

HIGHLIGHTS OF THIS ISSUE

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

INCOME TAX

Rev. Rul. 2008-14, page 578.

Fringe benefits aircraft valuation formula. The Standard Industry Fare Level (SIFL) cents-per-mile rates and terminal charge in effect for the first half of 2008 are set forth for purposes of determining the value of noncommercial flights on employer-provided aircraft under section 1.61-21(g) of the regulations.

Rev. Rul. 2008-16, page 585.

S corporations; charitable contributions. This ruling provides guidance for S corporations that made charitable contributions of appreciated property during a taxable year beginning after December 31, 2005 and before January 1, 2008. The ruling provides that the amount of the charitable deduction the shareholder may claim may not exceed the sum of (i) the shareholder's *pro rata* share of the fair market value of the contributed property over the shareholder's *pro rata* share of the contributed property's adjusted tax basis, and (ii) the amount of the Code section 1366(d) loss limitation amount that is allocable to the contributed property's basis under regulations section 1.1366-2(a)(4).

T.D. 9376, page 587.

Final regulations under section 1502 of the Code provide guidance regarding the manner in which the items (including items described in section 381(c) but excluding intercompany items under regulations section 1.1502-13) of a liquidating corporation are succeeded to and taken into account in cases in which multiple members acquire the assets of the liquidating corporation in a complete liquidation to which section 332 applies. The regulations affect corporations filing consolidated returns.

T.D. 9377, page 578.

Final regulations under section 338 of the Code relate to the determination of the adjusted basis of amortizable section 197 intangible assets in the hands of an insurance company resulting from certain reinsurance transactions, increases in an insurance company's reserves after a deemed sale, and a carryover to the new (target) insurance company of an election to use the old (target) insurance company's historical payment pattern to discount unpaid losses. The final regulations apply to insurance companies.

Notice 2008-31, page 592.

This notice updates procedures for issuers of tax-exempt bonds and tax credit bonds to submit requests for voluntary closing agreements to resolve violations of the Code. Notice 2001-60 modified and superseded.

Notice 2008-32, page 593.

This notice provides interim guidance on the treatment under section 67 of the Code of investment advisory costs and other costs subject to the 2-percent floor under section 67(a) that are bundled as part of one commission or fee paid to the trustee or executor and are incurred by a trust other than a grantor trust or an estate.

(Continued on the next page)

Finding Lists begin on page ii.



EMPLOYEE PLANS

REG-104946-07, page 596.

Proposed regulations provide guidance under sections 411(a)(13) and 411(b)(5) of the Code, which were added by the Pension Protection Act of 2006. Section 411(a)(13) provides rules relating to vesting and payment of benefits that must be satisfied in order for hybrid defined benefit plans to be tax-qualified. Section 411(b)(5) provides age discrimination rules for tax-qualified defined benefit plans, including hybrid defined benefit plans.

REG-136701-07, page 616.

Proposed regulations under section 401 of the Code provide guidance relating to diversification requirements for certain defined contribution plans and to publicly traded employer securities.

EXEMPT ORGANIZATIONS

Announcement 2008-20, page 625.

The IRS has revoked its determination that Drive for Youth 2020 of Missouri City, TX; Rise and Shine, Inc., of Medical Lake, WA; Bluegrass Gymnastic Boosters, Inc., of Lexington, KY; Debt-Tech of Columbia, MD; Nexum Credit Counseling, Inc., of Vero Beach, FL; New Home Gallery, Inc., of Louisville, KY; Alban Community Services Foundation of Lititz, PA; Union Oaks, Inc., of Omaha, NE; Shiloh Ministries of Hagerstown, Inc., of Hagerstown, MD; Credicure, Inc., of Martinsburg, WV; Newton Family Foundation of West Jordan, UT; Alliance to Rebuild LA of Santa Monica, CA; The Down Payment Assistance Group of San Diego, CA; Phillip J. Kronzer Foundation for Religious Research of Los Gatos, CA; Credit Success Company of Jacksonville, FL; Mario C. and Elva G. Rapanotti Charitable Supporting Organization of San Antonio, TX; and Anthony & Megan Wolfenden Charitable Supporting Organization of Santa Clara, CA, qualify as organizations described in sections 501(c)(3) and 170(c)(2) of the Code.

ADMINISTRATIVE

Rev. Proc. 2008-19, page 594.

Qualified mortgage bonds; mortgage credit certificates; national median gross income. Guidance is provided concerning the use of the national and area median gross income figures by issuers of qualified mortgage bonds and mortgage credit certificates in determining the housing cost/income ratio described in section 143(f) of the Code. Rev. Proc. 2007-31 obsoleted in part.

Announcement 2008-19, page 624.

This announcement contains changes to Publication 1187 for filing procedures for Form 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*, filed electronically or magnetically. These changes are effective immediately. Announcement 2008-6 superseded.

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying

the tax law with integrity and fairness to all.

Introduction

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

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

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

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations,

court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.

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

Part II.—Treaties and Tax Legislation.

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

Part III.—Administrative, Procedural, and Miscellaneous.

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

Part IV.—Items of General Interest.

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

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

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

Section 25.—Interest on Certain Home Mortgages

A revenue procedure provides guidance with respect to the United States and area median gross income figures that are to be used by issuers of qualified mortgage bonds, as defined in § 143(a) of the Internal Revenue Code, and issuers of mortgage credit certificates, as defined in § 25(c), in computing the housing cost/income ratio described in § 143(f)(5). See Rev. Proc. 2008-19, page 594.

Section 61.—Gross Income Defined

26 CFR 1.61-21: Taxation of fringe benefits.

Fringe benefits aircraft valuation formula. The Standard Industry Fare Level

(SIFL) cents-per-mile rates and terminal charge in effect for the first half of 2008 are set forth for purposes of determining the value of noncommercial flights on employer-provided aircraft under section 1.61-21(g) of the regulations.

Rev. Rul. 2008-14

For purposes of the taxation of fringe benefits under section 61 of the Internal Revenue Code, section 1.61-21(g) of the Income Tax Regulations provides a rule for valuing noncommercial flights on employer-provided aircraft. Section 1.61-21(g)(5) provides an aircraft valuation formula to determine the value of such flights. The value of a flight is determined

under the base aircraft valuation formula (also known as the Standard Industry Fare Level formula or SIFL) by multiplying the SIFL cents-per-mile rates applicable for the period during which the flight was taken by the appropriate aircraft multiple provided in section 1.61-21(g)(7) and then adding the applicable terminal charge. The SIFL cents-per-mile rates in the formula and the terminal charge are calculated by the Department of Transportation and are reviewed semi-annually.

The following chart sets forth the terminal charge and SIFL mileage rates:

<i>Period During Which the Flight Is Taken</i>	<i>Terminal Charge</i>	<i>SIFL Mileage Rates</i>
1/1/08 - 6/30/08	\$39.86	Up to 500 miles = \$.2180 per mile 501-1500 miles = \$.1662 per mile Over 1500 miles = \$.1598 per mile

DRAFTING INFORMATION

The principal author of this revenue ruling is Kathleen Edmondson of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt/Government Entities). For further information regarding this revenue ruling, contact Ms. Edmondson at (202) 622-0047 (not a toll-free call).

Section 103.—Interest on State and Local Bonds

A revenue procedure provides guidance with respect to the United States and area median gross income figures that are to be used by issuers of qualified mortgage bonds, as defined in § 143(a) of the Internal Revenue Code, and issuers of mortgage credit certificates, as defined in § 25(c), in computing the housing cost/income ratio described in § 143(f)(5). See Rev. Proc. 2008-19, page 594.

Section 143.—Mortgage Revenue Bonds: Qualified Mortgage Bond and Qualified Veterans' Mortgage Bond

A revenue procedure provides guidance with respect to the United States and area median gross income figures that are to be used by issuers of qualified mortgage bonds, as defined in § 143(a) of the Internal Revenue Code, and issuers of mortgage credit certificates, as defined in § 25(c), in computing the housing cost/income ratio described in § 143(f)(5). See Rev. Proc. 2008-19, page 594.

Section 338.—Certain Stock Purchases Treated as Asset Acquisitions

26 CFR 1.338-11: Effect on section 338 election on insurance company targets.

T.D. 9377

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 1 and 602

Application of Section 338 to Insurance Companies

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations under section 197 of the

Internal Revenue Code (Code) that apply to a section 197 intangible resulting from an assumption reinsurance transaction, and under section 338 that apply to reserve increases after a deemed asset sale. The final regulations also provide guidance with respect to existing section 846(e) elections to use historical loss payment patterns. The final regulations apply to insurance companies.

DATES: *Effective Date:* These regulations are effective on January 23, 2008.

Applicability Date: For date of applicability of these regulations, see §1.197-2(g)(5)(ii)(E), §1.338-11(d)(7) and §1.846-4(b).

FOR FURTHER INFORMATION CONTACT: William T. Sullivan (202) 622-7052 or Donald J. Drees, Jr. (202) 622-3970 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-1990.

The collection of information in these final regulations is in §1.338-11(e)(2). This information is required by the IRS to allow an insurance company to choose to cease using its historical loss payment pattern, and instead use industry-wide factors, to discount unpaid losses.

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

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

Background and Explanation of Provisions:

On March 8, 2002, the IRS and the Treasury Department published a notice

of proposed rulemaking REG-118861-00, 2002-1 C.B. 651, in the **Federal Register** (67 FR 10640) (2002-1 Cumulative Bulletin (C.B.) 651) (the 2002 proposed regulations) that set forth rules applying to taxable acquisitions and dispositions of insurance businesses, including those that are deemed to occur when an election under section 338 of the Code is made. (See §601.601(d)(2)(ii)(b)). The C.B. is made available by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402. Written comments were received in response to the 2002 proposed regulations, and a public hearing was held. After consideration of all the comments, the IRS and the Treasury Department published final regulations in the **Federal Register** on April 10, 2006, (T.D. 9257, 2006-1 C.B. 821) (71 FR 17990), as corrected in the **Federal Register** (T.D. 9257) (71 FR 26826) to remove an error that might have proven to be misleading.

T.D. 9257 also contains temporary regulations under sections 197, 338, and 846, which serve as the basis for a cross-reference notice of proposed rulemaking published in the **Federal Register** (REG-146384-05, 2006-1 C.B. 843) (71 FR 18053) with respect to issues that were the subject of comments on the 2002 proposed regulations. Specifically, §1.197-2T(g)(5)(ii) provides guidance with regard to the interplay between section 197(f)(5) (concerning the treatment of certain reinsurance transactions) and section 848 (requiring the capitalization of certain policy acquisition expenses); §1.338-11T(d) addresses reserve increases after a deemed asset sale that results from a section 338 election; and §1.338-11T(e) provides guidance on the effect of a section 338 election on an insurance company's election under section 846(e) to use its historical loss payment pattern to discount certain unpaid losses.

Although the 2002 proposed regulations generated a number of comments which are discussed in detail in the preamble to T.D. 9257, no new comments were received with respect to the temporary regulations that served as a cross-reference notice of proposed rulemaking in 2006. Accordingly, this Treasury decision adopts the proposed regulations without substantive change and removes the corresponding temporary regulations. This

Treasury decision also revises cross-references where appropriate to reflect the removal of temporary regulations and their replacement with final regulations and corrects two obvious errors, one a mathematical error in the last sentence of §1.381(c)(22)-1(b)(7)(v), Example 3, the other an error in the captioning of §1.338(i)-1(c)(2)(ii)(B).

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 is hereby certified that the collection of information requirement in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations do not have a substantial economic impact because they merely provide guidance about the operation of the tax law in the context of acquisitions of insurance companies and businesses. Moreover, they are expected to apply predominantly to transactions involving larger businesses. In addition, the collection of information requirement merely requires a taxpayer to prepare a written representation that contains minimal information relating to the making of an election. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Under section 7805(f) of the Code, the notice of proposed rulemaking preceding this regulation 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 the final regulations is William T. Sullivan, Office of Chief Counsel (Financial Institutions and Products). However, other personnel from the IRS and the Treasury Department participated in the development of these regulations.

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Adoption of Amendments to the Regulations

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

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entries for §§1.197-2T, 1.338-1T, and 1.338-11T to read, in part, as follows:

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

Par. 2. Section 1.197-0 is amended by:

1. Revising the introductory text and the entries for §1.197-2(g)(5)(ii).

2. Removing the entries for §1.197-2T. The revisions read as follows:

§1.197-0 Table of contents.

This section lists the headings that appear in §1.197-2.

§1.197-2 Amortization of goodwill and certain other intangibles.

* * * * *

(g) * * *

(5) * * *

(ii) Determination of adjusted basis of amortizable section 197 intangible resulting from an assumption reinsurance transaction.

(A) In general.

(B) Amount paid or incurred by acquirer (reinsurer) under the assumption reinsurance transaction.

(C) Amount required to be capitalized under section 848 in connection with the transaction.

(1) In general.

(2) Required capitalization amount.

(3) General deductions allocable to the assumption reinsurance transaction.

(4) Treatment of a capitalization shortfall allocable to the reinsurance agreement.

(i) In general.

(ii) Treatment of additional capitalized amounts as the result of an election under §1.848-2(g)(8).

(5) Cross references and special rules.

(D) Examples.

(E) Effective/applicability date.

* * * * *

Par. 3. Section 1.197-2(g)(5)(ii) is revised to read as follows:

§1.197-2 Amortization of goodwill and certain other intangibles.

* * * * *

(g) * * *

(5) * * *

(ii) *Determination of adjusted basis of amortizable section 197 intangible resulting from an assumption reinsurance transaction—(A) In general.* Section 197(f)(5) determines the basis of an amortizable section 197 intangible for insurance or annuity contracts acquired in an assumption reinsurance transaction. The basis of such intangible is the excess, if any, of—

(1) The amount paid or incurred by the acquirer (reinsurer) under the assumption reinsurance transaction; over

(2) The amount, if any, required to be capitalized under section 848 in connection with such transaction.

(B) *Amount paid or incurred by acquirer (reinsurer) under the assumption reinsurance transaction.* The amount paid or incurred by the acquirer (reinsurer) under the assumption reinsurance transaction is—

(1) In a deemed asset sale resulting from an election under section 338, the amount of the adjusted grossed-up basis (AGUB) allocable thereto (see §§1.338-6 and 1.338-11(b)(2));

(2) In an applicable asset acquisition within the meaning of section 1060, the amount of the consideration allocable thereto (see §§1.338-6, 1.338-11(b)(2), and 1.1060-1(c)(5)); and

(3) In any other transaction, the excess of the increase in the reinsurer's tax reserves resulting from the transaction (computed in accordance with sections 807, 832(b)(4)(B), and 846) over the value of the net assets received from the ceding company in the transaction.

(C) *Amount required to be capitalized under section 848 in connection with the transaction—(1) In general.* The amount required to be capitalized under section 848 for specified insurance contracts (as defined in section 848(e)) acquired in an assumption reinsurance transaction is the lesser of—

(i) The reinsurer's required capitalization amount for the assumption reinsurance transaction; or

(ii) The reinsurer's general deductions (as defined in section 848(c)(2)) allocable to the transaction.

(2) *Required capitalization amount.* The reinsurer determines the required capitalization amount for an assumption reinsurance transaction by multiplying the net positive or net negative consideration for the transaction by the applicable

percentage set forth in section 848(c)(1) for the category of specified insurance contracts acquired in the transaction. See §1.848-2(g)(5). If more than one category of specified insurance contracts is acquired in an assumption reinsurance transaction, the required capitalization amount for each category is determined as if the transfer of the contracts in that category were made under a separate assumption reinsurance transaction. See §1.848-2(f)(7).

(3) *General deductions allocable to the assumption reinsurance transaction.* The reinsurer determines the general deductions allocable to the assumption reinsurance transaction in accordance with the procedure set forth in §1.848-2(g)(6). Accordingly, the reinsurer must allocate its general deductions to the amount required under section 848(c)(1) on specified insurance contracts that the reinsurer has issued directly before determining the general deductions allocable to the assumption reinsurance transaction. For purposes of allocating its general deductions under §1.848-2(g)(6), the reinsurer includes premiums received on the acquired specified insurance contracts after the assumption reinsurance transaction in determining the amount required under section 848(c)(1) on specified insurance contracts that the reinsurer has issued directly. If the reinsurer has entered into multiple reinsurance agreements during the taxable year, the reinsurer determines the general deductions allocable to each reinsurance agreement (including the assumption reinsurance transaction) by allocating the general deductions allocable to reinsurance agreements under §1.848-2(g)(6) to each reinsurance agreement with a positive required capitalization amount.

(4) *Treatment of a capitalization shortfall allocable to the reinsurance agreement—(i) In general.* The reinsurer determines any capitalization shortfall allocable to the assumption reinsurance transaction in the manner provided in §§1.848-2(g)(4) and 1.848-2(g)(7). If the reinsurer has a capitalization shortfall allocable to the assumption reinsurance transaction, the ceding company must reduce the net negative consideration (as determined under §1.848-2(f)(2)) for the transaction by the amount described in §1.848-2(g)(3) unless the parties make the election provided in §1.848-2(g)(8) to determine the amounts capitalized under section 848 in

connection with the transaction without regard to the general deductions limitation of section 848(c)(2).

(ii) *Treatment of additional capitalized amounts as the result of an election under §1.848-2(g)(8).* The additional amounts capitalized by the reinsurer as the result of the election under §1.848-2(g)(8) reduce the adjusted basis of any amortizable section 197 intangible with respect to specified insurance contracts acquired in the assumption reinsurance transaction. If the additional capitalized amounts exceed the adjusted basis of the amortizable section 197 intangible, the reinsurer must reduce its deductions under section 805 or section 832 by the amount of such excess. The additional capitalized amounts are treated as specified policy acquisition expenses attributable to the premiums and other consideration on the assumption reinsurance transaction and are deducted ratably over a 120-month period as provided under section 848(a)(2).

(5) *Cross references and special rules.* In general, for rules applicable to the determination of specified policy acquisition expenses, net premiums, and net consideration, see section 848(c) and (d), and §1.848-2(a) and (f). However, the following special rules apply for purposes of this paragraph (g)(5)(ii)(C)—

(i) The amount required to be capitalized under section 848 in connection with the assumption reinsurance transaction cannot be less than zero;

(ii) For purposes of determining the company's general deductions under section 848(c)(2) for the taxable year of the assumption reinsurance transaction, the reinsurer takes into account a tentative amortization deduction under section 197(a) as if the entire amount paid or incurred by the reinsurer for the specified insurance contracts were allocated to an amortizable section 197 intangible with respect to insurance contracts acquired in an assumption reinsurance transaction; and

(iii) Any reduction of specified policy acquisition expenses pursuant to an election under §1.848-2(i)(4) (relating to an assumption reinsurance transaction with an insolvent insurance company) is disregarded.

(D) *Examples.* The following examples illustrate the principles of this paragraph (g)(5)(ii):

Example 1. (i) *Facts.* On January 15, 2006, P acquires all of the stock of T, an insurance company, in a qualified stock purchase and makes a section 338 election for T. T issues individual life insurance contracts which are specified insurance contracts as defined in section 848(e)(1). P and new T are calendar year taxpayers. Under §§1.338-6 and 1.338-11(b)(2), the amount of AGUB allocated to old T's individual life insurance contracts is \$300,000. On the acquisition date, the tax reserves for old T's individual life insurance contracts are \$2,000,000. After the acquisition date, new T receives \$1,000,000 of net premiums with respect to new and renewal individual life insurance contracts and incurs \$100,000 of general deductions under section 848(c)(2) through December 31, 2006. New T engages in no other reinsurance transactions other than the assumption reinsurance transaction treated as occurring by reason of the section 338 election.

(ii) *Analysis.* The transfer of insurance contracts and the assumption of related liabilities deemed to occur by reason of the election under section 338 is treated as an assumption reinsurance transaction. New T determines the adjusted basis under section 197(f)(5) for the life insurance contracts acquired in the assumption reinsurance transaction as follows. The amount paid or incurred for the individual life insurance contracts is \$300,000. To determine the amount required to be capitalized under section 848 in connection with the assumption reinsurance transaction, new T compares the required capitalization amount for the assumption reinsurance transaction with the general deductions allocable to the transaction. The required capitalization amount for the assumption reinsurance transaction is \$130,900, which is determined by multiplying the \$1,700,000 net positive consideration for the transaction (\$2,000,000 reinsurance premium less \$300,000 ceding commission) by the applicable percentage under section 848(c)(1) for the acquired individual life insurance contracts (7.7 percent). To determine its general deductions, new T takes into account a tentative amortization deduction under section 197(a) as if the entire amount paid or incurred for old T's individual life insurance contracts (\$300,000) were allocable to an amortizable section 197 intangible with respect to insurance contracts acquired in the assumption reinsurance transaction. Accordingly, for the year of the assumption reinsurance transaction, new T is treated as having general deductions under section 848(c)(2) of \$120,000 (\$100,000 + \$300,000/15). Under §1.848-2(g)(6), these general deductions are first allocated to the \$77,000 capitalization requirement for new T's directly written business (\$1,000,000 x .077). Thus, \$43,000 (\$120,000 - \$77,000) of the general deductions are allocable to the assumption reinsurance transaction. Because the general deductions allocable to the assumption reinsurance transaction (\$43,000) are less than the required capitalization amount for the transaction (\$130,900), new T has a capitalization shortfall of \$87,900 (\$130,900 - \$43,000) with regard to the transaction. Under §1.848-2(g), this capitalization shortfall would cause old T to reduce the net negative consideration taken into account with respect to the assumption reinsurance transaction by \$1,141,558 (\$87,900 ÷ .077) unless the parties make the election under §1.848-2(g)(8) to capitalize specified policy acquisition expenses in connection with the

assumption reinsurance transaction without regard to the general deductions limitation. If the parties make the election, the amount capitalized by new T under section 848 in connection with the assumption reinsurance transaction would be \$130,900. The \$130,900 capitalized by new T under section 848 would reduce new T's adjusted basis of the amortizable section 197 intangible with respect to the specified insurance contracts acquired in the assumption reinsurance transaction. Accordingly, new T would have an adjusted basis under section 197(f)(5) with respect to the individual life insurance contracts acquired from old T of \$169,100 (\$300,000 - \$130,900). New T's actual amortization deduction under section 197(a) with respect to the amortizable section 197 intangible for insurance contracts acquired in the assumption reinsurance transaction would be \$11,273 (\$169,100 ÷ 15).

Example 2. (i) *Facts.* The facts are the same as *Example 1*, except that T only issues accident and health insurance contracts that are qualified long-term care contracts under section 7702B. Under section 7702B(a)(5), T's qualified long-term care insurance contracts are treated as guaranteed renewable accident and health insurance contracts, and, therefore, are considered specified insurance contracts under section 848(e)(1). Under §§1.338-6 and 1.338-11(b)(2), the amount of AGUB allocable to T's qualified long-term care insurance contracts is \$250,000. The amount of T's tax reserves for the qualified long-term care contracts on the acquisition date is \$7,750,000. Following the acquisition, new T receives net premiums of \$500,000 with respect to qualified long-term care contracts and incurs general deductions of \$75,000 through December 31, 2006.

(ii) *Analysis.* The transfer of insurance contracts and the assumption of related liabilities deemed to occur by reason of the election under section 338 is treated as an assumption reinsurance transaction. New T determines the adjusted basis under section 197(f)(5) for the insurance contracts acquired in the assumption reinsurance transaction as follows. The amount paid or incurred for the insurance contracts is \$250,000. To determine the amount required to be capitalized under section 848 in connection with the assumption reinsurance transaction, new T compares the required capitalization amount for the assumption reinsurance transaction with the general deductions allocable to the transaction. The required capitalization amount for the assumption reinsurance transaction is \$577,500, which is determined by multiplying the \$7,750,000 net positive consideration for the transaction (\$7,750,000 reinsurance premium less \$250,000 ceding commission) by the applicable percentage under section 848(c)(1) for the acquired insurance contracts (7.7 percent). To determine its general deductions, new T takes into account a tentative amortization deduction under section 197(a) as if the entire amount paid or incurred for old T's insurance contracts (\$250,000) were allocable to an amortizable section 197 intangible with respect to insurance contracts acquired in the assumption reinsurance transaction. Accordingly, for the year of the assumption reinsurance transaction, new T is treated as having general deductions under section 848(c)(2) of \$91,667 (\$75,000 + \$250,000/15). Under §1.848-2(g)(6), these general deductions are first allocated to the \$38,500 capitalization requirement for new T's directly written

business (\$500,000 x .077). Thus, \$53,167 (\$91,667 - \$38,500) of general deductions are allocable to the assumption reinsurance transaction. Because the general deductions allocable to the assumption reinsurance transaction (\$53,167) are less than the required capitalization amount for the transaction (\$577,500), new T has a capitalization shortfall of \$524,333 (\$577,500 - \$53,167) with regard to the transaction. Under §1.848-2(g), this capitalization shortfall would cause old T to reduce the net negative consideration taken into account with respect to the assumption reinsurance transaction by \$6,809,519 (\$524,333 ÷ .077) unless the parties make the election under §1.848-2(g)(8) to capitalize specified policy acquisition expenses in connection with the assumption reinsurance transaction without regard to the general deductions limitation. If the parties make the election, the amount capitalized by new T under section 848 in connection with the assumption reinsurance transaction would increase from \$53,167 to \$577,500. Pursuant to paragraph (g)(5)(ii)(C)(4) of this section, the additional \$524,333 (\$577,500 - \$53,167) capitalized by new T under section 848 would reduce new T's adjusted basis of the amortizable section 197 intangible with respect to the insurance contracts acquired in the assumption reinsurance transaction. Accordingly, new T's adjusted basis of the section 197 intangible with regard to the insurance contracts is reduced from \$196,833 (\$250,000 - \$53,167) to \$0. Because the additional \$524,333 capitalized pursuant to the §1.848-2(g)(8) election exceeds the \$196,833 adjusted basis of the section 197 intangible before the reduction, new T is required to reduce its deductions under section 805 by the \$327,500 (\$524,333 - \$196,833).

(E) *Effective/applicability date.* This section applies to acquisitions and dispositions of insurance contracts on or after April 10, 2006.

§1.197-2T [Removed]

Par. 4. Section 1.197-2T is removed.

Par. 5. Section 1.338-0 is amended by revising the entries for §1.338-11(d) and (e) to read as follows:

§1.338-0 Outline of topics.

§1.338-11 Effect of section 338 election on insurance company targets.

(d) Reserve increases by new target after the deemed asset sale.

- (1) In general.
- (2) Exceptions.
- (3) Amount of additional premium.
 - (i) In general.
 - (ii) Increases in unpaid loss reserves.
 - (iii) Increases in other reserves.
- (4) Limitation on additional premium.

(5) Treatment of additional premium under section 848.

(6) Examples.

(7) Effective/applicability date.

(i) In general.

(ii) Application to pre-effective date increases to reserves.

(e) Effect of section 338 election on section 846(e) election.

(1) In general.

(2) Revocation of existing section 846(e) election.

Par. 6. Section 1.338-1 is amended by adding paragraph (b)(2)(vii) to read as follows:

§1.338-1 General principles; status of old target and new target.

(b) *****

(2) *****

(vii) Section 846(e) (relating to an election to use an insurance company's historical loss payment pattern).

§1.338-1T [Removed]

Par. 7. Section 1.338-1T is removed.

Par. 8. Section 1.338-11 is amended by revising paragraphs (d) and (e) to read as follows:

§1.338-11 Effect of section 338 election on insurance company targets.

(d) *Reserve increases by new target after the deemed asset sale—(1) In general.* If in new target's first taxable year or any subsequent year, new target increases its reserves for any acquired contracts, new target is treated as receiving an additional premium, which is computed under paragraph (d)(3) of this section, in the assumption reinsurance transaction described in paragraph (c)(1) of this section. New target includes the additional premium in gross income for the taxable year in which new target increases its reserves for acquired contracts. New target's increase in reserves for the insurance contracts acquired in the deemed asset sale is a liability of new target not originally taken into account in determining

AGUB that is subsequently taken into account. Thus, AGUB is increased by the amount of the additional premium included in new target's gross income. See §§1.338-5(b)(2)(ii) and 1.338-7. Old target has no deduction under this paragraph (d) and makes no adjustments under §§1.338-4(b)(2)(ii) and 1.338-7.

(2) *Exceptions.* New target is not treated as receiving additional premium under paragraph (d)(1) of this section if—

(i) It is under state receivership as of the close of the taxable year for which the increase in reserves occurs; or

(ii) It is required by section 807(f) to spread the reserve increase over the 10 succeeding taxable years.

(3) *Amount of additional premium—(i) In general.* The additional premium taken into account under this paragraph (d) is an amount equal to the sum of the positive amounts described in paragraphs (d)(3)(ii) and (d)(3)(iii) of this section. However, the additional premium cannot exceed the limitation described in paragraph (d)(4) of this section.

(ii) *Increases in unpaid loss reserves.* The positive amount with respect to unpaid loss reserves is computed using the formula $A/B \times (C - [D + E])$ where—

(A) A equals old target's discounted unpaid losses (determined under section 846) included in AGUB under paragraph 11(b)(1) of this section;

(B) B equals old target's undiscounted unpaid losses (determined under section 846(b)(1)) as of the close of the acquisition date;

(C) C equals new target's undiscounted unpaid losses (determined under section 846(b)(1)) at the end of the taxable year that are attributable to losses incurred by old target on or before the acquisition date;

(D) D (which may be a negative number) equals old target's undiscounted unpaid losses as of the close of the acquisition date, reduced by the cumulative amount of losses, loss adjustment expenses, and reinsurance premiums paid by new target through the end of the taxable year for losses incurred by old target on or before the acquisition date; and

(E) E equals the amount obtained by dividing the cumulative amount of reserve increases taken into account under this paragraph (d) in prior taxable years by A/B.

(iii) *Increases in other reserves.* The positive amount with respect to reserves other than discounted unpaid loss reserves is the net increase of those reserves due to changes in estimate, methodology, or other assumptions used to compute the reserves (including the adoption by new target of a methodology or assumptions different from those used by old target).

(4) *Limitation on additional premium.* The additional premium taken into account by new target under paragraph (d)(1) of this section is limited to the excess, if any, of—

(i) The fair market value of old target's assets acquired by new target in the deemed asset sale (other than Class VI and Class VII assets); over

(ii) The AGUB allocated to those assets (including increases in AGUB allocated to those assets as the result of reserve increases by new target in prior taxable years).

(5) *Treatment of additional premium under section 848.* If a portion of the positive amounts described in paragraphs (d)(3)(ii) and (iii) of this section are attributable to an increase in reserves for specified insurance contracts (as defined in section 848(e)), new target takes an allocable portion of the additional premium in determining its specified policy acquisition expenses under section 848(c) for the taxable year of the reserve increase.

