) notice and is given the right to withdraw consent without the imposition of any fees for such withdrawal and without the imposition of any condition or consequence that was not disclosed at the time of the initial consent; and

(B) The requirement of paragraph (c)(3)(i) of this Q&A–13 is again complied with.

Q–14. What are the consequences if a plan administrator fails to provide section 204(h) notice?

A–14. (a) *Egregious failures*—(1) *Effect of egregious failure to provide section 204(h) notice*. Section 204(h)(6)(A) of ERISA provides that, in the case of any egregious failure to meet the notice requirements with respect to any plan amendment, the plan provisions are applied so that all applicable individuals are entitled to the greater of the benefit to which they would have been entitled without regard to the amendment, or the benefit under the plan with regard to the amendment. For a special rule applicable in the case of a plan termination, see Q&A–17(b) of this section.

(2) *Definition of egregious failure*. For purposes of section 204(h) of ERISA and this Q&A–14, there is an egregious failure to meet the notice requirements if a failure to provide required notice is within the control of the plan sponsor and is either an intentional failure or a failure, whether or not intentional, to provide most of the individuals with most of the information they are entitled to receive. For this purpose, an intentional failure includes any failure to promptly provide the required notice or information after the plan administrator discovers an unintentional failure to meet the requirements. A failure to give section 204(h) notice is deemed not to be egregious if the plan administrator reasonably determines, taking into account section 4980F, section 204(h), these regulations, other administrative pronouncements, and relevant facts and circumstances, that the reduction in the rate of future benefit accrual resulting from an amendment is not significant (as described in Q&A–8 of this section), or that an amendment does not significantly reduce an early retirement benefit or retirement-type subsidy.

(3) *Example*. The following example illustrates the provisions of this paragraph (a):

Example. (i) *Facts*. Plan A is amended to reduce significantly the rate of future benefit accrual effective January 1, 2003. Section 204(h) notice is required to be provided 45 days before January 1, 2003. Timely section 204(h) notice is provided to all applicable individuals (and to each employee organization representing participants who are applicable individuals), except that the employer intentionally fails to provide section 204(h) notice to certain participants until May 16, 2003.

(ii) *Conclusion*. The failure to provide section 204(h) notice is egregious. Accordingly, for the period from January 1, 2003, through June 30, 2003 (which is the date that is 45 days after May 16, 2003), all participants and alternate payees are entitled to the greater of the benefit to which they would have been entitled under Plan A as in effect before the amendment or the benefit under the plan as amended.

(b) *Effect of non-egregious failure to provide section 204(h) notice*. If an egregious failure has not occurred, the amendment with respect to which section 204(h) notice is required may become effective with respect to all applicable individuals. However, see section 502 of ERISA for civil enforcement remedies. Thus, where there is a failure, whether or not egregious, to provide section 204(h) notice in accordance with this section, individuals may have recourse under section 502 of ERISA.

(c) *Excise taxes*. See section 4980F and Q&A–15 of this section for excise taxes that may apply to a failure to notify applicable individuals of a pension plan amendment that provides for a significant reduction in the rate of future benefit accrual or eliminates or significantly reduces an early retirement benefit or retirement-type subsidy, regardless of whether or not the failure is egregious.

Q–15. What are some of the rules that apply with respect to the excise tax under section 4980F?

A–15. (a) *Person responsible for excise tax*. In the case of a plan other than a multiemployer plan, the employer is responsible for reporting and paying the excise tax. In the case of a multiemployer plan, the plan is responsible for reporting and paying the excise tax.

(b) *Excise tax inapplicable in certain cases*. Under section 4980F(c)(1) of the Internal Revenue Code, no excise tax is imposed on a failure for any period during which it is established to the satisfaction of the Commissioner that the employer (or other person responsible for the tax) exercised reasonable diligence, but did not know that the failure existed. Under section 4980F(c)(2) of the Internal Revenue Code, no excise tax applies to a failure to provide section 204(h) notice if the employer (or other person responsible for the tax) exercised reasonable diligence and corrects the failure within 30 days after the employer (or other person responsible for the tax) first knew, or exercising reasonable diligence would have known, that such failure existed. For purposes of section 4980F(c)(1) of the Internal Revenue Code, a person has exercised reasonable diligence, but did not know that the failure existed if and only if—

(1) The person exercised reasonable diligence in attempting to deliver section 204(h) notice to applicable individuals by the latest date permitted under this section; and

(2) At the latest date permitted for delivery of section 204(h) notice, the person reasonably believes that section 204(h) notice was actually delivered to each applicable individual by that date.

(c) *Example*. The following example illustrates the provisions of paragraph (b) of this Q&A–15:

Example. (i) *Facts*. Plan A is amended to reduce significantly the rate of future benefit accrual. The employer sends out a section 204(h) notice to all affected participants and other applicable individuals and to any employee organization representing applicable individuals, including actual delivery by hand to employees at worksites and by first-class mail for any other applicable individual and to any employee organization representing applicable individuals. However, although the employer exercises reasonable diligence in seeking to deliver the notice, the notice is not delivered to any participants at one worksite due to a failure of an overnight delivery service to provide the notice to appropriate personnel at that site for them to timely hand deliver the notice to affected employees. The error is discovered when the employer subsequently calls to confirm delivery. Appropriate section 204(h) notice is then promptly delivered to all affected participants at the worksite.

(ii) *Conclusion*. Because the employer exercised reasonable diligence, but did not know that a failure existed, no excise tax applies, assuming that participants at the worksite receive section 204(h) notice within 30 days after the employer first knew, or exercising reasonable diligence would have known, that the failure occurred.

Q–16. How do section 4980F and section 204(h) apply when a business is sold?

A–16. (a) *Generally*. Whether section 204(h) notice is required in connection with the sale of a business depends on whether a plan amendment is adopted that significantly reduces the rate of future benefit accrual or significantly reduces an early retirement benefit or retirement-type subsidy.

(b) *Examples*. The following examples illustrate the rules of this Q&A–16:

Example 1. (i) *Facts*. Corporation Q maintains Plan A, a defined benefit plan that covers all employees of Corporation Q, including employees in its Division M. Plan A provides that participating employees cease to accrue benefits when they cease to be employees of Corporation Q. On January 1, 2006, Corporation Q sells all of the assets of Division M to Corporation R. Corporation R maintains Plan B, which covers all of the employees of Corporation R. Under the sale agreement, employees of Division M become employees of Corporation R on the date of the sale (and cease to be employees of Corporation Q), Corporation Q continues to maintain Plan A following the sale, and the employees of Division M become participants in Plan B.

(ii) *Conclusion*. No section 204(h) notice is required because no plan amendment was adopted that reduced the rate of future benefit accrual. The employees of Division M who become employees of Corporation R ceased to accrue benefits under Plan A because their employment with Corporation Q terminated.

Example 2. (i) *Facts*. Subsidiary Y is a wholly owned subsidiary of Corporation S. Subsidiary Y maintains Plan C, a defined benefit plan that covers employees of Subsidiary Y. Corporation S sells all of the stock of Subsidiary Y to Corporation T. At the effective date of the sale of the stock of Subsidiary Y, in accordance with the sale agreement between Corporation S and Corporation T, Subsidiary Y amends Plan C so that all benefit accruals cease.

