

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. 2003-104, page 636.

Interest rates; underpayments and overpayments. The rate of interest determined under section 6621 of the Code for the calendar quarter beginning October 1, 2003, will be 4 percent for overpayments (3 percent in the case of a corporation), 4 percent for underpayments, and 6 percent for large corporate underpayments. The rate of interest paid on the portion of a corporate overpayment exceeding \$10,000 will be 1.5 percent.

T.D. 9078, page 630.

Final regulations under section 1361 of the Code provide guidance regarding a qualified subchapter S trust election for testamentary trusts and the period for which former qualified subpart E trusts and testamentary trusts may be permitted shareholders of an S corporation. In addition, these regulations provide that the definition of a testamentary trust also includes a trust to which S corporation stock is either transferred under the terms of an electing qualified revocable trust during its election period or deemed to be distributed at the close of the last day of the election period.

Notice 2003-64, page 646.

Investments through multiple CDEs. The Treasury Department and the Service announce that they will amend regulations section 1.45D-1T(d)(1)(iv) to include investments through two additional qualified community development entities (CDEs) described in section 45D(c) of the Code.

Announcement 2003-56, page 694.

This announcement provides information regarding changes to the reporting for certain 2002 forms affected by the decrease in the capital gains tax rates. Partnerships, S corporations, estates, individuals, real estate investment trusts, and mutual funds and other regulated investment companies with a fiscal year beginning in 2002 and ending after May 5, 2003, must reflect the changes required by this announcement in their reporting for the tax year.

EMPLOYEE PLANS

T.D. 9075, page 608.

Final regulations under section 457 of the Code provide guidance on eligible section 457 deferred compensation plans of state and local governmental employers and tax-exempt entities. The regulations reflect changes made to section 457 by the Tax Reform Act of 1986, The Small Business Job Protection Act of 1996, The Economic Growth and Tax Relief Reconciliation Act of 2001, and other legislation. The regulations also make various technical changes and clarifications to the existing final regulations.

(Continued on the next page)

Finding Lists begin on page ii.



ESTATE TAX

T.D. 9077, page 634.

Final regulations under section 2519 of the Code relate to the amount treated as a transfer when there is a right to recover gift tax under section 2207A(b). The regulations also include related gift and estate tax consequences if the right to recover the gift tax is not exercised. These regulations will affect donee spouses who make lifetime dispositions of all or part of a qualifying income interest in qualified terminable interest property.

GIFT TAX

T.D. 9077, page 634.

Final regulations under section 2519 of the Code relate to the amount treated as a transfer when there is a right to recover gift tax under section 2207A(b). The regulations also include related gift and estate tax consequences if the right to recover the gift tax is not exercised. These regulations will affect donee spouses who make lifetime dispositions of all or part of a qualifying income interest in qualified terminable interest property.

ADMINISTRATIVE

T.D. 9074, page 601.

Final regulations under section 66 of the Code relate to the treatment of community income for certain married individuals in community property states who do not file joint federal income tax returns.

Notice 2003–60, page 643.

This notice addresses a number of collection issues arising from the Supreme Court decision in *United States v. Craft*, 535 U.S. 274 (2002–38 I.R.B. 548), in which the Court held that the federal tax lien attaches to the rights of the delinquent taxpayer in property held as a tenancy by the entirety, even though state law insulates entireties property from the claims of creditors of only one spouse.

Rev. Proc. 2003–73, page 647.

Substitute tax forms and schedules. Requirements are set forth for privately designed and printed federal tax forms and conditions under which the IRS will accept computer-prepared and computer-generated tax forms and schedules. Rev. Proc. 2002–60 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 consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

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

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

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

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

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.

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

Part II.—Treaties and Tax Legislation.

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

Part III.—Administrative, Procedural, and Miscellaneous.

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

Part IV.—Items of General Interest.

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

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

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

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

Section 66.—Treatment of Community Income

26 CFR 1.66-1: Treatment of community income.

T.D. 9074

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

Treatment of Community Income for Certain Individuals Not Filing Joint Returns

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the treatment of community income under Internal Revenue Code section 66 for certain married individuals in community property states who do not file joint federal income tax returns. The final regulations also reflect changes in the law made by the Internal Revenue Service Restructuring and Reform Act of 1998.

EFFECTIVE DATE: These final regulations are effective July 10, 2003.

FOR FURTHER INFORMATION CONTACT: Robin M. Tuczak, 202-622-4940 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in the 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) under control number 1545-1770. Responses to this collection of information are required in order for certain individuals to receive relief from the operation of community property law.

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

collection of information displays a valid control number assigned by the Office of Management and Budget.

Estimated total annual reporting burden for 2001 for Form 8857, "Request for Innocent Spouse Relief": 21,123 hours.

Estimated average annual burden hours per response: 59 minutes.

Estimated number of responses for 2001 for Form 8857: 21,336.

Requests for relief under section 66(c) constitute less than 1% of the total requests filed using Form 8857.

Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:T:T:SP, Washington, DC 20224.

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 return information are confidential, as required by section 6103 of the Internal Revenue Code (Code).

Background

This document contains amendments to 26 CFR part 1 under section 66 of the Code, relating to the treatment of community income for certain individuals not filing joint returns. For rules regarding relief from joint and several liability when a joint return is filed, see section 6015 and the regulations thereunder.

A notice of proposed rulemaking (REG-115054-01, 2002-1 C.B. 530 [67 FR 2841]) was published in the **Federal Register** on January 22, 2002. No public hearing was requested or held. Written 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 comments and revisions are discussed below.

Explanation and Summary of Comments

1. General

One commentator suggested that the proposed regulations under section 66 (particularly §1.66-2) were not helpful, given the community property laws of the commentator's state. This commentator also suggested that the proposed regulations appear to assume that the community property laws of all community property states are the same. The intent of these regulations is not to provide guidance based on the community property laws of any particular state. Instead, the regulations provide guidance on the effect of section 66 on taxpayers' community income as determined under state law. After a determination that an item of income is community income under state law, these regulations provide guidance on the treatment of this income under section 66 for certain individuals not filing joint returns.

One commentator noted that there are fundamental differences between married taxpayers who filed joint returns and request relief from joint and several liability under section 6015 and married taxpayers who filed separate returns and request relief from the federal income tax liability resulting from the operation of community property law under section 66(c).

The final regulations do not address differences between or make generalizations concerning married taxpayers who file joint returns and those who do not. The final regulations focus on providing guidance on the treatment of community income for certain taxpayers under section 66.

The preamble to the proposed regulations under section 66 references the spousal notification requirements set forth in regulations under section 6015 and discusses similar notification requirements under section 66. If the IRS grants relief under section 66, the liability of the requesting spouse will shift to the nonrequesting spouse. Thus, notification and participation requirements similar to those applicable in section 6015 cases are also appropriate for section 66 cases. In addition, information provided by a nonrequesting spouse may help to determine

the appropriate amount of relief for the requesting spouse, if any.

Similarities between the guidance set forth in the regulations under section 6015 and the regulations under section 66 are due to the similarities in the elements required, or factors considered, in determining relief under these statutes. The analysis set forth in proposed §1.66-4(a)(2) and (3) regarding knowledge or reason to know and benefit is similar to that contained in §1.6015-2(c) and (d). The final regulations modify this analysis and adopt commentators' suggestions to the extent that the suggestions are consistent with the statute, legislative history, and case law under section 66(c). These changes are more fully discussed in the comments and explanation under §1.66-4 below.

2. §1.66-1

One commentator stated that §1.66-1 of the proposed regulations failed to expressly require each of the spouses to report those items of separate income that are attributable to each spouse under applicable state community property laws. Generally, community income is reportable half by each spouse pursuant to *Poe v. Seaborn*, 282 U.S. 101 (1930), and section 61. Whether income is separate or community is determined under state law and the income is included in gross income under section 61. The final regulations do not include guidance on how to report income that is not community income under state law, as this would be outside the scope of section 66.

The final regulations clarify in §1.66-1(a) that the general rule of community property applies to married individuals domiciled in community property states. A taxpayer should report income in accordance with the laws of the state in which he or she is domiciled. *United States v. Mitchell*, 403 U.S. 190, 197 (1971); *Commissioner v. Wilkerson*, 368 F.2d 552, 553 (9th Cir. 1966). For example, a taxpayer who is domiciled in State A, a community property state, should report income in accordance with the community property laws of State A, although she may be living in State B temporarily, due to a work detail, military assignment, etc.

One commentator noted that under §1.66-1(b), the limitation of the scope of

the regulations to married taxpayers was too restrictive. The commentator noted that income earned during a marriage, but received after the dissolution of the marital community, was community income under the laws of the commentator's state. The commentator suggested that section 66 should apply to this income, as it is community income under state law. The final regulations frame the issue in terms of application of section 66 to community income, rather than in terms of marital status.

The final regulations state that section 66 applies only to community income, as defined by state law. The final regulations, however, make a distinction between community income and income from property that was formerly community property but, in accordance with state law, is converted to a form of property that is not community property, such as separate property or property held by joint tenancy or tenancy in common.

Under the laws of certain community property states, property that was community property during the marriage ceases to be community property after the dissolution of the marital community. Conversely, some state laws treat property that was not community property as community property for the limited purpose of dividing assets upon divorce. See *Estate of Mitchell v. Mitchell*, 76 Cal. App. 4th 1378 (Cal. Ct. App. 1999). Income from such property is not community income subject to the provisions of section 66. The determination as to whether income from such property is community income may be confusing due to the fact that sometimes courts will refer to the property, using "universally recognized shorthand," as community property. See *Bouterie v. Commissioner*, 36 F.3d 1361 (5th Cir. 1994) (in which the court found that the wife did not have community income from community property and the IRS improperly relied on a state court's imprecise use of the term "community property" in referring to property that was formerly community property), *rev'g* T.C. Memo. 1993-510.

Thus, in determining whether section 66 applies to income, it is first necessary to determine whether the income is community income under state law. The marital status of the parties likely will be relevant to this initial determination.

3. §1.66-2

One commentator noted that it may be difficult to determine whether a transfer of income is a transfer of *earned* income under §1.66-2(a)(5). A transfer of earned income precludes the reporting of income in accordance with §1.66-2, even if a taxpayer meets the other requirements of §1.66-2. The commentator suggested that there should be a presumption under §1.66-2 that any transfer of income or property is a transfer of earned income. The final regulations adopt this recommendation with respect to transfers of income. It is a logical presumption that income is more likely to be earned than unearned, and that a taxpayer who has unearned income is likely to have earned income as well.

Another commentator suggested that the final regulations clarify the requirement of §1.66-2 that spouses live apart. The final regulations adopt this recommendation by cross-referencing the definition of members of the same household in §1.6015-3(b).

The final regulations clarify that, when reporting income in accordance with section 66(a), an individual must report all income in accordance with section 66(a). Section 66(a) does not apply on an item-by-item basis.

4. §1.66-3

One commentator recommended that the final regulations emphasize that the IRS may disallow the federal income tax benefits of any community property law under section 66(b) on an item-by-item basis. Because the proposed regulations already reference "item of community income" in every sentence of §1.66-3, however, the final regulations do not adopt this recommendation.

One commentator suggested that the IRS should assert section 66(b) sparingly, only if "the . . . spouse had no knowledge whatever of the income . . . and did not benefit from the income in a division of marital assets." Section 66(b) allows the IRS to deny the federal income tax benefits of community property law only when a taxpayer acted as if solely entitled to the income and failed to notify the taxpayer's spouse of the income. The

final regulations do not impose additional requirements on the IRS.

Commentators also recommended that the final regulations provide examples of what constitutes treating income as solely one's own and how specific a taxpayer must be when notifying his or her spouse of the nature and amount of the income. The final regulations adopt this recommendation.

5. §1.66-4

The proposed regulations describe relief granted under the first sentence of section 66(c) as "specific relief." The final regulations adopt the term *traditional relief* to describe relief granted under this provision. The final regulations retain the term "equitable relief" to describe the relief granted under the second sentence of section 66(c).

The proposed regulations require that a spouse requesting relief under §1.66-4 file a separate return for the taxable year relating to the request. One commentator noted that section 66(c)(1) requires only that an individual not file a joint return. The legislative history of section 66(c) confirms that Congress did not intend to require an individual to file a return to be eligible for relief under this provision. The House Report uses the phrase "at the time the return was filed (if a return is filed)." H.R. Rep. No. 98-432, pt. 2, at 1503 (1984). In earlier cases regarding relief under section 66(c), the Tax Court implies that a requesting spouse must file a separate return. See, e.g., *Roberts v. Commissioner*, T.C. Memo. 1987-391, *aff'd* 860 F.2d 1235 (5th Cir. 1988). More recent cases, however, specifically state that not filing any return meets the requirement of not filing a joint return. See, e.g., *Ollestad v. Commissioner*, T.C. Memo. 1996-139; *Costa v. Commissioner*, T.C. Memo. 1990-572. The final regulations adopt the recommendation to limit the requirement to not filing a joint return.

One commentator suggested that the discussion of knowledge and reason to know of an item of community income in §1.66-4 ignores the low probability that a requesting spouse would have access to accurate information or knowledge regarding what the nonrequesting spouse reported or did not report for federal income tax purposes. Under section 66(c),

a requesting spouse is required to prove, among other things, that "he or she did not know of, and had no reason to know of, such item of community income" to obtain traditional relief. The final regulations include a discussion of knowledge and reason to know, as this is an element required by section 66(c)(3). The facts and circumstances considered in making the determination of knowledge or reason to know are consistent with the knowledge and reason to know analysis set forth in case law determining relief under section 66(c).

Additionally, the final regulations include new language regarding the knowledge standard under section 66(c). To more closely track the language of section 66(c), the phrase *item of community income* replaces the term *understatement* when referring to the item about which the requesting spouse has knowledge or reason to know. Finally, the final regulations clarify that knowledge of the source of community income or the income-producing activity, without knowledge of the specific amount of income, is sufficient knowledge to preclude relief under section 66(c). This is consistent with the knowledge and reason to know analysis set forth in case law under section 66(c). See, e.g., *McGee v. Commissioner*, 979 F.2d 66, 70 (5th Cir. 1992), *aff'g* T.C. Memo. 1991-510.

Two commentators questioned whether the standard of significant benefit in excess of normal support, which is used in determining whether it is equitable to grant relief under section 6015, is the applicable standard under section 66. One commentator noted that under community property laws, each spouse generally is entitled to half of the income of the other spouse. Under section 66, a requesting spouse essentially is seeking relief for half the income of both spouses, which may have been used to provide normal support to both spouses. Contrast this situation to that under section 6015, which permits a requesting spouse to seek relief from joint and several liability for the tax on all of the income of the nonrequesting spouse. This commentator suggested that the tax liability should be shifted to the nonrequesting spouse only if the nonrequesting spouse has treated the income in a manner inconsistent with the community property regime, for example, has not allowed use of the income for normal support or has

transferred no part of the income to the requesting spouse.

A majority of cases decided under section 66(c) make the determination of whether it is equitable to grant relief based on the "benefit" received by the requesting spouse, as opposed to the "significant benefit" standard applied by courts in determining relief under former section 6013(e) and section 6015(b). See *Beck v. Commissioner*, T.C. Memo. 2001-198, *acq.* 2002-49 I.R.B.; *Hardy v. Commissioner*, T.C. Memo. 1997-97. The court in *Beck* and *Hardy* cited the legislative history of section 66(c) when discussing benefit under section 66. The legislative history provides that, in determining whether it is equitable to grant relief under section 66(c), the standard is "whether the [requesting] spouse benefitted from the untaxed income." H. Rep. No. 98-432, pt. 2, at 1503 (1984). The final regulations adopt this standard.

One commentator suggested that the time limitations set forth in §1.66-4 for requesting relief under section 66(c) are not supported by the language of section 66(c). Although the statute itself does not set forth time limitations on the filing of a request for relief, the time limitations in the proposed regulations are supported by the legislative history of the traditional relief provision of section 66(c). Specifically, the House Report explaining traditional relief under section 66(c) states that, in making the determination as to relief, the IRS should consider (among other things) "whether the defense was promptly raised so as to prevent the period of limitations from running on the other spouse." H.R. Rep. No. 98-432, pt. 2, at 1501 (1984). Thus, the final regulations retain the time limitations set forth in the proposed regulations. In contrast, §1.66-4(j)(2)(ii) sets forth timing requirements for requesting equitable relief that are broader than the requirements applicable to traditional relief because the legislative history of the equitable relief provision does not contain similar timing requirements. Therefore, a requesting spouse who does not meet the time limitations to request traditional relief may be eligible to request equitable relief.