(6) *Examples.* The following examples illustrate this paragraph (d):

Example 1. (i) *Facts.* On January 1, 2006, P purchases all of the stock of T, a non-life insurance company, for \$120 and makes a section 338 election for T. On the acquisition date, old T has total reserve liabilities under state law of \$725, consisting of undiscounted unpaid losses of \$625 and unearned premiums of \$100. Old T's tax reserves on the acquisition date are \$580, which consist of discounted unpaid losses (as defined in section 846) of \$500 and unearned premiums (as computed under section 832(b)(4)(B)) of \$80. Old T has Class I through Class V assets with a fair market value of \$800. Old T also has a Class VI asset with a fair market value of \$75, consisting of the future profit stream of certain insurance contracts. During 2006, new T makes loss and loss adjustment expense payments of \$200 with respect to the unpaid losses incurred by old T before the acquisition date. As of December 31, 2006, new T reports undiscounted unpaid losses of \$475 attributable to losses incurred before the acquisition date. The related amount of discounted unpaid losses (as defined in section 846) for those losses is \$390.

(ii) *Computation and allocation of AGUB.* Under §1.338-5 and paragraph (b)(1) of this section, as of the acquisition date, AGUB is \$700, reflecting the sum of the amount paid for old T's stock (\$120) and

the tax reserves assumed by new T in the transaction (\$580). The fair market value of old T's Class I through V assets is \$800, whereas the AGUB available for such assets under §1.338-6 is \$700. There is no AGUB available for old T's Class VI assets, even though such assets have a fair market value of \$75 on the acquisition date.

(iii) *Adjustments for increases in reserves for unpaid losses.* Under paragraph (d) of this section, new T must determine whether there are any amounts by which it increased its unpaid loss reserves that will be treated as an additional premium and an increase in AGUB. New T applies the formula of paragraph (d)(3) of this section, where A equals \$500, B equals \$625, C equals \$475, D equals \$425 (\$625 - \$200), and E equals \$0. Under this formula, new T is treated as having increased its reserves for discounted unpaid losses attributable to losses incurred by old T by \$40 ($\$500/\$625 \times (\$475 - [\$425 + 0])$). The limitation under paragraph (d)(5) of this section based on the difference between the fair market value of old T's Class I through Class V assets and the AGUB allocated to such assets is \$100. Accordingly, new T includes an additional premium of \$40 in gross income for 2006, and increases the AGUB allocated to old T's Class I through Class V assets to reflect this additional premium.

Example 2. (i) *Facts.* Assume the same facts as in *Example 1*. Further assume that during 2007 new T deducts total loss and loss expense payments of \$375 with respect to losses incurred by old T before the acquisition date. On December 31, 2007, new T reports undiscounted unpaid losses of \$150 with respect to losses incurred before the acquisition date. The related amount of discounted unpaid losses (as defined in section 846) for those unpaid losses is \$125.

(ii) *Analysis.* New T must determine whether any amounts by which it increased its unpaid losses during 2007 will be treated as an additional premium in paragraph (d)(3) of this section. New T applies the formula under paragraph (d)(3) of this section, where A equals \$500, B equals \$625, C equals \$150, D equals \$50 ($\$625 - \575), and E equals \$50 ($\40 divided by .8). In paragraph (d)(3) of this section, new T is treated as increasing its reserves for discounted unpaid losses by \$40 during 2007 with respect to losses incurred by old T ($\$500/\$625 \times (\$150 - [\$50 + \$50])$). New T determines the limitation of paragraph (d)(5) of this section by comparing the \$800 fair market value of the Class I through V assets on the acquisition date to the \$740 AGUB allocated to such assets (which includes the \$40 addition to AGUB included during 2006). Thus, new T recognizes \$40 of additional premium as a result of the increase in reserves during 2007, and adjusts the AGUB allocable to the Class I through V assets acquired from old T to reflect such additional premium.

Example 3. (i) *Facts.* The facts are the same as *Example 2*, except that on January 1, 2008, new T reinsures the outstanding liability with respect to losses incurred by old T before the acquisition date through a portfolio reinsurance transaction with R, another non-life insurance company. R agrees to assume any remaining liability relating to losses incurred by old T before the acquisition date in exchange for a reinsurance premium of \$200. Accordingly, as of December 31, 2008, new T reports no undiscounted unpaid losses with respect to losses incurred by old T before the acquisition date.

(ii) *Analysis.* New T must determine whether any amount by which it increased its unpaid loss reserves will be treated as an additional premium under paragraph (d) of this section. New T applies the formula of paragraph (d)(3) of this section, where A equals \$500, B equals \$625, C equals \$0, and D equals -\$150 ($\$625 - (\$575 + \$200)$), and E equals \$100 ($\$80$ divided by .8). Thus, new T is treated as having increased its discounted unpaid losses by \$40 in 2008 with respect to losses incurred by old T before the acquisition date ($\$500/\$625 \times (0 - [-\$150 + \$100])$). New T includes this positive amount in gross income, subject to the limitation of paragraph (d)(4) of this section. The limitation of paragraph (d)(4) of this section equals \$20, which is computed by comparing the \$800 fair market value of the Class I through V assets acquired from old T with the \$780 AGUB allocated to such assets (which includes the \$40 addition to AGUB in 2006 and the \$40 addition to AGUB in 2007). Thus, New T includes \$20 in additional premium, and increases the AGUB allocated to the Class I through V assets acquired from old T by \$20. As a result of these adjustments, the limitation under paragraph (d)(4) of this section is reduced to zero.

(7) *Effective/applicability date—(i) In general.* This section applies to increases to reserves made by new target after a deemed asset sale occurring on or after April 10, 2006.

(ii) *Application to pre-effective date increases to reserves.* If either new target makes an election under §1.338(i)-1(c)(2) or old target makes an election under §1.338(i)-1(c)(3) to apply the rules of this section, in whole, to a qualified stock purchase occurring before April 10, 2006, then the rules contained in this section shall apply in whole to the qualified stock purchase.

(e) *Effect of section 338 election on section 846(e) election—(1) In general.* New target and old target are treated as the same corporation for purposes of an election by old target to use its historical loss payment pattern under section 846(e). See §1.338-1(b)(2)(vii). Therefore, if old target has a section 846(e) election in effect on the acquisition date, new target will continue to use the historical loss payment pattern of old target to discount unpaid losses incurred in accident years covered by the election, unless new target elects to revoke the section 846(e) election. In addition, new target may consider old target's historical loss payment pattern when determining whether to make the section 846(e) election for a determination year that includes or is subsequent to the acquisition date.

(2) *Revocation of existing section 846(e) election.* New target may revoke

old target's section 846(e) election to use its historical loss payment pattern to discount unpaid losses. If new target elects to revoke old target's section 846(e) election, new target will use the industry-wide patterns determined by the Secretary to discount unpaid losses incurred in accident years beginning on or after the acquisition date through the subsequent determination year. New target may revoke old target's section 846(e) election by attaching a statement to new target's original tax return for its first taxable year.

§1.338-11T [Removed]

Par. 9. Section 1.338-11T is removed.

Par. 10. Section 1.338(i)-1 is amended by:

1. Revising the section heading to read as set forth below.

2. Redesignating paragraph (c)(2)(ii)(b) as paragraph (c)(2)(ii)(B).

The revisions read as follows:

§1.381(i)-1 Effective/applicability date.

Par. 11. Section 1.381(c)(22)-1(b)(7)(v) is amended by revising the last sentence of *Example 3* to read as follows:

§1.381(c)(22)-1 Successor life insurance company.

- (b) ***
- (7) ***
- (v) ***

Example 3. *** In that case, in the taxable year of the indemnity reinsurance transaction, S takes into account as ordinary income the portion of the old T's accounts (\$1) that old T or S has not previously taken into account as income.

§1.846-0 [Amended]

Par. 12. Section 1.846-0 is amended by removing the entries for §§1.846-2T and 1.846-4T.

Par. 13. Section 1.846-2(d) is revised to read as follows:

§1.846-2 Election by taxpayer to use its own historical loss payment pattern.

(d) *Effect of section 338 election on section 846(e) election.* For rules regarding qualified stock purchase occurring on or after April 10, 2006, see §§1.338-1(b)(2)(vii) and 1.338-11(e).

Par. 14. Section 1.846-4 is amended by revising the section heading and paragraph (b) to read as follows:

§1.846-4 Effective/applicability date.

(b) *Section 338 election.* Section 1.846-2(d) applies to section 846(e) elections made with regard to a qualified stock purchase made on or after April 10, 2006.

Par. 15. For each entry in the "Section" column remove the phrase in the "Remove" column and add the phrase in the "Add" column in its place.

Section	Remove	Add
§1.338(i)-1(c)(2)(i)	§§1.338-11 and 1.338-11T(d)	§1.338-11
§1.338(i)-1(c)(2)(i)	1.197-2T(g)(5)(ii),	
§1.338(i)-1(c)(2)(ii)	§§1.338-11 and 1.338-11T(d)	§1.338-11
§1.338(i)-1(c)(2)(ii)	1.197-2T(g)(5)(ii),	
§1.338(i)-1(c)(2)(ii)(B) (First sentence)	§§1.338-11 and 1.338-11T(d)	§1.338-11
§1.338(i)-1(c)(2)(ii)(B) (First sentence)	1.197-2T(g)(5)(ii),	
§1.338(i)-1(c)(2)(ii)(B) (Second sentence)	§§1.338-11 and 1.338-11T(d)	§1.338-11
§1.338(i)-1(c)(2)(ii)(B) (Second sentence)	1.197-2T(g)(5)(ii),	
§1.338(i)-1(c)(3)(i)	§§1.338-11 and 1.338-11T(d)	§1.338-11
§1.338(i)-1(c)(3)(i)	1.197-2T(g)(5)(ii),	
§1.338(i)-1(c)(3)(ii)	§§1.338-11 and 1.338-11T(d)	§1.338-11
§1.338(i)-1(c)(3)(ii)	1.197-2T(g)(5)(ii),	
§1.338(i)-1(c)(3)(ii)(B) (First sentence)	§§1.338-11 and 1.338-11T(d)	§1.338-11
§1.338(i)-1(c)(3)(ii)(B) (First sentence)	1.197-2T(g)(5)(ii),	
§1.338(i)-1(c)(3)(ii)(B) (Second sentence)	§§1.338-11 and 1.338-11T(d)	§1.338-11

Section	Remove	Add
§1.338(i)-1(c)(3)(ii)(B) (Second sentence)	1.197-2T(g)(5)(ii),	
§1.1060-1(a)(2)(i)	§§1.338-11 and 1.338-11T(d)	§1.338-11
§1.1060-1(a)(2)(i)	1.197-2T(g)(5)(ii),	
§1.1060-1(a)(2)(ii)	§§1.338-11 and 1.338-11T(d)	§1.338-11
§1.1060-1(a)(2)(ii)	1.197-2T(g)(5)(ii),	
§1.1060-1(a)(2)(ii)(B)	§§1.338-11 and 1.338-11T(d)	§1.338-11
§1.1060-1(a)(2)(ii)(B)	1.197-2T(g)(5)(ii),	
§1.1060-1(a)(2)(iii)	§§1.338-11T(d) and 1.338-11T(d)	§1.338-11(d)
§1.1060-1(a)(2)(iii)	1.197-2T(g)(5)(ii),	
§1.1060-1(a)(2)(iii)(B)	§§1.338-11 and 1.338-11T(d)	§1.338-11
§1.1060-1(a)(2)(iii)(B)	1.197-2T(g)(5)(ii),	

PART 602 — OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 16. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.
 Par. 17. In §602.101, paragraph (b) is amended by removing the entry for §1.338-11T from the table and adding an entry to the table in numerical order to read as follows:

§602.101 OMB Control numbers.

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

CFR part or section where Identified and described	Current OMB control No.
* * * * * 1.338-11 * * * * *	1545-1990

Linda Stiff,
Deputy Commissioner for Services and Enforcement.

Approved January 9, 2008.

Eric Solomon,
Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on January 22, 2008, 8:45 a.m., and published in the issue of the Federal Register for January 23, 2008, 73 F.R. 3868)

Section 1366.—Pass-Thru of Items to Shareholders

26 CFR 1.1366-2: Limitations on deduction of pass-through items of an S corporation to its shareholders. (Also § 1367; 1.1367-1.)

S corporations; charitable contributions. This ruling provides guidance for S corporations that made charitable contributions of appreciated property during a taxable year beginning after December 31,

2005 and before January 1, 2008. The ruling provides that the amount of the charitable deduction the shareholder may claim may not exceed the sum of (i) the shareholder's *pro rata* share of the fair market value of the contributed property over the shareholder's *pro rata* share of the contributed property's adjusted tax basis, and (ii) the amount of the Code section 1366(d) loss limitation amount that is allocable to the contributed property's basis under regulations section 1.1366-2(a)(4).

Rev. Rul. 2008-16

ISSUE

If an S corporation makes a charitable contribution of appreciated property in a taxable year beginning after December 31, 2005, and before January 1, 2008, what is the amount of the charitable contribution deduction that a shareholder may claim in circumstances where § 1366(d) of the Internal Revenue Code (Code) limits the

shareholder's *pro rata* share of the S corporation's losses and deductions for the taxable year in which the property is contributed?

FACTS

Individual A is the sole shareholder of S Corporation X. At the beginning of X's 2007 taxable year, A has a basis of \$50x in the X stock. During 2007, X makes a charitable contribution of unencumbered real property, with an adjusted basis of \$100x and a fair market value of \$190x, in a transaction that qualifies under § 170(c). The charitable contribution is not subject to the limitations of § 170(e)(1). In 2007, X has \$1363 taxable income of \$30x and a long-term capital loss of \$25x.

LAW

Section 170(a) allows as a deduction any charitable contribution (as defined in § 170(c)) the payment of which is made

during the taxable year. The deduction allowable by § 170(a) is subject to the limitations of § 170(b).

Section 1.170A-1(c)(1) of the Income Tax Regulations provides that if a charitable contribution is made in property other than money, the amount of the contribution is the fair market value of the property at the time of the contribution reduced as provided in § 170(e)(1) and § 1.170A-4(a), or § 170(e)(3) and § 1.170A-4A(c).

Section 1363(b)(2) provides that the taxable income of an S corporation shall be computed in the same manner as in the case of an individual, except that the deductions referred to in § 703(a)(2), including the deduction for charitable contributions provided in § 170, shall not be allowed to the corporation.

Section 1366(a)(1)(A) provides that, in determining the tax of a shareholder, there shall be taken into account the shareholder's *pro rata* share of the corporation's items of income, loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder. Section 1366(a)(1) provides further that the items referred to in § 1366(a)(1)(A) include amounts described in § 702(a)(4). Section 702(a)(4) refers to charitable contributions (as defined in § 170(c)).

Section 1366(a)(1)(B) provides that, in determining the tax of a shareholder, there shall be taken into account the shareholder's *pro rata* share of any nonseparately computed income or loss.

Section 1366(d)(1) provides that the aggregate amount of losses and deductions taken into account by a shareholder under § 1366(a) for any taxable year shall not exceed the sum of (A) the adjusted basis of the shareholder's stock in the S corporation, and (B) the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder.

Section 1366(d)(2)(A) generally provides that any loss or deduction which is disallowed for any taxable year by reason of § 1366(d)(1) shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder.

Section 1.1366-1(a)(2)(i) and (iii) provides that each S corporation shareholder must take into account separately the shareholder's *pro rata* share of the S corporation's gains and losses from sales or exchanges of capital assets and the corporation's charitable contributions.

Section 1.1366-1(a)(3) provides that each shareholder must take into account separately the shareholder's *pro rata* share of the nonseparately computed income or loss of the S corporation.

Section 1.1366-1(b)(1) provides, in part, that the character of any item of income, loss, deduction, or credit described in § 1366(a)(1)(A) or (B) is determined for the S corporation and retains that character in the hands of the shareholder.

Section 1.1366-2(a)(4) generally provides that if a shareholder's *pro rata* share of the aggregate amount of losses and deductions exceeds the sum of the adjusted basis of the shareholder's stock in the corporation and the adjusted basis of any indebtedness of the corporation to the shareholder, then the limitation on losses and deductions under § 1366(d)(1) must be allocated among the shareholder's *pro rata* share of each loss or deduction. The amount of the limitation allocated to any loss or deduction is an amount that bears the same ratio to the amount of the limitation as the loss or deduction bears to the total of the losses and deductions.

Section 1367(a)(1)(B) provides that the basis of each shareholder's stock in an S corporation is increased for any period by any nonseparately computed income determined under § 1366(a)(1)(B).

Section 1367(a)(2)(B) provides that the basis of each shareholder's stock in an S corporation is decreased for any period (but not below zero) by the items of loss and deduction described in § 1366(a)(1)(A).

Section 1.1367-1(f) provides that increases in an S corporation shareholder's stock basis that are attributable to income items described in § 1367(a)(1)(B) are made before decreases in such basis that are attributable to items of loss or deduction described in § 1367(a)(2)(B).

Section 1203(a) of the Pension Protection Act of 2006 (Pension Act), P.L. 109-280, 120 Stat. 780 (2006), amended Code § 1367(a)(2) to provide that the decrease in shareholder basis under § 1367(a)(2)(B) by reason of a charitable contribution (as defined in § 170(c)) of property shall be the amount equal to the shareholder's *pro rata* share of the adjusted basis of such property. The Technical Explanation of the Pension Act, Technical Explanation of H.R. 4, "The Pension Protection Act of 2006," JCX-38-06 page

271, provides the following illustration of § 1203:

Thus, for example, assume an S corporation with one individual shareholder makes a charitable contribution of stock with a basis of \$200 and a fair market value of \$500. The shareholder will be treated as having made a \$500 charitable contribution (or a lesser amount if the special rules of section 170(e) apply), and will reduce the basis of the S corporation stock by \$200. (*Footnote 306*: This example assumes that basis of the S corporation stock (before reduction) is at least \$200.)

Section 3(b) of the Tax Technical Corrections Act of 2007 (Technical Corrections Act), P.L. 172, 121 Stat. 2473 (2007), added § 1366(d)(4), which concerns the application of the basis limitation rule of § 1366(d)(1) to charitable contributions of appreciated property by S corporations. Generally, under § 1366(d)(1), the amount of losses and deductions which a shareholder of an S corporation may take into account in any taxable year is limited to the shareholder's adjusted basis in his stock and indebtedness of the corporation. Section 1366(d)(4) provides that, in the case of a charitable contribution of property, § 1366(d)(1) shall not apply to the extent of the excess (if any) of (A) the shareholder's *pro rata* share of such contribution, over (B) the shareholder's *pro rata* share of the adjusted basis of such property. Thus, the basis limitation rule of § 1366(d)(1) does not apply to the amount of deductible appreciation in the contributed property. *See* Description of the Tax Technical Corrections Act of 2007, JCX-119-07, pages 2-3.

The Pension Act amendment to § 1367(a)(2) and the Technical Corrections Act amendment to § 1366(d) apply to charitable contributions made by S corporations in taxable years beginning after December 31, 2005, and before January 1, 2008. Charitable contributions made by S corporations in taxable years beginning after December 31, 2007, barring any statutory change, are subject to the law in existence prior to these amendments. The IRS and Treasury Department are considering issuing guidance on the treatment of charitable contributions made by S corporations in taxable years beginning after December 31, 2007.

ANALYSIS

Under the facts of this revenue ruling, X makes a charitable contribution of unencumbered real property with an adjusted basis of \$100x and a fair market value of \$190x in a transaction that qualifies under § 170(c). The charitable contribution is treated as a separately stated item of deduction that passes through to A and is deductible in computing A's individual tax liability. Section 1.1366-1(a)(2)(iii).

Pursuant to § 1.1367-1(f), A's \$50x basis in the X stock is first increased by \$30x under § 1367(a)(1)(B) to reflect A's share of X's taxable income. A's basis in the X stock is then decreased (but not below zero) by A's *pro rata* share of the sum of the adjusted basis of the contributed property (\$100x) pursuant to the flush language of § 1367(a)(2) and by A's *pro rata* share of X's long-term capital loss (\$25x) pursuant to § 1367(a)(2)(B). However, A's *pro rata* share of the aggregate amount of losses and deductions (\$125x) exceeds A's basis in the X stock of \$80x. Section 1366(d)(1), accordingly, will limit the allowable losses and deductions to A for X's 2007 tax year.

Pursuant to § 1366(d)(4), the basis limitation rule in § 1366(d)(1) does not apply to a contribution of appreciated property to the extent the shareholder's *pro rata* share of the contribution exceeds the shareholder's *pro rata* share of the adjusted basis of the contributed property. Accordingly, the basis limitation rule of § 1366(d)(1) does not apply to A's *pro rata* share of the amount of deductible appreciation in the contributed property (\$90x).

Under § 1.1366-2(a)(4), when a shareholder has losses or deductions in excess of the sum of the shareholder's basis in the stock plus indebtedness of the S corporation to the shareholder, the limitation on losses must be allocated *pro rata* to each item of loss or deduction. In the case of a charitable contribution deduction, the limitation amount allocable to such deduction is determined by reference to the shareholder's *pro rata* share of the contributed property's adjusted basis pursuant to § 1366(d)(4).

In applying § 1.1366-2(a)(4), the amount of the limitation allocable to a charitable contribution deduction is an amount that bears the same ratio to the § 1366(d) limitation as the shareholder's

pro rata share of the contributed property's adjusted basis bears to the total of the shareholder's *pro rata* share of the corporation's losses and deductions (excluding the charitable contribution deduction attributable to the shareholder's *pro rata* share of the fair market value of the contributed property over the contributed property's tax basis). Accordingly, the amount of the limitation allocable to A's share of X's charitable contribution deduction is determined by multiplying A's basis in the X stock (\$80x) by a fraction, the numerator of which is \$100x (the contributed property's adjusted basis) and the denominator of which is \$125x (the total of the capital loss and the contributed property's adjusted basis). Thus, \$64x is allocated to the charitable contribution deduction. The remaining \$16x is allocated to the capital loss.

Accordingly, in 2007, the amount of the charitable contribution deduction that A may claim is \$154x. This amount is comprised of A's *pro rata* share of the property's appreciation (\$90x) plus the amount of the loss limitation allocated to A's *pro rata* share of the contributed property's adjusted basis (\$64x). Under § 1367(a)(2)(B), A's basis in the X stock is reduced to 0 to reflect the \$16x reduction in basis attributable to the capital loss and the \$64x reduction in basis attributable to the charitable contribution deduction. Pursuant to § 1366(d)(2), the disallowed portion of the charitable contribution deduction (\$36x) and the capital loss (\$9x) shall be treated as incurred by X in the succeeding taxable year with respect to A.

HOLDING

If an S corporation makes a charitable contribution of appreciated property during a taxable year beginning after December 31, 2005, and before January 1, 2008, the amount of the charitable contribution deduction the shareholder may claim may not exceed the sum of (i) the shareholder's *pro rata* share of the fair market value of the contributed property over the contributed property's adjusted tax basis, and (ii) the amount of the § 1366(d) loss limitation amount that is allocable to the contributed property's adjusted basis under § 1.1366-2(a)(4). Any disallowed portion of the charitable contribution retains its character and is

treated as incurred by the corporation in the corporation's first succeeding taxable year, and subsequent taxable years, with respect to the shareholder.

DRAFTING INFORMATION

The principal author of this revenue ruling is Cynthia D. Morton of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this revenue ruling, contact Cynthia D. Morton at (202) 622-3060 (not a toll-free call).

Section 1502.—Regulations

26 CFR 1.1502-80: *Applicability of other provisions of law.*

T.D. 9376

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Guidance Under Section 1502; Miscellaneous Operating Rules for Successor Persons; Succession to Items of the Liquidating Corporation

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations under section 1502 of the Internal Revenue Code that provide guidance regarding the manner in which the items (including items described in section 381(c) but excluding intercompany items under § 1.1502-13) of a liquidating corporation are succeeded to and taken into account in cases in which multiple members acquire the assets of the liquidating corporation in a complete liquidation to which section 332 applies. These final regulations affect corporations filing consolidated returns.

DATES: *Effective Date:* These regulations are effective January 15, 2008.

Applicability Date: For the date of applicability, see § 1.1502-80(g)(7).

FOR FURTHER INFORMATION CONTACT: Amber C. Vogel or Marie C. Milnes-Vasquez, (202) 622-7530 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On February 22, 2005, the IRS and Treasury Department published in the **Federal Register** (70 FR 8552) a notice of proposed rulemaking (REG-131128-04, 2005-1 C.B. 733) under section 1502 proposing guidance as to how multiple consolidated group members (distributee members) that acquire assets in a liquidation to which section 332 applies succeed to and take into account the items of the liquidating corporation. The proposed regulations apply single-entity principles and allocate the items of the liquidating corporation that could be used to offset the income or tax liability of the group or any member to each distributee member to the extent that such items would have been reflected in investment adjustments to the stock of the liquidating corporation owned by such distributee member under the principles of §1.1502-32(c) if, immediately before the liquidation, any stock of the liquidating corporation owned by nonmembers had been redeemed, and then such items had been taken into account.

The proposed regulations also provide allocation rules for the credits and earnings and profits of the liquidating corporation. Under the proposed regulations, each distributee member succeeds to the credits of the liquidating corporation to the extent that the items of income, gain, loss, or deduction attributable to the activities that gave rise to the credit would have been reflected in investment adjustments to the stock of the liquidating corporation owned by such distributee member under the principles of §1.1502-32(c) if, immediately before the liquidation, any stock of the liquidating corporation owned by nonmembers had been redeemed, and then such items had been taken into account. The proposed regulations provide similar rules for allocating the liquidating corporation's earnings and profits to the distributee members.

Under the proposed regulations, a distributee member generally succeeds to any other items of the liquidating corporation

if, immediately before the liquidation, such distributee owns stock in the liquidating corporation meeting the requirements of section 1504(a)(2) without regard to the application of §1.1502-34. In contrast, a distributee member that does not meet the ownership requirements of section 1504(a)(2) without regard to the application of §1.1502-34 (a non-80-percent distributee) succeeds to any remaining items of the liquidating corporation only to the extent that it would have succeeded to those items if it had purchased, in a taxable transaction, the assets or businesses of the liquidating corporation that it received in the liquidation and had assumed the liabilities that it assumed in the liquidation.

In addition, the proposed regulations also provide guidance regarding the method for allocating the intercompany items of a liquidating subsidiary in cases in which multiple members acquire the assets of a liquidating subsidiary in a complete liquidation to which section 332 applies. The IRS and Treasury Department continue to study those rules. Accordingly, that portion of the notice of proposed rulemaking is withdrawn, and the final regulations do not apply to the intercompany items of the liquidating corporation. For rules applicable to the treatment of those items, see §1.1502-13(j)(2)(ii).

No public hearing was requested or held. Written and electronic comments responding to the notice of proposed rulemaking were received. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision. The revisions are discussed in this preamble.

Explanation and Summary of Comments

The Complete Liquidation Rules

Section 332(a) provides that no gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation. Section 332(b) provides, in part, that a distribution shall be considered to be in complete liquidation only if the corporation receiving such property was, on the date of the adoption of the plan of liquidation and at all times thereafter until the receipt of the property, the owner of stock meeting the requirements of section

1504(a)(2) and the distribution is made in complete cancellation or redemption of all of the stock of the liquidating corporation. Section 1.1502-34 provides that in determining the stock ownership of a member in another corporation (the issuing corporation) for purposes of determining the application of section 332(b)(1) there shall be included the stock of the issuing corporation owned by all other members of the group.

Section 337(a) provides that the liquidating corporation shall not recognize gain or loss on the distribution to the 80-percent distributee of any property in a complete liquidation to which section 332 applies. Section 337(c) provides that, for purposes of section 337, the term "80-percent distributee" means only the corporation that meets the 80-percent stock ownership requirements of section 332(b) without regard to the application of any consolidated return regulation. If section 337(a) does not apply, under section 336, the liquidating corporation will generally recognize gain or loss on the distribution of property in complete liquidation as if such property were sold to the distributee at its fair market value. Therefore, a complete liquidation to which section 332 applies may be taxable in whole or in part to the liquidating corporation but tax-free to the distributee members.

Deferred Income Items of the Liquidating Corporation

Section 1.451-5 generally allows accrual method taxpayers to defer the inclusion in gross income of advance payments for goods until the taxable year in which properly accruable under the taxpayer's method of accounting for tax purposes if such method results in gross income inclusion no later than when such items are included in gross income under the taxpayer's method of accounting for financial reporting purposes. However, if in a taxable year the taxpayer ceases to exist in a transaction other than one to which section 381(a) applies, or the liability under the agreement otherwise ends, then deferred income amounts are includable in the taxpayer's gross income for such taxable year.

Rev. Proc. 2004-34, 2004-1 C.B. 991, (see §601.601(d)(2)(ii)(b) of this chapter) allows taxpayers a limited deferral beyond

the taxable year of receipt for certain advance payments. However, inclusion of deferred income is accelerated to the taxable year of receipt if, in such taxable year, the taxpayer ceases to exist in a transaction other than a transaction to which section 381(a) applies or the taxpayer's obligation with respect to the advance payment is satisfied or otherwise ends other than in certain types of section 351(a) transfers or in a transaction to which section 381(a) applies.

Section 455 provides accrual method taxpayers with an election to include prepaid subscription income in gross income in the taxable year in which the liability exists to furnish or deliver a newspaper, magazine, or other periodical. However, if the liability to furnish or deliver the periodical ends or the taxpayer ceases to exist, then the amount of prepaid subscription income not previously included in the taxpayer's gross income is included in the taxpayer's gross income for the taxable year in which the liability ends. If the taxpayer's liability to furnish or deliver the periodical ends as a result of a transaction to which section 381(a) applies, the prepaid subscription income will generally not be included in the taxpayer's gross income, and the acquiring corporation must continue to defer the prepaid subscription income under section 455. Treas. Reg. §1.455-4 (citing section 381(c)(4) and the regulations under that section).

Section 381(a) applies to a distribution to which section 332 applies. As described in this preamble, a complete liquidation to which section 332 applies is taxable to the liquidating corporation to the extent that it distributes property to a non-80-percent distributee. In particular, the liquidating corporation is treated as if it had sold the property distributed to the non-80-percent distributee at its fair market value. If the liquidating corporation had sold a business with regard to which income items had been deferred (for example, deferred prepaid subscription income under section 455) and the purchaser had assumed the liquidating corporation's obligation or liability to perform the services or provide the goods relating to the deferred income, then the liquidating corporation would have recognized the deferred income. However, the liquidating corporation would also have been entitled to a deduction under section 162 for any amount

paid (or deemed paid) to the purchaser for its assumption of the obligation or liability related to the deferred income. See Rev. Rul. 68-112, 1968-1 C.B. 62 (see §601.601(d)(2)(ii)(b) of this chapter). The amount paid (or deemed paid) by the liquidating corporation to the purchaser for its liability assumption would have been includible in the purchaser's gross income. See Rev. Rul. 71-450, 1971-2 C.B. 78 (see §601.601(d)(2)(ii)(b) of this chapter).

The IRS and Treasury Department believe that it is appropriate for any deferred income items of a liquidating corporation attributable to assets and/or liabilities transferred to a non-80-percent distributee to be taken into account under applicable principles of law as a result of the liquidation despite the fact that the transaction is described in section 381(a). Likewise, section 332(a) does not apply in determining the recognition or nonrecognition of any income realized by the non-80-percent distributee attributable to its assumption of an obligation or liability related to the deferred income because such income is not gain or loss recognized with respect to the stock of the liquidating corporation. These final regulations include such rules.