(ii) *Conclusion*. Section 204(h) notice is required to be provided because Subsidiary Y adopted a plan amendment that significantly reduced the rate of future benefit accrual in Plan C.

Example 3. (i) *Facts*. As a result of an acquisition, Corporation U maintains two defined benefit plans: Plan D covers employees of Division N and Plan E covers the rest of the employees of Corporation U. Plan E provides a significantly lower rate of future benefit accrual than Plan D. Plan D is merged with Plan E, and all of the employees of Corporation U will accrue benefits under the merged plan in accordance with the benefit formula of former Plan E.

(ii) *Conclusion*. Section 204(h) notice is required.

Example 4. (i) *Facts*. The facts are the same as in *Example 3*, except that the rate of future benefit accrual in Plan E is not significantly lower. In addition, Plan D has a retirement-type subsidy that Plan E does not have and the Plan D employees' rights to the subsidy under the merged plan are limited to benefits accrued before the merger.

(ii) *Conclusion*. Section 204(h) notice is required for any participants or beneficiaries for whom the reduction in the retirement-type subsidy is significant (and for any employee organization representing such participants).

Example 5. (i) *Facts*. Corporation V maintains several plans, including Plan F, which covers employees of Division P. Plan F provides that participating employees cease to accrue further benefits under the plan when they cease to be employees of Corporation V. Corporation V sells all of the assets of Division P to Corporation W, which maintains Plan G for its employees. Plan G provides a significantly lower rate of future benefit accrual than Plan F. Plan F is merged with Plan G as part of the sale, and employees of Division P who become employees of Corporation W will accrue benefits under the merged plan in accordance with the benefit formula of former Plan G.

(ii) *Conclusion*. No section 204(h) notice is required because no plan amendment was adopted that reduces the rate of future benefit accrual or eliminates or significantly reduces an early retirement benefit or retirement-type subsidy. Under the terms of Plan F as in effect prior to the merger, employees of Division P cease to accrue any further benefits (including benefits with respect to early retirement benefits and any retirement-type subsidy) under Plan F after the date of the sale because their employment with Corporation V terminated.

Q–17. How are amendments to cease accruals and terminate a plan treated under section 4980F and section 204(h)?

A–17. (a) *General rule*—(1) *Rule*. An amendment providing for the cessation of benefit accruals on a specified future date and for the termination of a plan is subject to section 4980F and section 204(h).

(2) *Example*. The following example illustrates the rule of paragraph (a)(1) of this Q&A–17:

Example. (i) *Facts*. An employer adopts an amendment that provides for the cessation of benefit accruals under a defined benefit plan on December 31, 2003, and for the termination of the plan pursuant to title IV of ERISA as of a proposed termination date that is also December 31, 2003. As part of the notice of intent to terminate required under title IV in order to terminate the plan, the plan administrator gives section 204(h) notice of the amendment ceasing accruals, which states that benefit accruals will cease "on December 31, 2003, whether or not the plan is terminated on that date." However, because all the requirements of title IV for a plan termination are not satisfied, the plan cannot be terminated until a date that is later than December 31, 2003.

(ii) *Conclusion*. Nonetheless, because section 204(h) notice was given stating that the plan was amended to cease accruals on December 31, 2003, section 204(h) does not prevent the amendment to cease accruals from being effective on December 31, 2003. The result would be the same had the section 204(h) notice informed the participants that the plan was amended to provide for a proposed termination date of December 31, 2003, and to provide that "benefit accruals will cease on the proposed termination date whether or not the plan is terminated on that date." However, neither section 4980F nor section 204(h) would be satisfied with respect to the December 31, 2003, effective date if the section 204(h) notice had merely stated that benefit accruals would cease "on the termination date" or "on the proposed termination date."

(3) *Additional requirements under title IV of ERISA*. See 29 CFR 4041.23(b)(4) and 4041.43(b)(5) for special rules applicable to plans terminating under title IV of ERISA.

(b) *Terminations in accordance with title IV of ERISA*. A plan that is terminated in accordance with title IV of ERISA is deemed to have satisfied section 4980F and section 204(h) not later than the termination date (or date of termination, as applicable) established under section 4048 of ERISA. Accordingly, neither section 4980F nor section 204(h) would in any event require that any additional benefits accrue after the effective date of the termination.

(c) *Amendment effective before termination date of a plan subject to title IV of ERISA*. To the extent that an amendment providing for a significant reduction in the rate of future benefit accrual or a significant reduction in an early retirement benefit or retirement-type subsidy has an effective date that is earlier than the termination date (or date of termination, as applicable) established under section 4048 of ERISA, that amendment is subject to section 4980F and section 204(h). Accordingly, the plan administrator must provide section 204(h) notice (either separately, with, or as part of the notice of intent to terminate) with respect to such an amendment.

Q–18. What are the effective dates of section 4980F, section 204(h), as amended by EGTRRA, and these regulations?

A–18. (a) *Statutory effective date*—(1) *General rule*. Section 4980F and section 204(h), as amended by EGTRRA, apply to plan amendments taking effect on or after June 7, 2001 (statutory effective date), which is the date of enactment of EGTRRA.

(2) *Transition rule*. For amendments applying after the statutory effective date in paragraph (a)(1) of this Q&A–18 and prior to the regulatory effective date in paragraph (c) of this Q&A–18, the requirements of section 4980F(e)(2) and (3) of the Internal Revenue Code and section 204(h), as amended by EGTRRA, are treated as satisfied if the plan administrator makes a reasonable, good faith effort to comply with those requirements.

(3) *Special notice rule*—(i) *In general*. Notwithstanding Q&A–9 of this section, section 204(h) notice is not required by section 4980F(e) of the Internal Revenue Code or section 204(h), as amended by EGTRRA, to be provided prior to September 7, 2001

(the date that is three months after the date of enactment of EGTRRA).

(ii) *Reasonable notice*. The requirements of section 4980F and section 204(h), as amended by EGTRRA, do not apply to any plan amendment that takes effect on or after June 7, 2001 if, before April 25, 2001, notice was provided to participants and beneficiaries adversely affected by the plan amendment (and their representatives) which was reasonably expected to notify them of the nature and effective date of the plan amendment. For purposes of this paragraph (a)(3)(ii), notice that complies with §1.411(d)–6 of this chapter, as it appeared in the April 1, 2001, edition of 26 CFR part 1, is deemed to be notice which was reasonably expected to notify participants and beneficiaries adversely affected by the plan amendment (and their representatives) of the nature and effective date of the plan amendment.

(b) *Regulatory effective date*— (1) *General effective date*. Except for Q&A–7(a)(2), Q&A–1 through Q&A–18 of this section apply to amendments with an effective date that is on or after September 1, 2003.

(2) *Effective date for Q&A–7(a)(2)*. Q&A–7(a)(2) of this section applies to amendments with an effective date that is on or after January 1, 2004.