Another commentator noted that perhaps the timeliness of the requesting spouse's request should be only one factor in determining whether to grant traditional

relief under section 66(c), as opposed to a threshold requirement. This comment was not adopted because a requesting spouse who does not meet the timing requirements for traditional relief still may receive equitable relief under section 66(c).

One commentator urged that no request for relief under section 66 should be considered premature. There must be some indication that the IRS may determine a deficiency prior to the filing of a request for relief from a deficiency under section 66(c). Thus, the final regulations retain the timing limitations set forth in the proposed regulations regarding premature requests.

The final regulations incorporate an item-by-item approach to relief from the federal income tax liability resulting from the operation of community property law under section 66(c). If a requesting spouse receives relief under section 66(c), the proposed regulations provide for treatment of *any* community income of the spouses in accordance with the rules provided by section 879(a), which is consistent with the statutory rule under section 66(a). The final regulations provide that if a requesting spouse receives relief for an item, the rules provided by section 879(a) will govern the treatment of the item. The item-by-item approach adopted in the final regulations is consistent with the statutory language in section 66(c) that states “such *item* of community income shall be included in the gross income of the other spouse (and not in the gross income of the individual).” (Emphasis added.)

Traditionally, section 66(c) provided relief from liability resulting only from items of income, unlike former section 6013(e) and section 6015. The final regulations expand equitable relief under §1.66-4(b) to include relief for underpayments of tax or any deficiency, including those arising from disallowed deductions or credits. This is consistent with the equitable relief provision in section 66(c).

Special Analyses

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

not apply to the regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply.

Drafting Information

The principal author of the regulations is Robin M. Tuczak of the Office of Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice Division.

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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 adding an entry in numerical order to the table to read in part as follows:

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

Section 1.66-4 also issued under 26 U.S.C. 66(c). * * *

Par. 2. Sections 1.66-1 through 1.66-5 are added to read as follows:

§1.66-1 Treatment of community income.

(a) *In general.* Married individuals domiciled in a community property state who do not elect to file a joint individual federal income tax return under section 6013 generally must report half of the total community income earned by the spouses during the taxable year except at times when one of the following exceptions applies:

(1) The spouses live apart and meet the qualifications of §1.66-2.

(2) The Secretary denies a spouse the federal income tax benefits resulting from community property law under §1.66-3, because that spouse acted as if solely entitled to the income and failed to notify his or her spouse of the nature and amount of the income prior to the due date for the filing of his or her spouse's return.

(3) A requesting spouse qualifies for traditional relief from the federal income tax liability resulting from the operation of community property law under §1.66-4(a).

(4) A requesting spouse qualifies for equitable relief from the federal income tax liability resulting from the operation of community property law under §1.66-4(b).

(b) *Applicability.* (1) The rules of this section apply only to community income, as defined by state law. The rules of this section do not apply to income that is not community income. Thus, the rules of this section do not apply to income from property that was formerly community property, but in accordance with state law, has ceased to be community property, becoming, *e.g.*, separate property or property held by joint tenancy or tenancy in common.

(2) When taxpayers report income under paragraph (a) of this section, *all* community income for the calendar year is treated in accordance with the rules provided by section 879(a). Unlike the other provisions under section 66, section 66(a) does not permit inclusion on an item-by-item basis.

(c) *Transferee liability.* The provisions of section 66 do not negate liability that arises under the operation of other laws. Therefore, a spouse who is not subject to federal income tax on community income may nevertheless remain liable for the unpaid tax (including additions to tax, penalties, and interest) to the extent provided by federal or state transferee liability or property laws (other than community property laws). For the rules regarding the liability of transferees, see sections 6901 through 6904 and the regulations thereunder.

§1.66-2 Treatment of community income where spouses live apart.

(a) Community income of spouses domiciled in a community property state will be treated in accordance with the rules provided by section 879(a) if all of the following requirements are satisfied—

(1) The spouses are married to each other at any time during the calendar year;

(2) The spouses live apart at all times during the calendar year;

(3) The spouses do not file a joint return with each other for a taxable year beginning or ending in the calendar year;

(4) One or both spouses have earned income that is community income for the calendar year; and

(5) No portion of such earned income is transferred (directly or indirectly) between

such spouses before the close of the calendar year.

(b) *Living apart.* For purposes of this section, living apart requires that spouses maintain separate residences. Spouses who maintain separate residences due to temporary absences are not considered to be living apart. Spouses who are not members of the same household under §1.6015-3(b) are considered to be living apart for purposes of this section.

(c) *Transferred income.* For purposes of this section, transferred income does not include a *de minimis* amount of earned income that is transferred between the spouses. In addition, any amount of earned income transferred for the benefit of the spouses' child will not be treated as an indirect transfer to one spouse. Additionally, income transferred between spouses is presumed to be a transfer of earned income. This presumption is rebuttable.

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

Example 1. Living apart. H and W are married, domiciled in State A, a community property state, and have lived apart the entire year of 2002. W, who is in the Army, was stationed in Korea for the entire calendar year. During their separation, W intended to return home to H, and H intended to live with W upon W's return. H and W do not file a joint return for taxable year 2002. H and W may not report their income under this section because a temporary absence due to military service is not living apart as contemplated under this section.

Example 2. Transfer of earned income—de minimis exception. H and W are married, domiciled in State B, a community property state, and have lived apart the entire year of 2002. H and W are estranged and intend to live apart indefinitely. H and W do not file a joint return for taxable year 2002. H occasionally visits W and their two children, who live with W. When H visits, he often buys gifts for the children, takes the children out to dinner, and occasionally buys groceries or gives W money to buy the children new clothes for school. Both W and H have earned income in the year 2002 that is community income under the laws of State B. H and W may report their income on separate returns under this section.

Example 3. Transfer of earned income—source of transfer. H and W are married, domiciled in State C, a community property state, and have lived apart the entire year of 2002. H and W are estranged and intend to live apart indefinitely. H and W do not file a joint return for taxable year 2002. W provides H \$1,000 a month from March 2002 through August 2002 while H is working part-time and seeking full-time employment. W is not legally obligated to make the \$1,000 payments. W earns \$75,000 in 2002 in wage income. W also receives \$10,000 in capital gains income in December 2002. H wants to report his income in accordance with this section, alleging that the \$6,000

that he received from W was not from W's earned income, but from the capital gains income W received in 2002. The facts and circumstances surrounding the periodic payments to H from W do not indicate that W made the payments out of her capital gains. H and W may not report their income in accordance with this section, as the \$6,000 W transferred to H is presumed to be from W's earned income, and H has not presented any facts to rebut the presumption.

§1.66-3 Denial of the federal income tax benefits resulting from the operation of community property law where spouse not notified.

(a) *In general.* The Secretary may deny the federal income tax benefits of community property law to any spouse with respect to any item of community income if that spouse acted as if solely entitled to the income and failed to notify his or her spouse of the nature and amount of the income before the due date (including extensions) for the filing of the return of his or her spouse for the taxable year in which the item of income was derived. Whether a spouse has acted as if solely entitled to the item of income is a facts and circumstances determination. This determination focuses on whether the spouse used, or made available, the item of income for the benefit of the marital community.

(b) *Effect.* The item of community income will be included, in its entirety, in the gross income of the spouse to whom the Secretary denied the federal income tax benefits resulting from community property law. The tax liability arising from the inclusion of the item of community income must be assessed in accordance with section 6212 against this spouse.

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

Example 1. Acting as if solely entitled to income. (i) H and W are married and are domiciled in State A, a community property state. W's Form W-2 for taxable year 2000 showed wage income of \$35,000. W also received a Form 1099-INT, "Interest Income," showing \$1,000 W received in taxable year 2000. W's wage income was directly deposited into H and W's joint account, from which H and W paid bills and household expenses. W did not inform H of her interest income or the Form 1099-INT, but W gave H a copy of the W-2 when she received it in January 2001. W did not use her interest income for bills or household expenses. Instead W gave her interest income to her brother, who was unemployed. Neither the separate return filed by H nor the separate return filed by W included the interest income. In 2002, the IRS audits both H and W. The Internal Revenue Service (IRS) may raise section 66(b) as to W's interest

income, denying W the federal income tax benefit resulting from community property law as to this item of income.

(ii) H and W are married and are domiciled in State B, a community property state. For taxable year 2000, H receives \$45,000 in wage income that H places in a separate account. H and W maintain separate residences. H's wage income is community income under the laws of State B. That same year, W loses her job, and H pays W's mortgage and household expenses for several months while W seeks employment. Neither H nor W files a return for 2000, the taxable year for which the IRS subsequently audits them. The IRS may not raise section 66(b) and deny H the federal income tax benefits resulting from the operation of community property law as to H's wage income of \$45,000, as H has not treated this income as if H were solely entitled to it.

Example 2. Notification of nature and amount of the income. H and W are married and domiciled in State C, a community property state. H and W do not file a joint return for taxable year 2001. H's and W's earned income for 2001 is community income under the laws of State C. H receives \$50,000 in wage income in 2001. In January 2002, H receives a Form W-2 that erroneously states that H earned \$45,000 in taxable year 2001. H provides W a copy of H's Form W-2 in February 2002. W files an extension prior to April 15, 2002. H receives a corrected Form W-2 reflecting wages of \$50,000 in May 2002. H provides a copy of the corrected Form W-2 to W in May 2002. W files a separate return in June 2002, but reports one half of \$45,000 (\$22,500) of wage income that H earned. H files a separate return reporting half of \$50,000 (\$25,000) in wage income. The IRS audits both H and W. Even if H had acted as if solely entitled to the wage income, the IRS may not raise section 66(b) as to this income because H notified W of the nature and amount of the income prior to the due date of W's return (including extensions).

§1.66-4 Request for relief from the federal income tax liability resulting from the operation of community property law.

(a) *Traditional relief—(1) In general.* A requesting spouse will receive relief from the federal income tax liability resulting from the operation of community property law for an item of community income if—

(i) The requesting spouse did not file a joint federal income tax return for the taxable year for which he or she seeks relief;

(ii) The requesting spouse did not include in gross income for the taxable year an item of community income properly includible therein, which, under the rules contained in section 879(a), would be treated as the income of the nonrequesting spouse;

(iii) The requesting spouse establishes that he or she did not know of, and had no reason to know of, the item of community income; and

(iv) Taking into account all of the facts and circumstances, it is inequitable to include the item of community income in the requesting spouse's individual gross income.

(2) *Knowledge or reason to know.* (i) A requesting spouse had knowledge or reason to know of an item of community income if he or she either actually knew of the item of community income, or if a reasonable person in similar circumstances would have known of the item of community income. All of the facts and circumstances are considered in determining whether a requesting spouse had reason to know of an item of community income. The relevant facts and circumstances include, but are not limited to, the nature of the item of community income, the amount of the item of community income relative to other income items, the couple's financial situation, the requesting spouse's educational background and business experience, and whether the item of community income was reflected on prior years' returns (e.g., investment income omitted that was regularly reported on prior years' returns).

(ii) If the requesting spouse is aware of the source of community income or the income-producing activity, but is unaware of the specific amount of the nonrequesting spouse's community income, the requesting spouse is considered to have knowledge or reason to know of the item of community income. The requesting spouse's lack of knowledge of the specific amount of community income does not provide a basis for relief under this section.

(3) *Inequitable.* All of the facts and circumstances are considered in determining whether it is inequitable to hold a requesting spouse liable for a deficiency attributable to an item of community income. One relevant factor for this purpose is whether the requesting spouse benefitted, directly or indirectly, from the omitted item of community income. A benefit includes normal support, but does not include *de minimis* amounts. Evidence of direct or indirect benefit may consist of transfers of property or rights to property, including transfers received several years after the filing of the return. Thus, for example, if a requesting spouse receives from the nonrequesting spouse property (including life insurance proceeds) that is traceable to items of community income

attributable to the nonrequesting spouse, the requesting spouse will have benefitted from those items of community income. Other factors may include, if the situation warrants, desertion, divorce or separation. Factors relevant to whether it would be inequitable to hold a requesting spouse liable, more specifically described under the applicable administrative procedure issued under section 66(c) (Revenue Procedure 2000-15, 2000-1 C.B. 447) (See §601.601(d)(2) of this chapter), or other applicable guidance published by the Secretary, are to be considered in making a determination under this paragraph.

(b) *Equitable relief.* Equitable relief may be available when the four requirements of paragraph (a)(1) of this section are not satisfied, but it would be inequitable to hold the requesting spouse liable for the unpaid tax or deficiency. Factors relevant to whether it would be inequitable to hold a requesting spouse liable, more specifically described under the applicable administrative procedure issued under section 66(c) (Revenue Procedure 2000-15, 2000-1 C.B. 447), or other applicable guidance published by the Secretary, are to be considered in making a determination under this paragraph.

(c) *Applicability.* Traditional relief under paragraph (a) of this section applies only to deficiencies arising out of items of omitted income. Equitable relief under paragraph (b) of this section applies to any deficiency or any unpaid tax (or any portion of either). Equitable relief is available only for the portion of liabilities that were unpaid as of July 22, 1998, and for liabilities that arise after July 22, 1998.

(d) *Effect of relief.* When the requesting spouse qualifies for relief under paragraph (a) or (b) of this section, the IRS must assess any deficiency of the nonrequesting spouse arising from the granting of relief to the requesting spouse in accordance with section 6212.

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

Example 1. Item-by-item approach. H and W are married, living together, and domiciled in State A (a community property state). H and W file separate returns for taxable year 2002 on April 15, 2003. H earns \$56,000 in wages, and W earns \$46,000 in wages, in 2002. H reports half of his wage income as shown on his Form W-2, in the amount of \$28,000, and half of W's wage income as shown on her Form W-2, in the amount of \$23,000. W reports half of her

wage income as shown on her W-2, in the amount of \$23,000, and half of H's wage income as shown on his Form W-2, in the amount of \$28,000. Neither H nor W reports W's income from her sole proprietorship of \$34,000 or W's investment income of \$5,000 for taxable year 2002. The Internal Revenue Service (IRS) proposes deficiencies with respect to H's and W's taxable year 2002 returns due to the omission of W's income from her sole proprietorship and investments. H timely requests relief under section 66(c). Because the IRS determines that H satisfies the four requirements of the traditional relief provision of section 66(c) with respect to W's omitted investment income, the IRS grants H's request for relief as to the omitted investment income. The IRS determines that H does not satisfy the four requirements of the traditional relief provision of section 66(c) as to W's sole proprietorship income. The IRS further determines that, under the equitable relief provision of section 66(c), it is not inequitable to hold H liable for the sole proprietorship income. Relief is applicable on an item-by-item basis. Thus, H is liable for the tax on half of his wage income in the amount of \$28,000, half of W's wage income in the amount of \$23,000, half of W's sole proprietorship income in the amount of \$17,000, but none of W's investment income, for which H obtained relief under section 66(c). W is liable for the tax on half of H's wage income in the amount of \$28,000, half of W's wage income in the amount of \$23,000, half of W's sole proprietorship income in the amount of \$17,000, and all of W's investment income in the amount of \$5,000, because H obtained relief under section 66(c).

Example 2. Benefit. H and W are married, living together, and domiciled in State B (a community property state). Neither H nor W files a return for taxable year 2000. H earns \$60,000 in 2000, which he deposits in a joint account. H and W pay the mortgage payment, household bills, and other family expenses out of the joint account. W earns \$20,000 in 2000. W uses a portion of the \$20,000 to make monthly loan payments on the family cars, but loses the remainder at the local racetrack. In 2002, the IRS audits H and W. H requests relief under section 66(c), stating that he did not know or have reason to know of W's additional income, as H travels extensively while W handles the family finances. Regardless of whether H had knowledge or reason to know of the source of W's income, H is not eligible for traditional relief under section 66(c) because H benefitted from W's income. H's benefit, the portion of W's income used to make monthly payments on the car loans, was more than a *de minimis* amount. While this benefit was not in excess of normal support, it is enough to preclude relief under the traditional relief provision of section 66(c). H may still qualify for equitable relief under section 66(c), depending on all of the facts and circumstances.

(f) *Fraudulent scheme.* If the Secretary establishes that a spouse transferred assets to his or her spouse as part of a fraudulent scheme, relief is not available under this section. For purposes of this section, a fraudulent scheme includes a scheme to defraud the Secretary or another third party, such as a creditor, ex-spouse, or business partner.