Allocation of Items Specific to Property or a Business

The IRS and Treasury Department also believe that it is appropriate to allocate the full amount of deferred income items or deferred deductions of the liquidating corporation that are attributable to specific property or a specific business to the distributee member that receives such property or business in the liquidation. These final regulations include such a rule.

Succession to Credits of the Liquidating Corporation

As described in this preamble, the proposed regulations allocate credits to distributee members based on the items of income, gain, loss, or deduction attributable to the activities that gave rise to the credits. Comments were received indicating that it was unclear how to allocate credits that are not clearly associated with items of income, gain, loss, or deduction (for example, the section 53 minimum tax credit). The IRS and Treasury Department agree with those comments. Accordingly, these

final regulations revise the credit allocation rule and provide that credits will be allocated proportionally based on the value of the stock of the liquidating corporation owned by each distributee member. The IRS and Treasury Department believe that this rule represents a reasonable and administrable approach to allocating credits.

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. Further, it is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations will primarily affect affiliated groups of corporations that have elected to file a consolidated return, which tend to be larger businesses. Accordingly, a regulatory flexibility analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding this regulation 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 Amber C. Vogel of the Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

Partial Withdrawal of Proposed Regulations

Accordingly, we are not adopting the amendments to §1.1502-13 as proposed in the notice of proposed rulemaking (REG-131128-04) that was published in the **Federal Register** on Tuesday, February 22, 2005 (70 FR 8552).

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Section 1.1502-80 also issued under 26 U.S.C. 1502. * * *

Par. 2. Section 1.1502-80 is amended by:

1. Removing the second sentence from paragraph (a).

2. Revising the third sentence of paragraph (a).

3. Adding paragraph (g).

The revision and addition read as follows:

§1.1502-80 Applicability of other provisions of law.

(a) * * * For example, sections 269 and 482 apply for any consolidated year. * * *

* * * * *

(g) *Special rules for liquidations to which section 332 applies.* Notwithstanding the general rule of section 381, if multiple members (distributee members) acquire assets of a corporation in a liquidation to which section 332 applies (regardless of whether any single member owns stock in the liquidating corporation meeting the requirements of section 1504(a)(2)), such members succeed to and take into account the items of the liquidating corporation (including items described in section 381(c), but excluding intercompany items under §1.1502-13) as provided in this paragraph (g) to the extent not otherwise prohibited by any applicable provision of law. This paragraph (g) does not apply to the intercompany items of the liquidating corporation. See §1.1502-13(j)(2)(ii).

(1) *Income offset items and deferred income.* Except as otherwise provided in this paragraph (g)(1), each distributee member succeeds to and takes into account the items of the liquidating corporation that could be used to offset the income of the group or any member (including deferred deductions, net operating loss carryovers, and capital loss carryovers) (income offset items) to the extent that such items would have been reflected in investment adjustments to the stock of the liquidating corporation owned by such distributee member under §1.1502-32(c) if, immediately prior to the liquidation, any stock of the liqui-

dating corporation owned by nonmembers had been redeemed and then such items had been taken into account. However, each distributee member succeeds to the full amount of any deferred deduction or deferred income item attributable to the particular property or business operations distributed to such distributee in the liquidation to the extent that such item is not taken into account in the determination of the income or loss of the liquidating corporation with regard to the liquidation under chapter 1 of the Internal Revenue Code (Code). If the liquidating corporation is not a member of the group at the time of the liquidation, the rules of this paragraph (g)(1) are applied as if the liquidating corporation had been a member of the group.

(2) *Accounting for deferred income items.* Solely for the purpose of determining whether deferred income items of a liquidating corporation are taken into account under applicable principles of law as a result of a liquidation to which section 332 applies, the transfer of property to, and the assumption of liabilities by, a distributee member that does not own stock in the liquidating corporation meeting the requirements of section 1504(a)(2) without regard to the application of §1.1502-34 immediately prior to the liquidation is not treated as part of a transaction to which section 381(a) applies. In addition, section 332(a) does not apply in determining the recognition or nonrecognition of any income realized by the distributee member under applicable principles of law on account of consideration received (or deemed received) on the assumption of the liquidating corporation's obligation or liability attributable to any deferred income item.

(3) *Credits and earnings and profits.* Each distributee member succeeds to and takes into account a percentage of each credit of the liquidating corporation equal to the value of the stock of the liquidating corporation owned by such distributee at the time of the liquidation divided by the total value of all the stock of the liquidating corporation owned by members of the group at the time of the liquidation. Except to the extent that the distributee member's earnings and profits already reflect the liquidating corporation's earnings and profits, each distributee member succeeds to and takes into account under the principles of §1.1502-32(c) the earnings and profits,

or deficit in earnings and profits, of the liquidating corporation (determined after taking into account the amount of earnings and profits properly applicable to distributions to non-member shareholders under §1.381(c)(2)-1(c)(2)). If the liquidating corporation is not a member of the group at the time of the liquidation, the rules of this paragraph (g)(3) are applied as if the liquidating corporation had been a member of the group.

(4) *Other items.* With regard to items to which neither paragraph (g)(1) nor (g)(3) of this section applies, a distributee member that, immediately prior to the liquidation, owns stock in the liquidating corporation meeting the requirements of section 1504(a)(2) without regard to the application of §1.1502-34 succeeds to the items of the liquidating corporation in accordance with section 381 and other applicable principles. A distributee member that, immediately prior to the liquidation, does not own stock in the liquidating corporation meeting the requirements of section 1504(a)(2) without regard to the application of §1.1502-34 succeeds to the items of the liquidating corporation to the extent that it would have succeeded to those items if it had purchased, in a taxable transaction, the assets or businesses of the liquidating corporation that it received in the liquidation and had assumed the liabilities that it assumed in the liquidation.

(5) *Determination of the items of a liquidating subsidiary.* For purposes of this section, the items of a liquidating subsidiary include the amount of any consolidated tax attribute attributable to the liquidating subsidiary that is determined pursuant to the principles of §1.1502-21(b)(2)(iv). In addition, if the liquidating subsidiary is a member of a separate return limitation year subgroup, the amount of a tax attribute that arose in a separate return limitation year that is attributable to that member shall also be determined pursuant to the principles of §1.1502-21(b)(2)(iv).

(6) *Examples.* The following examples illustrate the application of this paragraph (g):

Example 1. Liquidation-80 percent distributee.

(i) *Facts.* X has only common stock outstanding. On January 1 of year 1, X acquired equipment with a 10-year recovery period and elected to depreciate the equipment using the straight-line method of depreciation. On January 1 of year 7, M1 and M2 own 80 percent and 20 percent, respectively, of X's stock. X

is a domestic corporation but is not a member of the group that includes M1 and M2. On that date, X distributes all of its assets to M1 and M2 in complete liquidation. The equipment is distributed to M1. Under section 334(b), M1's basis in the equipment is the same as it would be in X's hands. After computing its tax liability for the taxable year that includes the liquidation, X has net operating losses of \$100, business credits of \$40, and earnings and profits of \$80.

(ii) *Succession to items described in section 381(c)*. (A) *Losses*. Under paragraph (g)(1) of this section, each distributee member succeeds to X's items that could be used to offset the income of the group or any member to the extent that such items would have been reflected in investment adjustments to the stock of X it owned under §1.1502-32(c) if, immediately prior to the liquidation, such items had been taken into account. Accordingly, M1 and M2 succeed to \$80 and \$20, respectively, of X's net operating loss.

(B) *Credits and earnings and profits*. Under paragraph (g)(3) of this section, because, immediately prior to the liquidation, M1 and M2 hold 80 percent and 20 percent, respectively, of the value of the stock of X, M1 and M2 succeed to \$32 and \$8, respectively, of X's \$40 of business credits. In addition, because M1's and M2's earnings and profits do not reflect X's earnings and profits, X's earnings and profits are allocated to M1 and M2 under the principles of §1.1502-32(c). Therefore, M1 and M2 succeed to \$64 and \$16, respectively, of X's earnings and profits.

(C) *Depreciation of equipment's basis*. Under paragraph (g)(4) of this section, because M1 owns stock in X meeting the requirements of section 1504(a)(2) without regard to the application of §1.1502-34, M1 is required to continue to depreciate the equipment using the straight-line method of depreciation over the remaining recovery period of 4.5 years (assuming X used a half-year convention).

Example 2. Liquidation-no 80 percent distributee. (i) *Facts*. The facts are the same as in *Example 1* except that M1 and M2 own 60 percent and 40 percent, respectively, of X's stock. In addition, on January 1 of year 6, X entered into a long-term contract with Y, an unrelated party. The total contract price is \$1000, and X estimates the total allocable contract costs to be \$500. At the time of the liquidation, X had received \$250 in progress payments under the contract and incurred costs of \$125. X accounted for the contract under the percentage of completion method described in section 460(b). In the liquidation, M1 assumes X's contract obligations and rights.

(ii) *Succession to items described in section 381(c)*. (A) *Losses*. Under paragraph (g)(1) of this

section, each distributee member succeeds to X's items that could be used to offset the income of the group or any member to the extent that such items would have been reflected in investment adjustments to the stock of X it owned under §1.1502-32(c) if, immediately prior to the liquidation, such items had been taken into account. Accordingly, M1 and M2 succeed to \$60 and \$40, respectively, of X's net operating loss.

(B) *Credits and earnings and profits*. Under paragraph (g)(3) of this section, because, immediately prior to the liquidation, M1 and M2 hold 60 percent and 40 percent, respectively, of the value of the stock of X, M1 and M2 succeed to \$24 and \$16, respectively, of X's \$40 of business credits. In addition, because M1's and M2's earnings and profits do not reflect X's earnings and profits, X's earnings and profits are allocated to M1 and M2 under the principles of §1.1502-32(c). Therefore, M1 and M2 succeed to \$48 and \$32, respectively, of X's earnings and profits.

(C) *Depreciation of equipment's basis*. Under section 334(a), M1's basis in the equipment is its fair market value at the time of the distribution. Pursuant to section 168(i)(7), to the extent that M1's basis in the equipment does not exceed X's adjusted basis in the equipment at the time of the transfer, M1 is required to continue to depreciate the equipment using the straight-line method of depreciation over the remaining recovery period of 4.5 years (assuming X used a half-year convention). Any portion of M1's basis in the equipment that exceeds X's adjusted basis in the equipment at the time of the transfer is treated as being placed in service by M1 in the year of the transfer. Thus, M1 may choose any applicable depreciation method, recovery period, and convention under section 168 for such excess basis.

(D) *Method of accounting for long-term contract*. Under paragraph (g)(4) of this section, M1 does not succeed to X's method of accounting for the contract. Rather, under §1.460-4(k)(2), M1 is treated as having entered into a new contract on the date of the liquidation. Under §1.460-4(k)(2)(iii), M1 must evaluate whether the new contract should be classified as a long-term contract within the meaning of §1.460-1(b) and account for the contract under a permissible method of accounting.

Example 3. Liquidation—deferred items. (i) *Facts*. X has only common stock outstanding, and M1 and M2 (who are members of the same group) own 80 percent and 20 percent, respectively, of X's stock. X operates two divisions, each of which defers prepaid subscription income pursuant to an election under section 455. X distributes all of its assets in complete liquidation. M1 receives all of the assets of

Division 1, including prepaid subscription income, and assumes X's liability to furnish or deliver the newspaper, magazine, or other periodical to which the prepaid subscription income received by M1 relates. M2 receives all of the assets of Division 2, including prepaid subscription income, and assumes X's liability to furnish or deliver the newspaper, magazine, or other periodical to which the prepaid subscription income received by M2 relates.

(ii) *Acceleration of deferred income items and succession to other deferred items*. Under paragraph (g)(1) of this section, M1 succeeds to the full amount of the deferred prepaid subscription income of X attributable to Division 1. Under applicable law, X does not recognize the deferred prepaid subscription income attributable to Division 1 because X's liability to furnish or deliver the newspaper, magazine, or other periodical ends as a result of a transaction to which section 381(a) applies. Under paragraph (g)(2) of this section, solely for purposes of determining whether the deferred income items of X attributable to Division 2 are taken into account as a result of the liquidation, the distribution of property to M2 is not treated as a transaction to which section 381(a) applies. Therefore, under applicable law, X's deferred prepaid subscription income attributable to Division 2 is taken into account in the determination of X's income or loss with regard to the liquidation. Further, under paragraph (g)(2) of this section, section 332(a) does not apply in determining the recognition or non-recognition of any income that M2 realizes on account of consideration received (or deemed received) on its assumption of X's liability to furnish or deliver the newspaper, magazine, or other periodical to which the prepaid subscription income relates.

(7) *Effective/applicability date*. This paragraph (g) applies to transactions occurring after April 14, 2008.

Linda E. Stiff,
Deputy Commissioner for
Services and Enforcement.

Approved January 8, 2008.

Eric Solomon,
Assistant Secretary of
the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on January 14, 2008, 8:45 a.m., and published in the issue of the Federal Register for January 15, 2008, 73 F.R. 2416)

Part III. Administrative, Procedural, and Miscellaneous

Voluntary Closing Agreement Program For Tax-Exempt Bonds and Tax Credit Bonds

Notice 2008–31

SECTION 1. PURPOSE

This notice provides information about the voluntary closing agreement program for tax-exempt bonds and tax credit bonds (“TEB VCAP”). In particular, the notice updates procedures whereby issuers of tax-exempt bonds and tax credit bonds can resolve violations of the Internal Revenue Code (the “Code”) through closing agreements with the Internal Revenue Service (the “Service”). The Tax Exempt Bonds Compliance & Program Management (“TEB CPM”) function of Tax Exempt and Government Entities (TE/GE) is continuing to develop voluntary compliance initiatives to insure compliance by issuers of tax-exempt bonds and tax credit bonds with applicable provisions of the Code. TEB VCAP is part of the TEB CPM voluntary compliance initiatives and provides appropriate remedies when issuers voluntarily come forward and express a desire to resolve violations of the Code. TEB VCAP is intended to encourage issuers and conduit borrowers to exercise due diligence in complying with the Code and to provide a vehicle to correct violations of the Code. It is the continuing policy of the Service to attempt to resolve violations of the Code without taxing bondholders. TEB VCAP reflects this policy.

The Service is continuing to work on more detailed procedures about the program, and intends to provide those procedures in forthcoming guidance. For example, the Service anticipates specifying standardized closing agreement terms and amounts for particular violations.

SECTION 2. CHANGES

This notice modifies and supersedes Notice 2001–60, 2001–2 C.B. 304. In general, Notice 2001–60 is amended by: (1) changing references to Outreach Planning and Review (OPR) to Compliance & Program Management (CPM); (2) incorporating tax credit bonds into the TEB VCAP program; (3) simplifying section

5(a) by referring to Internal Revenue Manual (“IRM”) 7.2.3 for the specific information required for a VCAP submission; (4) clarifying that under section 5(b) CPM staff will obtain additional information as needed; (5) clarifying that all information for a VCAP submission must be provided in electronic format; and (6) providing email and regular mail addresses for submissions.

SECTION 3. BACKGROUND

Gross income does not include interest on any state or local bond that meets the requirements of section 103 and related provisions of the Code. A credit against tax is provided to a holder of a qualified tax credit bond issued under sections 54, 1397E or 1400N that meets the requirements of those sections and related provisions of the Code. Under certain circumstances, an issuer may take remedial action under provisions such as sections 1.141–12, 1.142–2, 1.144–2, 1.145–2, and 1.147–2 of the Income Tax Regulations and similar provisions that are applicable to tax credit bonds in order to cure a violation of the Code.

The Service has previously provided formal tax-exempt bond closing agreement programs such as the program described in Rev. Proc. 97–15, 1997–1 C.B. 635. Violations of section 103 and related provisions of the Code that cannot be remediated under existing remedial action provisions or other tax-exempt bond closing agreement programs contained in regulations or other published guidance may be resolved by entering into a closing agreement under TEB VCAP.

Section 7121 of the Code and the regulations thereunder authorize the Commissioner to enter into written closing agreements with any person in connection with the tax liability of such person (or of the person or estate for which he acts). Section 301.7121–1 of the Income Tax Regulations provides, in part, that a closing agreement may be entered into in any case in which there appears to be an advantage in having the case permanently and conclusively closed, or if good and sufficient reasons are shown by the taxpayer for desiring a closing agreement and it is determined by the Commissioner that the United States will

sustain no disadvantage through consummation of such an agreement.

SECTION 4. SCOPE OF TEB VCAP

Under TEB VCAP, an issuer may request a closing agreement with respect to its bonds to resolve violations of sections 103, 54, 1397E, 1400N and related provisions of the Code. TEB VCAP is not available when:

(a) Absent extraordinary circumstances, the violation can be remediated under existing remedial action provisions or tax-exempt bond closing agreement programs contained in regulations or other published guidance.

(b) The bond issue is under examination. A bond issue is generally treated as under examination on the date a letter opening an examination on the bond issue is sent.

(c) The tax-exempt status of the bonds or qualified status of tax credit bonds is at issue in any court proceeding or is being considered by the IRS Office of Appeals.

(d) The Service determines that the violation was due to willful neglect.

SECTION 5. PROCEDURES FOR REQUESTING A CLOSING AGREEMENT UNDER TEB VCAP

(a) *Information Required in Requests.* An issuer or its authorized representative requesting a closing agreement must submit the information specified in IRM 7.2.3 and the information reporting return for the applicable bonds on IRS Form 8038 or other comparable form that was filed with respect to the issue. (For convenience of reference, the relevant portions of the Internal Revenue Manual (IRM) are available on the IRS website, at www.irs.gov, in the section on the Tax-Exempt Bond Community, under the subheading of Published Guidance.) All information concerning the closing agreement must be submitted under penalty of perjury signed by an official of the issuer with knowledge of the issue and authorized to make the submissions on behalf of the issuer. The request may also contain a Form 2848 with the name, address, phone number, and fax number of an authorized contact person.

(b) *Additional Information for Requests.* CPM staff may require additional information depending on the facts and circumstances. All additional information must be submitted under penalty of perjury signed by the person who initially signed the submission or who would have been authorized to make the original submission.

(c) *Electronic Format.* All information submitted in support of a closing agreement request must be provided in an electronic format that is either emailed in PDF format or provided on a compact disc (“CD”) sent via regular mail to the address provided by this notice. Hard copies of the submissions can be provided but are not required.

(d) *Anonymous Closing Agreement Requests.* An issuer or its authorized representative may initiate discussions regarding the appropriate terms of a closing agreement on an anonymous basis. An anonymous request may be made on behalf of a group of similarly situated issuers. However, the execution of a closing agreement must be between the Service and a disclosed issuer, and all terms of a closing agreement must be consistent with section 7121 of the Code. Until the name of the bond issue is disclosed to the Service, a request for a closing agreement under TEB VCAP will not prevent the Service from beginning an examination of the bond issue. An issue for which a request has been submitted under this paragraph (d) that has been placed under examination prior to the date the issue is identified to the Service will no longer be eligible for TEB VCAP.

(e) *TEB VCAP Mailing Address.* TEB VCAP submissions should be mailed to:

Internal Revenue Service
Attn: TEB VCAP
1122 Town & Country Commons
St. Louis, MO 63017

(f) *TEB VCAP E-Mail Address.* In the alternative, VCAP information may be submitted in PDF format to TEBVCAP@irs.gov. TEB CPM will provide an acknowledgement of receipt of an email request.

SECTION 6. CLOSING AGREEMENT TERMS

Closing agreements under TEB VCAP will generally follow the model closing agreement in IRM 4.81.1, Exhibit 9, as the same may be modified or changed. Specific closing agreement terms will depend on the facts and circumstances of the case, including the degree of diligence exercised by the issuer and any conduit borrower. Any standardized closing agreement terms that are developed for TEB VCAP will be set forth in the Internal Revenue Manual and/or other published guidance.

SECTION 7. EFFECT OF CLOSING AGREEMENT EXECUTED UNDER TEB VCAP

A closing agreement properly executed by the issuer and the Service will protect bondholders from including in their gross income any interest on the bonds or from recapturing tax credits during the period specified in the agreement for any violation described in the agreement. A closing agreement executed under section 7121 of the Code shall be final and conclusive except that: (1) the matter it relates to may be reopened in the event of fraud, malfeasance, or misrepresentation of a material fact; (2) it is subject to the sections of the Code that expressly provide that effect be given to their provisions (including any stated exception for section 7122 of the Code) notwithstanding any other law or rule of law; and (3) it is subject to any law, enacted after the date of the agreement, that applies to a tax period ending after the date of the agreement covered by the agreement.

SECTION 8. REQUESTS FOR COMMENTS

We anticipated that TEB VCAP will continue to be expanded and refined over time based on experience and public comment. The Service welcomes comments regarding the format and operation of TEB VCAP, and suggestions with regard to the general framework of closing agreement terms including standardized closing agreement terms and amounts that may be specified for particular violations. Comments should be submitted in writing and should be emailed to

Steven.A.Chamberlin@irs.gov or mailed to the following address:

Steven A. Chamberlin
Manager, Tax Exempt Bonds
Compliance & Program
Management
SE:T:GE:TEB:CPM
1122 Town & Country Commons
St. Louis, MO 63017

SECTION 9. EFFECT ON OTHER DOCUMENTS

Notice 2001–60, 2001–2 C.B. 304, is modified and superseded.

SECTION 10. EFFECTIVE DATE

TEB VCAP is effective February 27, 2008.

SECTION 11. DRAFTING INFORMATION

The principal authors of this notice are Steven A. Chamberlin of Tax Exempt Bonds Compliance & Program Management, Tax Exempt & Government Entities, and Carla Young of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this notice, contact Steven Chamberlin at (636) 255–1290 or Carla Young at (202) 622–3980 (not toll-free calls).

Section 67 Limitations on Estates or Trusts for Bundled Investment Management and Advisory Costs

Notice 2008–32

This notice provides interim guidance on the treatment under § 67 of the Internal Revenue Code of investment advisory costs and other costs subject to the 2-percent floor under § 67(a) that are bundled as part of one commission or fee paid to the trustee or executor (“Bundled Fiduciary Fee”) and are incurred by a trust other than a grantor trust (nongrantor trust) or an estate.

BACKGROUND

On January 16, 2008, the Supreme Court of the United States issued its decision in *Michael J. Knight, Trustee of*

William L. Rudkin Testamentary Trust v. Commissioner, 552 U.S. ___, 128 S. Ct. 782 (2008), holding that costs paid to an investment advisor by a nongrantor trust or estate generally are subject to the 2-percent floor for miscellaneous itemized deductions under § 67(a). The IRS and the Treasury Department expect to issue final regulations under § 1.67-4 of the Income Tax Regulations consistent with the Supreme Court's holding in *Knight*. The final regulations also will address the issue raised when a nongrantor trust or estate pays a Bundled Fiduciary Fee for costs incurred in-house by the fiduciary, some of which are subject to the 2-percent floor and some of which are fully deductible without regard to the 2-percent floor. The final regulations, however, will not be issued prior to the due date for filing 2007 income tax returns (determined without regard to extensions), and will apply only prospectively. Accordingly, in light of the Supreme Court's decision in *Knight*, the IRS and the Treasury Department are providing interim guidance that specifically addresses the treatment of a Bundled Fiduciary Fee.

INTERIM GUIDANCE

Taxpayers will not be required to determine the portion of a Bundled Fiduciary Fee that is subject to the 2-percent floor under § 67 for any taxable year beginning before January 1, 2008. Instead, for each such taxable year, taxpayers may deduct the full amount of the Bundled Fiduciary Fee without regard to the 2-percent floor. Payments by the fiduciary to third parties for expenses subject to the 2-percent floor are readily identifiable and must be treated separately from the otherwise Bundled Fiduciary Fee.

The IRS and the Treasury Department anticipate that final regulations under § 1.67-4 will be published without delay after the extended comment period granted in this notice. The final regulations may contain one or more safe harbors for the allocation of fees and expenses between those costs that are subject to the 2-percent floor and those that are not. Any safe harbors in the final regulations for determining the allocation of a bundled fiduciary fee between costs subject to the 2-percent floor and those not subject to the 2-percent floor may be available for tax-

payers to use for taxable years beginning on or after January 1, 2008.

REQUESTS FOR COMMENTS

Interested parties are invited to submit comments on this notice and § 1.67-4 of the proposed regulations published in the **Federal Register** of July 27, 2007 (REG-128224-06, 2007-36 I.R.B. 551 [72 FR 41243-01]) by May 27, 2008.

The IRS and the Treasury Department are considering various modifications to § 1.67-4 of the proposed regulations that may include safe harbors for determining the allocation of a Bundled Fiduciary Fee between costs subject to the 2-percent floor and those that are not. The IRS and the Treasury Department request comments on whether safe harbors would be helpful and request suggestions on how the safe harbors may be formulated. Comments are specifically requested on reasonable estimates of the percentage(s) of the total costs of administering a nongrantor trust or estate that is attributable to costs subject to the 2-percent floor including, but not limited to, costs for investment management and advice. Comments are also requested on whether the safe harbors should reflect the nature or value of the assets in the nongrantor trust or estate, and/or the number of beneficiaries of the nongrantor trust or estate.

Comments should be submitted to: Internal Revenue Service, CC:PA:LPD:PR (Notice 2008-32), Room 5203, P.O. Box 7604, Ben Franklin Station, Washington, DC 20224. Alternatively, comments may be hand delivered Monday through Friday between the hours of 8:00 a.m. to 4:00 p.m. to: CC:PA:LPD:PR (Notice 2008-32), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC. Comments may also be submitted electronically via the following e-mail address: Notice.Comments@irs.counsel.treas.gov. Please include Notice 2008-32 in the subject line of any electronic submissions.

EFFECTIVE DATE

This notice is effective February 27, 2008.

CONTACT INFORMATION

The principal author of this notice is Jennifer N. Keeney of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this notice, contact Jennifer N. Keeney at (202) 622-3060 (not a toll-free call).

26 CFR 601.601: Rules and regulations.
(Also Part 1, §§ 25, 103, 143; 1.25-4T, 1.103-1, 6a.103A-2.)

Rev. Proc. 2008-19

SECTION 1. PURPOSE

This revenue procedure provides guidance with respect to the United States and area median gross income figures that are to be used by issuers of qualified mortgage bonds, as defined in § 143(a) of the Internal Revenue Code, and issuers of mortgage credit certificates, as defined in § 25(c), in computing the housing cost/income ratio described in § 143(f)(5).

SECTION 2. BACKGROUND

.01 Section 103(a) provides that, except as provided in § 103(b), gross income does not include interest on any state or local bond. Section 103(b)(1) provides that § 103(a) shall not apply to any private activity bond that is not a qualified bond (within the meaning of § 141). Section 141(e) provides that the term "qualified bond" includes any private activity bond that (1) is a qualified mortgage bond, (2) meets the applicable volume cap requirements under § 146, and (3) meets the applicable requirements under § 147.

.02 Section 143(a)(1) provides that the term "qualified mortgage bond" means a bond that is issued as part of a "qualified mortgage issue". Section 143(a)(2)(A) provides that the term "qualified mortgage issue" means an issue of one or more bonds by a state or political subdivision thereof, but only if (i) all proceeds of the issue (exclusive of issuance costs and a reasonably required reserve) are to be used to finance owner-occupied residences; (ii) the issue meets the requirements of subsections (c), (d), (e), (f), (g), (h), (i), and (m)(7) of § 143; (iii) the issue does not

meet the private business tests of paragraphs (1) and (2) of § 141(b); and (iv) with respect to amounts received more than 10 years after the date of issuance, repayments of \$250,000 or more of principal on financing provided by the issue are used not later than the close of the first semi-annual period beginning after the date the prepayment (or complete repayment) is received to redeem bonds that are part of the issue.

.03 Section 143(f) imposes eligibility requirements concerning the maximum income of mortgagors for whom financing may be provided by qualified mortgage bonds. Section 25(c)(2)(A)(iii)(IV) provides that recipients of mortgage credit certificates must meet the income requirements of § 143(f). Generally, under §§ 143(f)(1) and 25(c)(2)(A)(iii)(IV), these income requirements are met only if all owner-financing under a qualified mortgage bond and all certified indebtedness amounts under a mortgage credit certificate program are provided to mortgagors whose family income is 115 percent or less of the applicable median family income. Under § 143(f)(6), the income limitation is reduced to 100 percent of the applicable median family income if there are fewer than three individuals in the family of the mortgagor.

.04 Section 143(f)(4) provides that the term “applicable median family income” means the greater of (A) the area median gross income for the area in which the residence is located, or (B) the statewide median gross income for the state in which the residence is located.

.05 Section 143(f)(5) provides for an upward adjustment of the income limitations in certain high housing cost areas. Under § 143(f)(5)(C), a high housing cost area is a statistical area for which the housing cost/income ratio is greater than 1.2. The housing cost/income ratio is determined under § 143(f)(5)(D) by dividing (a) the applicable housing price ratio by (b) the ratio that the area median gross income bears to the median gross income for the United States. The applica-

ble housing price ratio is the new housing price ratio (new housing average purchase price for the area divided by the new housing average purchase price for the United States) or the existing housing price ratio (existing housing average area purchase price divided by the existing housing average purchase price for the United States), whichever results in the housing cost/income ratio being closer to 1. This income adjustment applies only to bonds issued, and nonissued bond amounts elected, after December 31, 1988. See § 4005(h) of the Technical and Miscellaneous Revenue Act of 1988, 1988-3 C.B. 1, 311 (1988).

.06 The Department of Housing and Urban Development (HUD) has computed the median gross income for the United States, the states, and statistical areas within the states. The income information was released to the HUD regional offices on February 13, 2008, and may be obtained by calling the HUD reference service at 1-800-245-2691. The income information is also available at HUD’s World Wide Web site, <http://huduser.org/datasets/il.html>, which provides a menu from which you may select the year and type of data of interest. The Internal Revenue Service annually publishes the median gross income for the United States.

.07 The most recent nationwide average purchase prices and average area purchase price safe harbor limitations were published on March 10, 2008, in Rev. Proc. 2008-17, 2008-10 I.R.B. 549.

SECTION 3. APPLICATION

.01 When computing the housing cost/income ratio under § 143(f)(5), issuers of qualified mortgage bonds and mortgage credit certificates must use \$61,500 as the median gross income for the United States. See § 2.06 of this revenue procedure.

.02 When computing the housing cost/income ratio under § 143(f)(5), issuers of qualified mortgage bonds and mortgage credit certificates must use the area median gross income figures released

by HUD on February 13, 2008. See § 2.06 of this revenue procedure.

SECTION 4. EFFECT ON OTHER REVENUE PROCEDURES

.01 Rev. Proc. 2007-31, 2007-19 I.R.B. 1225, is obsolete except as provided in § 5.02 of this revenue procedure.

.02 This revenue procedure does not affect the effective date provisions of Rev. Rul. 86-124, 1986-2 C.B. 27. Those effective date provisions will remain operative at least until the Service publishes a new revenue ruling that conforms the approach to effective dates set forth in Rev. Rul. 86-124 to the general approach taken in this revenue procedure.

SECTION 5. EFFECTIVE DATES

.01 Issuers must use the United States and area median gross income figures specified in § 3 of this revenue procedure for commitments to provide financing that are made, or (if the purchase precedes the financing commitment) for residences that are purchased, in the period that begins on February 13, 2008, and ends on the date when these United States and area median gross income figures are rendered obsolete by a new revenue procedure.