(c) *Amendments taking effect prior to June 7, 2001*. For rules applicable to amendments taking effect prior to June 7, 2001, see §1.411(d)–6 of this chapter, as it appeared in the April 1, 2001, edition of 26 CFR part 1.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 5. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 6. In §602.101, paragraph (b) is amended by adding the following entry in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

*****

(b) ***

CFR part or section where identified and described	Current OMB Control No.
*****	
54.4980F–1	1545–1780
*****	

David A. Mader,
Assistant Deputy Commissioner of Internal Revenue.

Approved March 27, 2003.

Pamela F. Olson,
Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on April 8, 2003, 8:45 a.m., and published in the issue of the Federal Register for April 9, 2003, 68 F.R. 17277)

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2003. See Rev. Rul. 2003–45, page 876.

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 May 2003. See Rev. Rul. 2003–45, page 876.

Part III. Administrative, Procedural, and Miscellaneous

Eligible Deferred Compensation Plans Under Section 457

Notice 2003–20

I. PURPOSE AND SCOPE

This notice describes the withholding and reporting requirements applicable to eligible deferred compensation plans described in § 457(b) of the Internal Revenue Code ("§ 457(b) plans") for periods after December 31, 2001.

Specifically, this notice addresses —

- income tax withholding and reporting with respect to annual deferrals made to a § 457(b) plan;
- income tax withholding and reporting with respect to distributions from a § 457(b) plan, including changes for a § 457(b) plan established by a state or local government employer enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Pub. L. No. 107–16;
- Federal Insurance Contributions Act (FICA) payment and reporting with respect to annual deferrals under a § 457(b) plan;
- employer identification numbers (EINs) used in connection with trusts established under § 457(g); and
- the application of annual reporting requirements to § 457(b) plan administrators and trustees holding assets of a § 457(b) plan in accordance with § 457(g).

The rules provided in this notice apply to deferrals and distributions from eligible § 457(b) plans made after December 31, 2001. This notice addresses only reporting and withholding rules that apply to § 457(b) plan participants who are or were employees of state and local governments or tax-exempt organizations and does not cover special reporting rules that may apply to § 457(b) plan participants who are or were independent contractors. Notice 2000–38, 2000–2 C.B. 174, applies to § 457(b) plan distributions made before January 1, 2002, but see Section IX of this notice concerning its effective date provisions.

II. BACKGROUND

Section 457 provides rules for nonqualified deferred compensation plans established by eligible employers. State and local governments and tax-exempt organizations are eligible employers. They can establish either eligible plans that meet the requirements of § 457(b) or plans that do not meet the requirements of § 457(b) and that are therefore subject to § 457(f).

EGTRRA made numerous revisions to § 457, most of them effective after December 31, 2001. EGTRRA § 641(a)(1)(D)(i) added new § 3401(a)(12)(E) which provides that remuneration paid to an employee or beneficiary from a § 457(b) plan maintained by a state or local governmental employer (a governmental § 457(b) plan) is no longer treated as wages for purposes of income tax withholding under section 3402(a), but is now subject to income tax withholding under section 3405. This change is effective for distributions made after December 31, 2001. However, EGTRRA did not revise the provision of Chapter 21 of the Internal Revenue Code treating amounts deferred under a § 457(b) plan as subject to FICA taxes. See § 3121(v)(2) and (3). FICA taxes include both the Old Age, Survivors, and Disability Insurance (OASDI) tax and the Hospital Insurance (HI) tax, which are referred to in federal tax forms as social security and Medicare tax, respectively. This notice includes guidance under these new provisions regarding income tax withholding and reporting upon distributions from governmental § 457(b) plans.

Section 1448 of the Small Business Job Protection Act of 1996 ("SBJPA"), Pub. L. 104–188, 1996–3 C.B. 155, 212, amended § 457 by adding § 457(g), which requires that governmental § 457(b) plans hold all plan assets and income in trust, or in custodial accounts or annuity contracts described in § 401(f), for the exclusive benefit of participants and their beneficiaries. Section 457(g) does not apply to a § 457(b) plan established by a tax-exempt organization that is not a state or local governmental entity. Notice 2000–38 provided guidance in response to inquiries concerning withholding and reporting upon § 457(b) plan distributions in light of this SBJPA amendment and certain changes made by the Taxpayer Relief Act of 1997, Pub. L. No. 105–34.

This notice updates and supersedes Notice 2000–38 for contributions and distributions made after December 31, 2001.

III. INCOME TAX WITHHOLDING AND REPORTING ON ANNUAL DEFERRALS

As amended by EGTRRA, § 457(a)(1)(A) provides that annual deferrals under a governmental § 457(b) plan and any income attributable to the amounts so deferred are not includible in a participant's gross income until that amount is paid to the participant or beneficiary. Section 457(a)(1)(B) retains the pre-EGTRRA rule that annual deferrals under a § 457(b) plan of a tax-exempt entity and any income attributable to the amounts so deferred are not includible in a participant's gross income until that amount is paid or made available to the participant or beneficiary. Therefore, annual deferrals under a § 457(b) plan are not subject to income tax withholding at the time of the deferral. However, a participant's annual deferrals during the taxable year under a § 457(b) plan are reported on Form W–2, *Wage and Tax Statement*, in the manner described in the instructions to that form. "Annual deferrals," as used in this notice, means the amount of compensation deferred under the plan in accordance with § 457(b), and in compliance with the annual maximum deferral limitation under the plan, whether by elective deferral or nonelective employer contribution, during a taxable year. Deferrals in a single employer's eligible plan or plans in excess of the § 457(b) limitations are not annual deferrals and thus are subject to income tax withholding rules.

IV. INCOME TAX WITHHOLDING AND REPORTING ON GOVERNMENTAL § 457(b) PLAN DISTRIBUTIONS

A. Income Tax Withholding on Governmental § 457(b) Plan Distributions

"Distributions" from a governmental § 457(b) plan to a participant or beneficiary (including an alternate payee) include all amounts that are paid from the governmental § 457(b) plan. See Section V for provisions regarding income tax withholding on distributions from a § 457(b) plan of a non-governmental tax-exempt organization.

EGTRRA revises Chapter 24 of the Code, to provide that, effective after December 31, 2001, distributions to an individual from a governmental § 457(b) plan are subject to income tax withholding in accordance with the income tax withholding requirements of § 3405 applicable to distributions from qualified plans, annuities, and individual retirement arrangements (IRAs). Thus, EGTRRA extends the § 3405(c) direct rollover and mandatory 20 percent withholding rules to governmental § 457(b) plan distributions that qualify as eligible rollover distributions as defined under § 402(c)(4).

In addition, EGTRRA provides that the § 3405(a) and (b) elective withholding rules applicable to distributions from qualified plans, § 403(b) annuities, and IRAs that are not eligible rollover distributions are also extended to distributions from governmental § 457(b) plans. Thus, periodic distributions from governmental § 457(b) plans that are not eligible rollover distributions are subject to withholding under § 3405(a) as if the distribution were wages, and nonperiodic distributions from such plans that are not eligible rollover distributions are subject to withholding under § 3405(b) at a 10-percent rate. In either case (periodic or nonperiodic distributions), the recipient may elect not to have withholding apply under § 3405(a) or (b) to a distribution that is not an eligible rollover distribution from a governmental § 457(b) plan. For additional information regarding the provisions of § 3405 and related sections, see § 35.3405–1T of the Employment Taxes and Collection of Income Tax at Source Regulations under the Tax Equity and Fiscal Responsibility Act of 1982, § 31.3405(c)–1 of the Employment Taxes and Collection of Income Tax at Source Regulations, and §§ 1.401(a)(31)–1, 1.402(c)–2, and 1.402(f)–1 of the Income Tax Regulations.