(g) *Definitions*—(1) *Requesting spouse*. A requesting spouse is an individual who does not file a joint federal income tax return with the nonrequesting spouse for the taxable year in question, and who requests relief from the federal income tax liability resulting from the operation of community property law under this section for the portion of the liability arising from his or her share of community income for such taxable year.

(2) *Nonrequesting spouse*. A nonrequesting spouse is the individual to whom the requesting spouse was married and whose income or deduction gave rise to the tax liability from which the requesting spouse seeks relief in whole or in part.

(h) *Effect of prior closing agreement or offer in compromise*. A requesting spouse is not entitled to relief from the federal income tax liability resulting from the operation of community property law under section 66 for any taxable year for which the requesting spouse has entered into a closing agreement (other than an agreement pursuant to section 6224(c) relating to partnership items) with the Secretary that disposes of the same liability that is the subject of the request for relief. In addition, a requesting spouse is not entitled to relief from the federal income tax liability resulting from the operation of community property law under section 66 for any taxable year for which the requesting spouse has entered into an offer in compromise with the Secretary. For rules relating to the effect of closing agreements and offers in compromise, see sections 7121 and 7122, and the regulations thereunder.

(i) [Reserved]

(j) *Time and manner for requesting relief*—(1) *Requesting relief*. To request relief from the federal income tax liability resulting from the operation of community property law under this section, a requesting spouse must file, within the time period prescribed in paragraph (j)(2) of this section, Form 8857, “*Request for Innocent Spouse Relief*” (or other specified form), or other written request, signed under penalties of perjury, stating why relief is appropriate. The requesting spouse must include the nonrequesting spouse’s name and taxpayer identification number in the written request. The requesting spouse must also comply with the Secretary’s reasonable requests for information that will assist the

Secretary in identifying and locating the nonrequesting spouse.

(2) *Time period for filing a request for relief*—(i) *Traditional relief*. The earliest time for submitting a request for relief from the federal income tax liability resulting from the operation of community property law under paragraph (a) of this section, for an amount underreported on, or omitted from, the requesting spouse’s separate return, is the date the requesting spouse receives notification of an audit or a letter or notice from the IRS stating that there may be an outstanding liability with regard to that year (as described in paragraph (j)(2)(iii) of this section). The latest time for requesting relief under paragraph (a) of this section is 6 months before the expiration of the period of limitations on assessment, including extensions, against the nonrequesting spouse for the taxable year that is the subject of the request for relief, unless the examination of the requesting spouse’s return commences during that 6-month period. If the examination of the requesting spouse’s return commences during that 6-month period, the latest time for requesting relief under paragraph (a) of this section is 30 days after the commencement of the examination.

(ii) *Equitable relief*. The earliest time for submitting a request for relief from the federal income tax liability resulting from the operation of community property law under paragraph (b) of this section is the date the requesting spouse receives notification of an audit or a letter or notice from the IRS stating that there may be an outstanding liability with regard to that year (as described in paragraph (j)(2)(iii) of this section). A request for equitable relief from the federal income tax liability resulting from the operation of community property law under paragraph (b) of this section for a liability that is properly reported but unpaid is properly submitted with the requesting spouse’s individual federal income tax return, or after the requesting spouse’s individual federal income tax return is filed.

(iii) *Premature requests for relief*. The Secretary will not consider a premature request for relief under this section. The notices or letters referenced in this paragraph (j)(2) do not include notices issued pursuant to section 6223 relating to TEFRA partnership proceedings.

These notices or letters include notices of computational adjustment to a partner or partner’s spouse (Notice of Income Tax Examination Changes) that reflect a computation of the liability attributable to partnership items of the partner or the partner’s spouse.

(k) *Nonrequesting spouse’s notice and opportunity to participate in administrative proceedings*—(1) *In general*. When the Secretary receives a request for relief from the federal income tax liability resulting from the operation of community property law under this section, the Secretary must send a notice to the nonrequesting spouse’s last known address that informs the nonrequesting spouse of the requesting spouse’s request for relief. The notice must provide the nonrequesting spouse with an opportunity to submit any information for consideration in determining whether to grant the requesting spouse relief from the federal income tax liability resulting from the operation of community property law. The Secretary will share with each spouse the information submitted by the other spouse, unless the Secretary determines that the sharing of this information will impair tax administration.

(2) *Information submitted*. The Secretary will consider all of the information (as relevant to the particular relief provision) that the nonrequesting spouse submits in determining whether to grant relief from the federal income tax liability resulting from the operation of community property law under this section.

§1.66–5 Effective date.

Sections 1.66–1 through 1.66–4 are applicable on July 10, 2003. In addition, §1.66–4 applies to any request for relief filed prior to July 10, 2003, for which the Internal Revenue Service has not issued a preliminary determination as of July 10, 2003.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 9. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 10. The following entry is added in numerical order to the table:

* * * * *
(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.66-4	1545-1770
* * * * *	

David A. Mader,
*Commissioner for
Services and Enforcement.*

Approved July 1, 2003.

Gregory F. Jenner,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on July 9, 2003, 8:45 a.m., and published in the issue of the Federal Register for July 10, 2003, 68 F.R. 41067)

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

26 CFR 1.457-1: General overviews of section 457.

T.D. 9075

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

Compensation Deferred Under Eligible Deferred Compensation Plans

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that provide guidance on deferred compensation plans of state and local governments and tax-exempt entities. The regulations reflect the changes made to section 457 by the Tax Reform Act of 1986, the Small Business Job Protection Act of 1996, the Taxpayer Relief Act of 1997, the Economic Growth and Tax Relief Reconciliation Act of 2001, the Job

Creation and Worker Assistance Act of 2002, and other legislation. The regulations also make various technical changes and clarifications to the existing final regulations on many discrete issues. These regulations provide the public with guidance necessary to comply with the law and will affect plan sponsors, administrators, participants, and beneficiaries.

DATES: Effective Date: July 11, 2003.

Applicability Date: These regulations apply to taxable years beginning after December 31, 2001. See “Effective date of the regulations” for additional information concerning the applicability of these regulations.

FOR FURTHER INFORMATION CONTACT: Cheryl Press, (202) 622-6060 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1580. Responses to this collection of information are mandatory.

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

The estimated burden per respondent varies from .033 hour to 2 hours per trust established depending upon individual respondents’ circumstances, with an estimated average of one hour for each trust established, and from 20 hours to 50 hours

per application for approval as a custodian with an estimated average of 35 hours for each application submitted to qualify as a custodian.

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

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

Background

Section 131 of the Revenue Act of 1978 (92 Stat. 2779) added section 457 to the Internal Revenue Code of 1954. On September 27, 1982, final regulations (T.D. 7836, 1982-2 C.B. 91 [47 FR 42335]) under section 457 (the 1982 regulations) were published in the **Federal Register**. The 1982 regulations provided guidance for complying with the changes to the applicable tax law made by the Revenue Act of 1978 relating to deferred compensation plans maintained by state and local governments and rural electric cooperatives.

Section 1107 of the Tax Reform Act of 1986 (100 Stat. 2494) extended section 457 to tax-exempt organizations. Section 6064 of the Technical and Miscellaneous Act of 1988 (102 Stat. 3700) codified certain exceptions for certain plans.

Notice 88-68, 1988-1 C.B. 556, addressed the treatment of nonelective deferred compensation of nonemployees, and provided an exception under which section 457 does not to apply to certain church plans.

Section 1404 of the Small Business Job Protection Act of 1996 (110 Stat. 1755) added section 457(g) which requires that section 457(b) plans maintained by state and local government employers hold all plan assets and income in trust, or in custodial accounts or annuity contracts (described in section 401(f) of the Internal Revenue Code), for the exclusive benefit of participants and beneficiaries.

Section 1071 of the Taxpayer Relief Act of 1997 (111 Stat. 788) permits certain accrued benefits to be cashed out.

Sections 615, 631, 632, 634, 635, 641, 647, and 649 of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) (115 Stat. 38) included increases in elective deferral limits, repeal of the rules coordinating the section 457 plan limit with contributions to certain other types of plans, catch-up contributions for individuals age 50 or over, extension of qualified domestic relation order rules to section 457 plans, rollovers among various qualified plans, section 403(b) contracts and individual retirement arrangements (IRAs), and transfers to purchase service credits under governmental pension plans.

Section 411(o)(8) and (p)(5) of the Job Creation and Worker Assistance Act of 2002 (116 Stat. 21) clarified certain provisions in EGTRRA concerning section 457 plans, including the use of certain compensation reduction elections to be taken into account in determining includible compensation.

On May 8, 2002, a notice of proposed rulemaking (REG-105885-99, 2002-1 C.B. 1103 [67 FR 30826]) was published in the **Federal Register** to issue new regulations under section 457, including amending the 1982 regulations to conform them to the legislative changes that had been made to section 457 since 1982.

Following publication of the proposed regulations, comments were received and a public hearing was held on August 28, 2002. After consideration of the comments received, the proposed regulations

are adopted by this Treasury decision, subject to a number of changes that are generally summarized below.

Summary of Comments Received and Changes Made

1. *Excess Deferrals*

The proposed regulations addressed the income tax treatment of excess deferrals and the effect of excess deferrals on plan eligibility under section 457(b). The proposed regulations provided that an eligible governmental plan may self-correct and distribute excess deferrals and continue to satisfy the eligibility requirements of section 457(b) (including the distribution rules and the funding rules) by reason of a distribution of excess deferrals. However, the proposed regulations provided that if an excess deferral arose under an eligible plan of a tax-exempt employer, the plan was no longer an eligible plan.

Commentators objected to the less favorable treatment for eligible plans of tax-exempt employers.

After consideration of the comments received, the regulations extend self-correction for excess deferrals to eligible plans of tax-exempt employers. If there is an excess deferral under such plan, the plan may distribute to a participant any excess deferrals (and any income allocable to such amount) not later than the first April 15 following the close of the taxable year of the excess deferrals, comparable to the rules for qualified plans under section 402(g). In such a case, the plan will continue to be treated as an eligible plan. However, in accordance with section 457(c), any excess deferral is included in the gross income of a participant for the taxable year of the excess deferral. If an excess deferral is not corrected by distribution, the plan is an ineligible plan under which benefits are taxable in accordance with ineligible plan rules.

The income tax treatment and payroll tax reporting of distributions of excess deferrals from eligible section 457(b) governmental plans are similar to the treatment and reporting of distribution of excess deferrals from tax-qualified plans. Such amounts should be reported on Form 1099 and taxed in the year of distribution to the extent of distributed earnings on the excess deferrals. For eligible section

457(b) tax-exempt plans, the excess deferrals are subject to income tax in the year of distribution to the extent of distributed earnings on the excess deferrals and such earnings should be reported on Form W-2 for the year of distribution. See also Notice 2003-20, 2003-19 I.R.B. 894, for information regarding the withholding and reporting requirements applicable to eligible plans generally.

2. *Aggregation Rules in the Proposed Regulations*

The proposed regulations included several rules that aggregate multiple plans for purposes of meeting the eligibility requirements of section 457(b). These regulations retain all of these rules. For example, the regulations provide that in any case in which multiple plans are used to avoid or evade the eligibility requirements under the regulations, the Commissioner may apply the eligibility requirements as if the plans were a single plan. Also, an eligible employer is required to have no more than one normal retirement age for each participant under all of the eligible plans it sponsors. In addition, all deferrals under all eligible plans under which an individual participates by virtue of his or her relationship with a single employer are treated as though deferred under a single plan for purposes of determining excess deferrals. Finally, annual deferrals under all eligible plans are combined for purposes of determining the maximum deferral limits.

Few comments were received with respect to the aggregation rules under the proposed regulations. However, one commentator requested that, where it is determined that multiple eligible plans maintained by a single employer, which have been aggregated pursuant to the proposed regulations, contain excess deferrals, the employer have the ability to disaggregate those plans solely for the purpose of either (1) distributing the excess deferrals under the self-correcting mechanism or (2) limiting the characterization of such plans as "ineligible" to the one(s) that actually contain the excess deferrals. Taking into account the ability for all eligible plans to self-correct by distribution, these regulations retain without material revision the aggregation rules that were in the proposed regulations.

3. *Deferral of Sick, Vacation, and Back Pay*

The proposed regulations would have allowed an eligible plan to permit participants to elect to defer compensation, including accumulated sick and vacation pay and back pay, only if an agreement providing for the deferral is entered into before the beginning of the month in which the amounts would otherwise be paid or made available and the participant is an employee in that month. Comments requested that terminating participants be allowed to elect deferral for accumulated sick and vacation pay and back pay even if the participant is not employed at the time of the deferral.

The final regulations retain the rule under which the deferral election must be made during employment and before the beginning of the month when the compensation would have been payable. However, the regulations include a special rule that allows an election for sick pay, vacation pay, or back pay that is not yet payable (subject of course to the maximum deferral limitations of section 457 in the year of deferral). Under the special rule, an employee who is retiring or otherwise having a severance from employment during a month may nevertheless elect to defer, for example, his or her unused vacation pay after the beginning of the month, provided that the vacation pay would otherwise have been payable before the employee has a severance from employment and the election is made before the date on which the vacation pay would otherwise have been payable.

4. *Unforeseeable Emergency Distributions*

The proposed regulations added examples that would illustrate when an unforeseeable emergency occurred. In particular, one example provided that the need to pay for the funeral expenses of a family member may constitute an unforeseeable emergency. Several commentators requested clarification in the final regulations of the definition of family member. The regulations have been modified to define a family member as a spouse or dependent as defined in section 152(a).

5. *Plan Terminations, Plan-to-Plan Transfers, and Rollovers*

The regulations include certain rules regarding plan terminations, plan-to-plan transfers, and rollovers. These topics have been affected by the statutory changes that impose a trust requirement on eligible governmental plans. The direct rollovers that were permitted by EGTRRA beginning in 2002 for eligible governmental plans provide participants affected by these types of events the ability to retain their retirement savings in a funded, tax-deferred savings vehicle by rollover to an IRA, qualified plan, or section 403(b) contract. The regulations provide an outline for the different plan termination and plan-to-plan transfer alternatives available to sponsors of eligible governmental plans in these situations.

a. *Plan terminations*

The regulations allow a plan to have provisions permitting plan termination whereupon amounts can be distributed without violating the distribution requirements of section 457. Under the regulations, an eligible plan is terminated only if all amounts deferred under the plan are paid to participants as soon as administratively practicable. If the amounts deferred under the plan are not distributed, the plan is treated as a frozen plan and must continue to comply with all of the applicable statutory requirements necessary for plan eligibility.

b. *Plan-to-plan transfers among eligible governmental plans and purchase of permissive service credit by plan-to-plan transfer*

The proposed regulations would have allowed plan-to-plan transfers between eligible governmental plans under new circumstances, as well as the purchase of permissive service credits by transfer from an eligible governmental plan to a governmental defined benefit plan, but only if the transfers were made by plans within the same state. Commentators objected to the requirement under the new transfer rules that the transfers be to plans within the same state.

Upon consideration of the comments received, the regulations allow transfers among eligible governmental plans in

three situations. In each case, the transferor plan must provide for transfers, the receiving plan must provide for the receipt of transfers, and the participant or beneficiary whose amounts deferred are being transferred must be entitled to an amount deferred immediately after the transfer that is at least equal to the amount deferred with respect to that participant or beneficiary immediately before the transfer. Transfers are permitted among eligible governmental plans in the following three cases:

- A person-by-person transfer is permitted for any beneficiary and for any participant who has had a severance from employment with the transferring employer and is performing services for the entity maintaining the receiving plan (whether or not the other plan is within the same state).
- No severance from employment is required if the entire plan's assets for all participants and beneficiaries are transferred to another eligible governmental plan within the same state.
- No severance from employment is required for a transfer from one eligible governmental plan of an employer to another eligible governmental plan of the same employer.