.02 Notwithstanding § 5.01 of this revenue procedure, issuers may continue to rely on the United States and area median gross income figures specified in Rev. Proc. 2007-31 with respect to bonds originally sold and nonissued bond amounts elected not later than March 30, 2008, if the commitments or purchases described in § 5.01 are made not later than May 29, 2008.

DRAFTING INFORMATION

The principal author of this revenue procedure is David White of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue procedure, contact Mr. White at (202) 622-3980 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking

Hybrid Retirement Plans

REG-104946-07

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations providing guidance relating to sections 411(a)(13) and 411(b)(5) of the Internal Revenue Code (Code) concerning certain hybrid defined benefit plans. These regulations provide guidance on changes made by the Pension Protection Act of 2006. These regulations affect sponsors, administrators, participants, and beneficiaries of hybrid defined benefit plans.

DATES: Written or electronic comments and requests for a public hearing must be received by March 27, 2008.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-104946-07), Room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-104946-07), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically via the Federal eRulemaking Portal at <http://www.regulations.gov> (IRS REG-104946-07).

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Lauson C. Green or Linda S. F. Marshall at (202) 622-6090; concerning submissions of comments or to request a public hearing, Funmi Taylor at (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR part

1) under sections 411(a)(13) and 411(b)(5) of the Code. Generally, a defined benefit pension plan must satisfy the minimum vesting standards of section 411(a) and the accrual requirements of section 411(b) in order to be qualified under section 401(a) of the Code. Sections 411(a)(13) and 411(b)(5), which were added to the Code by section 701(b) of the Pension Protection Act of 2006, Public Law 109-280, 120 Stat. 780 (PPA '06), modify the minimum vesting standards of section 411(a) and the accrual requirements of section 411(b).

Section 411(a)(13)(A) provides that an applicable defined benefit plan (which is defined in section 411(a)(13)(C)) is not treated as failing to meet either (i) The requirements of section 411(a)(2) (subject to a special vesting rule in section 411(a)(13)(B) with respect to benefits derived from employer contributions) or (ii) The requirements of section 411(c) or 417(e) with respect to contributions other than employee contributions, merely because the present value of the accrued benefit (or any portion thereof) of any participant is, under the terms of the plan, equal to the amount expressed as the balance in a hypothetical account or as an accumulated percentage of the participant's final average compensation. Section 411(a)(13)(B) requires an applicable defined benefit plan to provide that an employee who has completed at least 3 years of service has a nonforfeitable right to 100 percent of the employee's accrued benefit derived from employer contributions.

Under section 411(a)(13)(C)(i), a plan is an applicable defined benefit plan if the plan is a defined benefit plan under which the accrued benefit (or any portion thereof) of a participant is calculated as the balance of a hypothetical account maintained for the participant or as an accumulated percentage of the participant's final average compensation. Under section 411(a)(13)(C)(ii), the Secretary of the Treasury is to issue regulations which include in the definition of an applicable defined benefit plan any defined benefit plan (or portion of such a plan) which has an effect similar to a plan described in section 411(a)(13)(C)(i).

Section 411(b)(1)(H)(i) provides that a defined benefit plan fails to comply with section 411(b) if, under the plan, an employee's benefit accrual is ceased, or the employee's rate of benefit accrual is reduced, because of the attainment of any age. Section 411(b)(5), which was added to the Code by section 701(b)(1) of PPA '06, provides additional rules related to section 411(b)(1)(H)(i). Section 411(b)(5)(A) generally provides that a plan is not treated as failing to meet the requirements of section 411(b)(1)(H)(i) if a participant's accrued benefit, as determined as of any date under the terms of the plan, would be equal to or greater than that of any similarly situated younger individual who is or could be a participant. Section 411(b)(5)(G) provides that, for purposes of section 411(b)(5), any reference to the accrued benefit of a participant shall be a reference to the participant's benefit accrued to date. For purposes of section 411(b)(5)(A), section 411(b)(5)(A)(iv) provides that the accrued benefit may, under the terms of the plan, be expressed as an annuity payable at normal retirement age, the balance of a hypothetical account, or the current value of the accumulated percentage of the employee's final average compensation.

Section 411(b)(5)(B) imposes several requirements on an applicable defined benefit plan as a condition of the plan satisfying section 411(b)(1)(H). Section 411(b)(5)(B)(i) provides that such a plan is treated as failing to meet the requirements of section 411(b)(1)(H) if the terms of the plan provide for an interest credit (or an equivalent amount) for any plan year at a rate that is greater than a market rate of return. Under section 411(b)(5)(B)(i)(I), a plan is not treated as having an above-market rate merely because the plan provides for a reasonable minimum guaranteed rate of return or for a rate of return that is equal to the greater of a fixed or variable rate of return. Section 411(b)(5)(B)(i)(II) provides that an interest credit (or an equivalent amount) of less than zero can in no event result in the hypothetical account balance or similar amount being less than the aggregate amount of contributions credited to the account. Section 411(b)(5)(B)(i)(III) specifies that the Sec-

retary of the Treasury may provide by regulation for rules governing the calculation of a market rate of return for purposes of section 411(b)(5)(B)(i)(I) and for permissible methods of crediting interest to the account (including fixed or variable interest rates) resulting in effective rates of return meeting the requirements of section 411(b)(5)(B)(i)(I).

Section 411(b)(5)(B)(ii), (iii), and (iv) contain minimum benefit rules that apply if, after June 29, 2005, an applicable plan amendment is adopted. Section 411(b)(5)(B)(v)(I) defines an applicable plan amendment as an amendment to a defined benefit plan which has the effect of converting the plan to an applicable defined benefit plan. Under section 411(b)(5)(B)(ii), if, after June 29, 2005, an applicable plan amendment is adopted, the plan is treated as failing to meet the requirements of section 411(b)(1)(H) unless the requirements of section 411(b)(5)(B)(iii) are met with respect to each individual who was a participant in the plan immediately before the adoption of the amendment. Section 411(b)(5)(B)(iii) specifies that, subject to section 411(b)(5)(B)(iv), the requirements of section 411(b)(5)(B)(iii) are met with respect to any participant if the accrued benefit of the participant under the terms of the plan as in effect after the amendment is not less than the sum of: (I) The participant's accrued benefit for years of service before the effective date of the amendment, determined under the terms of the plan as in effect before the amendment; plus (II) The participant's accrued benefit for years of service after the effective date of the amendment, determined under the terms of the plan as in effect after the amendment. Section 411(b)(5)(B)(iv) provides that, for purposes of section 411(b)(5)(B)(iii)(I), the plan must credit the participant's account or similar amount with the amount of any early retirement benefit or retirement-type subsidy for the plan year in which the participant retires if, as of such time, the participant has met the age, years of service, and other requirements under the plan for entitlement to such benefit or subsidy.

Section 411(b)(5)(B)(v) sets forth certain provisions related to an ap-

plicable plan amendment. Section 411(b)(5)(B)(v)(II) provides that if the benefits under two or more defined benefit plans of an employer are coordinated in such a manner as to have the effect of adoption of an applicable plan amendment, the plan sponsor is treated as having adopted an applicable plan amendment as of the date the coordination begins. Section 411(b)(5)(B)(v)(III) directs the Secretary of the Treasury to issue regulations to prevent the avoidance of the purposes of section 411(b)(5)(B) through the use of two or more plan amendments rather than through a single plan amendment.

Section 411(b)(5)(B)(vi) provides a special rule for converting a variable interest crediting rate to a fixed rate for purposes of determining plan benefits in the case of a terminating applicable defined benefit plan.

Section 411(b)(5)(C) provides that a plan is not treated as failing to meet the requirements of section 411(b)(1)(H)(i) solely because the plan provides offsets against benefits under the plan to the extent the offsets are allowable in applying the requirements of section 401(a). Section 411(b)(5)(D) provides that a plan is not treated as failing to meet the requirements of section 411(b)(1)(H) solely because the plan provides a disparity in contributions or benefits with respect to which the requirements of section 401(l) (relating to permitted disparity for Social Security benefits and related matters) are met.

Section 411(b)(5)(E) provides that a plan is not treated as failing to meet the requirements of section 411(b)(1)(H) solely because the plan provides for indexing of accrued benefits under the plan. Under section 411(b)(5)(E)(iii), indexing means the periodic adjustment of the accrued benefit by means of the application of a recognized investment index or methodology. Section 411(b)(5)(E)(ii) requires that, except in the case of a variable annuity, the indexing not result in a smaller benefit than the accrued benefit determined without regard to the indexing.

Section 701(a) of PPA '06 added provisions to the Employee Retirement Income Security Act of 1974, Public Law 93-406

(88 Stat. 829) (ERISA), that are parallel to the above-described sections of the Code that were added by section 701(b) of PPA '06. The guidance provided in these proposed regulations with respect to the Code would also apply for purposes of the parallel amendments to ERISA made by section 701(a) of PPA '06.¹

Section 701(c) of PPA '06 added provisions to the Age Discrimination in Employment Act of 1967, Public Law 90-202 (81 Stat. 602) (ADEA), that are parallel to section 411(b)(5) of the Code. Executive Order 12067 requires all Federal departments and agencies to advise and offer to consult with the Equal Employment Opportunity Commission (EEOC) during the development of any proposed rules, regulations, policies, procedures or orders concerning equal employment opportunity. The IRS and the Treasury Department have consulted with the EEOC prior to the issuance of these proposed regulations.

Section 701(d) of PPA '06 provides that nothing in the amendments made by section 701 should be construed to create an inference concerning the treatment of applicable defined benefit plans or conversions of plans into applicable defined benefit plans under section 411(b)(1)(H), or concerning the determination of whether an applicable defined benefit plan fails to meet the requirements of section 411(a)(2), 411(c), or 417(e) as in effect before such amendments solely because the present value of the accrued benefit (or any portion thereof) of any participant is, under the terms of the plan, equal to the amount expressed as the balance in a hypothetical account or as an accumulated percentage of the participant's final average compensation.

Section 701(e) of PPA '06 sets forth the effective date provisions with respect to amendments made by section 701 of PPA '06. Section 701(e)(1) specifies that the amendments made by section 701 generally apply to periods beginning on or after June 29, 2005. Thus, the age discrimination safe harbors under section 411(b)(5)(A) and section 411(b)(5)(E) are effective for periods beginning on or after June 29, 2005. Section 701(e)(2) provides that the special present value rules

¹ Under section 101 of Reorganization Plan No. 4 of 1978 (43 FR 47713), the Secretary of the Treasury has interpretive jurisdiction over the subject matter addressed by these proposed regulations for purposes of ERISA, as well as the Code.

of section 411(a)(13)(A) are effective for distributions made after August 17, 2006.

Under section 701(e)(3) of PPA '06, in the case of a plan in existence on June 29, 2005, the 3-year vesting rule under section 411(a)(13)(B) and the market rate of return limitation under section 411(b)(5)(B)(i) are generally effective for years beginning after December 31, 2007. In the case of a plan not in existence on June 29, 2005, those sections are effective for periods beginning on or after June 29, 2005. Section 701(e)(4) of PPA '06 contains special effective date provisions for collectively bargained plans that modify these effective dates.

Under section 701(e)(5) of PPA '06, sections 411(b)(5)(B)(ii), (iii), and (iv) apply to a conversion amendment that is adopted after, and takes effect after, June 29, 2005.

Section 702 of PPA '06 provides for regulations to be prescribed by August 16, 2007, addressing the application of rules set forth in section 701 of PPA '06 where the conversion of a defined benefit pension plan into an applicable defined benefit plan is made with respect to a group of employees who become employees by reason of a merger, acquisition, or similar transaction.

Proposed regulations (EE-184-86, 1988-1 C.B. 881) under sections 411(b)(1)(H) and 411(b)(2) were published by the Treasury Department and the IRS in the Federal Register on April 11, 1988 (53 FR 11876), as part of a package of regulations that also included proposed regulations under sections 410(a), 411(a)(2), 411(a)(8), and 411(c) (relating to the maximum age for participation, vesting, normal retirement age, and actuarial adjustments after normal retirement age, respectively).²

Notice 96-8, 1996-1 C.B. 359, see §601.601(d)(2)(ii)(b) of this chapter, described the application of sections 411 and 417(e) to a single sum distribution under a cash balance plan where interest credits under the plan are frontloaded (that is, where future interest credits to an employee's hypothetical account balance are not conditioned upon future service and thus accrue at the same time that the

benefits attributable to a hypothetical allocation to the account accrue). Under the analysis set forth in Notice 96-8, in order to comply with sections 411(a) and 417(e) in calculating the amount of a single sum distribution under a cash balance plan, the balance of an employee's hypothetical account must be projected to normal retirement age and converted to an annuity under the terms of the plan, and then the employee must be paid at least the present value of the projected annuity, determined in accordance with section 417(e). Under that analysis, where a cash balance plan provides frontloaded interest credits using an interest rate that is higher than the section 417(e) applicable interest rate, payment of a single sum distribution equal to the current hypothetical account balance as a complete distribution of the employee's accrued benefit may result in a violation of section 417(e) or a forfeiture in violation of section 411(a). In addition, Notice 96-8 proposed a safe harbor which provided that, if frontloaded interest credits are provided under a plan at a rate no greater than the sum of identified standard *indices* and associated margins, no violation of section 411(a) or 417(e) would result if the employee's entire accrued benefit is distributed in the form of a single sum distribution equal to the employee's hypothetical account balance, provided the plan uses appropriate annuity conversion factors. Since the issuance of Notice 96-8, four federal appellate courts have followed the analysis set out in the Notice: *Esden v. Bank of Boston*, 229 F.3d 154 (2d Cir. 2000), *cert. dismissed*, 531 U.S. 1061 (2001); *West v. AK Steel Corp. Ret. Accumulation Pension Plan*, 484 F.3d 395 (6th Cir. 2007), *reh'g and reh'g en banc denied*, No. 06-3442, 2007 U.S. App. LEXIS 20447 (6th Cir. Aug. 8, 2007); *Berger v. Xerox Corp. Ret. Income Guarantee Plan*, 338 F.3d 755 (7th Cir. 2003), *reh'g and reh'g en banc denied*, No. 02-3674, 2003 U.S. App. LEXIS 19374 (7th Cir. Sept. 15, 2003); *Lyons v. Georgia-Pacific Salaried Employees Ret. Plan*, 221 F.3d 1235 (11th Cir. 2000), *cert. denied*, 532 U.S. 967 (2001).

Notice 2007-6, 2007-3 I.R.B. 272 (January 16, 2007), see §601.601(d)(2)(ii)(b) of this chapter, provides transitional guidance with respect to certain requirements of sections 411(a)(13) and 411(b)(5) and section 701(b) of PPA '06. Notice 2007-6 includes certain special definitions, including: *accumulated benefit*, which is defined as a participant's benefit accrued to date under a plan; *lump sum-based plan*, which is defined as a defined benefit plan under the terms of which the accumulated benefit of a participant is expressed as the balance of a hypothetical account maintained for the participant or as the current value of the accumulated percentage of the participant's final average compensation; and *statutory hybrid plan*, which is a lump sum-based plan or a plan which has an effect similar to a lump sum-based plan. Notice 2007-6 provides guidance on a number of issues, including a rule under which a plan that provides for indexed benefits described in section 411(b)(5)(E) is a statutory hybrid plan (because it has an effect similar to a lump sum-based plan), unless the plan either solely provides for post-retirement adjustment of the amounts payable to a participant or is a variable annuity plan under which the assumed interest rate used to determine adjustments is at least 5 percent. The notice provides a safe harbor for applying the rules set forth in section 701 of PPA '06 where the conversion of a defined benefit pension plan into an applicable defined benefit plan is made with respect to a group of employees who become employees by reason of a merger, acquisition, or similar transaction. This transitional guidance, along with other guidance provided in Part III of Notice 2007-6, applies pending the issuance of further guidance and, thus, will cease to apply when these regulations are finalized and become effective.

Explanation of Provisions

Overview

In general, these proposed regulations would incorporate the transitional

² On December 11, 2002, the Treasury Department and the IRS issued proposed regulations regarding the age discrimination requirements of section 411(b)(1)(H) that specifically addressed cash balance plans as part of a package of regulations that also addressed section 401(a)(4) nondiscrimination cross-testing rules applicable to cash balance plans (67 FR 76123). The 2002 proposed regulations were intended to replace the 1988 proposed regulations. In Ann. 2003-22, 2003-1 C.B. 847, see §601.601(d)(2)(ii)(b) of this chapter, the Treasury Department and the IRS announced the withdrawal of the 2002 proposed regulations under section 401(a)(4), and in Ann. 2004-57, 2004-2 C.B. 15, see §601.601(d)(2)(ii)(b) of this chapter, the Treasury Department and the IRS announced the withdrawal of the 2002 proposed regulations relating to age discrimination.

guidance provided under Notice 2007-6. However, the proposed regulations would utilize new terminology (such as statutory hybrid benefit formula and lump sum-based benefit formula) to take into account situations where plans provide more than one benefit formula. These proposed regulations would also provide additional guidance with respect to sections 411(a)(13) and 411(b)(5), taking into account comments received in response to Notice 2007-6.

Section 411(a)(13): Special vesting rules for applicable defined benefit plans and applicable definitions

The proposed regulations would reflect new section 411(a)(13)(A) by providing that an applicable defined benefit plan does not violate the requirements of section 411(a)(2), or the requirements of section 411(c) or 417(e), with respect to a participant's accrued benefit derived from employer contributions, merely because the plan determines the present value of benefits determined under a lump sum-based benefit formula as the amount of the hypothetical account maintained for the participant or as the current value of the accumulated percentage of the participant's final average compensation under that formula. However, section 411(a)(13) does not alter the definition of an accrued benefit under section 411(a)(7)(A) (which generally defines a participant's accrued benefit as the annual benefit commencing at normal retirement age), nor does it alter the definition of a normal retirement benefit under section 411(a)(9) (which generally defines a participant's normal retirement benefit as the benefit under the plan commencing at normal retirement age).

Section 411(b)(5)(G) provides that, for purposes of section 411(b)(5), any reference to the accrued benefit means the benefit accrued to date. The proposed regulations refer to this as the accumulated benefit, which is distinct from the participant's accrued benefit under section 411(a)(7) (an annuity beginning at normal retirement age that is actuarially equivalent to the participant's accumulated benefit).

The regulations define a lump sum-based benefit formula as a benefit formula used to determine all or any part

of a participant's accumulated benefit under which the benefit provided under the formula is expressed as the balance of a hypothetical account maintained for the participant or as the current value of the accumulated percentage of the participant's final average compensation. Under the proposed regulations, whether a benefit formula is a lump sum-based benefit formula would be determined based on how the accumulated benefit of a participant is expressed under the terms of the plan, and would not depend on whether the plan provides an optional form of benefit in the form of a single sum payment. Similarly, a formula would not fail to be a lump sum-based benefit formula merely because the plan's terms state that the accrued benefit is an annuity at normal retirement age that is actuarially equivalent to a hypothetical account balance. In addition, the regulations would provide that a participant is not treated as having a lump sum-based benefit formula merely because the participant is entitled to a benefit under a defined benefit plan that is not less than the benefit properly attributable to after-tax employee contributions.

Section 411(a)(13)(A) applies only with respect to a benefit provided under a lump sum-based benefit formula. Accordingly, if the present value rules of section 417(e) apply to a form of benefit under a plan and the plan provides benefits under a benefit formula that is not a lump sum-based benefit formula (including, for example, a plan that provides for indexing as described in section 411(b)(5)(E)), then the plan must set forth a methodology to determine the projected benefit under that formula at normal retirement age for purposes of applying the rules of section 417(e), as described in the "Analysis" section of Notice 96-8.

The proposed regulations use the term *statutory hybrid benefit formula* to describe the portion of a defined benefit plan that is an applicable defined benefit plan described in section 411(a)(13)(C)(i) or the portion of the plan that has a similar effect. Specifically, the proposed regulations would define a statutory hybrid benefit formula as a benefit formula that is either a lump sum-based benefit formula or a formula that has an effect similar to a lump sum-based benefit formula. For this purpose, under the proposed regulations, a benefit formula under a defined

benefit plan has an effect similar to a lump sum-based benefit formula if the formula provides that a participant's accrued benefit payable at normal retirement age (or at benefit commencement, if later) is expressed as a benefit that includes periodic adjustments (including a formula that provides for indexed benefits described in section 411(b)(5)(E)) that are reasonably expected to result in a smaller annual benefit at normal retirement age (or at commencement of benefits, if later) for the participant, when compared to a similarly situated, younger individual who is or could be a participant in the plan. Thus, a benefit formula under a plan has an effect similar to a lump sum-based benefit formula if the right to future adjustments accrues at the same time as the benefit that is subject to the adjustments.

The proposed regulations would set forth certain additional rules that are used in determining whether a benefit formula has an effect similar to a lump sum-based benefit formula. For example, the proposed regulations provide that a benefit formula that does not include periodic adjustments is treated as a formula with an effect similar to a lump sum-based benefit formula if the formula is otherwise described in the preceding paragraph and the adjustments are provided pursuant to a pattern of repeated plan amendments. See §1.411(d)-4, A-1(c)(1). The proposed regulations would provide that, for purposes of determining whether a benefit formula has an effect similar to a lump sum-based benefit formula, indexing that applies to adjust benefits after the annuity starting date (for example, cost-of-living increases) is disregarded. In addition, the proposed regulations would provide that a benefit formula under a defined benefit plan that provides for a benefit properly attributable to after-tax employee contributions does not have an effect similar to a lump sum-based benefit formula. The proposed regulations would also provide that adjustments under a variable annuity do not have an effect similar to a lump sum-based benefit formula if the assumed interest rate used to determine the adjustments is at least 5 percent. Such an annuity does not have an effect similar to a lump sum-based benefit formula even if post-annuity starting date adjustments are made using a specified assumed interest rate that is less than 5 percent.

Pursuant to new section 411(a)(13)(B), the proposed regulations would provide that, in the case of a participant whose accrued benefit (or any portion thereof) under a defined benefit plan is determined under a statutory hybrid benefit formula, the plan is not treated as meeting the requirements of section 411(a)(2) unless the plan provides that the participant has a nonforfeitable right to 100 percent of the participant's accrued benefit if the participant has 3 or more years of service. This requirement would apply on a participant-by-participant basis and would apply to the participant's entire benefit (not just the portion of the participant's benefit that is determined under a statutory hybrid benefit formula). Furthermore, if the participant is entitled to the greater of two benefits under a plan, one of which is a benefit calculated under a statutory hybrid benefit formula, the proposed regulations would provide that the 3-year vesting requirement applies to that participant even if the participant's benefit under the statutory hybrid benefit formula is ultimately smaller than under the other formula. The proposed regulations do not address how the 3-year vesting requirement applies in the case of floor-offset arrangements.³ See the discussion in this preamble under the heading "Comments and Requests for Public Hearing."

Section 411(b)(5): Safe harbor for age discrimination, conversion protection, and market rate of return limitation

A. Safe harbor for age discrimination

The proposed regulations under new section 411(b)(5)(A) would provide that a plan is not treated as failing to meet the requirements of section 411(b)(1)(H)(i) with respect to certain benefit formulas if, as determined as of any date, a participant's accumulated benefit expressed under one of those formulas would not be less than any similarly situated, younger participant's accumulated benefit expressed under the same formula. A plan that does not satisfy this test is required to satisfy the general nondiscrimination test of section 411(b)(1)(H)(i).

Under the proposed regulations, the safe harbor standard for satisfying section 411(b)(5)(A) would be available only where a participant's accumulated benefit under the terms of the plan is expressed as an annuity payable at normal retirement age (or current age, if later), the balance of a hypothetical account, or the current value of the accumulated percentage of the employee's final average compensation. For this purpose, if the accumulated benefit of a participant is expressed as an annuity payable at normal retirement age (or current age, if later) under the plan terms, then the comparison of benefits is made using such an annuity. If the accumulated benefit of a participant is expressed under the plan terms as the balance of a hypothetical account or the current value of an accumulated percentage of the participant's final average compensation, then the comparison of benefits is made using the balance of a hypothetical account or the current value of the accumulated percentage of the participant's final average compensation, respectively.

The proposed regulations would require a comparison of the accumulated benefit of each possible participant in the plan to the accumulated benefit of each other similarly situated, younger individual who is or could be a participant in the plan. For this purpose, the proposed regulations would provide that an individual is similarly situated to another individual if the individual is identical to that other individual in every respect that is relevant in determining a participant's benefit under the plan (including but not limited to period of service, compensation, position, date of hire, work history, and any other respect) except for age.⁴ In determining whether an individual is similarly situated to another individual, any characteristic that is relevant for determining benefits under the plan and that is based directly or indirectly on age is disregarded. For example, if a particular benefit formula applies to a participant on account of the participant's age, an individual to whom the benefit formula does not apply and who is identical to a participant in all respects other than age is similarly situated to the participant. By contrast, an individual is not similarly situated to a participant

if a different benefit formula applies to the individual and the application of the different formula is based neither directly nor indirectly on age.

The comparison of accumulated benefits is made without regard to any subsidized portion of any early retirement benefit that is included in a participant's accumulated benefit. For this purpose, the subsidized portion of an early retirement benefit is the retirement-type subsidy within the meaning of §1.411(d)-3(g)(6) that is contingent on a participant's severance from employment and commencement of benefits before normal retirement age.

In addition, the comparison of accumulated benefits generally must be made using the same form of benefit. Thus, the safe harbor is not available for comparing the accumulated benefit of a participant expressed as an annuity at normal retirement age with the accumulated benefit of a similarly situated, younger participant expressed as a hypothetical account balance. Nevertheless, the proposed regulations would permit a plan that provides the sum of benefits that are expressed in two or more different forms of benefit to satisfy the safe harbor if the plan would separately satisfy the safe harbor for each separate form of benefit. Similarly, the proposed regulations would permit a plan that provides the greater of benefits that are expressed in two or more different forms of benefit to satisfy the safe harbor if the plan would separately satisfy the safe harbor for each separate form of benefit. For this purpose, a similarly situated, younger participant is treated as having an accumulated benefit of zero with respect to a benefit formula that does not apply to the participant. Thus, the safe harbor would be available if an older participant is entitled to benefits under more than one type of benefit formula, even if not all of those types of benefit formulas are available to every similarly situated participant who is younger.

The proposed regulations would reflect new section 411(b)(5)(C), which provides that a plan is not treated as failing to meet the requirements of section 411(b)(1)(H) solely because the plan provides offsets of benefits under the plan to the extent such offsets are allowable in applying

³ See Rev. Rul. 76-259, 1976-2 C.B. 111, see §601.601(d)(2)(ii)(b) of this chapter, for certain standards applicable to floor-offset arrangements.

⁴ For example, if a plan provides for an election extended to all participants that affects a participant's accumulated benefit, then someone who makes such an election is similarly situated to a participant who makes such an election, and someone who does not make an election is similarly situated to a participant who does not make such an election.

the requirements under section 401 and the applicable requirements of the Employee Retirement Income Security Act of 1974, Public Law 93-406 (88 Stat. 829) (ERISA) and the Age Discrimination in Employment Act of 1967, Public Law 90-202 (81 Stat. 602) (ADEA). The proposed regulations incorporate the provisions of section 411(b)(5)(D) (relating to permitted disparity under section 401(I)) without providing additional guidance.

The proposed regulations would reflect new section 411(b)(5)(E), which provides for the disregard of certain indexing of benefits for purposes of the age discrimination rules of section 411(b)(1)(H). The proposed regulations limit the disregard of indexing to formulas under defined benefit plans other than lump sum-based formulas. In addition, the proposed regulations limit the disregard of indexing to situations in which the extent of the indexing for a participant would not be less than the indexing applicable to a similarly situated, younger participant. Thus, the disregard of indexing is only available if the indexing is neither terminated nor reduced on account of the attainment of any age.

Section 411(b)(5)(E) requires that the indexing methodology be a recognized methodology. The proposed regulations would treat only the following indexing methodologies as recognized for this purpose: indexing using an eligible cost-of-living index as described in §1.401(a)(9)-6, A-14(b); indexing using the rate of return on the aggregate assets of the plan; and indexing using the rate of return on the annuity contract for the employee issued by an insurance company licensed under the laws of a State.

Under the proposed regulations, the section 411(b)(5)(E)(ii) protection against loss (“no-loss”) requirement for an indexed plan (which provides that the indexing not result in a smaller accrued benefit) would be implemented by applying the “preservation of capital” rule of section 411(b)(5)(B)(i)(II) to indexed plans. (The preservation of capital rule is discussed in this preamble paragraph heading “C. Market rate of return limitation.”) For this purpose, the exemption from the application of the no-loss rule for variable annuities would be limited to situations in which the variable annuity adjustment is based on the rate of return on the aggregate assets of the plan or the annuity

contract. Thus, the exemption from the application of the no-loss rule would not apply if the variable annuity adjustment is based on the rate of return of a portion of the assets of the plan. In addition, this exemption would also apply for purposes of the preservation of capital requirement that applies to statutory hybrid plans.

B. Conversion protection

The regulations would provide guidance on the new conversion protections under section 411(b)(5)(B)(ii), (iii), and (iv). Under the proposed regulations, a participant whose benefits are affected by a conversion amendment which occurred after June 29, 2005, must generally be provided with a benefit after the conversion that is at least equal to the sum of the benefits accrued through the date of the conversion and benefits earned after the conversion, with no permitted interaction between these two portions. This would assure participants that there will be no “wear-away” as a result of a conversion, both with respect to the participant’s accrued benefits and any early retirement subsidy to which the participant is entitled based on the pre-conversion benefits.

The proposed regulations would provide an alternative mechanism under which the plan provides for the establishment of an opening hypothetical account balance as part of the conversion and keeps separate track of (1) The opening hypothetical account balance and interest credits attributable thereto, and (2) The post-conversion hypothetical contributions and interest credits attributable thereto. Under this alternative, the plan must provide that, when a participant commences benefits, the plan will determine whether the benefit attributable to the opening hypothetical account payable in the particular optional form of benefit selected is greater than or equal to the benefit accrued under the plan prior to the date of conversion and payable in the same generalized optional form of benefit (within the meaning of §1.411(d)-3(g)(8)) at the same annuity starting date. For example, if a participant elects a straight life annuity payable at age 60, the plan must determine if the straight life annuity payable at age 60 that is attributable to the opening hypothetical account balance is greater than or equal to the straight life annuity

payable at age 60 based on service prior to the conversion and determined under the terms of the pre-conversion plan. If the benefit attributable to the opening hypothetical account balance is greater, then the plan must provide that such benefit is paid in lieu of the pre-conversion benefit together with the benefit attributable to post-conversion contribution credits. If the benefit attributable to the opening hypothetical account balance is less, then the plan must provide that such benefit will be increased sufficiently to provide the pre-conversion benefit. In such a case, the participant must also be entitled to the benefit attributable to post-conversion contribution credits.

The proposed regulations would provide that, if an optional form of benefit is available on the annuity starting date with respect to the benefit attributable to the opening hypothetical account balance or opening accumulated percentage, but no optional form within the same generalized optional form of benefit was available at that annuity starting date under the terms of a plan as in effect immediately prior to the effective date of the conversion amendment, then the comparison must still be made by assuming that the pre-conversion plan had such an optional form of benefit. For example, if the pre-conversion plan did not provide for a single sum distribution option, the alternative would require that any single sum distribution option that is attributable to the opening hypothetical account balance be greater than or equal to the present value of the pre-conversion benefit, where present value is determined in accordance with section 417(e).