B. Person Responsible for Income Tax Withholding on Distributions

EGTRRA amended § 3405(d) of the Code to make plan administrators of eligible governmental plans, rather than the payor of the designated distribution, generally liable for withholding under § 3405 upon distributions from such plans. However, under § 3405(d)(2)(A), a plan administrator is not liable for withholding if the administrator directs the payor to withhold income tax under § 3405 and provides the payor with the necessary information required by regulations at § 35.3405–1T, E 2–5. In that case, the payor is liable for withholding income tax. Subsections C, D, and E of this Section IV provide additional information on the withholding, deposit, and reporting obligations of the plan administrator or payor.

C. Reporting Governmental § 457(b) Plan Distributions on Form 1099–R

Distributions to an individual during a taxable year under a governmental § 457(b) plan are reported on Form 1099–R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, in the manner described in the instructions to that form. Income tax withheld from governmental § 457(b) plan distributions is reported annually on Form 945, *Annual Return of Withheld Federal Income Tax*.

D. EINs and Income Tax Deposits for Section 457(g) Trust Accounts

Generally, the income tax withheld on distributions should be reported on the Form 945 of the person responsible for withholding, usually the plan administrator, as described in section IV–B of this notice. The income tax withheld must be aggregated with other amounts reported by that person on Form 945 to determine the frequency of federal tax deposits under § 31.6302–4. This is the same as the first alternative described in Announcement 84–40, 1984–17 I.R.B. 31. Alternatively, the IRS will permit the plan administrator (or payor) of § 457(g) trusts, or custodial accounts or insurance contracts treated as trusts under § 457(g)(3) to use the other two alternatives contained in Announcement 84–40 for the tax administration of such withholdings:

1. The plan administrator or payor may request and use an EIN solely for the purpose of reporting the aggregated withholding from the distributions of every § 457(g) trust, custodial account, or annuity contract under its control, making deposits and filing Form 945 accordingly.
2. The plan administrator or payor may request and use a separate EIN for each § 457(g) trust (or custodial account or insurance contract), making deposits and filing Form 945 accordingly.

The plan administrator or payor exercising any of the above alternatives for depositing and reporting the tax withheld from § 457(g) trust distributions must also follow the same option in filing the related information returns, such as Forms 1099–R and Form 945. That is, the plan administrator or payor must use the same name and EIN on Forms 1099–R as that under which the tax was deposited and the annual Form 945 return filed. The plan administrator or payor must aggregate and deposit all taxes pursuant to § 31.6302–4 under the EIN chosen. The above-described options relate only to trusts, annuity contracts, or custodial accounts established pursuant to § 457(g) for amounts deferred under a governmental § 457(b) plan. For information on the remittance of social security, Medicare, and FUTA taxes by the employer, see section VI–D below.

V. INCOME TAX WITHHOLDING AND REPORTING ON TAX-EXEMPT EMPLOYERS' § 457(b) PLAN DISTRIBUTIONS

A. Income Tax Withholding on Tax-Exempt Employer's § 457(b) Plan Distributions

"Distributions" from a § 457(b) plan of a non-governmental tax-exempt entity to a participant include all amounts that are paid or made available under the § 457(b) plan. Distributions to a participant from a tax-exempt employer's § 457(b) plan are wages under § 3401(a) that are subject to income tax withholding in accordance with the income tax withholding requirements of § 3402(a). The pension withholding rules of § 3405 do not apply to distributions from a tax-exempt employer's § 457(b) plan. See § 35.3405–1T, Q&A–23. See Section IV of this notice for provisions regarding income tax withholding on distributions from a governmental § 457(b) plan.

Income tax withholding on distributions to a participant under a tax-exempt employer's § 457(b) plan is calculated in the same manner as withholding on other types of wage payments. For guidance on the use of the flat rate withholding method as a supplement to regular wage withholding in cases where the tax-exempt employer or its agent is paying wages to the participant in addition to the distribution from the § 457(b) plan, see § 31.3402(g)–1(a) and Rev. Rul. 82–46, 1982–1 C.B. 158. If an eligible payor uses the flat rate of withholding as an alternative to regular wage withholding on a lump sum payment, § 101(c)(11) of EGTRRA provides that this flat rate became 27 percent in 2002, then becomes 26 percent in 2004, and 25 percent in 2006 and thereafter.

B. Person Responsible for Income Tax Withholding on Distributions

When distributions are made under a tax-exempt employer's § 457(b) plan, the tax-exempt organization or other person having control of the payment of the distributions, as determined under § 3401(d)(1), is responsible for income tax withholding on the distributions.

C. Reporting Tax-Exempt Employer's § 457(b) Plan Distributions on Form W–2

Distributions to a participant during a taxable year under a tax-exempt employer's § 457(b) plan are wages and are reported on Form W–2, *Wage and Tax Statement*, in the manner described in the instructions to that form. See also Rev. Rul. 82–46, supra. Income tax withheld from a tax-exempt employer's § 457(b) plan distributions is deposited in accordance with § 31.6302–1 and reported quarterly on Form 941, *Employer's Quarterly Federal Tax Return*.

D. Reporting Death Benefit Payments

Distributions to a beneficiary of a deceased participant under a § 457(b) plan are reported on Form 1099–R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc*. See Rev. Rul. 86–109, 1986–2 C.B. 196. No income tax withholding is required for distributions from § 457(b) plans to beneficiaries. See Rev. Rul. 59–64, 1959–1 C.B. 31. The instructions for Form 1099–R describe how this form is completed for distributions made to a beneficiary from a nonqualified deferred compensation plan, such as a § 457(b) plan.

VI. FICA AND FUTA TAXES AND REPORTING

A. Scope

The rules described in this Section VI relating to FICA (social security and Medicare) tax apply to employees of state and local governments only if they are subject to social security or Medicare tax under § 3121(u) (relating to Medicare), § 3121(b)(7)(E) (relating to agreements entered into pursuant to section 218 of the Social Security Act), or other provisions of the Code, such as § 3121(b)(7)(F) (relating to state and local government employees who are not members of a state or local retirement system). As previously noted, EGTRRA did not revise the provision of Chapter 21 of the Internal Revenue Code treating § 457(b) plan distributions as "wages" for purposes of subjecting them to social security and Medicare taxes. The FICA rules discussed in this section generally apply to employees of tax-exempt organizations, unless a specific exclusion is applicable. The FICA tax discussed in this section includes the employer's share of the FICA tax imposed under § 3111 as well as the employee's share imposed under § 3101. Any FICA tax imposed on an employee's § 457(b) plan deferrals or distributions must be reported on a Form W–2 for that employee.