The final regulations also allow a plan-to-plan transfer from an eligible governmental plan to a governmental defined benefit plan for permissive service credit, without regard to whether the defined benefit plan is maintained by a governmental entity that is in the same state. In addition, language that was in an example which implied that section 415(n) (which addresses the application of maximum benefit limitations with respect to certain contributions) might apply to such a transfer has been eliminated because Treasury and the IRS have concluded that section 415(n) does not apply to such a transfer in any case in which the actuarial value of the benefit increase that results from the transfer does not exceed the amount transferred.

c. *Plan-to-plan transfers among eligible plans of tax-exempt entities*

The regulations retain the rule from the 1982 regulations allowing a plan-to-plan

transfer after a participant has had a severance from employment.

d. Rollovers

The proposed regulations specified the treatment of amounts rolled into or out of an eligible governmental plan and stated that amounts rolled into the plan are treated as amounts deferred under the plan for purposes of the regulations. Some commentators requested that consideration be given to allowing eligible governmental plans to have the same flexibility that they claimed was permitted for qualified plans with respect to the timing of distributions of rolled-in assets. Specifically, these commentators requested the ability for an eligible governmental plan to allow a participant to receive a distribution of rolled-in assets even though the participant may not yet be eligible for a distribution of other assets held under the plan. Commentators pointed out that, since section 402(c)(10) allows an eligible governmental plan to accept a rollover contribution only if the rolled-in assets from other plan types are separately accounted for (in order to apply the section 72(t) early withdrawal income tax for distributions from these assets), this ability should not cause administrative problems for plan sponsors. Commentators also asserted that the flexibility to design an eligible governmental plan to permit such distributions would be beneficial to its participants.

These regulations do not permit an eligible governmental plan to distribute rolled-in assets to a participant who is not yet eligible for a distribution until future guidance of general applicability is published that addresses this issue. Treasury and the IRS intend to issue, in the near future, guidance of general applicability resolving this issue in coordination with the applicable rules for qualified plans and section 403(b) contracts.

Commentators also requested clarification on the order of accounts for partial distributions to participants who have rolled-in assets that are subject to the early withdrawal income tax. They requested that consideration be given in final regulations to clarifying that the participant may be treated as receiving a partial distribution

first from other plan assets to minimize the early withdrawal income tax that would otherwise apply. These regulations clarify that, if a rollover is received by an eligible governmental plan from an IRA, qualified plan, or section 403(b) contract, then distributions from the eligible governmental plan are subject to the early withdrawal income tax in accordance with the plan's method of accounting, *i.e.*, for purposes of applying the section 72(t) early withdrawal income tax, a distribution is treated as made from an eligible governmental plan's separate account for rollovers from an IRA, qualified plan, or section 403(b) contract only if the plan accounts for the distribution as a distribution from that account. Thus, for example, an eligible governmental plan may provide that any unforeseeable emergency withdrawal is made from other accounts to the extent possible, in which event the early withdrawal tax will not apply assuming that the plan only debits such other accounts to reflect the distribution.

The proposed regulations had requested comments on the issue of separate accounting for rolled-in amounts and asked if there are any special characteristics that would be lost if multiple types of separate accounts were not maintained. Commentators asked for the regulations to permit maintenance of a single rollover account for all amounts that are rolled into the eligible governmental plan. These regulations require separate accounting only to the extent mandated by section 402(c)(10), *i.e.*, only for rollovers from IRAs, qualified plans and section 403(b) contracts. Section 72(t)(9) provides that the early withdrawal income tax applies to distributions from rollovers attributable to IRAs, qualified plans, and section 403(b) contracts. Thus, if an eligible governmental plan accepts a rollover *from another eligible governmental plan* of an amount that was originally deferred under an eligible governmental plan and commingles that rollover in the same separate account that includes a rollover amount from an IRA, qualified plan, or section 403(b) contract, then distributions from that account will be subject to the early withdrawal income tax. Accordingly, in order to avoid this result, eligible governmental plans

may choose to establish *three separate accounts* for a participant even though these regulations only require that a single separate rollover account be maintained for all amounts that are rolled into an eligible governmental plan: first, an account for all amounts deferred under that plan; second, an account for any rollover from another eligible governmental plan (disregarding any amounts that originated from an IRA, qualified plan, or section 403(b) contract); and third, an account for any rollover amount from an IRA, qualified plan, or section 403(b) contract (including any amounts rolled over from another eligible governmental plan that originated from an IRA, qualified plan, or section 403(b) contract). These regulations include an example illustrating that the early withdrawal income tax would not apply to a partial distribution from a plan with such accounts assuming that the plan debits either of the first two such other accounts to reflect the distribution.

6. Ineligible Plans

The proposed regulations included guidance regarding ineligible plans under section 457(f). Section 457(f) generally provides that, in the case of an agreement or arrangement for the deferral of compensation, the deferred compensation is included in gross income when deferred or, if later, when the rights to payment of the deferred compensation cease to be subject to a substantial risk of forfeiture. Section 457(f) was in section 457 when it was added to the Code in 1978 for governmental employees, and extended to employees of tax-exempt organizations (other than churches or certain church-controlled organizations) in 1986, because unfunded amounts held by a tax-exempt entity compound tax free like an eligible plan, a qualified plan, or a section 403(b) contract. Section 457(f) was viewed as essential in order to provide an incentive for employers that are not subject to income taxes to adopt an eligible plan, a qualified plan, or a section 403(b) contract.¹

Section 457(f) does not apply to an eligible plan, a qualified plan, a section 403(b) contract, a section 403(c) contract, a transfer of property described in section

¹ See generally the *Report to the Congress on the Tax Treatment of Deferred Compensation under Section 457*, Department of the Treasury, January 1992 (available from the Office of Tax Policy, Room 5315, Treasury Department, 1500 Pennsylvania Avenue, NW, Washington DC 20220).

83, a trust to which section 402(b) applies, or a qualified governmental excess benefit arrangement described in section 415(m). The proposed regulations stated that section 457(f) applies if the date on which there is no substantial risk of forfeiture with respect to the compensation deferred precedes the date on which there is a transfer of property to which section 83 applies. The proposed regulations included several examples, including an example illustrating that section 457(f) does not fail to apply merely because benefits are subsequently paid by a transfer of property. Comments were requested on the coordination of sections 457(f) and 83 under the proposed regulations.

In response, a number of commentators objected to the proposed coordination of sections 457(f) and 83, including arguing that the proposed regulation would place tax-exempt organizations at a competitive disadvantage when it comes to attracting and retaining executive talent because it would effectively eliminate the use of discounted mutual fund options as a tax effective component of total compensation. Some commentators also asserted that the proposed regulations were ambiguous as to their applicability to steeply discounted mutual fund options, and recommended that, if the provision is not removed, at a minimum future guidance should be more specific.

The final regulations retain the interpretation of the coordination of sections 457(f) and 83 that was in the proposed regulations, and also clarify the application of the rule by adding an example involving an option grant. The regulations also include a clarification that, when benefits are paid or made available under an ineligible plan, the amount included in gross income is equal to the amount paid or made available, but only to the extent that the amount exceeds the amount the participant included in gross income when he or she obtained a vested right to the benefit.

7. Severance Pay and Other Exceptions

In 2000, the IRS issued Announcement 2000-1, 2000-1 C.B. 294, which provided interim guidance on certain broad-based, nonelective plans of a state or local government that were in existence before 1999. Comments were requested on arrangements, such as those maintained

by certain state or local governmental educational institutions, under which supplemental compensation is payable as an incentive to terminate employment, or as an incentive to retain retirement-eligible employees, to ensure an appropriate workforce during periods in which a temporary surplus or deficit in workforce is anticipated. Treasury and the IRS continue to be interested in receiving comments on this issue, which should be sent to the following address: Internal Revenue Service, Attn: CC:DOM:CORP:R (Section 457 Plans), Room 5201, P. O. Box 7604, Ben Franklin Station, Washington, D.C. 20044. Written comments may be hand delivered Monday through Friday between 8 a.m. and 4 p.m. to: Internal Revenue Service, Courier's Desk, Attn: CC:PA:RU (Section 457 Plans), 1111 Constitution Avenue, NW, Washington, DC 20224. Alternatively, written comments may be submitted electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting them directly to the IRS Internet site at: http://www.irs.gov/tax_regs/reglist.html. Comments should be received by October 9, 2003.

8. Effective Date of the Regulations

The proposed regulations included a general effective date under which the regulations would have applied to taxable years beginning after December 31, 2001. This is the general effective date for the changes made in section 457 by EGTRRA. Commentators did not express concern about this effective date and some commentators also stated that eligible governmental plans have adopted plan amendments to address the changes that have been allowed by EGTRRA, so that it would be appropriate to have the final regulations effective date coincide with the effective date for EGTRRA.

These regulations are generally applicable to taxable years beginning after December 31, 2001, subject to certain specific transition rules. Under one of these transition rules, for taxable years beginning after December 31, 2001, and before January 1, 2004, a plan will not fail to be an eligible plan if it is operated in accordance with a reasonable, good faith interpretation of section 457(b). Whether a plan is operated in accordance with a reasonable, good

faith interpretation of section 457(b) will generally be determined based on all of the relevant facts and circumstances, including the extent to which the employer has resolved unclear issues in its favor. The regulations state that a plan will be deemed to be operated in accordance with a reasonable, good faith interpretation of section 457(b) if it is operated in accordance with the terms of these regulations. The IRS will also deem a plan to be operated in accordance with a reasonable, good faith interpretation of section 457(b) if it is operated in accordance with the terms of the 1982 regulations as in effect for taxable years beginning before January 1, 2002 (to the extent those 1982 regulations are consistent with subsequent changes in law, including EGTRRA) or in accordance with the terms of the 2001 proposed regulations. However, a plan will be deemed not to be operated in accordance with a reasonable, good faith interpretation of section 457(b) if it is operated in a manner that is inconsistent with the terms of the 1982 regulations as in effect for taxable years beginning before January 1, 2002 (to the extent those 1982 regulations are consistent with subsequent changes in law, including EGTRRA), except to the extent permitted under either these final regulations or the 2001 proposed regulations.

Further, there is a special delayed effective date for the rule under which an eligible governmental plan cannot distribute rollover account benefits to a participant who is not yet eligible for a distribution. Thus, this rule is not applicable until years beginning after December 31, 2003, since this issue is expected to be resolved before that date.

The regulations also retain the rule in the proposed regulations under which the regulations do not apply with respect to an option that lacked a readily ascertainable fair market value (within the meaning of section 83(e)(3)) at grant that was granted on or before May 8, 2002. Thus, the status of such an option under section 457(f) would be determined without regard to these regulations.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment

is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. The collection of information in the regulations is in section 1.457-8(a)(3)(ii)(B) and consists of the requirement that a custodian of a custodial account may be a person other than a bank only if the person demonstrates to the satisfaction of the Commissioner that the manner in which the person will administer the custodial account will be consistent with the requirement of section 457(g)(1) and (3) of the Code. This certification is based on the fact that the cost of submitting this information is small, even for small entities. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

* * * * *

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

Authority: 26 U.S.C. 7805 *

Par. 2. Sections 1.457-1, 1.457-2, 1.457-3 and 1.457-4 are revised to read as follows:

§1.457-1 General overviews of section 457.

Section 457 provides rules for nonqualified deferred compensation plans established by eligible employers as defined under §1.457-2(d). Eligible employers can establish either deferred compensation plans that are eligible plans and that meet the requirements of section 457(b) and §§1.457-3 through 1.457-10, or deferred compensation plans or arrangements that do not meet the requirements of section 457(b) and §§1.457-3 through 1.457-10

and that are subject to tax treatment under section 457(f) and §1.457-11.

§1.457-2 Definitions.

This section sets forth the definitions that are used under §§1.457-1 through 1.457-11.

(a) *Amount(s) deferred.* *Amount(s) deferred* means the total annual deferrals under an eligible plan in the current and prior years, adjusted for gain or loss. Except as provided at §§1.457-4(c)(1)(iii) and 1.457-6(a), amount(s) deferred includes any rollover amount held by an eligible plan as provided under §1.457-10(e).

(b) *Annual deferral(s)*—(1) *Annual deferral(s)* means, with respect to a taxable year, the amount of compensation deferred under an eligible plan, whether by salary reduction or by nonelective employer contribution. The amount of compensation deferred under an eligible plan is taken into account as an annual deferral in the taxable year of the participant in which deferred, or, if later, the year in which the amount of compensation deferred is no longer subject to a substantial risk of forfeiture.

(2) If the amount of compensation deferred under the plan during a taxable year is not subject to a substantial risk of forfeiture, the amount taken into account as an annual deferral is not adjusted to reflect gain or loss allocable to the compensation deferred. If, however, the amount of compensation deferred under the plan during the taxable year is subject to a substantial risk of forfeiture, the amount of compensation deferred that is taken into account as an annual deferral in the taxable year in which the substantial risk of forfeiture lapses must be adjusted to reflect gain or loss allocable to the compensation deferred until the substantial risk of forfeiture lapses.

(3) If the eligible plan is a defined benefit plan within the meaning of section 414(j), the annual deferral for a taxable year is the present value of the increase during the taxable year of the participant's accrued benefit that is not subject to a substantial risk of forfeiture (disregarding any such increase attributable to prior annual deferrals). For this purpose, present value must be determined using actuarial assumptions and methods that are reasonable (both individually and in the aggregate), as determined by the Commissioner.

(4) For purposes solely of applying § 1.457-4 to determine the maximum amount of the annual deferral for a participant for a taxable year under an eligible plan, the maximum amount is reduced by the amount of any deferral for the participant under a plan described at paragraph (k)(4)(i) of this section (relating to certain plans in existence before January 1, 1987) as if that deferral were an annual deferral under another eligible plan of the employer.

(c) *Beneficiary.* *Beneficiary* means a person who is entitled to benefits in respect of a participant following the participant's death or an alternate payee as described in §1.457-10(c).

(d) *Catch-up.* *Catch-up* amount or *catch-up* limitation for a participant for a taxable year means the annual deferral permitted under section 414(v) (as described in §1.457-4(c)(2)) or section 457(b)(3) (as described in §1.457-4(c)(3)) to the extent the amount of the annual deferral for the participant for the taxable year is permitted to exceed the plan ceiling applicable under section 457(b)(2) (as described in §1.457-4(c)(1)).

(e) *Eligible employer.* *Eligible employer* means an entity that is a state that establishes a plan or a tax-exempt entity that establishes a plan. The performance of services as an independent contractor for a state or local government or a tax-exempt entity is treated as the performance of services for an eligible employer. The term *eligible employer* does not include a church as defined in section 3121(w)(3)(A), a qualified church-controlled organization as defined in section 3121(w)(3)(B), or the federal government or any agency or instrumentality thereof. Thus, for example, a nursing home which is associated with a church, but which is not itself a church (as defined in section 3121(w)(3)(A)) or a qualified church-controlled organization as defined in section 3121(w)(3)(B)), would be an eligible employer if it is a tax-exempt entity as defined in paragraph (m) of this section.

(f) *Eligible plan.* An *eligible plan* is a plan that meets the requirements of §§1.457-3 through 1.457-10 that is established and maintained by an eligible employer. An *eligible governmental plan* is an eligible plan that is established and maintained by an eligible employer as defined in paragraph (l) of this section.

An arrangement does not fail to constitute a single eligible governmental plan merely because the arrangement is funded through more than one trustee, custodian, or insurance carrier. An *eligible plan of a tax-exempt entity* is an eligible plan that is established and maintained by an eligible employer as defined in paragraph (m) of this section.

(g) *Includible compensation.* *Includible compensation* of a participant means, with respect to a taxable year, the participant's compensation, as defined in section 415(c)(3), for services performed for the eligible employer. The amount of includible compensation is determined without regard to any community property laws.

(h) *Ineligible plan.* *Ineligible plan* means a plan established and maintained by an eligible employer that is not maintained in accordance with §§1.457-3 through 1.457-10. A plan that is not established by an eligible employer as defined in paragraph (e) of this section is neither an eligible nor an ineligible plan.

(i) *Nonelective employer contribution.* A *nonelective employer contribution* is a contribution made by an eligible employer for the participant with respect to which the participant does not have the choice to receive the contribution in cash or property. Solely for purposes of section 457 and §§1.457-2 through 1.457-11, the term *nonelective employer contribution* includes employer contributions that would be described in section 401(m) if they were contributions to a qualified plan.

(j) *Participant.* *Participant* in an eligible plan means an individual who is currently deferring compensation, or who has previously deferred compensation under the plan by salary reduction or by nonelective employer contribution and who has not received a distribution of his or her entire benefit under the eligible plan. Only individuals who perform services for the eligible employer, either as an employee or as an independent contractor, may defer compensation under the eligible plan.