The IRS and the Treasury Department are seeking comments on another alternative means of satisfying the conversion requirements that would involve establishing an opening hypothetical account balance, but in limited situations would not require the subsequent comparison. Any such alternative would be permitted only if it were designed to provide adequate protection to participants in plans that adopt conversion amendments. For example, such an alternative might be limited to situations in which the participant elects a single sum distribution, and where the pre-conversion plan either did not provide a single sum option or had a single sum option that was based on the benefit payable at normal retirement age

(rather than the benefit payable at early retirement age). In those situations, the alternative might provide that the comparison is not necessary if (1) The opening hypothetical account balance is equal to the present value of the pre-conversion benefit determined in accordance with section 417(e), (2) The interest credits on the opening hypothetical account balance are reasonably expected to be no lower than the interest rate used to determine the opening hypothetical account balance, and (3) Either the plan provides a death benefit equal to the hypothetical account balance or no pre-retirement mortality decrement is applied in establishing the opening hypothetical account balance. Such an alternative could result in a single sum distribution attributable to the pre-conversion benefit that is lower, or higher, than the present value of the pre-conversion benefit, depending on whether the actual interest credits applicable to the opening hypothetical account balance during the interim are lower, or higher, than the interest rate used in determining the opening hypothetical account balance and whether the applicable interest rate and applicable mortality table under section 417(e)(3) have changed in the interim.

The proposed regulations also would provide guidance on what constitutes a conversion amendment under section 411(b)(5)(B)(v). Under the proposed regulations, whether an amendment is a conversion amendment is determined on a participant-by-participant basis. The proposed regulations would provide that an amendment (or amendments) is a conversion amendment with respect to a participant if it meets two criteria: (1) The amendment reduces or eliminates the benefits that, but for the amendment, the participant would have accrued after the effective date of the amendment under a benefit formula that is not a statutory hybrid benefit formula and under which the participant was accruing benefits prior to the amendment, and (2) After the effective date of the amendment, all or a portion of the participant's benefit accruals under the plan are determined under a statutory hybrid benefit formula.

The proposed regulations would provide that only amendments that reduce or eliminate accrued benefits described in section 411(a)(7), or retirement-type subsidies described in section 411(d)(6)(B)(i),

that would otherwise accrue as a result of future service are treated as amendments that reduce or eliminate the participant's benefits that would have accrued after the effective date of the amendment under a benefit formula that is not a statutory hybrid benefit formula. Under the proposed regulations, a plan is treated as having been amended for this purpose if, under the terms of the plan, a change in the conditions of a participant's employment results in a reduction or elimination of the benefits that the participant would have accrued in the future under a benefit formula that is not a statutory hybrid benefit formula (for example, a job transfer from an operating division covered by a non-statutory hybrid defined benefit plan to an operating division that is covered by a cash balance formula). However, in the absence of coordination between the formulas, the special requirements for conversion amendments typically will be satisfied automatically.

The proposed regulations would provide rules prohibiting the avoidance of the conversion protections through the use of multiple plans or multiple employers. Under the proposed regulations, an employer is treated as having adopted a conversion amendment if the employer adopts an amendment under which a participant's benefits under a plan that is not a statutory hybrid plan are coordinated with a separate plan that is a statutory hybrid plan, such as through a reduction (offset) of the benefit under the plan that is not a statutory hybrid plan. In addition, if an employee's employer changes as a result of a merger, acquisition, or other transaction described in §1.410(b)-2(f), then the two employers would be treated as a single employer for this purpose. Thus, for example, in an acquisition, if the buyer adopts an amendment to its statutory hybrid plan under which a participant's benefits under the seller's plan (that is not a statutory hybrid plan) are coordinated with benefits under the buyer's plan, such as through a reduction (offset) of the buyer's plan benefits, the seller and buyer would be treated as a single employer and as having adopted a conversion amendment. However, if there is no coordination between the plans, there is no conversion amendment.

The proposed regulations would provide that a conversion amendment also includes multiple amendments that result

in a conversion amendment, even if the amendments would not be conversion amendments individually. Under the proposed regulations, if an amendment to provide a benefit under a statutory hybrid benefit formula is adopted within 3 years after adoption of an amendment to reduce non-statutory hybrid benefit formula benefits, then those amendments would be consolidated in determining whether a conversion amendment has been adopted. In the case of an amendment to provide a benefit under a statutory hybrid benefit formula that is adopted more than 3 years after adoption of an amendment to reduce non-statutory hybrid benefit formula benefits, there would be a presumption that the amendments are not consolidated unless the facts and circumstances indicate that adoption of an amendment to provide a statutory hybrid benefit formula was intended at the time of the reduction in the non-statutory hybrid benefit formula.

The proposed regulations would provide that the effective date of a conversion amendment is, with respect to a participant, the date as of which the reduction occurs of the benefits that the participant would have accrued after the effective date of the amendment under a benefit formula that is not a statutory hybrid benefit formula. In accordance with section 411(d)(6), the proposed regulations would provide that the date of a reduction of those benefits cannot be earlier than the date of adoption of the conversion amendment.

C. Market rate of return limitation

The proposed regulations would reflect the rule in section 411(b)(5)(B)(i)(I) under which a statutory hybrid plan is treated as failing to satisfy section 411(b)(1)(H) if it provides an interest crediting rate that is in excess of a market rate of return. The proposed regulations would define an interest crediting rate as the rate by which a participant's benefit is increased under the ongoing terms of a plan to the extent the amount of the increase is not conditioned on current service, regardless of how the amount of that increase is calculated. Thus, whether the amount is an interest credit for this purpose is determined without regard to whether the amount is calculated by reference to a rate of interest, a rate of return, an index, or otherwise.

The proposed regulations would require a plan to specify the timing for determining the plan's interest crediting rate that will apply for each plan year (or portion of a plan year) using one of two permitted methods — either pursuant to a daily interest crediting rate based on permissible interest crediting rates specified in the proposed regulations, or pursuant to a specified lookback month and stability period. For this purpose, the plan's lookback month and stability period must satisfy the rules for selecting the lookback month and stability period under §1.417(e)-1(d)(4). However, the stability period and lookback month need not be the same as those used under the plan for purposes of section 417(e)(3).

In addition, the proposed regulations would require a plan to specify the periodic (at least annual) frequency at which interest credits are made under the plan. If, under a plan, interest is credited more frequently than annually (for example, monthly or quarterly), then the interest credit for that period must be a *pro rata* portion of the annual interest credit. Thus, for example, in the case of a plan the terms of which provide for interest to be credited at an interest crediting rate that would be permitted under the proposed regulations, if the plan provides for monthly interest credits and if the interest rate for a plan year has a value of 6 percent, then the accumulated benefits at the beginning of each month would be increased by 0.5 percent per month during the plan year. The proposed regulations would provide that interest credits are not treated as creating an effective rate of return in excess of a market rate of return merely because an otherwise permissible interest crediting rate is compounded more frequently than annually.

The proposed regulations would provide that an interest crediting rate for a plan year is not in excess of a market rate of return if it is based on specified *indices*. As in Notice 2007-6, these include the safe harbor rates described in Notice 96-8, the interest rates on 30-Year Treasury securities, and the rate of interest on long-term investment grade corporate bonds (as described in section 412(b)(5)(B)(ii)(II) prior

to amendment by PPA '06 for plan years beginning before January 1, 2008, and the third-segment bond rate used under section 430 for subsequent plan years). For this purpose, the third-segment bond rate is permitted to be determined with or without regard to the transition rules of section 430(h)(2)(G).

These rates would be required to change on at least an annual basis.⁵ These rates are market yields to maturity on outstanding bonds and do not reflect the change in the market value of an outstanding bond as a result of future changes in the interest rate environment or in a bond issuer's risk profile.⁶ As noted in the preceding paragraph, the proposed rules generally are similar to those described in Notice 2007-6 but do not provide guidance on a number of issues related to market rate of return. It is expected that these issues will be addressed in the first part of 2008.

The proposed regulations would reflect the preservation of capital rule in section 411(b)(5)(B)(i)(II) that requires a statutory hybrid plan to provide that interest credits will not result in a hypothetical account balance (or similar amount) being less than the aggregate amount of the hypothetical allocations. Under the proposed regulations, this requirement would be applied at the participant's annuity starting date. In addition, the proposed regulations would provide that the combination of this preservation of capital protection with a rate of return which otherwise satisfies the market rate of return limitation will not result in an effective interest crediting rate that is in excess of a market rate of return.

While the second sentence of section 411(b)(5)(B)(i)(I) provides that a statutory hybrid plan is not treated as having an above-market rate merely because the plan provides for a reasonable minimum guaranteed rate of return or for a rate of return that is equal to the greater of a fixed or variable rate of return, these proposed regulations do not provide guidance for these alternatives. Moreover, the presence of a preservation of capital requirement indicates that Congress considered that a rate of return that could be negative in some years (such as a rate of return on an equity portfolio) could be permissible. How-

ever, as discussed in the following paragraphs, the Treasury Department and the IRS have concerns that the use of a minimum guaranteed rate of return or the use of the greater of a fixed and a variable rate could result in effective interest crediting rates that are above market rates of return and are soliciting comments on how to avoid that result.

Some commentators have suggested that it should be acceptable for a plan to adopt a fixed interest crediting rate that would apply without regard to changes in the interest rate environment. This is particularly important where the plan provides for hypothetical contributions that increase with age or service and the plan needs a minimum interest crediting rate in order to satisfy the accrual rules of section 411(b). While this issue is reserved under these proposed regulations, the approach suggested by commentators could be accomplished in two different ways. Under one possibility, the regulations might set forth a specific interest crediting rate (such as 4 percent or 5 percent) that a plan may be permitted to use. Under an alternative approach, the regulations might set forth a permitted methodology under which a plan would be permitted to establish a fixed interest crediting rate based on the then-applicable level of a permissible rate, such as the 3rd segment rate. For example, if the 3rd segment rate were 5.5 percent at the time the fixed rate is established under the plan, then under the alternative approach the plan might be permitted to fix the interest crediting rate at 5.5 percent. Comments are requested on these alternatives. In particular, comments are requested as to rules that the regulations could set forth that would avoid the potential for the fixed rate to be established at a time when interest rates are unusually high, such as occurred in the early 1980s.

With respect to the option for a plan to use an interest crediting rate that is the greater of a fixed or variable interest rate, the Treasury Department and the IRS believe that the interaction between the two interest rates must be taken into account in determining whether the effective interest crediting rate under a plan which provides an interest crediting rate that is equal to the

⁵ The requirement that an interest crediting rate change not less frequently than annually is intended to distinguish these rates from fixed rates, which are discussed later in this preamble. See also §31.3121(v)(2)-1(d)(2)(i)(C)(2) of the Employment Tax Regulations, which permits a rate to be fixed for up to 5 years.

⁶ Because this interest rate does not reflect the change in the market value of an outstanding bond when an issuer becomes higher risk or the bond goes into default, the bonds have been limited to investment grade bonds in the top three quality levels where the risk of default is small.

greater of a fixed or variable interest rate is above a market rate of return. Whether a statutory hybrid plan that is providing interest credits based on the greater of a fixed or variable interest rate effectively provides an interest crediting rate that exceeds a market rate of return depends on a number of factors, including how high the fixed interest rate is, how frequently the “greater of” determination is applied, and the volatility of the variable interest rate.

As noted earlier, the proposed regulations would provide that including the preservation of capital rule does not cause the plan’s effective interest crediting rate to be in excess of a market rate of return. This rule reflects the fact that the minimum rate under the preservation of capital rule is an interest rate of 0 percent which is applied on a one-time basis at the annuity starting date, and is premised on the expectation that the variable rate would rarely be negative for extended periods of time (so that the inclusion of the capital preservation rule should not significantly increase the effective rate of return under the plan). If the variable rate is the rate of interest on bonds that would be permitted under the proposed regulations, then that expectation is easily met.

By contrast, if the variable interest rate is the rate of return on an equity investment, the expectation that the capital preservation rule does not significantly increase the effective interest crediting rate is only applicable if the equity investment is a well-diversified portfolio. This is because a well-diversified portfolio should have sufficiently limited volatility so that the inclusion of the preservation of capital rule should not significantly increase the effective rate of return resulting from interest credits that are based on that portfolio. Accordingly, if the regulations were to permit the use of an interest crediting rate based on an asset portfolio as an interest credit, the regulations might limit the choice of portfolio to the actual plan assets (relying on the fiduciary rules to ensure that the portfolio is adequately diversified). Of course, any such regulations would only permit the use of an interest crediting rate based on an asset portfolio if the use of such a rate is prospective and is selected before the period during which the rate is determined.

Comments are requested on what other asset portfolios have sufficiently con-

strained volatility that they should be permitted to form the basis of a market rate of return for interest crediting under a statutory hybrid plan and whether it is appropriate to base an interest crediting rate on the value of an index. For example, are the assets under a regulated investment company (RIC) described in section 851 sufficiently diversified such that a statutory hybrid plan will not be treated as providing an effective interest crediting rate in excess of a market rate of return where it credits interest based on the rate of return on the RIC and also provides for the preservation of capital (as required for a statutory hybrid plan under section 411(b)(5)(B)(i)(II))? Similarly, if a statutory hybrid plan credits interest based on the rate of return on an equity index that is not a narrow-based equity index (as defined under section 3(a)(55) of the Securities Exchange Act of 1934) and which also provides for the preservation of capital, is the plan providing an interest crediting rate that is not in excess of a market rate of return?

If the determination of the greater of a fixed interest crediting rate and a variable interest crediting rate is made more frequently than required to comply with the capital preservation rule, the added frequency is more likely to result in an effective interest crediting rate that is in excess of a market rate of return. For example, if a statutory hybrid plan were to credit interest each day based on the greater of the actual rate of return on the plan assets for that day or 0 percent, the effective interest crediting rate would be far in excess of a market rate of return.

The Treasury Department and the IRS are considering providing that a plan will not have an effective interest crediting rate in excess of a market rate of return merely because it provides annual interest credits based on the greater of a reasonable fixed rate (such as 3 percent or 4 percent) and one of the rates of interest set forth in the proposed regulations. However, if a statutory hybrid plan were to provide interest credits based on the greater of a fixed rate (including a fixed rate of 0 percent) and the rate of return on plan assets or the value of an equity-based index, determined on an annual basis, then the effective interest crediting rate would typically be in excess of a market interest rate. Comments are requested on what types of reductions to

the variable rate would be appropriate in order to ensure that the effective interest crediting rate under these situations does not exceed a market rate of return. In addition, comments are requested on whether regulations should establish reductions in these situations where the determination of whether the fixed or variable interest crediting rate is greater is made more frequently than annually.

Pending issuance of guidance addressing this issue, plan sponsors should be cautious in adopting interest crediting rates other than those explicitly permitted in these proposed regulations. If such a rate were adopted, and it did not satisfy the requirement not to be in excess of a market rate of return under rules provided in future guidance, the rate would have to be reduced in order to satisfy the requirement.

The proposed regulations would provide that, to the extent that interest credits (or equivalent amounts) have accrued under the terms of a statutory hybrid plan, section 411(d)(6) is violated by a plan amendment that changes the interest crediting rate if the revised rate under any circumstances could result in a lower rate of return after the applicable amendment date of the plan amendment. An exception is provided that would permit certain changes in a plan’s interest crediting rate without violating section 411(d)(6). Under this exception, the proposed regulations would permit an amendment to change the plan’s interest crediting rate for future periods from the safe harbor market rates of interest (for example, rates based on eligible cost-of-living *indices*, or rates based on Treasury bonds with the margins specified in the proposed regulations) to the rate of interest on long-term investment grade corporate bonds. Such a change would not constitute a reduction in accrued benefits in violation of section 411(d)(6) because it is expected that the change would result in a reduction only in rare and unusual circumstances, and the change would be permitted only if the amendment is effective not less than 30 days after adoption and, on the effective date of the amendment, the new interest crediting rate is not less than the interest crediting rate that would have applied in the absence of the amendment. In addition, the IRS and the Treasury Department may provide additional guidance regarding changes to

the ongoing interest crediting rate under a plan that would or would not constitute a reduction of accrued benefits in violation of section 411(d)(6).

Pension Equity Plans (PEPs)

These proposed regulations do not include any rules specifically relating to plans that are often referred to as pension equity plans, or PEPs (other than defining a participant's accumulated benefit under a PEP as the accumulated percentage of final average compensation). Notice 2007-6 requested comments on the application of qualification requirements other than sections 411(b)(1)(H) and 417(e) to such plans, including the treatment of interest credited with respect to terminated vested participants. See §601.601(d)(2)(ii)(b) of this chapter. The IRS and the Treasury Department have received a number of comments pursuant to this request. These comments indicate that, apart from determining the accumulated benefit as a percentage of final average compensation, this design often provides explicit or implicit interest credits by determining the normal retirement benefit to be: (1) The accumulated percentage of final average compensation divided by a deferred annuity factor (thus implicitly providing interest and mortality credits for deferred benefits); or (2) The lesser of (a) the current single sum benefit projected to normal retirement age and using an interest rate set forth in the plan or (b) the projected single sum benefit based on projected service to normal retirement age (taking into account the plan's formula for the accumulated percentage of final average compensation without salary increases), with the lesser of these two amounts converted to an annuity. The right to future interest credits under these designs is earned at the same time as the related percentage of final average compensation; however, the comments indicated that the interest typically commences only after active participation ceases.

The IRS and the Treasury Department will continue to evaluate comments received regarding PEPs and are focusing on the following questions in situations where

the interest credit is credited only after active participation ceases:

- Are these designs properly treated as plans under which the accrued benefit is expressed "as an accumulated percentage of the participant's final average compensation" within the meaning of section 411(a)(13)(A)? After the date on which interest credits commence, should these designs be treated as plans under which the accrued benefit is expressed "as the balance of a hypothetical account" within the meaning of section 411(a)(13)(A)?
- Do any of the designs in (1) or (2) of the preceding paragraph provide for a lower rate of accrual for additional years of service (because no interest is credited if service is continued)? See section 411(b)(1)(G). Alternatively, can this issue be avoided by treating the annual rate at which the normal retirement benefit accrues as declining with each additional year of service?
- How should the backloading rules of section 411(b)(1)(A)-(C) apply to these designs and do they raise issues on which comments were requested in Notice 2007-14, 2007-7 I.R.B. 501? See §601.601(d)(2)(ii)(b) of this chapter.

Section 1107 of PPA '06 and Code Section 411(d)(6)

Under section 1107 of PPA '06, a plan sponsor is permitted to delay adopting a plan amendment pursuant to statutory provisions under PPA '06 (or pursuant to any regulation issued under PPA '06) until the last day of the first plan year beginning on or after January 1, 2009 (January 1, 2011 in the case of governmental plans). As described in Rev. Proc. 2007-44, 2007-28 I.R.B. 54, this amendment deadline applies to both interim and discretionary amendments that are made pursuant to PPA '06 statutory provisions or any regulation issued under PPA '06. See §601.601(d)(2)(ii)(b) of this chapter. If section 1107 of PPA '06 applies to an

amendment of a plan, section 1107 provides that the plan does not fail to meet the requirements of section 411(d)(6) by reason of such amendment, except as provided by the Secretary of the Treasury.⁷

The IRS and the Treasury Department are considering whether relief from section 411(d)(6) should be provided for particular amendments that would be made pursuant to section 701 of PPA '06 or these proposed regulations. In the following provisions of this section of the preamble, the IRS and the Treasury Department have set forth a description of amendments that are and are not entitled to section 411(d)(6) relief. Comments are requested on whether section 411(d)(6) relief is or is not appropriate for any additional amendments related to section 701 of PPA '06 or these proposed regulations.

Until further guidance is provided by the IRS and the Treasury Department, section 411(d)(6) relief is not available for the following amendments that are described in section 1107 of PPA '06:

- A conversion amendment where the effective date of the reduction in benefits that a participant, but for the amendment, would have accrued under a benefit formula that is not a statutory hybrid benefit formula is earlier than the date of adoption of the reduction amendment.
- An amendment that reduces a participant's hypothetical account balance or accumulated percentage of final average compensation below the amount on the date the amendment is adopted.
- An amendment to change the interest crediting rate from one of the rates specified in Notice 96-8 using a margin that is less than or equal to the maximum margin for that rate to the same or another rate specified in Notice 96-8 with an associated margin where the excess (if any) of the maximum margin under the second rate over the margin used for that second rate exceeds the excess (if any) of the maximum margin under the first rate over the margin used for that first rate.

⁷ Except to the extent permitted under section 411(d)(6) and §§1.411(d)-3 and 1.411(d)-4, or under a statutory provision such as section 1107 of PPA '06, section 411(d)(6) prohibits a plan amendment that decreases a participant's accrued benefits or that has the effect of eliminating or reducing an early retirement benefit or retirement-type subsidy, or eliminating an optional form of benefit, with respect to benefits attributable to service before the amendment. However, an amendment that eliminates or decreases benefits that have not yet accrued does not violate section 411(d)(6), provided that the amendment is adopted and effective before the benefits accrue.

Until further guidance is provided by the IRS and the Treasury Department, section 411(d)(6) relief is available for the following amendments that are described in section 1107 of PPA '06:

- As provided in Notice 2007-6, in the case of a plan that provides for a single sum distribution to a participant that exceeds the participant's hypothetical account balance or accumulated percentage of final average compensation, the plan may be amended to eliminate the excess for distributions made after August 17, 2006. See §601.601(d)(2)(ii)(b) of this chapter.
- An amendment to change the interest crediting rate from one of the rates specified in Notice 96-8 using a margin that is less than or equal to the maximum margin for that rate to one of the other rates specified in Notice 96-8 with an associated margin where the excess (if any) of the maximum margin under the second rate over the margin used for that second rate does not exceed the excess (if any) of the maximum margin under the first rate over the margin used for that first rate.

These rules under section 1107 of PPA '06 will be reflected in future guidance on the market rate of return rules under section 411(b)(5)(B)(i). The IRS and the Treasury Department expect that section 411(d)(6) relief under section 1107 of PPA '06 will be available in the case of an amendment pursuant to that future guidance to change a plan's interest crediting rate (including credits on pre-August 18, 2006 accruals) from an interest rate that is above a market rate of return to an interest rate that constitutes a market rate of return, provided that any retroactive change in the crediting rate does not apply for periods before the date that section 411(b)(5)(B)(i) first applies to the plan. In addition, to the extent permitted under future guidance, the IRS and the Treasury Department expect that section 411(d)(6) relief under section 1107 of PPA '06 will be available in the case of an amendment to change the plan's interest crediting rate to a rate that is expected

to be higher than the plan's current rate (such as an amendment to change to an equity-based rate of return).

Effective/Applicability Dates

Pursuant to section 701(e)(1) of PPA '06, the amendments made by section 701 of PPA '06 are generally effective for periods beginning on or after June 29, 2005. However, sections 701(e)(2) through 701(e)(5) of PPA '06 set forth a number of special effective/applicability date rules that are described earlier in the Background section of the preamble of these proposed regulations.

These proposed regulations reflect the statutory effective dates set forth in section 701(e) of PPA '06. Thus, the proposed regulations would reflect that section 411(a)(13)(A) applies to distributions made after August 17, 2006. In addition, the proposed regulations would reflect that, in the case of a plan that is in existence on June 29, 2005, section 411(a)(13)(B) applies to plan years beginning on or after January 1, 2008. At the date of issuance of these proposed regulations, bills have been introduced in the House of Representatives and the Senate which provide that (1) section 411(a)(13)(B) only applies to a participant who performs at least one hour of service on or after the effective date of section 411(a)(13)(B) with respect to the plan, and (2) in the case of a plan other than a plan described in section 701(e)(3) or 701(e)(4) of PPA '06, section 411(a)(13)(B) applies to years ending on or after June 29, 2005.⁸ Proposed §1.411(a)(13)-1(e)(1)(iii)(A)(2) and §1.411(a)(13)-1(e)(1)(iii)(B)(2) have been reserved in order to accommodate these changes.

These regulations are proposed to be effective for plan years beginning on or after January 1, 2009 (or, if later, the date that applies to certain collectively bargained plans pursuant to section 701(e)(4) of PPA '06). For periods after the statutory effective date and before the regulatory effective date set forth in the preceding sentence, a plan must comply with sections 411(a)(13) and 411(b)(5). During these periods, a plan is permitted to rely on the provisions set forth in the proposed

regulations for purposes of satisfying the requirements of sections 411(a)(13) and 411(b)(5).

These regulations should not be construed to create any inference concerning the applicable law prior to the effective dates of sections 411(a)(13) and 411(b)(5). See also section 701(d) of PPA '06.

Special Analyses

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

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (one signed and eight (8) copies) or electronic comments that are submitted timely to the IRS.

The IRS and the Treasury Department specifically request comments on the clarity of the proposed regulations and how they may be made easier to understand.

In addition to the comments requested under the "Conversion protection" and "Market rate of return limitation" headings of this preamble (and in Part V of Notice 2007-6), comments are also requested on issues not addressed in these proposed regulations, including:

- The application of the 3-year vesting requirement in section 411(a)(13)(B) to a plan that is not a statutory hybrid plan when the plan is part of a floor-offset arrangement with a plan that includes a lump sum-based benefit formula.

⁸ H.R. 3361 (Aug. 3, 2007) and S. 1974 (Aug. 2, 2007), at section 8(3)(B)(iv).

- Whether guidance should be issued under section 411(b)(5) as to whether a characteristic is indirectly on account of age.
- Whether the age discrimination safe harbor in section 411(b)(5)(A) should be available in the case of any plan that does not express a participant's accumulated benefit as either an annuity payable at normal retirement age (or current age, if later), the balance of a hypothetical account, or the current value of the accumulated percentage of a participant's final average compensation.

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

Drafting Information

The principal authors of these regulations are Lauson C. Green and Linda S. F. Marshall, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and the Treasury Department participated in the development of these regulations.

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries as follows:

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

Section 1.411(a)(13)–1 also issued under 26 U.S.C. 411(a)(13).

Section 1.411(b)(5)–1 also issued under 26 U.S.C. 411(b)(5). * * *

Par. 2. Section 1.411(a)(13)–1 is added to read as follows:

§1.411(a)(13)–1 Statutory hybrid plans.

(a) *In general.* This section sets forth certain rules that apply to statutory hybrid plans under section 411(a)(13). Paragraph (b) of this section describes special rules for certain statutory hybrid plans that determine benefits under a lump sum-based benefit formula. Paragraph (c) of this section describes the vesting requirement for statutory hybrid plans. Paragraphs (d) and (e) of this section contain definitions and effective/applicability dates, respectively.

(b) *Calculation of benefit by reference to hypothetical account balance or accumulated percentage.* Pursuant to section 411(a)(13)(A), a statutory hybrid plan that determines any portion of a participant's benefits under a lump sum-based benefit formula is not treated as failing to meet the requirements of section 411(a)(2), or the requirements of section 411(c) or 417(e) with respect to the participant's accrued benefit derived from employer contributions, solely because, with respect to benefits determined under that formula, the present value of those benefits is, under the terms of the plan, equal to the balance of the hypothetical account maintained for the participant or to the current value of the accumulated percentage of the participant's final average compensation under that formula.

(c) *Three-year vesting requirement—(1) In general.* Pursuant to section 411(a)(13)(B), if any portion of the participant's accrued benefit under a defined benefit plan is determined under a statutory hybrid benefit formula, the plan is not treated as meeting the requirements of section 411(a)(2) unless the plan provides that the participant has a nonforfeitable right to 100 percent of the participant's accrued benefit if the participant has 3 or more years of service. Thus, this 3-year vesting requirement applies with respect to the entire accrued benefit of a participant under a defined benefit plan even if only a portion of the participant's accrued benefit under the plan is determined under a statutory hybrid benefit formula. Similarly, if the participant's accrued benefit under a defined benefit plan is, under the plan's terms, the larger of two (or more) benefit amounts, where each amount is determined under a different benefit formula (including a benefit determined pursuant to an offset among formulas within the

plan) and at least one of those formulas is a statutory hybrid benefit formula, the participant's entire accrued benefit under the defined benefit plan is subject to the 3-year vesting rule of section 411(a)(13)(B) and this paragraph (c). The rule described in the preceding sentence applies even if the larger benefit is ultimately the benefit determined under a formula that is not a statutory hybrid benefit formula.

(2) *Floor-offset arrangements involving a statutory hybrid plan.* [Reserved]

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

Example 1. Employer M sponsors Plan X, pursuant to which each participant's accrued benefit is equal to the sum of the benefit provided under two benefit formulas. The first benefit formula is a statutory hybrid benefit formula, and the second formula is not. Because a portion of each participant's accrued benefit provided under Plan X is determined under a statutory hybrid benefit formula, the 3-year vesting requirement described in paragraph (c)(1) of this section applies to each participant's entire accrued benefit provided under Plan X.

Example 2. The facts are the same as in *Example 1*, except that the benefit formulas described in *Example 1* only apply to participants for service performed in Division A of Employer M and a different benefit formula applies to participants for service performed in Division B of Employer M. Pursuant to the terms of Plan X, the accrued benefit of a participant attributable to service performed in Division B is equal to the benefit provided by a benefit formula that is not a statutory hybrid benefit formula. Therefore, the 3-year vesting requirement described in paragraph (c)(1) of this section does not apply to a participant with an accrued benefit under Plan X if the participant's benefit is solely attributable to service performed in Division B.

(d) *Definitions—(1) In general.* The definitions in this paragraph (d) apply for purposes of this section.

(2) *Lump sum-based benefit formula.* The term lump sum-based benefit formula means a lump sum-based benefit formula as defined in §1.411(b)(5)–1(e)(3).

(3) *Statutory hybrid benefit formula—(i) In general.* A statutory hybrid benefit formula means a benefit formula that is either a lump sum-based benefit formula or a formula that is not a lump sum-based benefit formula but that has an effect similar to a lump sum-based benefit formula.

(ii) *Effect similar to a lump sum-based benefit formula.* Except as provided in paragraph (d)(3)(iii) of this section, a benefit formula under a defined benefit plan that is not a lump sum-based benefit formula has an effect similar to

a lump sum-based benefit formula if the formula provides that a participant's accumulated benefit (within the meaning of §1.411(b)(5)–1(e)(2)) payable at normal retirement age (or benefit commencement, if later) is expressed as a benefit that includes the right to periodic adjustments (including a formula that provides for indexed benefits under §1.411(b)(5)–1(b)(2)) that are reasonably expected to result in a smaller annual benefit at normal retirement age (or benefit commencement, if later) for the participant than for a similarly situated, younger individual (within the meaning of §1.411(b)(5)–1(b)(5)) who is or could be a participant in the plan. A benefit formula that does not include periodic adjustments is treated as a formula with an effect similar to a lump sum-based benefit formula if the formula is otherwise described in the preceding sentence and the adjustments are provided pursuant to a pattern of repeated plan amendments. See §1.411(d)–4, A–1(c)(1).