The rules described in this Section VI relating to the Federal Unemployment Tax Act (FUTA) do not apply to service for a state or local governmental entity because § 3306(c)(7) provides a FUTA exemption for service performed in the employ of a state or any political subdivision thereof or any instrumentality of any one or more of the foregoing. The rules described in this section relating to FUTA apply to service for a tax-exempt organization other than a tax-exempt organization described in § 501(c)(3). See § 3306(c)(8).

B. Timing of Social Security, Medicare, and FUTA Taxes

Sections 3121(a) (relating to social security and Medicare) and 3306(b) (relating to FUTA) define "wages" as all remuneration for employment, unless specifically excluded (see section VI–A, above). If social security, Medicare, or FUTA taxes apply, §§ 3121(v)(2) and 3306(r)(2) contain special timing rules that apply in determining when amounts deferred under a nonqualified deferred compensation plan (including employers' contributions) are required to be taken into account. Under these sections, an amount deferred under a nonqualified deferred compensation plan, including a § 457(b) plan, is required to be taken into account for purposes of social security, Medicare, and FUTA taxes as of the later of when the services are performed or when there is no substantial risk of forfeiture of the rights to such amount.

Thus, to the extent a § 457(b) plan provides that annual deferrals are immediately vested, the annual deferrals are subject to social security, Medicare, and FUTA taxes at the time of deferral. However, to the extent the annual deferrals are subject to a substantial risk of forfeiture, the annual deferrals (plus earnings thereon) are generally taken into account for purposes of social security, Medicare, and FUTA at the time such amounts are no longer subject to a substantial risk of forfeiture. For purposes of social security, Medicare, and FUTA taxes, the determination of whether a substantial risk of forfeiture exists is made in accordance with the principles of § 83 and the regulations thereunder. See §§ 31.3121(v)(2)–1(e)(3) and 31.3306(r)(2)–1.

If amounts deferred under a § 457(b) plan are properly taken into account as social security, Medicare, and FUTA wages when deferred (or, if later, when they cease to be subject to a substantial risk of forfeiture), the amounts subsequently paid or made available to a participant or beneficiary under the § 457(b) plan that are attributable to those deferrals generally are not subject to social security, Medicare, or FUTA taxes. See §§ 3121(v)(2)(B) and 3306(r)(2)(B) and §§ 31.3121(v)(2)–1(a)(2)(iii) and 31.3121(v)(2)–1(d)(2). If an amount deferred for a period is not properly taken into account, distributions attributable to that amount, including income on the amounts deferred, may be wages for FICA purposes when paid or made available. See § 31.3121(v)(2)–1(d)(1)(ii). Additional special rules apply to § 457(b) plans in which benefits are not based solely on a participant's account balance. See § 31.3121(v)(2)–1(e)(4).

C. Examples

The application of social security and Medicare tax is illustrated by the following examples:

Example 1. (i) State R's § 457(b) plan provides for elective deferrals from current salary, as well as a one percent of salary nonelective contribution for each employee who participates in the plan and who is employed with State R during the plan year. All employees who participate in the plan are covered by an agreement under section 218 of the Social Security Act. All deferrals and contributions, including the state's contribution, are fully and immediately vested.

(ii) Because these contributions are not subject to a substantial risk of forfeiture (and the services to which they relate have already been performed), the elective deferrals are required to be taken into account as wages at the time of the deferral and State R's nonelective contribution is required to be taken into account as wages at the time of the contribution for purposes of the social security and Medicare tax.

Example 2—(i) Assume the same facts as in *Example 1*, except that the plan has three-year vesting for State R's nonelective contribution. Therefore, an employee's rights to the nonelective contributions (and the associated earnings) are subject to a substantial risk of forfeiture until the employee has been employed by State R for three years.

(ii) State R's nonelective contributions (and earnings thereon) are not wages for purposes of the social security and Medicare tax until the employee has completed three years of service. At that time, the aggregate amount of State R's nonelective contributions, plus earnings thereon, is required to be taken into account as wages for purposes of the social security and Medicare tax. Once an individual has met the vesting requirements, future nonelective contributions by State R are required to be taken into account as wages for purposes of the social security and Medicare tax at the time of the contribution. Because the elective deferrals are not subject to a substantial risk of forfeiture (and the services to which they relate have already been performed), the elective deferrals are required to be taken into account as wages at the time of deferral.

D. Deposit and Reporting of Social Security, Medicare and FUTA Taxes

The employer must aggregate and deposit social security and Medicare taxes associated with a § 457(b) plan (including the employer's share of social security and Medicare taxes under § 3111) with all other social security and Medicare taxes and withheld income taxes paid on behalf of its employees in accordance with § 31.6302–1 and must report these taxes on Form 941. Employers subject to FUTA must aggregate and deposit FUTA amounts associated with a § 457(b) plan with all other FUTA amounts paid on behalf of its employees in accordance with § 31.6302(c)–3 and must report these payments on Form 940.

VII. ANNUAL REPORTING FOR § 457 PLANS

A. § 457(g) Trusts

A trust described in § 457(g) is not required to file Form 990, *Return of Organization Exempt From Income Tax*, Form 1041, *U.S. Income Tax Return for Estates and Trusts*, Form 1120, *U.S. Corporation Income Tax Return*, or Form 5500, *Annual Return/Report of Employee Benefit Plans*. See, for example, Rev. Proc. 95–48, 1995–2 C.B. 418, which provides that governmental units and affiliates of governmental units that are exempt from federal income tax under § 501(a) are not required to file annual information returns on Form 990, *Return of Organization Exempt From Income Tax*. A trust described in § 457(g) may be required to file Form 990–T, *Exempt Organization Business Income Tax Return*. See §§ 1.6012–2(e) and 1.6012–3(a)(5) for the requirements for filing Form 990–T.

B. Section 457(b) Plans of Tax-Exempt Organizations

Annual deferrals and payments to certain participants in a § 457(b) plan of a tax-exempt organization are reported on the organization's Form 990 in the manner described in the instructions to that form.

VIII. OTHER INFORMATION AVAILABLE

Further information regarding the reporting, payment and deposit of employment taxes such as social security, Medicare, FUTA, and withheld income tax can be found in Publication 15, *Circular E, Employer's Tax Guide*; Publication 15–A, *Employer's Supplemental Tax Guide*; and Publication 963, *Federal-State Reference Guide*: Social Security Coverage and FICA Reporting by State and Local Government Employers. These publications will be revised, as appropriate, to reflect the revisions enacted in EGTRRA.

IX. EFFECTIVE DATE

This notice is applicable with respect to deferrals and distributions made after December 31, 2001. However, for deferrals or distributions made after December 31, 2001, and before January 1, 2004, the Internal Revenue Service (IRS) will not assert that there has been a failure to comply with applicable reporting and withholding requirements if the applicable reporting and withholding requirements set forth in Notice 2000–38 have been satisfied. Thus, for example, in any case in which a series of distributions commenced before January 1, 2002, and the distributions are eligible rollover distributions (as defined in § 402(f)(2)(A)) that are payable over a specified period of less than 10 years, the IRS will not assert that there has been a failure to comply with applicable withholding requirements through December 31, 2003, if the applicable withholding requirements set forth in Notice 2000–38 have been satisfied.