(k) *Plan.* *Plan* includes any agreement or arrangement between an eligible employer and a participant or participants (including an individual employment agreement) under which the payment of compensation is deferred (whether by salary reduction or by nonelective employer contribution). The following types of plans

are not treated as agreements or arrangements under which compensation is deferred: a *bona fide* vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plan described in section 457(e)(11)(A)(i) and any plan paying length of service awards to *bona fide* volunteers (and their beneficiaries) on account of qualified services performed by such volunteers as described in section 457(e)(11)(A)(ii). Further, the term *plan* does not include any of the following (and section 457 and §§1.457-2 through 1.457-11 do not apply to any of the following)—

(1) Any nonelective deferred compensation under which all individuals (other than those who have not satisfied any applicable initial service requirement) with the same relationship with the eligible employer are covered under the same plan with no individual variations or options under the plan as described in section 457(e)(12), but only to the extent the compensation is attributable to services performed as an independent contractor;

(2) An agreement or arrangement described in §1.457-11(b);

(3) Any plan satisfying the conditions in section 1107(c)(4) of the Tax Reform Act of 1986 (100 Stat. 2494) (TRA '86) (relating to certain plans for state judges); and

(4) Any of the following plans or arrangements (to which specific transitional statutory exclusions apply)—

(i) A plan or arrangement of a tax-exempt entity in existence prior to January 1, 1987, if the conditions of section 1107(c)(3)(B) of the TRA '86, as amended by section 1011(e)(6) of the Technical and Miscellaneous Revenue Act of 1988 (102 Stat. 3700) (TAMRA), are satisfied (see §1.457-2(b)(4) for a special rule regarding such plan);

(ii) A collectively bargained nonelective deferred compensation plan in effect on December 31, 1987, if the conditions of section 6064(d)(2) of TAMRA are satisfied;

(iii) Amounts described in section 6064(d)(3) of TAMRA (relating to certain nonelective deferred compensation arrangements in effect before 1989); and

(iv) Any plan satisfying the conditions in section 1107(c)(4) or (5) of TRA '86 (relating to certain plans for certain individuals with respect to which the Service issued guidance before 1977).

(l) *State.* *State* means a state (treating the District of Columbia as a state as provided under section 7701(a)(10)), a political subdivision of a state, and any agency or instrumentality of a state.

(m) *Tax-exempt entity.* *Tax-exempt entity* includes any organization exempt from tax under subtitle A of the Internal Revenue Code, except that a governmental unit (including an international governmental organization) is not a tax-exempt entity.

(n) *Trust.* *Trust* means a trust described under section 457(g) and §1.457-8. Custodial accounts and contracts described in section 401(f) are treated as trusts under the rules described in §1.457-8(a)(2).

§ 1.457-3 General introduction to eligible plans.

(a) *Compliance in form and operation.*

An eligible plan is a written plan established and maintained by an eligible employer that is maintained, in both form and operation, in accordance with the requirements of §§1.457-4 through 1.457-10. An eligible plan must contain all the material terms and conditions for benefits under the plan. An eligible plan may contain certain optional features not required for plan eligibility under section 457(b), such as distributions for unforeseeable emergencies, loans, plan-to-plan transfers, additional deferral elections, acceptance of rollovers to the plan, and distributions of smaller accounts to eligible participants. However, except as otherwise specifically provided in §§1.457-4 through 1.457-10, if an eligible plan contains any optional provisions, the optional provisions must meet, in both form and operation, the relevant requirements under section 457 and §§1.457-2 through 1.457-10.

(b) *Treatment as single plan.* In any case in which multiple plans are used to avoid or evade the requirements of §§1.457-4 through 1.457-10, the Commissioner may apply the rules under §§1.457-4 through 1.457-10 as if the plans were a single plan. See also §1.457-4(c)(3)(v) (requiring an eligible employer to have no more than one normal retirement age for each participant

under all of the eligible plans it sponsors), the second sentence of §1.457-4(e)(2) (treating deferrals under all eligible plans under which an individual participates by virtue of his or her relationship with a single employer as a single plan for purposes of determining excess deferrals), and §1.457-5 (combining annual deferrals under all eligible plans).

§1.457-4 Annual deferrals, deferral limitations, and deferral agreements under eligible plans.

(a) *Taxation of annual deferrals.* Annual deferrals that satisfy the requirements of paragraphs (b) and (c) of this section are excluded from the gross income of a participant in the year deferred or contributed and are not includible in gross income until paid to the participant in the case of an eligible governmental plan, or until paid or otherwise made available to the participant in the case of an eligible plan of a tax-exempt entity. See §1.457-7.

(b) *Agreement for deferral.* In order to be an eligible plan, the plan must provide that compensation may be deferred for any calendar month by salary reduction only if an agreement providing for the deferral has been entered into before the first day of the month in which the compensation is paid or made available. A new employee may defer compensation payable in the calendar month during which the participant first becomes an employee if an agreement providing for the deferral is entered into on or before the first day on which the participant performs services for the eligible employer. An eligible plan may provide that if a participant enters into an agreement providing for deferral by salary reduction under the plan, the agreement will remain in effect until the participant revokes or alters the terms of the agreement. Nonelective employer contributions are treated as being made under an agreement entered into before the first day of the calendar month.

(c) *Maximum deferral limitations—(1) Basic annual limitation.* (i) Except as described in paragraphs (c)(2) and (3) of this section, in order to be an eligible plan, the plan must provide that the annual deferral amount for a taxable year (the plan ceiling) may not exceed the lesser of—

(A) The applicable annual dollar amount specified in section 457(e)(15): \$11,000 for 2002; \$12,000 for 2003;

\$13,000 for 2004; \$14,000 for 2005; and \$15,000 for 2006 and thereafter. After 2006, the \$15,000 amount is adjusted for cost-of-living in the manner described in paragraph (c)(4) of this section; or

(B) 100 percent of the participant's includible compensation for the taxable year.

(ii) The amount of annual deferrals permitted by the 100 percent of includible compensation limitation under paragraph (c)(1)(i)(B) of this section is determined under section 457(e)(5) and §1.457-2(g).

(iii) For purposes of determining the plan ceiling under this paragraph (c), the annual deferral amount does not include any rollover amounts received by the eligible plan under §1.457-10(e).

(iv) The provisions of this paragraph (c)(1) are illustrated by the following examples:

Example 1 (i) *Facts.* Participant A, who earns \$14,000 a year, enters into a salary reduction agreement in 2006 with A's eligible employer and elects to defer \$13,000 of A's compensation for that year. A is not eligible for the catch-up described in paragraph (c)(2) or (3) of this section, participates in no other retirement plan, and has no other income exclusions taken into account in computing includible compensation.

(ii) *Conclusion.* The annual deferral limit for A in 2006 is the lesser of \$15,000 or 100 percent of includible compensation, \$14,000. A's annual deferral of \$13,000 is permitted under the plan because it is not in excess of \$14,000 and thus does not exceed 100 percent of A's includible compensation.

Example 2. (i) *Facts.* Assume the same facts as in *Example 1*, except that A's eligible employer provides an immediately vested, matching employer contribution under the plan for participants who make salary reduction deferrals under A's eligible plan. The matching contribution is equal to 100 percent of elective contributions, but not in excess of 10 percent of compensation (in A's case, \$1,400).

(ii) *Conclusion.* Participant A's annual deferral exceeds the limitations of this paragraph (c)(1). A's maximum deferral limitation in 2006 is \$14,000. A's salary reduction deferral of \$13,000 combined with A's eligible employer's nonelective employer contribution of \$1,400 exceeds the basic annual limitation of this paragraph (c)(1) because A's annual deferrals total \$14,400. A has an excess deferral for the taxable year of \$400, the amount exceeding A's permitted annual deferral limitation. The \$400 excess deferral is treated as described in paragraph (e) of this section.

Example 3. (i) *Facts.* Beginning in year 2002, Eligible Employer X contributes \$3,000 per year for five years to B's eligible plan account. B's interest in the account vests in 2006. B has annual compensation of \$50,000 in each of the five years 2002 through 2006. B is 41 years old. B is not eligible for the catch-up described in paragraph (c)(2) or (3) of this section, participates in no other retirement plan, and has no other income exclusions taken into account in computing includible compensation. Adjusted for

gain or loss, the value of B's benefit when B's interest in the account vests in 2006 is \$17,000.

(ii) *Conclusion.* Under this vesting schedule, \$17,000 is taken into account as an annual deferral in 2006. B's annual deferrals under the plan are limited to a maximum of \$15,000 in 2006. Thus, the aggregate of the amounts deferred, \$17,000, is in excess of B's maximum deferral limitation by \$2,000. The \$2,000 is treated as an excess deferral described in paragraph (e) of this section.

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

(ii) *Coordination with special section 457 catch-up.* In accordance with sections 414(v)(6)(C) and 457(e)(18), the age 50 catch-up described in this paragraph (c)(2) does not apply for any taxable year for which a higher limitation applies under the special section 457 catch-up under paragraph (c)(3) of this section. Thus, for purposes of this paragraph (c)(2)(ii) and paragraph (c)(3) of this section, the special section 457 catch-up under paragraph (c)(3) of this section applies for any taxable year if and only if the plan ceiling taking into account paragraph (c)(1) of this section and the special section 457 catch-up described in paragraph (c)(3) of this section (and disregarding the age 50 catch-up described in this paragraph (c)(2)) is larger than the plan ceiling taking into account paragraph (c)(1) of this section and the age 50 catch-up described in this paragraph (c)(2) (and disregarding the special section 457 catch-up described in paragraph (c)(3) of this section). Thus, if a plan so provides, a participant who is eligible for the age 50 catch-up for a year and for whom the year is also one of the participant's last three taxable years ending before the participant attains normal retirement age is eligible for the larger of—

(A) The plan ceiling under paragraph (c)(1) of this section and the age 50 catch-up described in this paragraph (c)(2) (and disregarding the special section 457 catch-up described in paragraph (c)(3) of this section) or

(B) The plan ceiling under paragraph (c)(1) of this section and the special section 457 catch-up described in paragraph (c)(3) of this section (and disregarding the age 50 catch-up described in this paragraph (c)(2)).

(iii) *Examples.* The provisions of this paragraph (c)(2) are illustrated by the following examples:

Example 1. (i) *Facts.* Participant C, who is 55, is eligible to participate in an eligible governmental plan in 2006. The plan provides a normal retirement age of 65. The plan provides limitations on annual deferrals up to the maximum permitted under paragraphs (c)(1) and (3) of this section and the age 50 catch-up described in this paragraph (c)(2). For 2006, C will receive compensation of \$40,000 from the eligible employer. C desires to defer the maximum amount possible in 2006. The applicable basic dollar limit of paragraph (c)(1)(i)(A) of this section is \$15,000 for 2006 and the additional dollar amount permitted under the age 50 catch-up is \$5,000 for 2006.

(ii) *Conclusion.* C is eligible for the age 50 catch-up in 2006 because C is 55 in 2006. However, C is not eligible for the special section 457 catch-up under paragraph (c)(3) of this section in 2006 because 2006 is not one of the last three taxable years ending before C attains normal retirement age. Accordingly, the maximum that C may defer for 2006 is \$20,000.

Example 2. (i) *Facts.* The facts are the same as in *Example 1*, except that, in 2006, C will attain age 62. The maximum amount that C can elect under the special section 457 catch-up under paragraph (c)(3) of this section is \$2,000 for 2006.

(ii) *Conclusion.* The maximum that C may defer for 2006 is \$20,000. This is the sum of the basic plan ceiling under paragraph (c)(1) of this section equal to \$15,000 and the age 50 catch-up equal to \$5,000. The special section 457 catch-up under paragraph (c)(3) of this section is not applicable since it provides a smaller plan ceiling.

Example 3. (i) *Facts.* The facts are the same as in *Example 2*, except that the maximum additional amount that C can elect under the special section 457 catch-up under paragraph (c)(3) of this section is \$7,000 for 2006.

(ii) *Conclusion.* The maximum that C may defer for 2006 is \$22,000. This is the sum of the basic plan ceiling under paragraph (c)(1) of this section equal to \$15,000, plus the additional special section 457 catch-up under paragraph (c)(3) of this section equal to \$7,000. The additional dollar amount permitted under the age 50 catch-up is not applicable to C for 2006 because it provides a smaller plan ceiling.

(3) *Special section 457 catch-up—(i) In general.* Except as provided in paragraph (c)(2)(ii) of this section, an eligible plan may provide that, for one or more of the participant's last three taxable years

ending before the participant attains normal retirement age, the plan ceiling is an amount not in excess of the lesser of—

(A) Twice the dollar amount in effect under paragraph (c)(1)(i)(A) of this section; or

(B) The underutilized limitation determined under paragraph (c)(3)(ii) of this section.

(ii) *Underutilized limitation.* The underutilized amount determined under this paragraph (c)(3)(ii) is the sum of—

(A) The plan ceiling established under paragraph (c)(1) of this section for the taxable year; plus

(B) The plan ceiling established under paragraph (c)(1) of this section (or under section 457(b)(2) for any year before the applicability date of this section) for any prior taxable year or years, less the amount of annual deferrals under the plan for such prior taxable year or years (disregarding any annual deferrals under the plan permitted under the age 50 catch-up under paragraph (c)(2) of this section).

(iii) *Determining underutilized limitation under paragraph (c)(3)(ii)(B) of this section.* A prior taxable year is taken into account under paragraph (c)(3)(ii)(B) of this section only if it is a year beginning after December 31, 1978, in which the participant was eligible to participate in the plan, and in which compensation deferred (if any) under the plan during the year was subject to a plan ceiling established under paragraph (c)(1) of this section. This paragraph (c)(3)(iii) is subject to the special rules in paragraph (c)(3)(iv) of this section.

(iv) *Special rules concerning application of the coordination limit for years prior to 2002 for purposes of determining the underutilized limitation—(A) General rule.* For purposes of determining the underutilized limitation for years prior to 2002, participants remain subject to the rules in effect prior to the repeal of the coordination limitation under section 457(c)(2). Thus, the applicable basic annual limitation under paragraph (c)(1) of this section and the special section 457 catch-up under this paragraph (c)(3) for years in effect prior to 2002 are reduced, for purposes of determining a participant's underutilized amount under a plan, by amounts excluded from the participant's income for any prior taxable year by reason of a nonelective employer

contribution, salary reduction or elective contribution under any other eligible section 457(b) plan, or a salary reduction or elective contribution under any 401(k) qualified cash or deferred arrangement, section 402(h)(1)(B) simplified employee pension (SARSEP), section 403(b) annuity contract, and section 408(p) simple retirement account, or under any plan for which a deduction is allowed because of a contribution to an organization described in section 501(c)(18) (pre-2002 coordination plans). Similarly, in applying the section 457(b)(2)(B) limitation for includible compensation for years prior to 2002, the limitation is 33 $\frac{1}{3}$ percent of the participant's compensation includible in gross income.

(B) *Coordination limitation applied to participant.* For purposes of determining the underutilized limitation for years prior to 2002, the coordination limitation applies to pre-2002 coordination plans of all employers for whom a participant has performed services, whether or not those are plans of the participant's current eligible employer. Thus, for purposes of determining the amount excluded from a participant's gross income in any prior taxable year under paragraph (c)(3)(ii)(B) of this section, the participant's annual deferrals under an eligible plan, and salary reduction or elective deferrals under all other pre-2002 coordination plans, must be determined on an aggregate basis. To the extent that the combined deferrals for years prior to 2002 exceeded the maximum deferral limitations, the amount is treated as an excess deferral under paragraph (e) of this section for those prior years.

(C) *Special rule where no annual deferrals under the eligible plan.* A participant who, although eligible, did not defer any compensation under the eligible plan in any year before 2002 is not subject to the coordinated deferral limit, even though the participant may have deferred compensation under one of the other pre-2002 coordination plans. An individual is treated as not having deferred compensation under an eligible plan for a prior taxable year if all annual deferrals under the plan are distributed in accordance with paragraph (e) of this section. Thus, to the extent that a participant participated solely in one or more of the other pre-2002 coordination plans during a prior taxable

year (and not the eligible plan), the participant is not subject to the coordinated limitation for that prior taxable year. However, the participant is treated as having deferred an amount in a prior taxable year, for purposes of determining the underutilized limitation for that prior taxable year under this paragraph (c)(3)(iv)(C), to the extent of the participant's aggregate salary reduction contributions and elective deferrals under all pre-2002 coordination plans up to the maximum deferral limitations in effect under section 457(b) for that prior taxable year. To the extent an employer did not offer an eligible plan to an individual in a prior given year, no underutilized limitation is available to the individual for that prior year, even if the employee subsequently becomes eligible to participate in an eligible plan of the employer.