(iii) *Exceptions—(A) Post-retirement benefit adjustments.* Post-annuity starting date adjustments of the amounts payable to a participant (such as cost-of-living increases) are disregarded in determining whether a benefit formula under a defined benefit plan has an effect similar to a lump sum-based benefit formula.

(B) *Certain variable annuity benefit formulas.* If the assumed interest rate used for purposes of the adjustment of amounts payable to a participant under a variable annuity benefit formula is at least 5 percent, then the adjustments under the variable annuity benefit formula are not treated as being reasonably expected to result in a smaller annual benefit at normal retirement age (or benefit commencement, if later) for the participant than for a similarly situated, younger individual (within the meaning of §1.411(b)(5)–1(b)(5)) who is or could be a participant in the plan, and thus such a variable annuity benefit formula does not have an effect similar to a lump sum-based benefit formula.

(C) *Contributory plans.* A benefit formula under a defined benefit plan that provides for a benefit equal to the benefit properly attributable to after-tax employee contributions does not have an effect similar to a lump sum-based benefit formula. See section 411(c)(2) for rules for deter-

mining benefits attributable to after-tax employee contributions.

(4) *Variable annuity benefit formula.* A variable annuity benefit formula means any benefit formula under a defined benefit plan which provides that the amount payable is periodically adjusted by reference to the difference between the rate of return of plan assets (or specified market indices) and a specified assumed interest rate.

(e) *Effective/applicability date—(1) Statutory effective/applicability date—(i) In general.* Except as provided in paragraphs (e)(1)(ii) and (e)(1)(iii) of this section, section 411(a)(13) applies for periods beginning on or after June 29, 2005.

(ii) *Calculation of benefits.* Section 411(a)(13)(A) applies to distributions made after August 17, 2006.

(iii) *Vesting—(A) Plans in existence on June 29, 2005—(1) General rule.* In the case of a plan that is in existence on June 29, 2005 (regardless of whether the plan is a statutory hybrid plan on that date), section 411(a)(13)(B) applies to plan years beginning on or after January 1, 2008.

(2) *Hour of service required.* [Reserved]

(3) *Exception for plan sponsor election.* See §1.411(b)(5)–1(f)(1)(iii)(A)(2) for a special election for early application of section 411(a)(13)(B).

(B) *Plans not in existence on June 29, 2005—(1) In general.* In the case of a plan not in existence on June 29, 2005, section 411(a)(13)(B) applies for periods beginning on or after June 29, 2005.

(2) *Hour of service required.* [Reserved]

(C) *Collectively bargained plans.* Notwithstanding paragraphs (e)(1)(iii)(A) and (B) of this section, in the case of a collectively bargained plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified on or before August 17, 2006, the requirements of section 411(a)(13)(B) do not apply for plan years beginning before the earlier of—

(1) The later of—

(i) The date on which the last of those collective bargaining agreements terminates (determined without regard to any extension thereof on or after August 17, 2006), or

(ii) January 1, 2008; or

(2) January 1, 2010.

(D) *Treatment of plans with both collectively bargained and non-collectively bargained employees.* In the case of a plan where a collective bargaining agreement applies to some, but not all, of the plan participants, the plan is considered a collectively bargained plan for purposes of paragraph (e)(1)(iii)(C) of this section if at least 25 percent of the participants in the plan are members of collective bargaining units for which the benefit levels under the plan are specified under a collective bargaining agreement.

(2) *Effective/applicability date of regulations.* This section applies for plan years beginning on or after January 1, 2009 (or, if later, the date applicable under paragraph (e)(1)(iii)(C) of this section). For the periods after the statutory effective date set forth in paragraph (e)(1) of this section and before the regulatory effective date set forth in the preceding sentence, a plan must comply with section 411(a)(13). During these periods, a plan is permitted to rely on the provisions of this section for purposes of satisfying the requirements of section 411(a)(13).

Par. 3. Section 1.411(b)(5)–1 is added to read as follows:

§1.411(b)(5)–1 Reduction in rate of benefit accrual under a defined benefit plan.

(a) *In general.* This section sets forth certain rules related to reduction in the rate of benefit accrual under a defined benefit plan. Paragraph (b) of this section describes certain plan design-based safe harbors (including statutory hybrid plans) that are deemed to satisfy the age discrimination rules under section 411(b)(1)(H). Paragraph (c) of this section describes rules relating to statutory hybrid plan conversion amendments. Paragraph (d) of this section describes rules restricting interest credits (or equivalent amounts) under a statutory hybrid plan to a market rate of return. Paragraphs (e) and (f) of this section contain definitions and effective/applicability dates, respectively.

(b) *Safe harbors for certain plan designs—(1) Accumulated benefit testing—(i) In general.* Pursuant to section 411(b)(5)(A), and subject to paragraph (b)(1)(ii) of this section, a plan is not treated as failing to meet the requirements

of section 411(b)(1)(H)(i) if, as of any date, the accumulated benefit of a participant would not be less than the accumulated benefit of any similarly situated, younger participant. This test requires a comparison of the accumulated benefit of each individual who is or could be a participant in the plan with the accumulated benefit of each other similarly situated, younger individual who is or could be a participant in the plan. See paragraph (b)(5) of this section for rules regarding whether each younger individual who is or could be a participant is similarly situated to a participant. The comparison described in this paragraph (b)(1)(i) is based on—

(A) The annuity payable at normal retirement age (or current age, if later) if the accumulated benefit of the participant under the terms of the plan is expressed as an annuity payable at normal retirement age (or current age, if later);

(B) The balance of a hypothetical account if the accumulated benefit of the participant under the terms of the plan is expressed as a hypothetical account balance; or

(C) The current value of an accumulated percentage of the participant's final average compensation if the accumulated benefit of the participant under the terms of the plan is expressed as an accumulated percentage of final average compensation.

(ii) *Benefit formulas for comparison*—(A) *In general.* The safe harbor provided by section 411(b)(5)(A) and paragraph (b)(1)(i) of this section does not apply to a plan if the accumulated benefit of a participant under the plan is not described in paragraph (b)(1)(i)(A), (B) or (C) of this section. In addition, except as provided in paragraph (b)(1)(ii)(B) of this section, that safe harbor also does not apply to a plan if the comparison required under paragraph (b)(1)(i) of this section involves comparing accumulated benefits that are described in different subparagraphs of paragraph (b)(1)(i) of this section. Thus, for example, if a plan provides an accumulated benefit that is expressed under the terms of the plan as an annuity payable at normal retirement age as described in paragraph (b)(1)(i)(A) of this section for participants who are age 55 or over, and the plan provides an accumulated benefit that is expressed as the balance of a hypothetical account as described in paragraph (b)(1)(i)(B) of this

section for participants who are younger than age 55, the safe harbor described in section 411(b)(5)(A) and paragraph (b)(1)(i) of this section does not apply to the plan.

(B) *Greater-of and sum-of benefit formulas.* If a plan provides that a participant's accumulated benefit is equal to the sum of accumulated benefits that are described in different subparagraphs of paragraph (b)(1)(i) of this section, then the plan is deemed to satisfy paragraph (b)(1)(i) of this section if the plan satisfies the comparison described in paragraph (b)(1)(i) of this section separately for each of the different accumulated benefits. Similarly, if a plan provides that a participant's accumulated benefit is equal to the greater of accumulated benefits that are described in different subparagraphs of paragraph (b)(1)(i) of this section, then the plan is deemed to satisfy paragraph (b)(1)(i) of this section if the plan satisfies the comparison described in paragraph (b)(1)(i) of this section separately for each of the different accumulated benefits. For purposes of this paragraph (b)(1)(ii)(B), a similarly situated, younger participant is treated as having an accumulated benefit of zero under a benefit formula if the benefit formula does not apply to the participant.

(iii) *Disregard of certain subsidized benefits.* For purposes of paragraph (b)(1)(i) of this section, any subsidized portion of any early retirement benefit that is included in a participant's accumulated benefit is disregarded. For this purpose, the subsidized portion of an early retirement benefit is the retirement-type subsidy within the meaning of §1.411(d)-3(g)(6) that is contingent on a participant's severance from employment and commencement of benefits before normal retirement age.

(2) *Indexed benefits*—(i) *In general.* Except as provided in paragraph (b)(2)(iv) of this section, pursuant to section 411(b)(5)(E) and this paragraph (b)(2)(i), a defined benefit plan is not treated as failing to meet the requirements of section 411(b)(1)(H) solely because a benefit formula under the plan (other than a lump sum-based benefit formula) provides for the periodic adjustment of accrued benefits under the plan, but only if the adjustment is by means of the application of a recognized investment index or methodology described in paragraph

(b)(2)(ii) of this section and the plan satisfies paragraph (b)(2)(iii) of this section. A statutory hybrid plan that is not treated as failing to satisfy section 411(b)(1)(H) pursuant to the preceding sentence must nevertheless satisfy the qualification requirements otherwise applicable to statutory hybrid plans, including the requirements of §1.411(a)(13)-1(c) (relating to minimum vesting standards), paragraph (c) of this section (relating to plan conversion amendments), and paragraph (d) of this section (relating to market rates of return).

(ii) *Recognized investment index or methodology.* An adjustment is made pursuant to a recognized investment index or methodology if it is made pursuant to—

(A) An eligible cost-of-living index as described in §1.401(a)(9)-6, A-14(b);

(B) The rate of return on the aggregate assets of the plan; or

(C) The rate of return on the annuity contract for the employee issued by an insurance company licensed under the laws of a State.

(iii) *Similarly situated participant test.* A plan satisfies this paragraph (b)(2)(iii) if the aggregate periodic adjustments of each participant's accrued benefit under the plan (determined as a percentage of the unadjusted accrued benefit) would not be less than the aggregate periodic adjustments of any similarly situated, younger participant. This test requires a comparison of the aggregate periodic adjustments of each individual who is or could be a participant in the plan for any specified period with the aggregate periodic adjustments of each other similarly situated, younger individual who is or could be a participant in the plan for the same period. See paragraph (b)(5) of this section for rules regarding whether each younger individual who is or could be a participant is similarly situated to a participant.

(iv) *Protection against loss*—(A) *In general.* Paragraph (b)(2)(i) of this section does not apply unless the plan satisfies section 411(b)(5)(E)(ii) and paragraph (d)(2)(ii) of this section (relating to preservation of capital).

(B) *Exception for variable annuity benefit formulas.* The requirement to satisfy section 411(b)(5)(E)(ii) and paragraph (d)(2)(ii) of this section does not apply in the case of a benefit provided under a variable annuity benefit formula, but only if the adjustments under the variable

annuity benefit formula are based on the rate of return on the aggregate assets of the plan or the rate of return on the annuity contract for the employee issued by an insurance company licensed under the laws of a State.

(3) *Certain offsets permitted.* A plan is not treated as failing to meet the requirements of section 411(b)(1)(H) solely because the plan provides offsets against benefits under the plan to the extent the offsets are allowable in applying the requirements of section 401(a) and the applicable requirements of the Employee Retirement Income Security Act of 1974, Public Law 93-406 (88 Stat. 829), and the Age Discrimination in Employment Act of 1967, Public Law 90-202 (81 Stat. 602).

(4) *Permitted disparities in plan contributions or benefits.* A plan is not treated as failing to meet the requirements of section 411(b)(1)(H) solely because the plan provides a disparity in contributions or benefits with respect to which the requirements of section 401(l) are met.

(5) *Definition of similarly situated.* For purposes of paragraphs (b)(1) and (b)(2) of this section, an individual is similarly situated to another individual if the individual is identical to that other individual in every respect that is relevant in determining a participant's benefit under the plan (including period of service, compensation, position, date of hire, work history, and any other respect) except for age. In determining whether an individual is similarly situated to another individual, any characteristic that is relevant for determining benefits under the plan and that is based directly or indirectly on age is disregarded. For example, if a particular benefit formula applies to a participant on account of the participant's age, an individual to whom the benefit formula does not apply and who is identical to the participant in all other respects is similarly situated to the participant. By contrast, an individual is not similarly situated to a participant if a different benefit formula applies to the individual and the application of the different formula is not based directly or indirectly on age.

(c) *Special rules for plan conversion amendments—*(1) *In general.* Pursuant to section 411(b)(5)(B)(ii), (iii), and (iv), if there is a conversion amendment within the meaning of paragraph (c)(4) of this section with respect to a defined benefit plan,

then the plan is treated as failing to meet the requirements of section 411(b)(1)(H) unless the plan, after the amendment, satisfies the requirements of paragraph (c)(2) of this section.

(2) *Separate calculation of post-conversion benefit—*(i) *In general.* A statutory hybrid plan satisfies the requirements of this paragraph (c)(2) if the plan provides that, in the case of an individual who was a participant in the plan immediately before the date of adoption of the conversion amendment, the participant's benefit at any subsequent annuity starting date is not less than the sum of:

(A) The participant's section 411(d)(6) protected benefit (as defined in §1.411(d)-3(g)(14)) with respect to service before the effective date of the conversion amendment, determined under the terms of the plan as in effect immediately before the effective date of the amendment; and

(B) The participant's section 411(d)(6) protected benefit with respect to service on and after the effective date of the conversion amendment, determined under the terms of the plan as in effect after the effective date of the amendment.

(ii) *Rules of application.* For purposes of this paragraph (c)(2), except as provided in paragraph (c)(3) of this section, the benefits under paragraph (c)(2)(i)(A) and (B) of this section must each be determined in the same manner as if they were provided under separate plans that are independent of each other (for example, without any benefit offsets), and, except to the extent permitted under §1.411(d)-3 or §1.411(d)-4 (or other applicable law), each optional form of payment provided under the terms of the plan with respect to a participant's section 411(d)(6) protected benefit as in effect before the amendment must be available thereafter to the extent of the plan's benefits for service prior to the effective date of the amendment.

(3) *Establishment of opening hypothetical account balance—*(i) *In general.* Provided that the requirements of paragraph (c)(3)(ii) of this section are satisfied, a statutory hybrid plan under which an opening hypothetical account balance or opening accumulated percentage of the participant's final average compensation is established as of the effective date of the conversion amendment does not fail to satisfy the requirements of paragraph (c)(2) of this

section merely because benefits attributable to that opening hypothetical account balance or opening accumulated percentage (that is, benefits that are not described in paragraph (c)(2)(i)(B) of this section) are substituted for benefits described in paragraph (c)(2)(i)(A) of this section.

(ii) *Comparison of benefits—*(A) *Testing requirement.* For any optional form of benefit payable at an annuity starting date where there was an optional form of benefit within the same generalized optional form of benefits (within the meaning 1.411(d)-3(g)(8)) that would have been available to the participant at that annuity starting date under the terms of the plan as in effect immediately before the effective date of the conversion amendment, the requirements of this paragraph (c)(3)(ii) are satisfied only if the plan provides that the amount of the benefit under that optional form of benefit available to the participant under the lump sum-based benefit formula that is attributable to the opening hypothetical account balance or opening accumulated percentage as described in paragraph (c)(3)(i) of this section, determined under the terms of the plan as of the annuity starting date (including actuarial conversion factors), is not less than the benefit under that optional form of benefit described in paragraph (c)(2)(i)(A) of this section. To satisfy this requirement, if the benefit under an optional form attributable to the opening hypothetical account balance or opening accumulated percentage is less than the benefit described in paragraph (c)(2)(i)(A) of this section, then the benefit attributable to the opening hypothetical account balance or opening accumulated percentage must be increased to the extent necessary to provide the minimum benefit described in this paragraph (c)(3)(ii)(A). Thus, if a plan is using the option under this paragraph (c)(3) to satisfy paragraph (c)(2) of this section with respect to a participant, the participant must receive a benefit equal to not less than the sum of:

(I) The greater of the benefit attributable to the opening hypothetical account balance as described in this paragraph (c)(3)(ii) and the benefit described in paragraph (c)(2)(i)(A) of this section, and

(2) The benefit described in paragraph (c)(2)(i)(B) of this section.

(B) *Special rule for post-conversion optional forms of benefit.* If an optional

form of benefit is available on the annuity starting date with respect to the benefit attributable to the opening hypothetical account balance or opening accumulated percentage, but no optional form within the same generalized optional form of benefit (within the meaning of §1.411(d)-3(g)(8)) was available at that annuity starting date under the terms of a plan as in effect immediately prior to the effective date of the conversion amendment, then, for purposes of this paragraph (c)(3)(ii), the plan is treated as if such an optional form of benefit were available immediately prior to the effective date of the conversion amendment. In that event, paragraph (c)(3)(ii)(A) of this section must be applied by taking into account the optional form of benefit that is treated as if it were available on the annuity starting date under the terms of the plan as in effect immediately prior to the effective date of the conversion amendment. Thus, for example, if a single sum optional form of payment is not available under the plan terms applicable to the accrued benefit described in paragraph (c)(2)(i)(A) of this section, but a single sum form of payment is available with respect to the benefit attributable to the opening hypothetical account balance or opening accumulated percentage as of the annuity starting date, then, for purposes of paragraph (c)(3)(ii)(A) of this section, the plan is treated as if a single sum (to which section 417(e)(3) applies) were available under the terms of the plan as in effect immediately prior to the effective date of the conversion amendment.

(4) *Conversion amendment*—(i) *In general*. An amendment is a conversion amendment that is subject to the requirements of this paragraph (c) with respect to a participant if—

(A) The amendment reduces or eliminates the benefits that, but for the amendment, the participant would have accrued after the effective date of the amendment under a benefit formula that is not a statutory hybrid benefit formula (and under which the participant was accruing benefits prior to the amendment); and

(B) After the effective date of the amendment, all or a portion of the participant's benefit accruals under the plan are determined under a statutory hybrid benefit formula.

(ii) *Rules of application*—(A) *In general*. Paragraphs (c)(4)(iii), (iv), and (v)

of this section describe special rules that treat certain arrangements as conversion amendments. The rules described in those paragraphs apply both separately and in combination. Thus, for example, in an acquisition described in §1.410(b)-2(f), if the buyer adopts an amendment under which a participant's benefits under the seller's plan that is not a statutory hybrid plan are coordinated with a separate plan of the buyer that is a statutory hybrid plan, such as through an offset of the participant's benefit under the buyer's plan by the participant's benefit under the seller's plan, the seller and buyer are treated as a single employer under paragraph (c)(4)(iv) of this section and they are treated as having adopted a conversion amendment under paragraph (c)(4)(iii) of this section. However, pursuant to paragraph (c)(4)(iii) of this section, if there is no coordination between the two plans, there is no conversion amendment.

(B) *Covered amendments*. Only amendments that eliminate or reduce accrued benefits described in section 411(a)(7), or a retirement-type subsidy described in section 411(d)(6)(B)(i), that would otherwise accrue as a result of future service are treated as amendments described in paragraph (c)(4)(i)(A) of this section.

(C) *Operation of plan terms treated as covered amendment*. If, under the terms of a plan, a change in the conditions of a participant's employment results in a reduction of the participant's benefits that would have accrued in the future under a benefit formula that is not a statutory hybrid benefit formula, the plan is treated for purposes of this paragraph (c)(4) as if such plan terms constitute an amendment that reduces the participant's benefits that would have accrued after the effective date of the change under a benefit formula that is not a statutory hybrid benefit formula. Thus, for example, if a participant transfers from an operating division that is covered by a non-statutory hybrid benefit formula to an operating division that is covered by a statutory hybrid benefit formula, there has been a conversion amendment as of the date of the transfer.

(iii) *Multiple plans*. An employer is treated as having adopted a conversion amendment if the employer adopts an amendment under which a participant's benefits under a plan that is not a statutory

hybrid plan are coordinated with a separate plan that is a statutory hybrid plan, such as through a reduction (offset) of the benefit under the plan that is not a statutory hybrid plan.

(iv) *Multiple employers*. If the employer of an employee changes as a result of a transaction described in §1.410(b)-2(f), then the two employers are treated as a single employer for purposes of this paragraph (c)(4).

(v) *Multiple amendments*—(A) *In general*—(1) *General rule*. For purposes of this paragraph (c)(4), a conversion amendment includes multiple amendments that result in a conversion amendment even if the amendments are not conversion amendments individually. For example, an employer is treated as having adopted a conversion amendment if the employer first adopts an amendment described in paragraph (c)(4)(i)(A) of this section and, at a later date, adopts an amendment that adds a benefit under a statutory hybrid benefit formula as described in paragraph (c)(4)(i)(B) of this section, if they are consolidated under paragraph (c)(4)(v)(A)(2) of this section.

(2) *Delay between plan amendments*. In the case of an amendment to provide a benefit under a statutory hybrid benefit formula that is adopted within three years after adoption of an amendment to reduce non-statutory hybrid benefit formula benefits, those amendments are consolidated in determining whether a conversion amendment has been adopted. Thus, the later adoption of the statutory hybrid benefit formula will cause the earlier amendment to be treated as a conversion amendment. In the case of an amendment to provide a benefit under a statutory hybrid benefit formula that is adopted more than three years after adoption of an amendment to reduce benefits under a non-statutory hybrid benefit formula, there is a presumption that the amendments are not consolidated unless the facts and circumstances indicate that adoption of the amendment to provide a benefit under a statutory hybrid benefit formula was intended at the time of reduction in the non-statutory hybrid benefit formula.

(B) *Multiple conversion amendments*. If an employer adopts multiple amendments reducing benefits described in paragraph (c)(4)(i)(A) of this section, each amendment is treated as a separate conver-

sion amendment, provided that paragraph (c)(4)(i)(B) of this section is applicable at the time of the amendment (taking into account the rules of this paragraph (c)(4)).

(vi) *Effective date of a conversion amendment.* The effective date of a conversion amendment is, with respect to a participant, the date as of which the reduction of the participant's benefits described in paragraph (c)(4)(i)(A) of this section occurs. In accordance with section 411(d)(6), the date of a reduction of those benefits cannot be earlier than the date of adoption of the conversion amendment.

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

Example 1. (i) *Facts where plan does not establish opening hypothetical account balance for participants and participant elects life annuity at normal retirement age.* Employer N sponsors Plan E, a defined benefit plan that provides an accumulated benefit, payable as a straight life annuity commencing at age 65 (which is Plan E's normal retirement age), based on a percentage of highest average compensation times the participant's years of service. Plan E permits any participant who has had a severance from employment to elect payment in the following optional forms of benefit (with spousal consent if applicable), with any payment not made in a straight life annuity converted to an equivalent form based on reasonable actuarial assumptions: a straight life annuity; and a 50 percent, 75 percent, or 100 percent joint and survivor annuity. The payment of benefits may commence at any time after attainment of age 55, with an actuarial reduction if the commencement is before normal retirement age. In addition, the plan offers a single sum payment after attainment of age 55 equal to the present value of the normal retirement benefit using the applicable interest rate and mortality table under section 417(e)(3) in effect under the terms of the plan on the annuity starting date.

(ii) *Facts relating to the conversion amendment.* On January 1, 2010, Plan E is amended to eliminate future accruals under the highest average compensation benefit formula and to base future benefit accruals on a hypothetical account balance. For service on or after January 1, 2010, each participant's hypothetical account balance is credited monthly with a pay credit equal to a specified percentage of the participant's compensation during the month and also with interest based on the third segment rate described in section 430(h)(2)(C)(iii). With respect to benefits under the hypothetical account balance attributable to service on and after January 1, 2010, a participant is permitted to elect (with spousal consent if applicable) payment in the same generalized optional forms of benefit (even though different actuarial factors apply) as under the terms of the plan in effect before January 1, 2010, and also as a single sum distribution. The plan provides for the benefits attributable to service before January 1, 2010, to be determined under the terms of the plan as in effect immediately before the effective date of the amendment, and the benefits attributable to service on and after January

1, 2010 to be determined separately, under the terms of the plan as in effect after the effective date of the amendment, with neither benefit offsetting the other in any manner. Thus, each participant's benefits are equal to the sum of the benefits attributable to service before January 1, 2010 (to be determined under the terms of the plan as in effect immediately before the effective date of the amendment), plus the benefits attributable to the participant's hypothetical account balance.

(iii) *Facts relating to an affected participant.* Participant A is age 62 on January 1, 2010 and, on December 31, 2009, A's benefit for years of service before January 1, 2010, payable as a straight life annuity commencing at A's normal retirement age (age 65) which is January 1, 2013, is \$1,000 per month. Participant A has a severance from employment on January 1, 2013, and, on January 1, 2013, the hypothetical account balance, with pay credits and interest from January 1, 2010, to January 1, 2013, has become \$11,000. Using the conversion factors under the plan as amended on January 1, 2013, that balance is equivalent to a straight life annuity of \$100 per month commencing on January 1, 2013. This benefit is in addition to the benefit attributable to service before January 1, 2010. Participant A elects (with spousal consent) a straight life annuity of \$1,100 per month commencing January 1, 2013.

(iv) *Conclusion.* Participant A's benefit satisfies the requirements of paragraph (c)(3)(ii)(A) of this section because Participant A's benefit is not less than the sum of Participant A's section 411(d)(6) protected benefit (as defined in §1.411(d)-3(g)(14)) with respect to service before the effective date of the conversion amendment, determined under the terms of the plan as in effect immediately before the effective date of the amendment, and Participant A's section 411(d)(6) protected benefit with respect to service on and after the effective date of the conversion amendment, determined under the terms of the plan as in effect after the effective date of the amendment.

Example 2. (i) *Facts involving plan's establishment of opening hypothetical account balance and payment of pre-conversion accumulated benefit in life annuity at normal retirement age.* The facts in this Example 2 are the same as the facts under paragraph (i) of Example 1.

(ii) *Facts relating to the conversion amendment.* On January 1, 2010, Plan E is amended to eliminate future accruals under the highest average compensation benefit formula and to base future benefit accruals on a hypothetical account balance. An opening hypothetical account balance is established for each participant, and, under the plan's terms, that balance is equal to the present value of the participant's accumulated benefit on December 31, 2009 (payable as a straight life annuity at normal retirement age or immediately, if later), using the applicable interest rate and applicable mortality table under section 417(e)(3) on January 1, 2010. Under Plan E, the account based on this opening hypothetical account balance is maintained as a separate account from the account for accruals on or after January 1, 2010. The hypothetical account balance maintained for each participant for accruals on or after January 1, 2010, is credited monthly with a pay credit equal to a specified percentage of the participant's compensation during the month. A participant's hypothetical account balance (including both of the separate accounts) is credited

monthly with interest based on the third segment rate described in section 430(h)(2)(C)(iii).

(iii) *Facts relating to optional forms of benefit.* Following severance from employment and attainment of age 55, a participant is permitted to elect (with spousal consent if applicable) payment in the same generalized optional forms of benefit as under the plan in effect prior to January 1, 2010, with the amount payable calculated based on the hypothetical account balance on the annuity starting date and the applicable interest rate and applicable mortality table on the annuity starting date. The single sum distribution is equal to the hypothetical account balance.

(iv) *Facts relating to conversion protection.* The plan provides that, as of a participant's annuity starting date, the plan will determine whether the benefit attributable to the opening hypothetical account payable in the particular optional form of benefit selected is greater than or equal to the benefit accrued under the plan through the date of conversion and payable in the same generalized optional form of benefit with the same annuity starting date. If the benefit attributable to the opening hypothetical account balance is greater, the plan provides that such benefit is paid in lieu of the pre-conversion benefit, together with the benefit attributable to post-conversion contribution credits. If the benefit attributable to the opening hypothetical account balance is less, the plan provides that such benefit is increased sufficiently to provide the pre-conversion benefit, together with the benefit attributable to post-conversion contribution credits.

(v) *Facts relating to an affected participant.* On January 1, 2010, the opening hypothetical account balance established for Participant A is \$80,000, which is the present value of Participant A's straight life annuity of \$1,000 per month commencing at January 1, 2013, using the applicable interest rate and applicable mortality table under section 417(e)(3) in effect on January 1, 2010. On January 1, 2010, the applicable interest rate for Participant A is equivalent to a level rate of 5.5 percent. Thereafter, Participant A's hypothetical account balance for subsequent accruals is credited monthly with a pay credit equal to a specified percentage of the participant's compensation during the month. In addition, Participant A's hypothetical account balance (including both of the separate accounts) is credited monthly with interest based on the third segment rate described in section 430(h)(2)(C)(iii).

(vi) *Facts relating to calculation of the participant's benefit.* Participant A has a severance from employment on January 1, 2013 at age 65, and elects (with spousal consent) a straight life annuity commencing January 1, 2013. On January 1, 2013, the opening hypothetical account balance, with interest credits from January 1, 2010, to January 1, 2013, has become \$95,000, which, using the conversion factors under the plan on January 1, 2013, is equivalent to a straight life annuity of \$1,005 per month commencing on January 1, 2013 (which is greater than the \$1,000 a month payable at age 65 under the terms of the plan in effect before January 1, 2010). This benefit is in addition to the benefit determined using the hypothetical account balance for service after January 1, 2010.

(vii) *Conclusion.* The benefit satisfies the requirements of paragraph (c)(3)(ii)(A) of this section with respect to Participant A because A's benefit is not less than the sum of (A) the greater of Participant

A's benefits attributable to the opening hypothetical account balance and A's section 411(d)(6) protected benefit (as defined in §1.411(d)-3(g)(14)) with respect to service before the effective date of the conversion amendment, determined under the terms of the plan as in effect immediately before the effective date of the amendment, and (B) Participant A's section 411(d)(6) protected benefit with respect to service on and after the effective date of the conversion amendment, determined under the terms of the plan as in effect after the effective date of the amendment.

Example 3. (i) Facts involving a subsequent decrease in interest rates. The facts are the same as in *Example 2*, except that, because of a decrease in bond rates after January 1, 2010, and before January 1, 2013, the rate of interest credited in that period averages less than 5.5 percent, and, on January 1, 2013, the effective applicable interest rate under section 417(e)(3) under the plan's terms is 4.7 percent. As a result, Participant A's opening hypothetical account balance plus attributable interest credits has increased to only \$87,000 on January 1, 2013, and, using the conversion factors under the plan on January 1, 2013, is equivalent to a straight life annuity commencing on January 1, 2013, of \$775 per month. Under the terms of Plan E, the benefit attributable to A's opening account balance is increased so that A's straight life annuity commencing on January 1, 2013, is \$1,000 per month. This benefit is in addition to the benefit attributable to the hypothetical account balance for service after January 1, 2010.

(ii) *Conclusion.* The benefit satisfies the requirements of paragraph (c)(3)(ii)(A) of this section with respect to Participant A because A's benefit is not less than the sum of (A) the greater of A's benefits attributable to the opening hypothetical account balance and A's section 411(d)(6) protected benefit (as defined in §1.411(d)-3(g)(14)) with respect to service before the effective date of the conversion amendment, determined under the terms of the plan as in effect immediately before the effective date of the amendment, and (B) A's section 411(d)(6) protected benefit with respect to service on and after the effective date of the conversion amendment, determined under the terms of the plan as in effect after the effective date of the amendment.

Example 4. (i) Facts involving payment of a subsidized early retirement benefit. The facts are the same as in *Example 2*, except that under the terms of Plan E on December 31, 2009, a participant who retires before age 65 and after age 55 with 30 years of service has only a 3 percent per year actuarial reduction. Participant A has a severance from employment on January 1, 2011, when A is age 63 and has 30 years of service. On January 1, 2011, A's opening hypothetical account balance, with interest from January 1, 2010, to January 1, 2011, has become \$86,000, which, using the conversion factors under the plan (as amended) on January 1, 2011, is equivalent to a straight life annuity commencing on January 1, 2011, of \$850 per month.