X. REQUEST FOR COMMENTS

The IRS requests comments concerning this notice, and welcomes comments on any other useful approaches the Service might consider regarding the administration of § 457(b) plans. Comments can be addressed to the Internal Revenue Service, Office of Division Counsel/Associate Chief Counsel (TEGE), CC:TEGE:EB:QP2, Room 5201, 1111 Constitution Avenue, Washington, D.C. 20224. In addition, comments may be submitted electronically via the Internet by sending them in an e-mail to: *notice.comments@irscounsel.treas.gov* and specifying that the comments concern Notice 2003–20.

DRAFTING INFORMATION

The principal author of this notice is John Tolleris of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury participated in its development. For further information regarding this notice, contact John Tolleris at (202) 622–6060 (not a toll-free number).

Nonconventional Source Fuel Credit, Section 29 Inflation Adjustment Factor, and Section 29 Reference Price

Notice 2003–27

This notice publishes the nonconventional source fuel credit, inflation adjustment factor, and reference price under § 29 of the Internal Revenue Code for calendar year 2002. These are used to determine the credit allowable on fuel produced from a nonconventional source under § 29. The calendar year 2002 inflation-adjusted credit applies to the sales of barrel-of-oil equivalent of qualified fuels sold by a taxpayer to an unrelated person during the 2002 calendar year, the domestic production of which is attributable to the taxpayer.

BACKGROUND

Section 29(a) provides for a credit for producing fuel from a nonconventional source, measured in barrel-of-oil equivalent of qualified fuels, the production of which is attributable to the taxpayer and sold by the taxpayer to an unrelated person during the tax year. The credit is equal to the product of $3.00 and the appropriate inflation adjustment factor.

Section 29(b)(1) and (2) provides for a phaseout of the credit. The credit allowable under § 29(a) must be reduced by an amount which bears the same ratio to the amount of the credit (determined without regard to § 29(b)(1)) as the amount by which the reference price for the calendar year in which the sale occurs exceeds $23.50 bears to $6.00. The $3.00 in § 29(a) and the $23.50 and $6.00 must each be adjusted by multiplying these amounts by the 2002 inflation adjustment factor. In the case of gas from a tight formation, the $3.00 amount in § 29(a) must not be adjusted.

Section 29(c)(1) defines the term "qualified fuels" to include oil produced from shale and tar sands; gas produced from geopressurized brine, Devonian shale, coal seams, or a tight formation, or biomass; and liquid, gaseous, or solid synthetic fuels produced from coal (including lignite), including such fuels when used as feedstocks.

Section 29(d)(1) provides that the credit is to be applied only for sale of qualified fuels the production of which is within the United States (within the meaning of § 638(1)) or a possession of the United States (within the meaning of § 638(2)).

Section 29(d)(2)(A) requires that the Secretary, not later than April 1 of each calendar year, determine and publish in the Federal Register the inflation adjustment factor and the reference price for the preceding calendar year.

Section 29(d)(2)(B) defines "inflation adjustment factor" for a calendar year as the fraction the numerator of which is the GNP implicit price deflator for the calendar year and the denominator of which is the GNP implicit price deflator for calendar year 1979. The term "GNP implicit price deflator" means the first revision of the implicit price deflator for the gross national product as computed and published by the Department of Commerce.

Section 29(d)(2)(C) defines "reference price" to mean with respect to a calendar year the Secretary's estimate of the annual average wellhead price per barrel for all domestic crude oil the price of which is not subject to regulation by the United States.

Section 29(d)(3) provides that in the case of a property or facility in which more than one person has an interest, except to the extent provided in regulations prescribed by the Secretary, production from the property or facility (as the case may be) must be allocated among the persons in proportion to their respective interests in the gross sales from the property or facility.

Section 29(d)(5) provides that the term "barrel-of-oil equivalent" with respect to any fuel generally means that amount of the fuel which has a Btu content of 5.8 million.

INFLATION ADJUSTMENT FACTOR AND REFERENCE PRICE

The inflation adjustment factor for calendar year 2002 is 2.1169. The reference price for calendar year 2002 is $22.51. These amounts will be published in the Federal Register on April 9, 2003.

PHASEOUT CALCULATION

Because the calendar year 2002 reference price does not exceed $23.50 multiplied by the inflation adjustment factor, the phaseout of the credit provided for in § 29(b)(1) does not occur for any qualified fuel sold in calendar year 2002.

CREDIT AMOUNT

The nonconventional source fuel credit under § 29(a) is $6.35 per barrel-of-oil equivalent of qualified fuels ($3.00 x 2.1169). This amount will be published in the Federal Register on April 9, 2003.

DRAFTING INFORMATION

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

Part IV. Items of General Interest

Foundations Status of Certain Organizations

Announcement 2003–28

The following organizations have failed to establish or have been unable to maintain their status as public charities or as operating foundations. Accordingly, grantors and contributors may not, after this date, rely on previous rulings or designations in the Cumulative List of Organizations (Publication 78), or on the presumption arising from the filing of notices under section 508(b) of the Code. This listing does *not* indicate that the organizations have lost their status as organizations described in section 501(c)(3), eligible to receive deductible contributions.

Former Public Charities. The following organizations (which have been treated as organizations that are not private foundations described in section 509(a) of the Code) are now classified as private foundations:

21st Century Life Skills, Inc., Palm City, FL
79th Street Business Association, Chicago, IL
90 Ways, Inc., Omaha, NE
About Face, West Columbia, SC
Academic Excellence FDN Serving Esparto Madison & Capay Valley, Esparto, CA
Advocates for Enhanced Long Term Care, Rockville, MD
Advocates in Action, Alpena, MI
African Heritage Institute, Inc., Worcester, MA
Agency for Sustainable Systems in Science & Technology, Inc., Arcata, CA
Ahlul Bayt Assembly of America, Inc., Potomac, MD
AIDS Service Society of Arkansas, North Little Rock, AR
Al Baqir the Knowledge Expounder, Long Beach, CA
Al Maun Community Development Corporation, Atlanta, GA
Alaska Volleyball Association, Chugiak, AK
Alpha Foundation, Inc., Mobile, AL
Alzheimer Alliance of America, Bellingham, WA
American Animal Protection Charities, Inc., Boca Raton, FL
American Center for Law and Justice of Texas, Inc., Irving, TX
American Friends of Pamela, South Euclid, OH
American Institute of Natural Education, Inc., Holliswood, NY
American Library in Ukraine Charitable Trust, Tulsa, OK
American Medical Society Foundation, La Jolla, CA
American School for International Tour Directing, Inc., Scottsdale, AZ
Anash, Inc., Los Angeles, CA
Angels Tough Foundation, Clovis, CA
Arizona Science Teachers Association, Inc., Tempe, AZ
Attention Deficit Disorder A.D.D. Crusade, Portland, ME
August Ensemble Corporation, Carmichael, CA
Band-Aid Foundation, Inc., Littleton, CO
Barrio Crisis Center, Dallas, TX
Bay Area Symphonic Band Society, Webster, TX
Bean Equine Educational Foundation, El Cajon, CA
Beaverdam Youth League, Inc., Beaverdam, VA
Benei Avrohom, Inc., Brooklyn, NY
Black Sisters Sharing, Inglewood, CA
Booth Manor of St. Louis, Inc., St. Louis, MO
Boston Dnepropetrovsk Health Care Foundation, Inc., Boston, MA
Boys and Girls Clubs of the Columbia Area, Columbia, MO
Buffalo Soldier Memorial Association, Fort Bliss, TX
Caledonia Animal Rescue, Inc., St. Johnsbury, VT
Caliban Foundation, Tacoma, WA
Camden Clinic, San Antonia, TX
Camp Moraine, Inc., Lake Bluff, IL
Career Development & Training Rehab. & Ind. Living Skills, Inc., Mt. Clemens, MI
Caucus of South African Psychiatrists, Inc., Providence, RI
Celtic Regional Arts Institute of California, Rolling Hills, CA
Chapel of Hope-Gatesville Area, Dallas, TX
Cheverly Young Actors Guild, Cheverly, MD
Chinese American Cancer Foundation, San Gabriel, CA
Chippewa Falls Committee for the Twenty-First Century, Inc., Chippewa Falls, WI
Choralfest, Inc., Pittsburgh, PA
Christmas in April Broom Country, Inc., Binghamton, NY
Citizens for Community Action, Inc., Chicago, IL
Clinton House Non-Profit Corporation, Detroit, MI
Commonwealth Education Organization Pittsburgh, PA
Community Business Institute Inc., of Trumbull, Trumbull, CT
Community Counciling Center Development, Inc., Lakeland, FL
Community Social Services, Inc., Darby, PA
Corporation for Clean Air, Tiburon, CA
Coventry Village Main Street Partnership, Coventry, CT
CRCR Helps Foundation, Washington, DC
Cued Speech and Language Association of Utah, Park City, UT
Culmore Community Action Committee, Inc., Falls Church, VA
Culturelink Fieldwork Project, Clearlake, CA
Daake Halani Development, Inc., Many Farms, AZ
Dade Hialeah Community Development Corp., Hialeah, FL
Dance Empowerment, Fresno, CA
Darlene Brickey Foundation, Bakersfield, CA
Daughters of Zion, Inc., Yeadon, PA
David Scruggs Foundation, Dallas, TX
Dayton Youth Baseball League, Inc., Dayton, KY
Deep East Texas Council of Governments Regional 100 Club, Inc., Jasper, TX
Delusions of Magic, Tempe, AZ
Denison Kiwanis Club Charity, Inc., Denison, TX
Dick Sewell Memorial Golf Tournament, Washington, DC
Disabled Peoples International, Inc., W. Hempstead, NY
Donald Ross Society Foundation, Inc., W. Hartford, CT

Douglas County Fair Association, Inc., Ava, MO
E & R Youth Association, Dearborn, MI
Early Festival Association, Early, TX
East Central Community Development Center, Meridian, MS
East-West Shrine Football Classic and Pageant, San Mateo, CA
Eclectic Chorale, Highland, CA
Edgecliff Fire Department EMS AUX., Ft. Worth, TX
Employment & Housing Ombuds Service, Minneapolis, MN
Fairfield Hills of South Highlands Neighborhood Association, Shreveport, LA
Family Life Awareness Council, Inc., Sibley, IA
Family Life Learning Center, West Dundee, IL
Family Support & Life Management Services, Inc., Ft. Lauderdale, FL
Far West Texas & Southern NM Trauma Regional Advisory Council, El Paso, TX
Federal Bar Association FDN of Cincinnati, Inc., Cincinnati, OH
Fernald Community Reuse Organization, Inc., Ross, OH
Filarmonica Protuguesa De Tulare, Tulare, CA
Filipino-American Heritage Appreciation Project, San Jose, CA
Folk Traditions Conservancy, Santa Barbara, CA
Fort Wayne Christian Womens Retreat, Inc., Fort Wayne, IN
Fred D. Middleton Scholarship Foundation, Wichita, KS
Freds House, Inc., Chicago, IL
Fretz Park Library Friends, Dallas, TX
Friends and Family Alternative to Alcohol & Drug Dependency, Hanford, CA
Friends of Erna Nixon Park, Inc., Melbourne, FL
Friends of Utah Golf, Inc., Salt Lake City, UT
Friends of Yeshivah Mikdash Shelomo, Inc., Brooklyn, NY
Garden Grove Police Activities League, Garden Grove, CA
Garden Variety Shakespeare, Birmingham, AL
Gatekeepers, Richmond, VA
Genealogy Friends of Gladys Harrington Library, Inc., Plano, TX
George Washington Carver Scholarship Fund, Inc., Louisville, KY
Girls Softball Association, Inc., Spring Hill, FL
Godchaux-Reserve House Historical Society, Reserve, LA
Gold Beach Booster Club, Inc., Gold Beach, OR
Golden Heart, Dallas, TX
Golden West Aviation, Inc., Marysville, CA
Good Days Living, Signal Hill, CA
Good Samaritan Community Development, Inc., Washington, DC
Grace Foundation, Royal, AR
Greater Ohio Valley Fine Arts & Cultural Awareness Council, Woodsfiled, OH
Harriet Tubman Project, Inc., Dallas, TX
H. E. A. D. D. U. P., Royal Oak, MI
Hearts and Hands of Jefferson, Inc., Lake Hopatcong, NJ
Hinson Road Office Addition Owners Association, Inc., Little Rock, AR
Hispanic Health Program, Little Rock, AR
HIV-AIDS Human Rights Project, Inc., Red Hook, NY
Hollins Meaux Education & Recreation Center, Kaplan, LA
Home, Los Angeles, CA
Hope & Health Foundation Corp., Sarasota, FL
Hope Foundation for Education Denver Parents Assoc., Denver, CO
Hospice of Lincoln County, Inc., Ruidoso, NM
Hub of Belknap, Grand Rapids, MI
Hutson Weekend Ministries, Inc., Lakeview, MI
Immaculate Community Center, Inc., Hamtramck, MI
Independent Lifestyles, Inc., Asheville, NC
Indiana Friends of Animals, Inc., North Vernon, IN
Integrated Business Management Development Corporation, Dallas, TX
Intensive Learning Center, New York, NY
International Dental Technology Foundation, Los Angeles, CA
International Womens Athletic Foundation, Inc., Jupiter, FL
Jesus Cares Ministries, Inc., Spring Valley, IL
Joliet Cyclones Baseball, Joliet, IL
Kansas Minority Business Development Council, Inc., Wichita, KS
Kav Lachayim-Line to Life, Inc., Brooklyn, NY
Keep Opelika Beautiful, Inc., Opelika, AL
Keep Tallahassee Leon County Beautiful, Inc., Tallahassee, FL
Keren Yecheskial Duvid, Inc., Brooklyn, NY
Keystone Team Gymnastics, Inc., Dunmore, PA
Kids for Kids, Marks, MS
Kids Money Club, Inc., Newport Beach, CA
KWJ Community Outreach, Pleasantville, NJ
Land of Milk & Honey Foundation for Horses, Calabasas, CA
Latino Educational and Recreational Network, Woodburn, OR
Leetonia Little Bears Organization, Leetonia, OH
Legal Aid Rwanda Ltd., New York, NY
Light is Coming, Inc., Mercer, PA
Louisiana Institute for Education in the Arts, New Orleans, LA
Love for Life Animal Haven, Inc., Brooksville, FL
Lutheran Counseling Services, Inc., Dallas, TX
Macon County Commission, Tuskegee, AL
Management Opportunity of Neighborhood Service, Inc., Purvis, MS
Marine Animal Rescue Society, Inc., North Miami, FL
Marine Sanctuaries and Estuarine Reserves Foundation, Carmichael, CA
Marjan Foundation, South Gate, CA
Massachusetts Special Technology Access Center, Inc., Bedford, MA
Masters Services Empowerment Ministries, Milwaukee, WI
Maxus Community Developers, Inc., Phoenix, AZ
Mbegu Community Development Corporation, Milpitas, CA
Memphis Shelby Crime Commission, Memphis, TN
Menominee Indian Missionary, Inc., Suring, WI
Mercury Foundation, Incorporated, Washington, DC