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

Example 1. (i) *Facts.* In 2001 and in years prior to 2001, Participant D earned \$50,000 a year and was eligible to participate in both an eligible plan and a section 401(k) plan. However, D had always participated only in the section 401(k) plan and had always deferred the maximum amount possible. For each year before 2002, the maximum amount permitted under section 401(k) exceeded the limitation of paragraph (c)(3)(i) of this section. In 2002, D is in the 3-year period prior to D's attainment of the eligible plan's normal retirement age of 65, and D now wants to participate in the eligible plan and make annual deferrals of up to \$30,000 under the plan's special section 457 catch-up provisions.

(ii) *Conclusion.* Participant D is treated as having no underutilized amount under paragraph (c)(3)(ii)(B) of this section for 2002 for purposes of the catch-up limitation under section 457(b)(3) and paragraph (c)(3) of this section because, in each of the years before 2002, D has deferred an amount equal to or in excess of the limitation of paragraph (c)(3)(i) of this section under all of D's coordinated plans.

Example 2. (i) *Facts.* Assume the same facts as in *Example 1*, except that D only deferred \$2,500 per year under the section 401(k) plan for one year before 2002.

(ii) *Conclusion.* D is treated as having an underutilized amount under paragraph (c)(3)(ii)(B) of this section for 2002 for purposes of the special section 457 catch-up limitation. This is because D has deferred an amount for prior years that is less than the limitation of paragraph (c)(1)(i) of this section under all of D's coordinated plans.

Example 3. (i) *Facts.* Participant E, who earned \$15,000 for 2000, entered into a salary reduction agreement in 2000 with E's eligible employer and elected to defer \$3,000 for that year under E's eligible plan. For 2000, E's eligible employer provided an immediately vested, matching employer contribution under the plan for participants who

make salary reduction deferrals under E's eligible plan. The matching contribution was equal to 67 percent of elective contributions, but not in excess of 10 percent of compensation before salary reduction deferrals (in E's case, \$1,000). For 2000, E was not eligible for any catch-up contribution, participated in no other retirement plan, and had no other income exclusions taken into account in computing taxable compensation.

(ii) *Conclusion.* Participant E's annual deferral equaled the maximum limitation of section 457(b) for 2000. E's maximum deferral limitation in 2000 was \$4,000 because E's includible compensation was \$12,000 (\$15,000 minus the deferral of \$3,000) and the applicable limitation for 2000 was one third of the individual's includible compensation (one-third of \$12,000 equals \$4,000). E's salary reduction deferral of \$3,000 combined with E's eligible employer's matching contribution of \$1,000 equals the limitation of section 457(b) for 2000 because E's annual deferrals totaled \$4,000. E's underutilized amount for 2000 is zero.

(v) *Normal retirement age—(A) General rule.* For purposes of the special section 457 catch-up in this paragraph (c)(3), a plan must specify the normal retirement age under the plan. A plan may define normal retirement age as any age that is on or after the earlier of age 65 or the age at which participants have the right to retire and receive, under the basic defined benefit pension plan of the state or tax-exempt entity (or a money purchase pension plan in which the participant also participates if the participant is not eligible to participate in a defined benefit plan), immediate retirement benefits without actuarial or similar reduction because of retirement before some later specified age, and that is not later than age 70½. Alternatively, a plan may provide that a participant is allowed to designate a normal retirement age within these ages. For purposes of the special section 457 catch-up in this paragraph (c)(3), an entity sponsoring more than one eligible plan may not permit a participant to have more than one normal retirement age under the eligible plans it sponsors.

(B) *Special rule for eligible plans of qualified police or firefighters.* An eligible plan with participants that include qualified police or firefighters as defined under section 415(b)(2)(H)(ii)(I) may designate a normal retirement age for such qualified police or firefighters that is earlier than the earliest normal retirement age designated under the general rule of paragraph (c)(3)(i)(A) of this section, but in no event may the normal retirement age be earlier

than age 40. Alternatively, a plan may allow a qualified police or firefighter participant to designate a normal retirement age that is between age 40 and age 70½.

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

Example 1. (i) *Facts.* Participant F, who will turn 61 on April 1, 2006, becomes eligible to participate in an eligible plan on January 1, 2006. The plan provides a normal retirement age of 65. The plan provides limitations on annual deferrals up to the maximum permitted under paragraphs (c)(1) through (3) of this section. For 2006, F will receive compensation of \$40,000 from the eligible employer. F desires to defer the maximum amount possible in 2006. The applicable basic dollar limit of paragraph (c)(1)(i)(A) of this section is \$15,000 for 2006 and the additional dollar amount permitted under the age 50 catch-up in paragraph (c)(2) of this section for an individual who is at least age 50 is \$5,000 for 2006.

(ii) *Conclusion.* F is not eligible for the special section 457 catch-up under paragraph (c)(3) of this section in 2006 because 2006 is not one of the last three taxable years ending before F attains normal retirement age. Accordingly, the maximum that F may defer for 2006 is \$20,000. See also paragraph (c)(2)(iii) *Example 1* of this section.

Example 2. (i) *Facts.* The facts are the same as in *Example 1* except that, in 2006, F elects to defer only \$2,000 under the plan (rather than the maximum permitted amount of \$20,000). In addition, assume that the applicable basic dollar limit of paragraph (c)(1)(i)(A) of this section continues to be \$15,000 for 2007 and the additional dollar amount permitted under the age 50 catch-up in paragraph (c)(2) of this section for an individual who is at least age 50 continues to be \$5,000 for 2007. In F's taxable year 2007, which is one of the last three taxable years ending before F attains the plan's normal retirement age of 65, F again receives a salary of \$40,000 and elects to defer the maximum amount permissible under the plan's catch-up provisions prescribed under paragraph (c) of this section.

(ii) *Conclusion.* For 2007, which is one of the last three taxable years ending before F attains the plan's normal retirement age of 65, the applicable limit on deferrals for F is the larger of the amount under the special section 457 catch-up or \$20,000, which is the basic annual limitation (\$15,000) and the age 50 catch-up limit of section 414(v) (\$5,000). For 2007, F's special section 457 catch-up amount is the lesser of two times the basic annual limitation (\$30,000) or the sum of the basic annual limitation (\$15,000) plus the \$13,000 underutilized limitation under paragraph (c)(3)(ii) of this section (the \$15,000 plan ceiling in 2006, minus the \$2,000 contributed for F in 2006), or \$28,000. Thus, the maximum amount that F may defer in 2007 is \$28,000.

Example 3. (i) *Facts.* The facts are the same as in *Examples 1* and *2*, except that F does not make any contributions to the plan before 2010. In addition, assume that the applicable basic dollar limitation of paragraph (c)(1)(i)(A) of this section continues to be \$15,000 for 2010 and the additional dollar amount permitted under the age 50 catch-up in paragraph (c)(2) of this section for an individual who is at least age 50 continues to be \$5,000 for 2010. In F's

taxable year 2010, the year in which F attains age 65 (which is the normal retirement age under the plan), F desires to defer the maximum amount possible under the plan. F's compensation for 2010 is again \$40,000.

(ii) *Conclusion.* For 2010, the maximum amount that F may defer is \$20,000. The special section 457 catch-up provisions under paragraph (c)(3) of this section are not applicable because 2010 is not a taxable year ending before the year in which F attains normal retirement age.

(4) *Cost-of-living adjustment.* For years beginning after December 31, 2006, the \$15,000 dollar limitation in paragraph (c)(1)(i)(A) of this section will be adjusted to take into account increases in the cost-of-living. The adjustment in the dollar limitation is made at the same time and in the same manner as under section 415(d) (relating to qualified plans under section 401(a)), except that the base period is the calendar quarter beginning July 1, 2005, and any increase which is not a multiple of \$500 will be rounded to the next lowest multiple of \$500.

(d) *Deferral of sick, vacation, and back pay under an eligible plan—(1) In general.* An eligible plan may provide that a participant may elect to defer accumulated sick pay, accumulated vacation pay, and back pay under an eligible plan if the requirements of section 457(b) are satisfied. For example, the plan must provide, in accordance with paragraph (b) of this section, that these amounts may be deferred for any calendar month only if an agreement providing for the deferral is entered into before the beginning of the month in which the amounts would otherwise be paid or made available and the participant is an employee in that month. In the case of accumulated sick pay, vacation pay, or back pay that is payable before the participant has a severance from employment, the requirements of the preceding sentence are deemed to be satisfied if the agreement providing for the deferral is entered into before the amount is currently available (as defined in regulations under section 401(k)).

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

Example 1. (i) Facts. Participant G, who is age 62 in 2003, is an employee who participates in an eligible plan providing a normal retirement age of 65. Under the terms of G's employer's eligible plan and G's sick leave plan, G may, during November of 2003 (which is one of the three years prior to normal retirement age), make a one-time election to contribute amounts representing accumulated sick pay to the eligible plan

in December of 2003 (within the maximum deferral limitations). Alternatively, such amounts may remain in the "bank" under the sick leave plan. No cash out of the sick pay is available until the month in which a participant ceases to be employed by the employer. The total value of G's accumulated sick pay (determined, in accordance with the terms of the sick leave plan, by reference to G's current salary) is \$4,000 in December of 2003.

(ii) *Conclusion.* Under the terms of the eligible plan and sick leave plan, G may elect before December of 2003 to defer the \$4,000 value of accumulated sick pay under the eligible plan, provided that G's other annual deferrals to the eligible plan for 2003, when added to the \$4,000, do not exceed G's maximum deferral limitation for the year.

Example 2. (i) Facts. Same facts as in *Example 1*, except that G will separate from service on January 17, 2004, and elects, on January 4, 2004, to defer G's accumulated sick and vacation pay (which totals \$12,000) that is payable on January 15, 2004.

(ii) *Conclusion.* G may elect before January 15, 2004, to defer the accumulated sick and vacation pay under the eligible plan, even if the election is made after the beginning of January, because the agreement providing for the deferral is entered into before the amount is currently available and G does not cease to be an employee before the amount is currently available. G will have \$12,000 of includible compensation in 2004 because the deferral is taken into account in the definition of includible compensation.

Example 3. (i) Facts. Employer X maintains an eligible plan and a vacation leave plan. Under the terms of the vacation leave plan, employees generally accrue three weeks of vacation per year. Up to one week's unused vacation may be carried over from one year to the next, so that in any single year an employee may have a maximum of four weeks vacation time. At the beginning of each calendar year, under the terms of the eligible plan (which constitutes an agreement providing for the deferral), the value of any unused vacation time from the prior year in excess of one week is automatically contributed to the eligible plan, to the extent of the employee's maximum deferral limitations. Amounts in excess of the maximum deferral limitations are forfeited.

(ii) *Conclusion.* The value of the unused vacation pay contributed to X's eligible plan pursuant to the terms of the plan and the terms of the vacation leave plan is treated as an annual deferral to the eligible plan in the calendar year the contribution is made. No amounts contributed to the eligible plan will be considered made available to a participant in X's eligible plan.

(e) *Excess deferrals under an eligible plan—(1) In general.* Any amount deferred under an eligible plan for the taxable year of a participant that exceeds the maximum deferral limitations set forth in paragraphs (c)(1) through (3) of this section, and any amount that exceeds the individual limitation under §1.457-5, constitutes an excess deferral that is taxable in accordance with §1.457-11 for that taxable year. Thus, an excess deferral is includible in gross income in the taxable year deferred

or, if later, the first taxable year in which there is no substantial risk of forfeiture.

(2) *Excess deferrals under an eligible governmental plan other than as a result of the individual limitation.* In order to be an eligible governmental plan, the plan must provide that any excess deferral resulting from a failure of a plan to apply the limitations of paragraphs (c)(1) through (3) of this section to amounts deferred under the eligible plan (computed without regard to the individual limitation under §1.457-5) will be distributed to the participant, with allocable net income, as soon as administratively practicable after the plan determines that the amount is an excess deferral. For purposes of determining whether there is an excess deferral resulting from a failure of a plan to apply the limitations of paragraphs (c)(1) through (3) of this section, all plans under which an individual participates by virtue of his or her relationship with a single employer are treated as a single plan (without regard to any differences in funding). An eligible governmental plan does not fail to satisfy the requirements of paragraphs (a) through (d) of this section or §§1.457-6 through 1.457-10 (including the distribution rules under §1.457-6 and the funding rules under §1.457-8) solely by reason of a distribution made under this paragraph (e)(2). If such excess deferrals are not corrected by distribution under this paragraph (e)(2), the plan will be an ineligible plan under which benefits are taxable in accordance with §1.457-11.

(3) *Excess deferrals under an eligible plan of a tax-exempt employer other than as a result of the individual limitation.* If a plan of a tax-exempt employer fails to comply with the limitations of paragraphs (c)(1) through (3) of this section, the plan will be an ineligible plan under which benefits are taxable in accordance with §1.457-11. However, a plan may distribute to a participant any excess deferrals (and any income allocable to such amount) not later than the first April 15 following the close of the taxable year of the excess deferrals. In such a case, the plan will continue to be treated as an eligible plan. However, any excess deferral is included in the gross income of a participant for the taxable year of the excess deferral. If the excess deferrals are not corrected by distribution under this paragraph (e)(3), the plan is an ineligible plan under which benefits

are taxable in accordance with §1.457-11. For purposes of determining whether there is an excess deferral resulting from a failure of a plan to apply the limitations of paragraphs (c)(1) through (3) of this section, all eligible plans under which an individual participates by virtue of his or her relationship with a single employer are treated as a single plan.

(4) *Excess deferrals arising from application of the individual limitation.* An eligible plan may provide that an excess deferral that is a result solely of a failure to comply with the individual limitation under §1.457-5 for a taxable year may be distributed to the participant, with allocable net income, as soon as administratively practicable after the plan determines that the amount is an excess deferral. An eligible plan does not fail to satisfy the requirements of paragraphs (a) through (d) of this section or §§1.457-6 through 1.457-10 (including the distribution rules under §1.457-6 and the funding rules under §1.457-8) solely by reason of a distribution made under this paragraph (e)(4). Although a plan will still maintain eligible status if excess deferrals are not distributed under this paragraph (e)(4), a participant must include the excess amounts in income as provided in paragraph (e)(1) of this section.

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

Example 1. (i) *Facts.* In 2006, the eligible plan of State Employer X in which Participant H participates permits a maximum deferral of the lesser of \$15,000 or 100 percent of includible compensation. In 2006, H, who has compensation of \$28,000, nevertheless defers \$16,000 under the eligible plan. Participant H is age 45 and normal retirement age under the plan is age 65. For 2006, the applicable dollar limit under paragraph (c)(1)(i)(A) of this section is \$15,000. Employer X discovers the error in January of 2007 when it completes H's 2006 Form W-2 and promptly distributes \$1,022 to H (which is the sum of the \$1,000 excess and \$22 of allocable net income).

(ii) *Conclusion.* Participant H has deferred \$1,000 in excess of the \$15,000 limitation provided for under the plan for 2006. The \$1,000 excess must be included by H in H's income for 2006. In order to correct the failure and still be an eligible plan, the plan must distribute the excess deferral, with allocable net income, as soon as administratively practicable after determining that the amount exceeds the plan deferral limitations. In this case, \$22 of the distribution of \$1,022 is included in H's gross income for 2007 (and is not an eligible rollover distribution). If the excess deferral were not distributed, the plan would be an ineligible plan with respect to which benefits are taxable in accordance with §1.457-11.

Example 2. (i) *Facts.* The facts are the same as in *Example 1*, except that X uses a number of separate arrangements with different trustees and annuity insurers to permit employees to defer and H elects deferrals under several of the funding arrangements none of which exceeds \$15,000 for any individual funding arrangement, but which total \$16,000.

(ii) *Conclusion.* The conclusion is the same as in *Example 1*.

Example 3. (i) *Facts.* The facts are the same as in *Example 1*, except that H's deferral under the eligible plan is limited to \$11,000 and H also makes a salary reduction contribution of \$5,000 to an annuity contract under section 403(b) with the same Employer X.

(ii) *Conclusion.* H's deferrals are within the plan deferral limitations of Employer X. Because of the repeal of the application of the coordination limitation under former paragraph (2) of section 457(c), H's salary reduction deferrals under the annuity contract are no longer considered in determining H's applicable deferral limits under paragraphs (c)(1) through (3) of this section.

Example 4. (i) *Facts.* The facts are the same as in *Example 1*, except that H's deferral under the eligible governmental plan is limited to \$14,000 and H also makes a deferral of \$4,000 to an eligible governmental plan of a different employer. Participant H is age 45 and normal retirement age under both eligible plans is age 65.