(ii) *Facts relating to calculation of the participant's benefit.* Under the terms of Plan E on December 31, 2009, Participant A is entitled to a straight life annuity commencing on January 1, 2011, equal to at least \$940 per month (\$1,000 reduced by 3 percent for each of the 2 years that A's benefits commence before normal retirement age). Under the terms of Plan

E, the benefit attributable to A's opening account balance is increased so that A is entitled to a straight life annuity of \$940 per month commencing on January 1, 2013. This benefit is in addition to the benefit determined using the hypothetical account balance for service after January 1, 2010.

(iii) *Conclusion.* The benefit satisfies the requirements of paragraph (c)(3)(ii)(A) of this section with respect to Participant A because A's benefit is not less than the sum of (A) the greater of Participant A's benefits attributable to the opening hypothetical account balance (increased by attributable interest credits) and A's section 411(d)(6) protected benefit (as defined in §1.411(d)-3(g)(14)) with respect to service before the effective date of the conversion amendment, determined under the terms of the plan as in effect immediately before the effective date of the amendment, and (B) Participant A's section 411(d)(6) protected benefit with respect to service on and after the effective date of the conversion amendment, determined under the terms of the plan as in effect after the effective date of the amendment.

Example 5. (i) Facts involving addition of a single sum payment option. The facts are the same as in *Example 2*, except that, before January 1, 2010, Plan E did not offer payment in a single sum distribution for amounts in excess of \$5,000. Plan E, as amended on January 1, 2010, offers payment in any of the available annuity distribution forms commencing at any time following severance from employment as were provided under Plan E before January 1, 2010. In addition, Plan E, as amended on January 1, 2010, offers payment in the form of a single sum attributable to service before January 1, 2010, which is the greater of the opening hypothetical account balance (increased by attributable interest credits) or a single sum distribution of the straight life annuity payable at age 65 using the same actuarial factors as are used for mandatory cashouts for amounts equal to \$5,000 or less under the terms of the plan on December 31, 2009. Participant B is age 40 on January 1, 2010, and B's opening hypothetical account balance (increased by attributable interest credits) is \$33,000 (which is the present value, using the conversion factors under the plan (as amended) on January 1, 2010, of Participant B's straight life annuity of \$1,000 per month commencing at January 1, 2035, which is when B will be age 65). Participant B has a severance from employment on January 1, 2013, and elects (with spousal consent) an immediate single sum distribution. Participant B's opening hypothetical account balance (increased by attributable interest) on January 1, 2013, is \$45,000. The present value, on January 1, 2013, of Participant B's benefit of \$1,000 per month, commencing immediately using the actuarial factors for mandatory cashouts under the terms of the plan on December 31, 2009, would result in a single sum payment of \$44,750. Participant B is paid a single sum distribution equal to the sum of \$45,000 plus an amount equal to B's January 1, 2013, hypothetical account balance for benefit accruals for service after January 1, 2010.

(ii) *Conclusion.* Because, under Plan E, Participant B is entitled to the sum of (A) The greater of the \$45,000 opening hypothetical account balance (increased by attributable interest credits) and \$44,750 (present value of the benefit with respect to service prior to January 1, 2010, using the actuarial factors for mandatory cashout distributions under the terms of

the plan on December 31, 2009), plus (B) An amount equal to B's hypothetical account balance for benefit accruals for service after January 1, 2010, the benefit satisfies the requirements of paragraph (c)(3)(ii)(A) of this section with respect to Participant B. If Participant B's hypothetical account balance under Plan E was instead less than \$44,750 on January 1, 2013, Participant B would be entitled to a single sum payment equal to the sum of \$44,750 and an amount equal to B's hypothetical account balance for benefit accruals for service after January 1, 2010.

Example 6. (i) Facts involving addition of new annuity optional form of benefit. The facts are the same as in *Example 2*, except that, after December 31, 2009, and before January 1, 2013, Plan E is amended to offer payment in a 5-, 10-, or 15-year term certain and life annuity, using the same actuarial assumptions that apply for other optional forms of distribution. When Participant A has a severance from employment on January 1, 2013, A elects (with spousal consent) a 5-year term certain and life annuity commencing immediately equal to \$935 per month. Application of the same actuarial assumptions to Participant A's benefit of \$1,000 per month (under Plan E as in effect on December 31, 2009), commencing immediately on January 1, 2013, would result in a 5-year term certain and life annuity commencing immediately equal to \$955 per month. Under the terms of Plan E, the benefit attributable to A's opening account balance is increased so that, using the conversion factors under the plan (as amended) on January 1, 2013, A's opening hypothetical account balance (increased by attributable interest credits) produces a 5-year term certain and life annuity commencing immediately equal to \$955 per month commencing on January 1, 2013. This benefit is in addition to the benefit determined using the January 1, 2013, hypothetical account balance for service after January 1, 2010.

(ii) *Conclusion.* This benefit satisfies the requirements of paragraph (c)(3)(ii)(A) of this section with respect to Participant A.

Example 7. (i) Facts involving addition of distribution option before age 55. The facts are the same as in *Example 5*, except that Participant B (age 43) elects (with spousal consent) a straight life annuity. Under Plan E, the straight life annuity attributable to Participant B's opening hypothetical account balance at age 43 is \$221 per month. Application of the same actuarial assumptions to Participant B's benefit of \$1,000 per month (under Plan E as in effect on December 31, 2009), commencing immediately on January 1, 2013, would result in a straight life annuity at age 43 equal to \$219 per month.

(ii) *Conclusion.* Because, under its terms, Plan E provides that Participant B is entitled to an amount not less than the present value (using the same actuarial assumptions as apply on January 1, 2013, in converting the \$45,000 hypothetical account balance attributable to the opening hypothetical account balance to the \$221 straight life annuity) of Participant B's straight life annuity of \$1,000 per month commencing at January 1, 2035, and the \$221 straight life annuity is in addition to the benefit accruals for service after January 1, 2010, payment of the \$221 monthly annuity would satisfy the requirements of paragraph (c)(3)(ii)(A) of this section with respect to Participant B.

(d) *Market rate of return*—(1) *In general*—(i) *Basic test*. Subject to paragraph (d)(3) of this section, a statutory hybrid plan satisfies the requirements of section 411(b)(1)(H) and this paragraph (d) only if, for any plan year, the interest crediting rate under the terms of the plan is no greater than a market rate of return.

(ii) *Definition of interest crediting rate and interest credit*. For purposes of this paragraph (d), a plan's interest crediting rate means the rate by which a participant's benefit is increased under the ongoing terms of the plan to the extent the amount of the increase is not conditioned on current service, regardless of how the amount of that increase is calculated. The amount of such an increase is an interest credit. Thus, whether the amount is an interest credit for this purpose is determined without regard to whether the amount is calculated by reference to a rate of interest, a rate of return, an index, or otherwise.

(iii) *Single rates*. Except as is otherwise provided in this paragraph (d)(1), an interest crediting rate is not in excess of a market rate of return only if the plan provides an interest credit for the year at a rate that is equal to one of the following rates that is specified in the terms of the plan:

(A) The interest rate on long-term investment grade corporate bonds (as described in paragraph (d)(4) of this section);

(B) An interest rate that is deemed to be not in excess of a market rate of return under paragraph (d)(5) of this section; or

(C) An interest rate that is described in paragraph (d)(6) of this section.

(iv) *Timing rules*—(A) *In general*. A plan must specify the timing for determining the plan's interest crediting rate that will apply for each plan year (or portion of a plan year) using either of the methods described in paragraph (d)(1)(iv)(B) of this section and must specify the frequency of interest crediting under the plan pursuant to paragraph (d)(1)(iv)(C) of this section.

(B) *Methods to determine interest crediting rate*. A plan is permitted to provide daily interest credits using a daily interest crediting rate based on the permitted rates specified in paragraph (d)(1)(iii) of this section. Alternatively, a plan is permitted to provide an interest credit for a stability period that is based on the interest crediting rate for a specified lookback month with respect to that stability period. The stability period and lookback month

must satisfy the rules for selecting the stability period and lookback month under §1.417(e)–1(d)(4). (However, the interest rates can be any of the rates in paragraph (d)(1)(iii) of this section and the stability period and lookback month need not be the same as those used under the plan for purposes of section 417(e)(3).)

(C) *Frequency of interest crediting*. Interest credits under a plan must be made on an annual or more frequent periodic basis. If a plan provides for the crediting of interest more frequently than annually (for example, monthly or quarterly), then the interest credit for that period must be a *pro rata* portion of the annual interest credit. Thus, for example, if a plan's terms provide for interest to be credited monthly and for the interest crediting rate to be equal to the interest rate on long-term investment grade corporate bonds (as described in paragraph (d)(4) of this section), and that interest rate for a plan year is 6 percent, the accumulated benefits at the beginning of each month would be increased by 0.5 percent per month during the plan year. Interest credits under the terms of a plan are not treated as creating an effective rate of return that is in excess of a market rate of return merely because an otherwise permissible interest crediting rate is compounded more frequently than annually.

(v) *Lesser rates*. An interest crediting rate is not in excess of a market rate of return if the plan provides an interest crediting rate that, under all circumstances, is always less than one of the rates described in paragraph (d)(1)(iii) of this section.

(vi) *Greater-of rates*. If a statutory hybrid plan provides for an interest credit that is equal to the interest credits determined under the greater of 2 or more different interest crediting rates, the effective interest crediting rate is not in excess of a market rate of return only if each of the different rates satisfies the requirements of paragraph (d)(1)(ii) of this section and the additional requirements of paragraph (d)(7) of this section are satisfied.

(2) *Preservation of capital requirement*—(i) *In general*. A statutory hybrid plan is treated as failing to meet the requirements of section 411(b)(1)(H) if the requirements of paragraph (d)(2)(ii) of this section are not satisfied.

(ii) *Preservation of capital defined*—(A) *In general*. The requirements of this paragraph (d)(2)(ii) are satisfied

if the plan provides that, as of the participant's annuity starting date, the participant's benefit under the plan is no less than the benefit determined as of that date based on the sum of the hypothetical contributions credited under the plan (or the accumulated percentage of the participant's final average compensation, or the participant's accrued benefits determined without regard to any indexing under section 411(b)(5)(E), as applicable).

(B) *Hypothetical contributions defined*. For purposes of this paragraph (d)(2)(ii), a hypothetical contribution is any amount credited under a statutory hybrid plan other than an interest credit (as defined in paragraph (d)(1)(ii) of this section). Thus, if an opening hypothetical account balance or opening accumulated percentage of the participant's final average compensation is established pursuant to paragraph (c)(3) of this section, that opening hypothetical account balance or opening accumulated percentage as of the date established is treated as a hypothetical contribution and, thus, is taken into account for purposes of the preservation of capital requirement of this paragraph (d)(2)(ii).

(3) *Plan termination*—(i) *In general*. Except as provided in paragraph (d)(3)(ii) of this section, a statutory hybrid plan is treated as meeting the requirements of paragraph (d)(1) of this section only if the terms of the plan provide that, upon termination of the plan, a participant's benefit as of the termination is determined using the interest rate and mortality table otherwise applicable for determining that benefit under the plan (without regard to termination of the plan).

(ii) *Variable interest rates*. A statutory hybrid plan is treated as meeting the requirements of paragraph (d)(1) of this section only if the terms of the plan provide that, upon termination of the plan, any interest rate used to determine a participant's benefits under the plan (including any interest crediting rate and any interest rate used to determine annuity benefits) that is a variable rate is determined as the average of the rates of interest used under the plan for that purpose during the 5-year period ending on the termination date.

(4) *Long-term investment grade corporate bonds*. For purposes of this paragraph (d), the rate of interest on long-term investment grade corporate bonds means the third segment rate described in sec-

tion 430(h)(2)(C)(iii) (determined with or without regard to the transition rules of section 430(h)(2)(G)), provided that such rate floats on a periodic basis not less frequently than annually. However, for plan years beginning prior to January 1, 2008, the rate of interest on long-term investment

grade corporate bonds means the rate described in section 412(b)(5)(B)(ii)(II) prior to amendment by the Pension Protection Act of 2006, Public Law 109-280 (120 Stat. 780) (PPA '06).

(5) *Safe harbor rates of interest*—(i) *Rates based on Treasury bonds with mar-*

gins. An interest crediting rate is deemed to be not in excess of a market rate of return if the rate is adjusted at least annually and is equal to the sum of any of the following rates of interest for Treasury bonds and the associated margin for that interest rate:

Treasury bond interest rates	Associated Margin
The discount rate on 3-month Treasury Bills	175 basis points
The discount rate on 12-month or shorter Treasury Bills	150 basis points
The yield on 1-year Treasury Constant Maturities	100 basis points
The yield on 3-year or shorter Treasury bonds	50 basis points
The yield on 7-year or shorter Treasury bonds	25 basis points
The yield on 30-year or shorter Treasury bonds	0 basis points

(ii) *Eligible cost-of-living indices.* An interest crediting rate is deemed to be not in excess of a market rate of return if the rate is adjusted no less frequently than annually and is equal to the rate of increase with respect to an eligible cost-of-living index described in §1.401(a)(9)-6, A-14(b), except that for purposes of this paragraph (d)(5)(ii), the eligible cost-of-living index described in §1.401(a)(9)-6, A-14(b)(2), is increased by 300 basis points.

(iii) *Additional safe harbors.* The Commissioner may, in guidance of general applicability, specify additional interest crediting rates that are deemed to be not in excess of a market rate of return. See §601.601(d)(2)(ii)(b) of this chapter.

(6) *Other interest rates*—(i) *Reasonable minimum guaranteed rate of return.* [Reserved]

(ii) *Equity-based rates.* [Reserved]

(7) *Combinations of rates of return*—(i) *In general.* If a plan provides an interest crediting rate that is equal to the interest credits determined under the greater of 2 or more different interest crediting rates where each of the different rates satisfies the requirements of paragraph (d)(1)(iii) of this section, then the interest credits provided by the plan satisfy this paragraph (d)(7) only if one or more of the different interest crediting rates under the plan are adjusted as provided in paragraphs (d)(7)(iii) or (d)(7)(iv) of this section in order to provide that the effective interest crediting rate resulting from the use of the greater of 2 or more rates does not exceed a market rate of return. This paragraph (d)(7) provides the exclusive rules that may be used for this purpose and,

therefore, a plan does not satisfy the requirements of this paragraph (d) if the plan provides for interest credits determined using the greater of 2 or more interest crediting rates and that combination of interest crediting rates is not specifically permitted by this paragraph (d)(7).

(ii) *Coordination with preservation of capital rule.* No adjustment under this paragraph (d)(7) is required merely because the plan satisfies the requirements of paragraph (d)(2) of this section.

(iii) *Combination of fixed and variable interest rates.* [Reserved]

(iv) *Other combinations.* [Reserved]

(8) *Section 411(d)(6)*—(i) *General rule.* Except as provided in this paragraph (d)(8), to the extent that benefits have accrued under the terms of a statutory hybrid plan that entitle the participant to future interest credits, an amendment to the plan to change the interest crediting rate for such interest credits violates section 411(d)(6) if the revised rate under any circumstances could result in a lower interest crediting rate as of any date after the applicable amendment date of the amendment (within the meaning of §1.411(d)-3(g)(4)) changing the interest crediting rate. For additional rules, see §1.411(d)-3(a)(1).

(ii) *Adoption of long-term investment grade corporate bond rate or safe harbor rate.* An amendment to a statutory hybrid plan to change the interest crediting rate for future periods from an interest crediting rate described in paragraph (d)(5) of this section to the interest crediting rate described in paragraph (d)(4) of this section does not constitute a decrease of an accrued benefit and, therefore, does not violate section 411(d)(6). However,

an amendment described in this paragraph (d)(8)(ii) cannot be effective less than 30 days after adoption and, on the effective date of the amendment, the new interest crediting rate cannot be less than the interest crediting rate that would have applied in the absence of the amendment.

(iii) *Other changes not treated as prohibited reduction of accrued benefit.* [Reserved]

(e) *Definitions*—(1) *In general.* The definitions in this paragraph (e) apply for purposes of this section.

(2) *Accumulated benefit.* A participant's accumulated benefit at any date means the participant's benefit, as expressed under the terms of the plan, accrued to that date. For this purpose, the accumulated benefit of a participant may be expressed under the terms of the plan as either the balance of a hypothetical account or the current value of an accumulated percentage of the participant's final average compensation, even if the plan defines the participant's accrued benefit as an annuity beginning at normal retirement age that is actuarially equivalent to that balance or value.

(3) *Lump sum-based benefit formula*—(i) *In general.* A lump sum-based benefit formula means a benefit formula used to determine all or any part of a participant's accumulated benefit under a defined benefit plan under which the benefit provided under the formula is expressed as the balance of a hypothetical account maintained for the participant or as the current value of the accumulated percentage of the participant's final average compensation. Whether a benefit formula is a lump sum-based benefit formula is

determined based on how the accumulated benefit of a participant is expressed under the terms of the plan, and does not depend on whether the plan provides an optional form of benefit in the form of a single sum payment.

(ii) *Exception for contributory plans.* A participant is not treated as having a lump sum-based benefit formula merely because the participant is entitled to a benefit under a defined benefit plan that is equal to the greater of the otherwise applicable benefit formula and the benefit properly attributable to after-tax employee contributions.

(4) *Statutory hybrid benefit formula.* A statutory hybrid benefit formula means a statutory hybrid benefit formula as defined in §1.411(a)(13)–1(d)(3).

(5) *Statutory hybrid plan.* A statutory hybrid plan means a defined benefit plan that contains a statutory hybrid benefit formula.

(6) *Variable annuity benefit formula.* A variable annuity benefit formula means a variable annuity benefit formula as defined in §1.411(a)(13)–1(d)(4).

(f) *Effective/applicability date*—(1) *Statutory effective/applicability dates*—(i) *In general.* Except as provided in paragraph (f)(1)(iii) of this section, section 411(b)(5) applies for periods beginning on or after June 29, 2005.

(ii) *Conversion amendments.* The requirements of section 411(b)(5)(B)(ii), (iii), and (iv) apply to a conversion amendment (as defined in paragraph (c)(4) of this section) that is adopted after, and takes effect after, June 29, 2005.

(iii) *Market rate of return*—(A) *Plans in existence on June 29, 2005*—(1) *In general.* In the case of a plan that is in existence on June 29, 2005 (regardless of whether the plan is a statutory hybrid plan on that date), section 411(b)(5)(B)(i) only applies to plan years beginning on or after January 1, 2008.

(2) *Exception for plan sponsor election.* Notwithstanding paragraph (f)(1)(iii)(A)(1) of this section, a plan sponsor of a plan that is in existence on June 29, 2005 (regardless of whether the plan is a statutory hybrid plan on that date) may elect to have the requirements of section 411(a)(13)(B) and section 411(b)(5)(B)(i) apply for any period after June 29, 2005, and before the first plan year beginning after December 31, 2007. In accordance with section 1107 of the

PPA '06, an employer is permitted to adopt an amendment to make this election as late as the last day of the first plan year that begins on or after January 1, 2009 (January 1, 2011, in the case of a governmental plan as defined in section 414(d)) if the plan operates in accordance with the election.

(B) *Plans not in existence on June 29, 2005.* In the case of a plan not in existence on June 29, 2005, section 411(b)(5)(B)(i) applies to the plan on and after the later of June 29, 2005, and the date the plan becomes a statutory hybrid plan.

(2) *Effective/applicability date of regulations.* This section applies for plan years beginning on or after January 1, 2009 (or, if later, the date applicable under paragraph (f)(3) of this section). For the periods after the statutory effective date set forth in paragraph (f)(1) or (f)(3) of this section and before the regulatory effective date set forth in the preceding sentence, a plan must comply with section 411(b)(5). During these periods, a plan is permitted to rely on the provisions of this section for purposes of satisfying the requirements of section 411(b)(5).

(3) *Collectively bargained plans*—(i) *In general.* Notwithstanding paragraph (f)(1)(iii) of this section, in the case of a collectively bargained plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified on or before August 17, 2006, the requirements of section 411(b)(5)(B)(i) do not apply to plan years beginning before the earlier of—

(A) The later of—

(1) The date on which the last of those collective bargaining agreements terminates (determined without regard to any extension thereof on or after August 17, 2006), or

(2) January 1, 2008; or

(B) January 1, 2010.

(ii) *Treatment of plans with both collectively bargained and non-collectively bargained employees.* In the case of a plan where a collective bargaining agreement applies to some, but not all, of the plan participants, the plan is considered a collectively bargained plan for purposes of paragraph (f)(3)(i) of this section if at least 25 percent of the participants in the plan are members of collective bargaining units for which the benefit levels under the plan are

specified under the collective bargaining agreement.

Linda E. Stiff,
Deputy Commissioner for
Services and Enforcement.

(Filed by the Office of the Federal Register on December 27, 2007, 8:45 a.m., and published in the issue of the Federal Register for December 28, 2007, 72 F.R. 73680)

Notice of Proposed Rulemaking

Diversification Requirements for Certain Defined Contribution Plans

REG–136701–07

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of Proposed Rulemaking.

SUMMARY: This document contains proposed regulations under section 401(a)(35) of the Internal Revenue Code (Code) relating to diversification requirements for certain defined contribution plans and to publicly traded employer securities. These regulations will affect administrators of, employers maintaining, participants in, and beneficiaries of defined contribution plans that are invested in employer securities.

DATES: Written or electronic comments and requests for a public hearing must be received by April 2, 2008.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–136701–07), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, D.C. 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG–136701–07), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C., or sent electronically via the Federal eRulemaking Portal at <http://www.regulations.gov> (IRS REG–136701–07).

FOR FURTHER INFORMATION CONTACT: Concerning the regulations,

R. Lisa Mojiri-Azad or Dana Barry at (202) 622-6060; concerning submission of comments or to request a public hearing, Kelly Banks at (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed regulations under section 401(a)(35) of the Code, which was added by section 901 of the Pension Protection Act of 2006, Public Law 109-280, 120 Stat. 780 (PPA '06).¹

Section 401(a)(35)(A) provides that a trust which is part of an applicable defined contribution plan is not a qualified trust under section 401(a) unless the plan satisfies the diversification requirements of sections 401(a)(35)(B), (C), and (D). Under section 401(a)(35)(B), each individual must have the right to direct the plan to divest employer securities allocated to the individual's account that are attributable to employee contributions or elective deferrals and to reinvest an equivalent amount in other investment options meeting the requirements of section 401(a)(35)(D).²

Under section 401(a)(35)(C), each individual who is a participant who has completed at least three years of service, a beneficiary of a participant who has completed at least three years of service, or a beneficiary of a deceased participant must be permitted to elect to direct the plan to divest employer securities allocated to the individual's account and to reinvest an equivalent amount in other investment options meeting the requirements of section 401(a)(35)(D).

Section 401(a)(35)(D)(i) requires an applicable defined contribution plan to offer individuals not less than three investment options, other than employer securities, to which the individuals may direct the proceeds from the divestment of employer securities, each of which is diversified and has materially different risk and return characteristics.

Under section 401(a)(35)(D)(ii)(I), a plan does not fail to meet the requirements of section 401(a)(35)(D) if it allows individuals to divest employer securities and reinvest the proceeds at periodic, reasonable opportunities occurring no less frequently than quarterly.

Under section 401(a)(35)(D)(ii)(II), a plan is not permitted to impose restrictions or conditions with respect to the investment of employer securities that are not imposed on the investment of other assets of the plan. However, this rule does not apply to restrictions or conditions imposed to comply with securities laws. The Secretary is authorized to issue regulations providing additional exceptions to the requirements of section 401(a)(35)(D)(ii)(II).

An applicable defined contribution plan under section 401(a)(35) is a defined contribution plan that holds any publicly traded employer securities. A publicly traded employer security is defined as an employer security under section 407(d)(1) of the Employee Retirement Income Security Act of 1974, Public Law 93-406, 88 Stat. 829 (ERISA) which is readily tradable on an established securities market. Section 401(a)(35)(F)(i) provides that a plan that does not hold publicly traded employer securities is nevertheless treated as holding publicly traded employer securities if any employer corporation or any member of a controlled group of corporations which includes the employer (determined by applying section 1563(a), except substituting 50 percent for 80 percent) has issued a class of stock that is a publicly traded employer security. However, section 401(a)(35)(F) does not apply to a plan if no employer corporation, or parent corporation (as defined in section 424(e)) of an employer corporation, has issued any publicly traded employer security and no employer or parent corporation has issued any special class of stock which grants particular rights to, or bears particular risks for, the holder or issuer with respect to any corporation described in

section 401(a)(35)(F)(i) which has issued any publicly traded employer security.

Section 401(a)(35)(E) provides that section 401(a)(35) does not apply to an employee stock ownership plan within the meaning of section 4975(e)(7) (ESOP) that holds no contributions (or earnings thereunder) that are subject to section 401(k) or (m) (generally relating to elective deferrals and matching and employee after-tax contributions) and the ESOP is a separate plan for purposes of section 414(l) with respect to any other defined benefit plan or defined contribution plan maintained by the same employer or employers. Section 401(a)(35)(E) further provides that section 401(a)(35) does not apply to one-participant retirement plans.

Section 401(a)(35) is generally effective for plan years beginning after December 31, 2006. Section 401(a)(35)(H) generally provides a three year phase-in rule with respect to an individual's right to direct the divestment of employer securities attributable to employer contributions, except with respect to certain participants who have attained age 55. Section 901(c)(2) of PPA '06 includes a special rule for a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers that was ratified on or before August 17, 2006. Under this rule, section 401(a)(35) is not effective until plan years beginning after the earlier of (1) the later of (a) December 31, 2007 or (b) the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof after August 17, 2006) or (2) December 31, 2008.

Notice 2006-107, 2006-2 C.B. 1114 (December 18, 2006) (see §601.601(d)(2)(ii)(b) of this chapter), includes guidance and transitional rules with respect to the diversification requirements of section 401(a)(35).³ Notice 2006-107 provides that a plan (and an investment option described in section 401(a)(35)(D)(i)) is not treated as holding employer secu-

¹ Section 901 of PPA '06 also added a parallel provision at section 204(j) of the Employee Retirement Income Security Act of 1974, Public Law 93-406, 88 Stat. 829 (ERISA). Under section 101 of Reorganization Plan No. 4 of 1978 (43 FR 47713), the Secretary of Treasury has interpretative jurisdiction over the subject matter addressed in these proposed regulations for purposes of section 204(j) of ERISA. Thus, the guidance provided in these proposed regulations with respect to section 401(a)(35) of the Code also applies for purposes of section 204(j) of ERISA.

² Section 401(a)(28) provides certain diversification rights to participants in an employee stock ownership plan within the meaning of section 4975(e)(7) (ESOP). Section 401(a)(28)(B) also generally requires that the plan offer at least three alternative investment options. Section 401(a)(28)(B) permits a plan to satisfy these diversification requirements by distributing, within 90 days after the period during which the election may be made, the portion of the participant's account that is subject to section 401(a)(28)(B). Section 401(a)(28)(B) was amended by section 901(a)(2)(A) of PPA '06 not to apply to a plan to which section 401(a)(35) applies.

³ Notice 2006-107 also includes guidance regarding the related notice requirements of section 101(m) of ERISA, including a model notice.

rities to which section 401(a)(35) applies with respect to any securities held through either an investment company registered under the Investment Company Act of 1940 or a similar pooled investment vehicle that is regulated and subject to periodic examination by a State or Federal agency and with respect to which investment in securities is made both in accordance with the stated investment objectives of the investment vehicle and independent of the employer and any affiliate thereof, but only if the holdings of the investment company or similar investment vehicle are diversified so as to minimize the risk of large losses. Notice 2006–107 also provides that investment options satisfy the requirement that investment options be diversified and have materially different risk and return characteristics under section 401(a)(35)(D)(i) if the investment options satisfy the requirements of section 2550.404c–1(b)(3) of the Department of Labor regulations.

Notice 2006–107 further provides that, for purposes of section 401(a)(35), the date on which a participant completes three years of service occurs immediately after the end of the third vesting computation period provided for under the plan that constitutes the completion of a third year of service under section 411(a)(5). For a plan using the elapsed time method of crediting service for vesting purposes (or a plan that provides for immediate vesting without using a vesting computation period or elapsed time method of determining vesting), the date on which a participant completes three years of service is the third anniversary of the participant's date of hire.

Notice 2006–107 includes special rules regarding restrictions or conditions with respect to employer securities under section 401(a)(35)(D)(ii)(II). An impermissible restriction or condition is either a restriction on an individual's right to divest an investment in employer securities that is not imposed on an investment that is not in employer securities or a benefit that is conditioned on an investment in employer securities. Examples of restrictions or conditions that are prohibited by section 401(a)(35)(D)(ii)(II) under Notice 2006–107 include: (1) a plan allows an individual the right to divest employer securities on a quarterly basis but permits divestiture of another investment on a more

frequent basis; (2) a plan provides that a participant who divests his or her account of employer securities receives less favorable treatment (such as a lower rate of matching contributions) than a participant whose account remains invested in employer securities; and (3) a plan that provides if a participant divests his or her account balance with respect to investment in a class of employer securities, the participant is not permitted for a period of time to reinvest in that class of securities where that restriction is not imposed on other investments. Notice 2006–107 also provided examples of restrictions or conditions that are not prohibited by section 401(a)(35)(D)(ii)(II): (1) a provision that limits the extent to which an individual's account balance can be invested in employer securities; (2) a provision under which an employer securities fund is closed; (3) a restriction imposed by reason of application of securities laws or a restriction that is reasonably designed to ensure compliance with such laws; (4) an imposition of fees on other investment options under the plan but not on investments in employer securities; and (5) a plan restriction on the availability of otherwise applicable diversification rights under the plan for up to 90 days following an initial public offering of the employer's stock.

Notice 2006–107 provides certain transition rules. For example, for the period prior to January 1, 2008, a plan does not impose a restriction or condition prohibited by section 401(a)(35)(D)(ii)(II) merely because the plan, as in effect on December 18, 2006, (1) does not impose an otherwise applicable restriction on a stable value fund or (2) allows individuals the right to divest employer securities on a periodic basis (at least quarterly), but permits divestiture of another investment on a more frequent basis, provided that the other investment is not a generally available investment.

Explanation of Provisions

Overview

The proposed regulations would provide guidance with respect to the requirements of section 401(a)(35) that incorporates much of the guidance provided under Notice 2006–107. The regulations would clarify the scope of the rule in sec-

tion 401(a)(35)(D)(ii)(II) that generally prohibits restrictions and conditions on investment in employer securities, but would specifically permit certain restrictions and conditions on such investment that are consistent with the statute, and would also define when employer securities are publicly traded on an established securities market under section 401(a)(35)(D).

Basic diversification rights

The proposed regulations incorporate the guidance on the basic diversification rights of section 401(a)(35) that is contained in Notice 2006–107. Thus, if an applicable defined contribution plan holds employee contributions (including rollover contributions) or elective deferrals with respect to an individual that are invested in employer securities, the plan must provide that the individual is given the opportunity to divest the employer securities and reinvest an equivalent amount in another investment. These rights must be provided to each participant, to each alternate payee who has an account under the plan, and to each beneficiary of a deceased participant.