Michigan Greenscapes, Inc.,
Dearborn, MI
Michigan Tradeswomen Association,
Detroit, MI
Might Have Been Known Theatre
Company, St. Paul, MN
Mike Dubose Charities, Bessemer, AL
Millennial Foundation, Inc.,
New York, NY
Mind & Body Foundation, Inc.,
Columbia, MD
Minnesota Metro Alpha Phi Omega
Alumni Association, Eagan, MN
Mississippi Rural Development
Partnership, Inc., Jackson, MS
Missouri Valley Health Span,
Warrensburg, MO
Mitakolapi, Inc., Silver Spring, MD
Mo Valley Magic, Inc., Springfield, MO
Mohona Cultural Group,
Lawrenceville, GA
Monett Downtown Betterment Group,
Inc., Monett, MO
Montbello-Green Valley Ranch-Gateway
Family Presrvtn Family Support,
Denver, CO
Montgomery Area Crime Stopper, Inc.,
Prattville, AL
Moore Fast Pitch Association,
Moore, OK
Moore for a Clean Environment, Inc.,
Southern Pines, NC
Mothers Voices Houston Gulf Coast,
Houston, TX
Mothers Voices Illinois, Chicago, IL
Muldoon Community Development
Corporation, Anchorage, AK
Murrieta Soccer Club Hawks,
Murrieta, CA
National Association of 10 Black
Women South Bay Chapter,
San Jose, CA
National Association of Aides Education
and Training Centers, Detroit, MI
National Right to Compete Legal
Defense Foundation, Inc.,
Albany, NY
National Student Achievement Awards,
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National Suffolk Foundation,
Columbia, MO
Native American Association of
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New Beginning Child Nutrition Center,
Inc., East Orange, NJ
New England Therapeutic Recreation
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New Hanover County Parks Foundation,
Wilmington, NC
New Serenity House, Austin, TX
Newcomers Association,
San Francisco, CA
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Miami, FL
North East Texas Intertribal Alliance,
Daingerfield, TX
Northside Senior Citizens Center,
Unadilla, GA
Now More Than Ever, Inc.,
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NW Alabama Services & Development,
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Oak Grove Optimist Baseball
Association, Inc., Hattieburg, MS
Oddlife Theater Company, Chicago, IL
Ohio Heart & Vascular Research
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Omadi Foundation, So. Souix City, NE
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Omaha, NE
One Per Cent Connecting the
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Open Arms Housing, Inc.,
Washington, DC
Optimist Penny Reapers of Southern
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Orchid Mania South Florida, Inc.,
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Paint it Yellow Productions, Inc.,
Stafford, TX
Peace Community Development
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Peacemakers Evangelistic Team, Inc.,
Dayton, OH
Pearland Enrichment Foundation,
Pearland, TX
Pecan Acres Resident Management
Corp., Petersburg, VA
Peoples Health Care Corporation,
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Platinum Foundation, Carbondale, IL
Plymouth South High School Panther
Volleyball Booster Club, Inc.,
Manomet, MA
Power Twistars Parents Association,
Frederick, OK
Powhatan Youth Athletic Association,
Inc., Powhatan, VA
Praise & Resurrection Ministries of
Jesus Christ, Oxon Hill, MD
Prevent Child Abuse, Chicago, IL
Project Partnership, Incorporated,
Pawcatuck, CT
Prufrock Childrens Basic Needs Fund,
Los Angeles, CA
Raw, Inc., Hampton, VA
Reagan All Sports Booster Club, Inc.,
Austin, TX
Recovery in Motion, Inc., Vista, CA
Recovery Lifestyles, Inc., Adrian, MI
Red Rose Rising Foundation, Inc.,
New York, NY
Refreshing Spring Alliance, Inc.,
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Reserve Forces Educational Assistance
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Richardson Weekend Ministries, Inc.,
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Saintes Assisted Independent Living at
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St. Marys Villa, Inc., Knoxville, TN
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Starlight Friends, Inc., Euless, TX
T.L. Kirkland 17th District Mission Co.,
Los Angeles, CA
Textilemuseum Associates of Southern
Cal, Inc., Glendale, CA
Theatre Atlantis, Inc., Eugene, OR
Thimble Islands Historical Society, Inc.,
Branford, CT

Three Sisters Animal Foundation, Denver, CO
Thumb Outreach Minority Services, Sandusky, MI
Tikvatam, Inc., Brooklyn, NY
Tomorrow, Inc., Lathrup Village, MI
Torrey Pines Pond Foundation, Del Mar, CA
Tribal Angels, Inc., New York, NY
Triple Play Ballpark, Inc., Newalla, OK
Triton Rainbow Foundation, Dodge Center, MN
Umoja Literary Group, Vista, CA
United Child Guidance Council, Inc., Dallas, TX
United Residents of Taylor Center, Inc., Las Cruces, NM
United Resources Management, Inc., Beverly Hills, CA
Urban Grasshopper, Inc., Brooklyn, NY
Utah Grizzlies Youth Foundation, W. Valley City, UT
Values First, Washington, DC
Victory Fellowship, Chicago, IL
Voting Integrity Project, Inc., Arlington, VA
Welcome Place, Salt Lake City, UT
West Virginia K-Family Childrens Festival Foundation, Inc., Morgantown, WV
Western Colorado Camp Courage, Inc., Eckert, CO
Williamsburg Housing Resident Council, Williamsburg, KY
Women After Gods Own Heart Ministry, Fayetteville, GA
Womens Wasatch Lacrosse, Salt Lake City, UT
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Woodbridge Garden Apartments Resident Council, Woodbridge, NJ
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Yaldei Russia, Inc., Brooklyn, NY
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Zichron Yakov Menachem, Inc., Brooklyn, NY

If an organization listed above submits information that warrants the renewal of its classification as a public charity or as a private operating foundation, the Internal Revenue Service will issue a ruling or determination letter with the revised classification as to foundation status. Grantors and contributors may thereafter rely upon such ruling or determination letter as provided in section 1.509(a)–7 of the Income Tax Regulations. It is not the practice of the Service to announce such revised classification of foundation status in the Internal Revenue Bulletin.

Definition of Terms

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

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

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

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

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

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

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

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

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

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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[2] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2002–26 through 2002–52 is in Internal Revenue Bulletin 2003–1, dated January 6, 2003.

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