(ii) *Conclusion.* Because of the application of the individual limitation under §1.457-5, H has an excess deferral of \$3,000 (the sum of \$14,000 plus \$4,000 equals \$18,000, which is \$3,000 in excess of the dollar limitation of \$15,000). The \$3,000 excess deferral, with allocable net income, may be distributed from either plan as soon as administratively practicable after determining that the combined amount exceeds the deferral limitations. If the \$3,000 excess deferral is not distributed to H, each plan will continue to be an eligible plan, but the \$3,000 must be included by H in H's income for 2006.

Example 5. (i) *Facts.* Assume the same facts as in *Example 3*, except that H's deferral under the eligible governmental plan is limited to \$14,000 and H also makes a deferral of \$4,000 to an eligible plan of Employer Y, a tax-exempt entity.

(ii) *Conclusion.* The results are the same as in *Example 3*, namely, because of the application of the individual limitation under §1.457-5, H has an excess deferral of \$3,000. If the \$3,000 excess deferral is not distributed to H, each plan will continue to be an eligible plan, but the \$3,000 must be included by H in H's income for 2006.

Example 6. (i) *Facts.* Assume the same facts as in *Example 5*, except that X is a tax-exempt entity and thus its plan is an eligible plan of a tax-exempt entity.

(ii) *Conclusion.* The results are the same as in *Example 5*, namely, because of the application of the individual limitation under §1.457-5, H has an excess deferral of \$3,000. If the \$3,000 excess deferral is not distributed to H, each plan will continue to be an eligible plan, but the \$3,000 must be included by H into H's income for 2006.

Par. 3. Sections 1.457-5 through 1.457-12 are added to read as follows:

§1.457-5 Individual limitation for combined annual deferrals under multiple eligible plans.

(a) *General rule.* The individual limitation under section 457(c) and this section equals the basic annual deferral limitation under §1.457-4(c)(1)(i)(A), plus either the age 50 catch-up amount under §1.457-4(c)(2), or the special section 457 catch-up amount under §1.457-4(c)(3), applied by taking into account the combined annual deferral for the participant for any taxable year under all eligible plans. While an eligible plan may include provisions under which it will limit deferrals to meet the individual limitation under section 457(c) and this section, annual deferrals by a participant that exceed the individual limit under section 457(c) and this section (but do not exceed the limits under § 1.457-4(c)) will not cause a plan to lose its eligible status. However, to the extent the combined annual deferrals for a participant for any taxable year exceed the individual limitation under section 457(c) and this section for that year, the amounts are treated as excess deferrals as described in §1.457-4(e).

(b) *Limitation applied to participant.* The individual limitation in this section applies to eligible plans of all employers for whom a participant has performed services, including both eligible governmental plans and eligible plans of a tax-exempt entity and both eligible plans of the employer and eligible plans of other employers. Thus, for purposes of determining the amount excluded from a participant's gross income in any taxable year (including the underutilized limitation under §1.457-4(c)(3)(ii)(B)), the participant's annual deferral under an eligible plan, and the participant's annual deferrals under all other eligible plans, must be determined on an aggregate basis. To the extent that the combined annual deferral amount exceeds the maximum deferral limitation applicable under §1.457-4(c)(1)(i)(A), (c)(2), or (c)(3), the amount is treated as an excess deferral under §1.457-4(e).

(c) *Special rules for catch-up amounts under multiple eligible plans.* For purposes of applying section 457(c) and this section, the special section 457 catch-up under §1.457-4(c)(3) is taken into account only to the extent that an annual

deferral is made for a participant under an eligible plan as a result of plan provisions permitted under §1.457-4(c)(3). In addition, if a participant has annual deferrals under more than one eligible plan and the applicable catch-up amount under §1.457-4(c)(2) or (3) is not the same for each such eligible plan for the taxable year, section 457(c) and this section are applied using the catch-up amount under whichever plan has the largest catch-up amount applicable to the participant.

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

Example 1. (i) *Facts.* Participant F is age 62 in 2006 and participates in two eligible plans during 2006, Plans J and K, which are each eligible plans of two different governmental entities. Each plan includes provisions allowing the maximum annual deferral permitted under §1.457-4(c)(1) through (3). For 2006, the underutilized amount under §1.457-4(c)(3)(ii)(B) is \$20,000 under Plan J and is \$40,000 under Plan K. Normal retirement age is age 65 under both plans. Participant F defers \$15,000 under each plan. Participant F's includible compensation is in each case in excess of the deferral. Neither plan designates the \$15,000 contribution as a catch-up permitted under each plan's special section 457 catch-up provisions.

(ii) *Conclusion.* For purposes of applying this section to Participant F for 2006, the maximum exclusion is \$20,000. This is equal to the sum of \$15,000 plus \$5,000, which is the age 50 catch-up amount. Thus, F has an excess amount of \$10,000 which is treated as an excess deferral for Participant F for 2006 under §1.457-4(e).

Example 2. (i) *Facts.* Participant E, who will turn 63 on April 1, 2006, participates in four eligible plans during 2006. Plan W which is an eligible governmental plan; and Plans X, Y, and Z which are each eligible plans of three different tax-exempt entities. For 2006, the limitation that applies to Participant E under all four plans under §1.457-4(c)(1)(i)(A) is \$15,000. For 2006, the additional age 50 catch-up limitation that applies to Participant E under all four plans under §1.457-4(c)(2) is \$5,000. Further, for 2006, different limitations under §1.457-4(c)(3) and (c)(3)(ii)(B) apply to Participant E under each of these plans, as follows: under Plan W, the underutilized limitation under §1.457-4(c)(3)(ii)(B) is \$7,000; under Plan X, the underutilized limitation under §1.457-4(c)(3)(ii)(B) is \$2,000; under Plan Y, the underutilized limitation under §1.457-4(c)(3)(ii)(B) is \$8,000; and under Plan Z, §1.457-4(c)(3) is not applicable since normal retirement age is age 62 under Plan Z. Participant E's includible compensation is in each case in excess of any applicable deferral.

(ii) *Conclusion.* For purposes of applying this section to Participant E for 2006, Participant E could elect to defer \$23,000 under Plan Y, which is the maximum deferral limitation under §1.457-4(c)(1) through (3), and to defer no amount under Plans W, X, and Z. The \$23,000 maximum amount is equal to the sum of \$15,000 plus \$8,000, which is the catch-up amount applicable to Participant E under Plan Y and

which is the largest catch-up amount applicable to Participant E under any of the four plans for 2006. Alternatively, Participant E could instead elect to defer the following combination of amounts: an aggregate total of \$20,000 to any of the four plans; or \$22,000 to Plan W and none to any of the other three plans.

(iii) If the underutilized amount under Plans W, X, and Y for 2006 were in each case zero (because E had always contributed the maximum amount or E was a new participant) or an amount not in excess of \$5,000, the maximum exclusion under this section would be \$20,000 for Participant E for 2006 (\$15,000 plus the \$5,000 age 50 catch-up amount), which Participant E could contribute to any of the plans.

§1.457-6 Timing of distributions under eligible plans.

(a) *In general.* Except as provided in paragraph (c) of this section (relating to distributions on account of an unforeseeable emergency), paragraph (e) of this section (relating to distributions of small accounts), §1.457-10(a) (relating to plan terminations), or §1.457-10(c) (relating to domestic relations orders), amounts deferred under an eligible governmental plan may not be paid to a participant or beneficiary before the participant has a severance from employment with the eligible employer or when the participant attains age 70½, if earlier. For rules relating to loans, see paragraph (f) of this section. This section does not apply to distributions of excess amounts under §1.457-4(e). However, except to the extent set forth by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin, this section applies to amounts held in a separate account for eligible rollover distributions maintained by an eligible governmental plan as described in §1.457-10(e)(2).

(b) *Severance from employment—(1) Employees.* An employee has a severance from employment with the eligible employer if the employee dies, retires, or otherwise has a severance from employment with the eligible employer. See regulations under section 401(k) for additional guidance concerning severance from employment.

(2) *Independent contractors—(i) In general.* An independent contractor is considered to have a severance from employment with the eligible employer upon the expiration of the contract (or in the case of more than one contract, all contracts) under which services are performed for the eligible employer if the expiration

constitutes a good-faith and complete termination of the contractual relationship. An expiration does not constitute a good faith and complete termination of the contractual relationship if the eligible employer anticipates a renewal of a contractual relationship or the independent contractor becoming an employee. For this purpose, an eligible employer is considered to anticipate the renewal of the contractual relationship with an independent contractor if it intends to contract again for the services provided under the expired contract, and neither the eligible employer nor the independent contractor has eliminated the independent contractor as a possible provider of services under any such new contract. Further, an eligible employer is considered to intend to contract again for the services provided under an expired contract if the eligible employer's doing so is conditioned only upon incurring a need for the services, the availability of funds, or both.

(ii) *Special rule.* Notwithstanding paragraph (b)(2)(i) of this section, the plan is considered to satisfy the requirement described in paragraph (a) of this section that no amounts deferred under the plan be paid or made available to the participant before the participant has a severance from employment with the eligible employer if, with respect to amounts payable to a participant who is an independent contractor, an eligible plan provides that—

(A) No amount will be paid to the participant before a date at least 12 months after the day on which the contract expires under which services are performed for the eligible employer (or, in the case of more than one contract, all such contracts expire); and

(B) No amount payable to the participant on that date will be paid to the participant if, after the expiration of the contract (or contracts) and before that date, the participant performs services for the eligible employer as an independent contractor or an employee.

(c) *Rules applicable to distributions for unforeseeable emergencies—(1) In general.* An eligible plan may permit a distribution to a participant or beneficiary faced with an unforeseeable emergency. The distribution must satisfy the requirements of paragraph (c)(2) of this section.

(2) *Requirements—(i) Unforeseeable emergency defined.* An unforeseeable

emergency must be defined in the plan as a severe financial hardship of the participant or beneficiary resulting from an illness or accident of the participant or beneficiary, the participant's or beneficiary's spouse, or the participant's or beneficiary's dependent (as defined in section 152(a)); loss of the participant's or beneficiary's property due to casualty (including the need to rebuild a home following damage to a home not otherwise covered by homeowner's insurance, e.g., as a result of a natural disaster); or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant or the beneficiary. For example, the imminent foreclosure of or eviction from the participant's or beneficiary's primary residence may constitute an unforeseeable emergency. In addition, the need to pay for medical expenses, including non-refundable deductibles, as well as for the cost of prescription drug medication, may constitute an unforeseeable emergency. Finally, the need to pay for the funeral expenses of a spouse or a dependent (as defined in section 152(a)) may also constitute an unforeseeable emergency. Except as otherwise specifically provided in this paragraph (c)(2)(i), the purchase of a home and the payment of college tuition are not unforeseeable emergencies under this paragraph (c)(2)(i).

(ii) *Unforeseeable emergency distribution standard.* Whether a participant or beneficiary is faced with an unforeseeable emergency permitting a distribution under this paragraph (c) is to be determined based on the relevant facts and circumstances of each case, but, in any case, a distribution on account of unforeseeable emergency may not be made to the extent that such emergency is or may be relieved through reimbursement or compensation from insurance or otherwise, by liquidation of the participant's assets, to the extent the liquidation of such assets would not itself cause severe financial hardship, or by cessation of deferrals under the plan.

(iii) *Distribution necessary to satisfy emergency need.* Distributions because of an unforeseeable emergency must be limited to the amount reasonably necessary to satisfy the emergency need (which may include any amounts necessary to pay any federal, state, or local income taxes or

penalties reasonably anticipated to result from the distribution).

(d) *Minimum required distributions for eligible plans.* In order to be an eligible plan, a plan must meet the distribution requirements of section 457(d)(1) and (2). Under section 457(d)(2), a plan must meet the minimum distribution requirements of section 401(a)(9). See section 401(a)(9) and the regulations thereunder for these requirements. Section 401(a)(9) requires that a plan begin lifetime distributions to a participant no later than April 1 of the calendar year following the later of the calendar year in which the participant attains age 70½ or the calendar year in which the participant retires.

(e) *Distributions of smaller accounts—(1) In general.* An eligible plan may provide for a distribution of all or a portion of a participant's benefit if this paragraph (e)(1) is satisfied. This paragraph (e)(1) is satisfied if the participant's total amount deferred (the participant's total account balance) which is not attributable to rollover contributions (as defined in section 411(a)(11)(D)) is not in excess of the dollar limit under section 411(a)(11)(A), no amount has been deferred under the plan by or for the participant during the two-year period ending on the date of the distribution, and there has been no prior distribution under the plan to the participant under this paragraph (e). An eligible plan is not required to permit distributions under this paragraph (e).

(2) *Alternative provisions possible.* Consistent with the provisions of paragraph (e)(1) of this section, a plan may provide that the total amount deferred for a participant or beneficiary will be distributed automatically to the participant or beneficiary if the requirements of paragraph (e)(1) of this section are met. Alternatively, if the requirements of paragraph (e)(1) of this section are met, the plan may provide for the total amount deferred for a participant or beneficiary to be distributed to the participant or beneficiary only if the participant or beneficiary so elects. The plan is permitted to substitute a specified dollar amount that is less than the total amount deferred. In addition, these two alternatives can be combined; for example, a plan could provide for automatic distributions for up to \$500, but allow a participant or beneficiary to elect

a distribution if the total account balance is above \$500.

(f) *Loans from eligible plans—(1) Eligible plans of tax-exempt entities.* If a participant or beneficiary receives (directly or indirectly) any amount deferred as a loan from an eligible plan of a tax-exempt entity, that amount will be treated as having been paid or made available to the individual as a distribution under the plan, in violation of the distribution requirements of section 457(d).

(2) *Eligible governmental plans.* The determination of whether the availability of a loan, the making of a loan, or a failure to repay a loan made from a trustee (or a person treated as a trustee under section 457(g)) of an eligible governmental plan to a participant or beneficiary is treated as a distribution (directly or indirectly) for purposes of this section, and the determination of whether the availability of the loan, the making of the loan, or a failure to repay the loan is in any other respect a violation of the requirements of section 457(b) and the regulations, depends on the facts and circumstances. Among the facts and circumstances are whether the loan has a fixed repayment schedule and bears a reasonable rate of interest, and whether there are repayment safeguards to which a prudent lender would adhere. Thus, for example, a loan must bear a reasonable rate of interest in order to satisfy the exclusive benefit requirement of section 457(g)(1) and §1.457-8(a)(1). See also §1.457-7(b)(3) relating to the application of section 72(p) with respect to the taxation of a loan made under an eligible governmental plan, and §1.72(p)-1 relating to section 72(p)(2).

(3) *Example.* The provisions of paragraph (f)(2) of this section are illustrated by the following example:

Example. (i) *Facts.* Eligible Plan X of State Y is funded through Trust Z. Plan X permits an employee's account balance under Plan X to be paid in a single sum at severance from employment with State Y. Plan X includes a loan program under which any active employee with a vested account balance may receive a loan from Trust Z. Loans are made pursuant to plan provisions regarding loans that are set forth in the plan under which loans bear a reasonable rate of interest and are secured by the employee's account balance. In order to avoid taxation under §1.457-7(b)(3) and section 72(p)(1), the plan provisions limit the amount of loans and require loans to be repaid in level installments as required under section 72(p)(2). Participant J's vested account balance under Plan X is \$50,000. J receives a loan from Trust Z in the amount of \$5,000 on December 1, 2003, to be repaid in level installments made quarterly over the

5-year period ending on November 30, 2008. Participant J makes the required repayments until J has a severance from employment from State Y in 2005 and subsequently fails to repay the outstanding loan balance of \$2,250. The \$2,250 loan balance is offset against J's \$80,000 account balance benefit under Plan X, and J elects to be paid the remaining \$77,750 in 2005.

(ii) *Conclusion.* The making of the loan to J will not be treated as a violation of the requirements of section 457(b) or the regulations. The cancellation of the loan at severance from employment does not cause Plan X to fail to satisfy the requirements for plan eligibility under section 457. In addition, because the loan satisfies the maximum amount and repayment requirements of section 72(p)(2), J is not required to include any amount in income as a result of the loan until 2005, when J has income of \$2,250 as a result of the offset (which is a permissible distribution under this section) and income of \$77,750 as a result of the distribution made in 2005.

§1.457-7 Taxation of distributions under eligible plans.

(a) *General rules for when amounts are included in gross income.* The rules for determining when an amount deferred under an eligible plan is includible in the gross income of a participant or beneficiary depend on whether the plan is an eligible governmental plan or an eligible plan of a tax-exempt entity. Paragraph (b) of this section sets forth the rules for an eligible governmental plan. Paragraph (c) of this section sets forth the rules for an eligible plan of a tax-exempt entity.