If employer contributions (other than elective deferrals) are invested in employer securities under the plan, the divestment right must be provided to each participant who has completed at least three years of service, to each alternate payee who has an account under the plan with respect to a participant who has at least three years of service, and to each beneficiary of a deceased participant (regardless of whether the participant had completed at least three years of service). For this purpose, the regulations would provide that a participant has completed three years of service on the last day of the vesting computation period as determined under the plan that constitutes the completion of the third year of service (or the third anniversary of hire for a plan that either uses the elapsed time method or that does not define the vesting computation period because the plan provides for full and immediate vesting).

The regulations would require a plan to provide individuals who have section 401(a)(35) diversification rights the opportunity to divest the employer securities and reinvest an equivalent amount in another investment at least quarterly. The individ-

uals must be permitted to select among no less than three investment options, each of which is diversified and has materially different risk and return characteristics. For this purpose, investment options that constitute a broad range of investment alternatives within the meaning of Department of Labor Regulations section 2550.404c-1(b)(3) are treated as being diversified and having materially different risk and return characteristics.

Plans subject to section 401(a)(35)

Under the proposed regulations, a defined contribution plan which holds publicly-traded employer securities (referred to as an applicable defined contribution plan) is subject to the diversification requirements of section 401(a)(35), unless it is exempted under section 401(a)(35)(E) as a stand-alone ESOP or as a one-participant retirement plan. For this purpose, an employer security is defined by reference to section 407(d)(1) of ERISA.

Under section 401(a)(35)(G)(v), an employer security is a publicly traded employer security if it is readily tradable on an established securities market. The regulations would provide separate rules for securities traded on domestic securities exchanges and foreign securities exchanges.

If a security is traded on a securities exchange that is registered under section 6 of the Securities Exchange Act of 1934, then the security would be deemed to be readily tradable on an established securities market. This definition is consistent with the definition of publicly traded found in §54.4975-7(b)(1)(iv), but deletes the reference to a system sponsored by the National Association of Securities Dealers (NASDAQ) registered under section 15A(b) of the Act (15 U.S.C. 78o) because NASDAQ is now registered as a securities exchange under section 6 of the Securities Exchange Act of 1934. Thus, if a security is not traded on a national securities exchange that is registered under section 6 of the Securities Exchange Act of 1934, then the security would not be publicly traded for purposes of section 401(a)(35), (unless it is traded on a foreign securities exchange and has a “ready market” as described in the next paragraph). This would apply to U.S. securities that are only traded on the

“Over-The-Counter Bulletin Board” and the “pink sheets.”

Under the proposed regulations, if a security is not listed on a securities exchange that is registered under section 6 of the Securities Exchange Act of 1934, but is traded on a foreign national securities exchange that is officially recognized, sanctioned, or supervised by a governmental authority, then under the proposed regulations, the security would be traded on an established securities market. The proposed regulations would provide that such a security is readily tradable if the security is deemed by the Securities and Exchange Commission (SEC) as having a “ready market” under SEC Rule 15c3-1 (17 CFR 240.15c3-1).⁴

The proposed regulations would reflect section 401(a)(35)(F), which, subject to certain exceptions, treats a plan holding employer securities that are not publicly traded as nonetheless subject to the rules of section 401(a)(35) if any employer sponsoring the plan, or any member of the controlled group of corporations (determined by applying section 1563(a), except substituting 50 percent for 80 percent) has issued a class of stock which is publicly traded (as defined above).

Section 401(a)(35)(E)(ii) provides that an ESOP that is a separate plan holding no contributions that are subject to section 401(k) or section 401(m) is not an applicable defined contribution plan. (As noted earlier in this preamble, such a plan is subject to the diversification requirements of section 401(a)(28)(B).) The proposed regulations would clarify that a plan does not lose this exemption merely because it receives rollover contributions of amounts from another plan that are held in a separate account, even if those amounts were attributable to contributions that were subject to section 401(k) or 401(m) in the other plan. In addition, the proposed regulations would reflect the exemption for one-participant retirement plans under section 401(a)(35)(E)(iv).

Notice 2006-107 provides that employer securities held by an investment company registered under the Investment Company Act of 1940 or similar pooled investment vehicle are not treated as being held by the plan. Some comments on Notice 2006-107 had recommended

a broader rule, under which a commingled fund that holds employer securities and other securities would not be treated as holding employer securities that are subject to the section 401(a)(35) diversification requirement. The proposed regulations would not adopt this broad exemption from the diversification rules.

The proposed regulations, however, clarify the types of pooled investment vehicles that are exempt from the diversification requirements. Under the proposed regulations, in order to be exempt from the diversification requirements, the pooled investment vehicle must be a common or collective trust fund or pooled investment fund maintained by a bank or trust company supervised by a State or Federal agency, a pooled investment fund of an insurance company that is qualified to do business in a State, or an investment fund designated by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin. As under Notice 2006-107, the regulations would include the requirement that in order to be exempt from the diversification requirements the pooled investment fund that holds the employer securities must have stated investment objectives and the investment must be independent of the employer and any affiliate thereof. The proposed regulations would add a percentage limitation rule to ensure that the investment in the employer securities through a pooled fund is not an attempt to evade the rules of section 401(a)(35). Under this rule, if the employer securities held by such fund is more than 10 percent of the total value of all of the fund’s investment, then the fund is not considered to be independent of the employer.

Prohibition on restrictions or conditions

The proposed regulations would provide that the section 401(a)(35)(D)(ii)(II) prohibition on restrictions or conditions with respect to the investment of employer securities which are not imposed on the investment of other assets of the plan applies to a direct or indirect restriction on an individual’s rights to divest an investment in employer securities that is not imposed on an investment that is not employer securities as well as a direct or indirect ben-

⁴ Under the current SEC rules, a security is deemed to have a ready market if it is included on the FTSE Group (FTSE) World Index.

efit that is conditioned on investment in employer securities. However, like Notice 2006–107, the regulations would not apply this prohibition to restrictions that are imposed by reason of the application of securities laws and in certain other situations described below.

Like Notice 2006–107, the proposed regulations would allow a plan to impose a restriction on divestiture that is reasonably designed to comply with securities law, even if the restriction is broader than the minimum restriction needed to comply with securities laws. The proposed regulations incorporate the example of such a restriction from Notice 2006–107. This is merely an example and broader restrictions on divestiture are permitted, provided they are reasonably designed to comply with securities law. For example, in some smaller entities a broad restriction allowing divestiture to occur only once a quarter might be a restriction that is reasonably designed to comply with securities law.

Notice 2006–107 includes a rule that permits a plan to restrict the otherwise applicable diversification rights under section 401(a)(35) for a period of up to 90 days following an initial public offering of the employer's stock. The proposed regulations would extend this rule to apply to the first 90 days after the plan becomes an applicable defined contribution plan. This could happen, for example, when some other entity in the controlled group first issues stock which is publicly traded or when a stand-alone ESOP first provides for contributions that are subject to section 401(k) or section 401(m).

Notice 2006–107 permits a plan to impose a restriction on an investment in employer securities that is not imposed on a stable value fund. The proposed regulations extend this rule to a fund that is similar to a stable value fund. Specifically, the proposed regulations would provide that in the case of a plan that has several investment funds, including a fund invested in employer securities, a fund which is a stable value or similar fund, and other funds which are not invested in employer securities, the plan does not impose a restriction prohibited under section 401(a)(35)(D)(ii)(II) merely because the plan permits transfers to be made

into the stable value or similar fund more frequently than into the fund invested in employer securities (assuming the plan does not impose a restriction on transfers to or from the employer securities fund that it does not impose with respect to the other funds).

While the proposed regulations would generally prohibit indirect restrictions on an individual's exercise of diversification rights (such as a plan provision that limits the right of an individual who diversifies out of employer securities by providing that such a participant is not permitted to reinvest in employer securities for a period of time), the rules would permit certain indirect restrictions, as well as certain indirect benefits that are conditioned on investment in employer securities. Under the proposed regulations, a plan would be permitted to limit the extent to which an individual's account balance can be invested in employer securities. For example, a plan would not be treated as imposing a restriction that violates section 401(a)(35)(D)(ii)(II) merely because the plan prohibits a participant from investing additional amounts in employer securities if more than 10 percent of that participant's account balance is (or would be after the change) invested in employer securities. In addition, an applicable defined contribution plan does not violate a prohibition against reinvestment in employer securities if the plan has terminated any further investment in employer securities.

The proposed regulations would provide that a plan is not providing an indirect benefit that is conditioned on investment in employer securities merely because the plan imposes fees on other investment options that are not imposed on the investment in employer securities. In addition, a plan is not providing a restriction on the right to divest an investment in employer securities merely because the plan imposes a reasonable fee for the divestment of employer securities.

The proposed regulations would permit a restriction on the frequency of investment elections that was not in Notice 2006–107. Under this rule, a plan would be permitted to impose reasonable restrictions on the timing and number of investment elections that an individual can make

to invest in employer securities, provided that the restrictions are designed to limit short-term trading in the employer securities. For example, a fund could limit the purchase of employer securities if there has been a sale within a short period of time, such as 7 days. The regulations, however, would not permit a plan to limit an individual's right to divest employer securities.

Proposed Effective Date

Section 401(a)(35) is applicable to plan years beginning on or after January 1, 2007, subject to certain deferred effective dates and transition rules. The proposed regulations would provide guidance on these effective dates and transition rules. In particular, the regulations would provide that a plan is eligible for the deferred effective date applicable to collectively bargained plans only if at least 25 percent of the participants in the plan are members of collective bargaining units for which the contributions under the plan are specified under a collective bargaining agreement.

The regulations under section 401(a)(35) are proposed to be effective for plan years beginning on or after January 1, 2009. Until the regulations go into effect, Notice 2006–107 will continue to apply. For this purpose, the transitional relief provided for the period prior to January 1, 2008, in paragraph 4 of Section III.D. of Notice 2006–107 will continue to apply after 2007 until the regulations go into effect.⁵ In addition, plans are also permitted to apply the proposed regulations for plan years before the regulations go into effect.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because §1.401(a)(35)–1 would not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code,

⁵ The Treasury and IRS are issuing a notice to reflect this extension. The notice is expected to be published as Notice 2008–7 in the 2008–3 issue of the I.R.B. on January 22, 2008, (see §601.601(d)(2)(ii)(b) of this chapter).

this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (one signed and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and the Treasury Department specifically request comments on the clarity of the proposed regulations and how they can be made easier to understand.

In particular, the IRS and Treasury Department request comments on whether the determination of when an employer security is readily tradable on an established securities market under these proposed regulations should also be applied for purposes of determining whether an employer security is readily tradable on an established securities market in applying other provisions relating to qualified plans, given that the same words used in interrelated provisions of the Code are presumed to have the same meaning. These interrelated provisions include section 401(a)(28)(C) (requiring the use of an independent appraiser for valuation of employer securities that are not readily tradable on an established securities market), section 409(h)(1)(B) (relating to put options for employer securities that are not readily tradable on an established market), the definition of employer securities under section 409(l)(1) (including regulations under section 4975), and the special rules under section 1042 (providing nonrecognition treatment for certain sales to an ESOP).

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

Drafting Information

The principal authors of these regulations are Dana A. Barry and Lisa Mojiri-Azad, Office of Division

Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and the Treasury participated in the development of these regulations.

* * * * *

Proposed Amendments to the Regulations

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

Part 1—INCOME TAXES

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

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

Section 1.401(a)(35)–1 is also issued under 26 U.S.C. 401(a)(35). * * *

Par. 2. Section 1.401(a)(35)–1 is added to read as follows:

§1.401(a)(35)–1 Diversification Requirements for Certain Defined Contribution Plans.

(a) *General rule*—(1) *Diversification requirements.* Section 401(a)(35) imposes diversification requirements on applicable defined contribution plans. A trust that is part of an applicable defined contribution plan is not a qualified trust under section 401(a) unless the plan—

(i) Satisfies the diversification election requirements for elective deferrals and employee contributions set forth in paragraph (b) of this section;

(ii) Satisfies the diversification election requirements for employer nonelective contributions set forth in paragraph (c) of this section;

(iii) Satisfies the investment option requirement set forth in paragraph (d) of this section; and

(iv) Does not apply any restrictions or conditions on investments in employer securities that violate the requirements of paragraph (e) of this section.

(2) *Definitions, effective dates, and transition rules.* The definitions of applicable defined contribution plan, employer security, parent corporation, and publicly traded are set forth in paragraph (f) of this section. Effective/applicability dates and transition rules are set forth in paragraph (g) of this section.

(b) *Diversification requirements for elective deferrals and employee contributions invested in employer securities*—(1) *General rule.* With respect to any individual described in paragraph (b)(2) of this section, if any portion of the individual's account under an applicable defined contribution plan attributable to elective deferrals (as described in section 402(g)(3)(A)), after-tax employee contributions, or rollover contributions is invested in employer securities, then the plan satisfies the requirements of this paragraph (b) if the individual may elect to divest those employer securities and reinvest an equivalent amount in other investment options. The plan may limit the time for divestment and reinvestment to periodic, reasonable opportunities occurring no less frequently than quarterly.

(2) *Applicable individual with respect to elective deferrals and employee contributions.* An individual is described in this paragraph (b)(2) if the individual is—

- (i) A participant;
- (ii) An alternate payee who has an account under the plan; or
- (iii) A beneficiary of a deceased participant.

(c) *Diversification requirements for employer nonelective contributions invested in employer securities*—(1) *General rule.* With respect to any individual described in paragraph (c)(2) of this section, if a portion of the individual's account under an applicable defined contribution plan attributable to employer nonelective contributions, other than elective deferrals, is invested in employer securities, then the plan satisfies the requirements of this paragraph (c) if the individual may elect to divest those employer securities and reinvest an equivalent amount in other investment options. The plan may limit the time for divestment and reinvestment to periodic, reasonable opportunities occurring no less frequently than quarterly.

(2) *Applicable individual with respect to employer nonelective contributions.* An individual is described in this paragraph (c)(2) if the individual is—

- (i) A participant who has completed at least three years of service;
- (ii) An alternate payee who has an account under the plan with respect to a participant who has completed at least three years of service; or

(iii) A beneficiary of a deceased participant.

(3) *Completion of 3 years of service.* For purposes of paragraph (c)(2) of this section, a participant completes three years of service on the last day of the vesting computation period provided for under the plan that constitutes the completion of the third year of service under section 411(a)(5). However, for a plan that uses the elapsed time method of crediting service for vesting purposes (or a plan that provides for immediate vesting without using a vesting computation period or the elapsed time method of determining vesting), a participant completes three years of service on the day immediately preceding the third anniversary of the participant's date of hire.

(d) *Investment option.* An applicable defined contribution plan must offer not less than three investment options, other than employer securities, to which an individual who has the right to divest under paragraph (b)(1) or (c)(1) of this section may direct the proceeds from the divestment of employer securities. Each of the three investment options must be diversified and have materially different risk and return characteristics. For this purpose, investment options that constitute a broad range of investment alternatives within the meaning of Department of Labor Regulation section 2550.404c-1(b)(3) are treated as being diversified and having materially different risk and return characteristics.

(e) *Restrictions or conditions on investments in employer securities—(1) Impermissible restrictions or conditions—(i) General rule.* Except as provided in paragraph (e)(2) of this section, an applicable defined contribution plan violates the requirements of this paragraph (e) if the plan imposes restrictions or conditions with respect to the investment of employer securities that are not imposed on the investment of other assets of the plan. A restriction or condition with respect to employer securities means—

(A) A restriction on an individual's right to divest an investment in employer securities that is not imposed on an investment that is not employer securities; and

(B) A benefit that is conditioned on investment in employer securities.

(ii) *Indirect restrictions or conditions.* Except as provided in paragraph (e)(3) of this section, a plan violates the require-

ments of this paragraph (e) if the plan imposes a restriction or condition in paragraph (e)(1)(i)(A) or (B) of this section either directly or indirectly. For example, a plan imposes an indirect restriction on an individual's right to divest an investment in employer securities if the plan provides that a participant who divests his or her account balance with respect to investment in employer securities is not permitted for a period of time thereafter to reinvest in employer securities.

(2) *Permitted restrictions or conditions—(i) In general.* An applicable defined contribution plan does not violate the requirements of this paragraph (e) merely because it imposes a restriction or a condition set forth in paragraph (e)(2)(ii) or (e)(2)(iii) of this section.

(ii) *Securities laws.* A plan is permitted to impose a restriction or condition on the divestiture of employer securities that is either required in order to ensure compliance with applicable securities laws or is reasonably designed to ensure compliance with applicable securities laws. For example, it is permissible for a plan to limit divestiture rights for participants who are subject to section 16(b) of the Securities Exchange Act of 1934 to a reasonable period (such as 3 to 12 days) following publication of the employer's quarterly earnings statements because it is reasonably designed to ensure compliance with Rule 10b-5 of the Securities and Exchange Commission.

(iii) *Deferred application of the diversification requirements.* An applicable defined contribution plan is permitted to restrict the application of the diversification requirements of section 401(a)(35) and this section for up to 90 days after the plan becomes an applicable defined contribution plan (for example, the date on which the employer securities held under the plan become publicly traded).

(3) *Permitted indirect restrictions or conditions—(i) In general.* An applicable defined contribution plan does not violate the requirements of this paragraph (e) merely because it imposes an indirect restriction or condition set forth in paragraphs (e)(3)(ii) through (e)(3)(v) of this section.

(ii) *Limitation on investment in employer securities.* The plan is permitted to limit the extent to which an individual's account balance can be invested in em-

ployer securities, provided the limitation applies without regard to a prior exercise of rights to divest employer securities. For example, a plan does not impose a restriction that violates this paragraph (e) merely because the plan prohibits a participant from investing additional amounts in employer securities if more than 10 percent of that participant's account balance is invested in employer securities.

(iii) *Trading frequency.* A plan is permitted to impose reasonable restrictions on the timing and number of investment elections that an individual can make to invest in employer securities, provided that the restrictions are designed to limit short-term trading in the employer securities. For example, a plan could provide that a participant may not elect to invest in employer securities if the employee has elected to divest employer securities within a short period of time, such as seven days.

(iv) *Frozen funds.* A plan is permitted to prohibit any further investment in employer securities.

(v) *Fees.* The plan has not provided an indirect benefit that is conditioned on investment in employer securities merely because the plan imposes fees on other investment options that are not imposed on the investment in employer securities. In addition, the plan has not provided a restriction on the right to divest an investment in employer securities merely because the plan imposes a reasonable fee for the divestment of employer securities.

(vi) *Transfers to stable value fund.* In the case of a plan that has several investment funds, including one or more funds invested in employer securities, a fund which is a stable value or similar fund, and other funds which are not invested in employer securities, the plan does not impose a restriction prohibited under this paragraph (e) merely because the plan permits transfers to be made into the stable value or similar fund more frequently than other funds (including funds invested in employer securities).

(f) *Definitions—(1) Application of definitions.* This paragraph (f) contains definitions that are applicable for purposes of this section.

(2) *Applicable defined contribution plan—(i) General rule.* Except as provided in this paragraph (f)(2), an applicable defined contribution plan means any

defined contribution plan which holds employer securities that are publicly traded. See paragraph (f)(2)(iv) of this section for a special rule that treats certain plans that hold employer securities that are not publicly traded as applicable defined contribution plans and paragraph (f)(3)(ii) of this section for a special rule that treats certain plans as not holding publicly traded employer securities for purposes of this section.

(ii) *Exception for certain ESOPs.* An employee stock ownership plan (ESOP), as defined in section 4975(e)(7), is not an applicable defined contribution plan if the plan is a separate plan for purposes of section 414(l) with respect to any other defined benefit plan or defined contribution plan maintained by the same employer or employers and holds no contributions (or earnings thereunder) that are (or were ever) subject to section 401(k) or 401(m). Thus, an employee stock ownership plan is an applicable defined contribution plan if that ESOP is a portion of a larger plan (whether or not that larger plan includes contributions that are subject to section 401(k) or 401(m)). For purposes of this paragraph (f)(2)(ii), a plan is not considered to hold amounts ever subject to section 401(k) or 401(m) merely because the plan holds amounts attributable to rollover amounts in a separate account that were previously subject to section 401(k) or 401(m).

(iii) *Exception for one-participant plans.* A one-participant plan, as defined in section 401(a)(35)(E)(iv), is not an applicable defined contribution plan.

(iv) *Certain defined contribution plans treated as holding publicly traded employer securities—(A) General rule.* A defined contribution plan holding employer securities that are not publicly traded is treated as an applicable defined contribution plan if any employer maintaining the plan or any member of a controlled group of corporations that includes such employer has issued a class of stock which is publicly traded. For purposes of this paragraph (f)(2)(iv), a controlled group of corporation has the meaning given such term by section 1563(a), except that “50 percent” is substituted for “80 percent” each place it appears.

(B) *Exception for certain plans.* Paragraph (f)(2)(iv)(A) of this section does not apply to a plan if—

(1) No employer maintaining the plan (or a parent corporation with respect to such employer) has issued stock that is publicly traded; and

(2) No employer maintaining the plan (or parent corporation with respect to such employer) has issued any special class of stock which grants to the holder or issuer particular rights, or bears particular risks for the holder or issuer, with respect to any employer maintaining the plan (or any member of a controlled group of corporations that includes such employer) which has issued any stock that is publicly traded.

(3) *Employer security—(i) General rule.* Employer security has the meaning given such term by section 407(d)(1) of the Employee Retirement Income Security Act of 1974, as amended.

(ii) *Certain defined contribution plans or investment funds not treated as holding employer securities—(A) Exception for certain flow-through investments.* Subject to paragraph (f)(3)(ii)(B) and (C) of this section, a plan (and an investment option described in paragraph (d) of this section) is not treated as holding employer securities for purposes of this section to the extent the employer securities are held indirectly through—

(1) An investment company registered under the Investment Company Act of 1940;

(2) A common or collective trust fund or pooled investment fund maintained by a bank or trust company supervised by a State or a Federal agency;

(3) A pooled investment fund of an insurance company that is qualified to do business in a State; or

(4) Any other investment fund designated by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin.

(B) *Investment must be independent.* The exception set forth in paragraph (f)(3)(ii)(A) of this section applies only if the investment in the employer securities are held in a fund under which—

(1) There are stated investment objectives of the fund; and

(2) The investment is independent of the employer and any affiliate thereof.

(C) *Percentage limitation rule.* For purposes of paragraph (f)(3)(ii)(B)(2) of this section, an investment in employer securities in a fund is considered to be independent of the employer and any affiliate

thereof only if the aggregate value of the employer securities held in the fund is not in excess of 10 percent of the total value of all of the fund’s investments.

(4) *Parent corporation.* Parent corporation has the meaning given such term by section 424(e).

(5) *Publicly traded—(i) In general.* A security is publicly traded if it is readily tradable on an established securities market.

(ii) *Established securities market.* For purposes of this paragraph (f)(5), a security is traded on an established securities market if—

(A) The security is traded on a national securities exchange that is registered under section 6 of the Securities and Exchange Act of 1934 (15 U.S.C. 78f); or

(B) The security is traded on a foreign national securities exchange that is officially recognized, sanctioned, or supervised by a governmental authority.

(iii) *Readily tradable.* For purposes of this paragraph (f)(5), except as provided by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin, a security is readily tradable if—

(A) The security is traded on a securities exchange that is described in paragraph (f)(5)(ii)(A) of this section; or

(B) The security is traded on a securities exchange that is described in paragraph (f)(5)(ii)(B) of this section and the security is deemed by the Securities and Exchange Commission (SEC) as having a “ready market” under SEC Rule 15c3-1 (17 CFR 240.15c3-1).

(g) *Effective date and transition rules—(1) Statutory effective date—(i) General rule.* Except as otherwise provided in this paragraph (g), section 401(a)(35) is effective for plan years beginning after December 31, 2006.

(ii) *Collectively bargained plans—(A) Delayed effective date.* In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified on or before August 17, 2006, section 401(a)(35) is effective for plan years beginning after the earlier of

(1) the later of—

(i) December 31, 2007; or

(ii) the date on which the last such collective bargaining agreement terminates

(determined without regard to any extension thereof); or

(2) December 31, 2008.

(B) *Definition of collectively bargained plans.* For purposes of this paragraph (g)(1)(ii), in the case of a plan for which one or more collective bargaining agreements apply to some, but not all, of the plan participants, the plan is considered a collectively bargained plan if at least 25 percent of the participants in the plan are members of collective bargaining units for which the contributions under the plan

are specified under a collective bargaining agreement.

(iii) *Special rule for certain employer securities held in an ESOP.* Section 901(c)(3)(A) and (B) of the Pension Protection Act of 2006, Public Law 109–280, 120 Stat. 780 (PPA '06), provides a special effective date for an employee stock ownership plan that holds a class of preferred stock with a guaranteed minimum value, as described in that section.

(2) *Statutory transition rules—(i) General rule.* Pursuant to section

401(a)(35)(H), in the case of the portion of an account to which paragraph (c) of this section applies and that consists of employer securities acquired in a plan year beginning before January 1, 2007, the requirements of paragraph (c) of this section only apply to the applicable percentage of such securities.

(ii) *Applicable percentage—(A) Phase-in percentage.* For purposes of this paragraph (g)(2), the applicable percentage is determined as follows—

Plan year to which paragraph (c) of this section applies:	The applicable percentage is:
1st	33
2nd	66
3rd and following	100

(B) *Special rule.* For a plan described in paragraph (g)(1)(iii) of this section for which the special effective date under section 901(c)(3) of PPA '06 applies, the applicable percentage under this paragraph (g)(2)(ii) is determined without regard to the delayed effective date in section 901(c)(3)(A) and (B) of PPA '06.

(iii) *Nonapplication for participants age 55 with three years of service.* Paragraph (g)(2)(i) of this section does not apply to an individual who is a participant who attained age 55 and had completed at least three years of service (as defined in paragraph (c)(3) of this section) before the first day of the first plan year beginning after December 31, 2005.

(iv) *Separate application by class of securities.* This paragraph (g)(2) applies separately with respect to each class of securities.

(3) *Regulatory effective date.* This section is effective for plan years beginning on or after January 1, 2009.

Linda E. Stiff,
Deputy Commissioner for
Services and Enforcement.

(Filed by the Office of the Federal Register on January 2, 2008, 8:45 a.m., and published in the issue of the Federal Register for January 3, 2008, 73 F.R. 421)

Update to Publication 1187, Specifications for Filing Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding, Electronically or Magnetically, revised September 2006

Announcement 2008-19

This announcement supersedes Announcement 2008-6 and corrects a typographical error. The reference to the state code table in the second bullet was changed to Sec. 17. Publicly Traded Partnership (PTP) was added the 'Q' record descriptions below which reference NQI/FLW-THR. Continue to use Publication 1187, *Specifications for Filing Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding, Electronically or Magnetically*, revised September 2006 along with the changes listed below for your Tax Year 2007 filing. The following changes are effective for Tax Year 2007 filed in calendar year 2008.

- An explanatory note was added to the Recipient 'Q' Record which reads: If you are a nominee that is the withholding agent under Code Section 1446, enter the Publicly Traded Partnership's (PTP) name and other information in the NQI/FLW-THR/PTP fields; positions 401-666.

- In the Recipient 'Q' Record, a new field, NQI/FLW-THR/PTP State Code, was added to positions 643-644. Enter the two-alpha character state code (see table Part A, Sec. 17). If a state code or APO/FPO is not applicable then blank fill.
- Additional instructions were added to the Recipient 'Q' Record, NQI/FLW-THR/PTP Country Code, positions 647-648. The instructions read: Enter the two-character Country Code abbreviation, where the NQI/FLW-THR/PTP is located. Enter blanks if the NQI/FLW-THR/PTP has a U.S. address.
- The Field Title was changed and additional instructions were added to the Recipient 'Q' Record, NQI/FLW-THR/PTP Postal Code/ZIP Code, positions 649-657. The instructions read: Enter the alpha/numeric foreign postal code or U.S. ZIP Code for all U.S. addresses including territories, possessions and APO/FPO. Enter the code in the left most position and blank fill the remaining positions. **DO NOT** use hyphens or blanks between numbers or letters (e.g., if the postal code is written as A6B 3C5 input as A6B3C5). Left-justify.
- Some of the Canadian Province codes changed. Use the chart below to code your file.

Province Code**Province**

AB	Alberta
BC	British Columbia
MB	Manitoba
NB	New Brunswick
NL	Newfoundland & Labrador
NS	Nova Scotia
NT	Northwest Territories
NU	Nunavut
ON	Ontario
PE	Prince Edward Island
QC	Quebec
SK	Saskatchewan
YT	Yukon Territory

If you have questions concerning the filing of Form 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*, please contact the Internal Revenue Service ECC-MTB toll-free at 866-455-7438.

Deletions From Cumulative List of Organizations Contributions to Which are Deductible Under Section 170 of the Code

Announcement 2008-20

The Internal Revenue Service has revoked its determination that the organizations listed below qualify as organizations described in sections 501(c)(3) and 170(c)(2) of the Internal Revenue Code of 1986.

Generally, the Service will not disallow deductions for contributions made to a listed organization on or before the date of announcement in the Internal Revenue Bulletin that an organization no longer qualifies. However, the Service is not precluded from disallowing a deduction for any contributions made after an organization ceases to qualify under section 170(c)(2) if the organization has not timely

filed a suit for declaratory judgment under section 7428 and if the contributor (1) had knowledge of the revocation of the ruling or determination letter, (2) was aware that such revocation was imminent, or (3) was in part responsible for or was aware of the activities or omissions of the organization that brought about this revocation.

If on the other hand a suit for declaratory judgment has been timely filed, contributions from individuals and organizations described in section 170(c)(2) that are otherwise allowable will continue to be deductible. Protection under section 7428(c) would begin on March 17, 2008, and would end on the date the court first determines that the organization is not described in section 170(c)(2) as more particularly set forth in section 7428(c)(1). For individual contributors, the maximum deduction protected is \$1,000, with a husband and wife treated as one contributor. This benefit is not extended to any individual, in whole or in part, for the acts or omissions of the organization that were the basis for revocation.

Drive for Youth 2020
Missouri City, TX
Rise and Shine, Inc.
Medical Lake, WA
Bluegrass Gymnastic Boosters, Inc.
Lexington, KY

DebtTech
Columbia, MD
Nexum Credit Counseling, Inc.
Vero Beach, FL
New Home Gallery, Inc.
Louisville, KY
Alban Community Services Foundation
Lititz, PA
Union Oaks, Inc.
Omaha, NE
Shiloh Ministries of Hagerstown, Inc.
Hagerstown, MD
Credicure, Inc.
Martinsburg, WV
Newton Family Foundation
West Jordan, UT
Alliance to Rebuild LA
Santa Monica, CA
The Down Payment Assistance Group
San Diego, CA
Phillip J. Kronzer Foundation for
Religious Research
Los Gatos, CA
Credit Success Company
Jacksonville, FL
Mario C. and Elva G. Rapanotti Charitable
Supporting Organization
San Antonio, TX
Anthony & Megan Wolfenden Charitable
Supporting Organization
Santa Clara, CA

Definition of Terms

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

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

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

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

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A

and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

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

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

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance

of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

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

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

Abbreviations

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

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.

ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.

PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statement of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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