(b) *Amounts included in gross income under an eligible governmental plan—(1) Amounts included in gross income in year paid under an eligible governmental plan.* Except as provided in paragraphs (b)(2) and (3) of this section (or in §1.457-10(c) relating to payments to a spouse or former spouse pursuant to a qualified domestic relations order), amounts deferred under an eligible governmental plan are includible in the gross income of a participant or beneficiary for the taxable year in which paid to the participant or beneficiary under the plan.

(2) *Rollovers to individual retirement arrangements and other eligible retirement plans.* A trustee-to-trustee transfer in accordance with section 401(a)(31) (generally referred to as a direct rollover) from an eligible government plan is not includible in gross income of a participant or beneficiary in the year transferred. In addition, any payment made from an eligible government plan in the form of an eligible rollover distribution (as defined

in section 402(c)(4)) is not includible in gross income in the year paid to the extent the payment is transferred to an eligible retirement plan (as defined in section 402(c)(8)(B)) within 60 days, including the transfer to the eligible retirement plan of any property distributed from the eligible governmental plan. For this purpose, the rules of section 402(c)(2) through (7) and (9) apply. Any trustee-to-trustee transfer under this paragraph (b)(2) from an eligible government plan is a distribution that is subject to the distribution requirements of §1.457-6.

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

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

Example 1. (i) *Facts.* Eligible Plan G of a governmental entity permits distribution of benefits in a single sum or in installments of up to 20 years, with such benefits to commence at any date that is after severance from employment (up to the later of severance from employment or the plan's normal retirement age of 65). Effective for participants who have a severance from employment after December 31, 2001, Plan X allows an election—as to both the date on which payments are to begin and the form in which payments are to be made—to be made by the participant at any time that is before the commencement date selected. However, Plan X chooses to require elections to be filed at least 30 days before the commencement date selected in order for Plan X to have enough time to be able to effectuate the election.

(ii) *Conclusion.* No amounts are included in gross income before actual payments begin. If installment payments begin (and the installment payments are payable over at least 10 years so as not to be eligible rollover distributions), the amount included in gross income for any year is equal to the amount of the installment payment paid during the year.

Example 2. (i) *Facts.* Same facts as in *Example 1*, except that the same rules are extended to participants who had a severance from employment before January 1, 2002.

(ii) *Conclusion.* For all participants (that is, both those who have a severance from employment after December 31, 2001, and those who have a severance from employment before January 1, 2002, including those whose benefit payments have commenced before January 1, 2002), no amounts are included in gross income before actual payments begin. If installment payments begin (and the installment payments are payable over at least 10 years so as not to be eligible rollover distributions), the amount included in gross income for any year is equal to the amount of the installment payment paid during the year.

(c) *Amounts included in gross income under an eligible plan of a tax-exempt entity—(1) Amounts included in gross income in year paid or made available under an eligible plan of a tax-exempt entity.* Amounts deferred under an eligible plan of a tax-exempt entity are includible in the gross income of a participant or beneficiary for the taxable year in which paid or otherwise made available to the participant or beneficiary under the plan. Thus, amounts deferred under an eligible plan of a tax-exempt entity are includible in the gross income of the participant or beneficiary in the year the amounts are first made available under the terms of the plan, even if the plan has not distributed the amounts deferred. Amounts deferred under an eligible plan of a tax-exempt entity are not considered made available to the participant or beneficiary solely because the participant or beneficiary is permitted to choose among various investments under the plan.

(2) *When amounts deferred are considered to be made available under an eligible plan of a tax-exempt entity—(i) General rule.* Except as provided in paragraphs (c)(2)(ii) through (iv) of this section, amounts deferred under an eligible plan of a tax-exempt entity are considered made available (and, thus, are includible in the gross income of the participant or beneficiary under this paragraph (c)) at the earliest date, on or after severance from employment, on which the plan allows distributions to commence, but in no event later than the date on which distributions must commence pursuant to section 401(a)(9). For example, in the case of a plan that permits distribution to commence on the date that is 60 days after the close of the plan year in which the participant has a

severance from employment with the eligible employer, amounts deferred are considered to be made available on that date. However, distributions deferred in accordance with paragraphs (c)(2)(ii) through (iv) of this section are not considered made available prior to the applicable date under paragraphs (c)(2)(ii) through (iv) of this section. In addition, no portion of a participant or beneficiary's account is treated as made available (and thus currently includible in income) under an eligible plan of a tax-exempt entity merely because the participant or beneficiary under the plan may elect to receive a distribution in any of the following circumstances:

(A) A distribution in the event of an unforeseeable emergency to the extent the distribution is permitted under §1.457-6(c).

(B) A distribution from an account for which the total amount deferred is not in excess of the dollar limit under section 411(a)(11)(A) to the extent the distribution is permitted under §1.457-6(e).

(ii) *Initial election to defer commencement of distributions*—(A) *In general.* An eligible plan of a tax-exempt entity may provide a period for making an initial election during which the participant or beneficiary may elect, in accordance with the terms of the plan, to defer the payment of some or all of the amounts deferred to a fixed or determinable future time. The period for making this initial election must expire prior to the first time that any such amounts would be considered made available under the plan under paragraph (c)(2)(i) of this section.

(B) *Failure to make initial election to defer commencement of distributions.* Generally, if no initial election is made by a participant or beneficiary under this paragraph (c)(2)(ii), then the amounts deferred under an eligible plan of a tax-exempt entity are considered made available and taxable to the participant or beneficiary in accordance with paragraph (c)(2)(i) of this section at the earliest time, on or after severance from employment (but in no event later than the date on which distributions must commence pursuant to section 401(a)(9)), that distribution is permitted to commence under the terms of the plan. However, the plan may provide for a default payment schedule that applies if no election is made. If the plan provides for

a default payment schedule, the amounts deferred are includible in the gross income of the participant or beneficiary in the year the amounts deferred are first made available under the terms of the default payment schedule.

(iii) *Additional election to defer commencement of distribution.* An eligible plan of a tax-exempt entity is permitted to provide that a participant or beneficiary who has made an initial election under paragraph (c)(2)(ii)(A) of this section may make one additional election to defer (but not accelerate) commencement of distributions under the plan before distributions have commenced in accordance with the initial deferral election under paragraph (c)(2)(ii)(A) of this section. Amounts payable to a participant or beneficiary under an eligible plan of a tax-exempt entity are not treated as made available merely because the plan allows the participant to make an additional election under this paragraph (c)(2)(iii). A participant or beneficiary is not precluded from making an additional election to defer commencement of distributions merely because the participant or beneficiary has previously received a distribution under §1.457-6(c) because of an unforeseeable emergency, has received a distribution of smaller amounts under §1.457-6(e), has made (and revoked) other deferral or method of payment elections within the initial election period, or is subject to a default payment schedule under which the commencement of benefits is deferred (for example, until a participant is age 65).

(iv) *Election as to method of payment.* An eligible plan of a tax-exempt entity may provide that an election as to the method of payment under the plan may be made at any time prior to the time the amounts are distributed in accordance with the participant or beneficiary's initial or additional election to defer commencement of distributions under paragraph (c)(2)(ii) or (iii) of this section. Where no method of payment is elected, the entire amount deferred will be includible in the gross income of the participant or beneficiary when the amounts first become made available in accordance with a participant's initial or additional elections to defer under paragraphs (c)(2)(ii) and (iii) of this section, unless the eligible plan provides for a default method of payment

(in which case amounts are considered made available and taxable when paid under the terms of the default payment schedule). A method of payment means a distribution or a series of periodic distributions commencing on a date determined in accordance with paragraph (c)(2)(ii) or (iii) of this section.

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

Example 1. (i) *Facts.* Eligible Plan X of a tax-exempt entity provides that a participant's total account balance, representing all amounts deferred under the plan, is payable to a participant in a single sum 60 days after severance from employment throughout these examples, unless, during a 30-day period immediately following the severance, the participant elects to receive the single sum payment at a later date (that is not later than the plan's normal retirement age of 65) or elects to receive distribution in 10 annual installments to begin 60 days after severance from employment (or at a later date, if so elected, that is not later than the plan's normal retirement age of 65). On November 13, 2004, K, a calendar year taxpayer, has a severance from employment with the eligible employer. K does not, within the 30-day window period, elect to postpone distributions to a later date or to receive payment in 10 fixed annual installments.

(ii) *Conclusion.* The single sum payment is payable to K 60 days after the date K has a severance from employment (January 12, 2005), and is includible in the gross income of K in 2005 under section 457(a).

Example 2. (i) *Facts.* The terms of eligible Plan X are the same as described in *Example 1*. Participant L participates in eligible Plan X. On November 11, 2003, L has a severance from the employment of the eligible employer. On November 24, 2003, L makes an initial deferral election not to receive the single-sum payment payable 60 days after the severance, and instead elects to receive the amounts in 10 annual installments to begin 60 days after severance from employment.

(ii) *Conclusion.* No portion of L's account is considered made available in 2003 or 2004 before a payment is made and no amount is includible in the gross income of L until distributions commence. The annual installment payable in 2004 will be includible in L's gross income in 2004.

Example 3. (i) *Facts.* The facts are the same as in *Example 1*, except that eligible Plan X also provides that those participants who are receiving distributions in 10 annual installments may, at any time and without restriction, elect to receive a cash out of all remaining installments. Participant M elects to receive a distribution in 10 annual installments commencing in 2004.

(ii) *Conclusion.* M's total account balance, representing the total of the amounts deferred under the plan, is considered made available and is includible in M's gross income in 2004.

Example 4. (i) *Facts.* The facts are the same as in *Example 3*, except that, instead of providing for an unrestricted cashout of remaining payments, the plan provides that participants or beneficiaries

who are receiving distributions in 10 annual installments may accelerate the payment of the amount remaining payable to the participant upon the occurrence of an unforeseeable emergency as described in §1.457-6(c)(1) in an amount not exceeding that described in §1.457-6(c)(2).

(ii) *Conclusion.* No amount is considered made available to participant M on account of M's right to accelerate payments upon the occurrence of an unforeseeable emergency.

Example 5. (i) *Facts.* Eligible Plan Y of a tax-exempt entity provides that distributions will commence 60 days after a participant's severance from employment unless the participant elects, within a 30-day window period following severance from employment, to defer distributions to a later date (but no later than the year following the calendar year the participant attains age 70½). The plan provides that a participant who has elected to defer distributions to a later date may make an election as to form of distribution at any time prior to the 30th day before distributions are to commence.

(ii) *Conclusion.* No amount is considered made available prior to the date distributions are to commence by reason of a participant's right to defer or make an election as to the form of distribution.

Example 6. (i) *Facts.* The facts are the same as in *Example 1*, except that the plan also permits participants who have made an initial election to defer distribution to make one additional deferral election at any time prior to the date distributions are scheduled to commence. Participant N has a severance from employment at age 50. The next day, during the 30-day period provided in the plan, N elects to receive distribution in the form of 10 annual installment payments beginning at age 55. Two weeks later, within the 30-day window period, N makes a new election permitted under the plan to receive 10 annual installment payments beginning at age 60 (instead of age 55). When N is age 59, N elects under the additional deferral election provisions, to defer distributions until age 65.

(ii) *Conclusion.* In this example, N's election to defer distributions until age 65 is a valid election. The two elections N makes during the 30-day window period are not additional deferral elections described in paragraph (c)(2)(iii) of this section because they are made before the first permissible payout date under the plan. Therefore, the plan is not precluded from allowing N to make the additional deferral election. However, N can make no further election to defer distributions beyond age 65 (or accelerate distribution before age 65) because this additional deferral election can only be made once.

§1.457-8 Funding rules for eligible plans.

(a) *Eligible governmental plans—(1) In general.* In order to be an eligible governmental plan, all amounts deferred under the plan, all property and rights purchased with such amounts, and all income attributable to such amounts, property, or rights, must be held in trust for the exclusive benefit of participants and their beneficiaries. A trust described in this paragraph (a) that also meets the requirements

of §§1.457-3 through 1.457-10 is treated as an organization exempt from tax under section 501(a), and a participant's or beneficiary's interest in amounts in the trust is includible in the gross income of the participants and beneficiaries only to the extent, and at the time, provided for in section 457(a) and §§1.457-4 through 1.457-10.

(2) *Trust requirement.* (i) A trust described in this paragraph (a) must be established pursuant to a written agreement that constitutes a valid trust under state law. The terms of the trust must make it impossible, prior to the satisfaction of all liabilities with respect to participants and their beneficiaries, for any part of the assets and income of the trust to be used for, or diverted to, purposes other than for the exclusive benefit of participants and their beneficiaries.

(ii) Amounts deferred under an eligible governmental plan must be transferred to a trust within a period that is not longer than is reasonable for the proper administration of the participant accounts (if any). For purposes of this requirement, the plan may provide for amounts deferred for a participant under the plan to be transferred to the trust within a specified period after the date the amounts would otherwise have been paid to the participant. For example, the plan could provide for amounts deferred under the plan at the election of the participant to be contributed to the trust within 15 business days following the month in which these amounts would otherwise have been paid to the participant.

(3) *Custodial accounts and annuity contracts treated as trusts—(i) In general.* For purposes of the trust requirement of this paragraph (a), custodial accounts and annuity contracts described in section 401(f) that satisfy the requirements of this paragraph (a)(3) are treated as trusts under rules similar to the rules of section 401(f). Therefore, the provisions of §1.401(f)-1(b) will generally apply to determine whether a custodial account or an annuity contract is treated as a trust. The use of a custodial account or annuity contract as part of an eligible governmental plan does not preclude the use of a trust or another custodial account or annuity contract as part of the same plan, provided that all such vehicles satisfy the requirements of section 457(g)(1) and (3) and paragraphs (a)(1) and (2) of this section

and that all assets and income of the plan are held in such vehicles.

(ii) *Custodial accounts—(A) In general.* A custodial account is treated as a trust, for purposes of section 457(g)(1) and paragraphs (a)(1) and (2) of this section, if the custodian is a bank, as described in section 408(n), or a person who meets the nonbank trustee requirements of paragraph (a)(3)(ii)(B) of this section, and the account meets the requirements of paragraphs (a)(1) and (2) of this section, other than the requirement that it be a trust.

(B) *Nonbank trustee status.* The custodian of a custodial account may be a person other than a bank only if the person demonstrates to the satisfaction of the Commissioner that the manner in which the person will administer the custodial account will be consistent with the requirements of section 457(g)(1) and (3). To do so, the person must demonstrate that the requirements of §1.408-2(e)(2) through (6) (relating to nonbank trustees) are met. The written application must be sent to the address prescribed by the Commissioner in the same manner as prescribed under §1.408-2(e). To the extent that a person has already demonstrated to the satisfaction of the Commissioner that the person satisfies the requirements of §1.408-2(e) in connection with a qualified trust (or custodial account or annuity contract) under section 401(a), that person is deemed to satisfy the requirements of this paragraph (a)(3)(ii)(B).

(iii) *Annuity contracts.* An annuity contract is treated as a trust for purposes of section 457(g)(1) and paragraph (a)(1) of this section if the contract is an annuity contract, as defined in section 401(g), that has been issued by an insurance company qualified to do business in the state, and the contract meets the requirements of paragraphs (a)(1) and (2) of this section, other than the requirement that it be a trust. An annuity contract does not include a life, health or accident, property, casualty, or liability insurance contract.

(4) *Combining assets.* [Reserved]

(b) *Eligible plans maintained by tax-exempt entity—(1) General rule.* In order to be an eligible plan of a tax-exempt entity, the plan must be unfunded and plan assets must not be set aside for participants or their beneficiaries. Under section

457(b)(6) and this paragraph (b), an eligible plan of a tax-exempt entity must provide that all amounts deferred under the plan, all property and rights to property (including rights as a beneficiary of a contract providing life insurance protection) purchased with such amounts, and all income attributable to such amounts, property, or rights, must remain (until paid or made available to the participant or beneficiary) solely the property and rights of the eligible employer (without being restricted to the provision of benefits under the plan), subject only to the claims of the eligible employer's general creditors.

(2) *Additional requirements.* For purposes of paragraph (b)(1) of this section, the plan must be unfunded regardless of whether or not the amounts were deferred pursuant to a salary reduction agreement between the eligible employer and the participant. Any funding arrangement under an eligible plan of a tax-exempt entity that sets aside assets for the exclusive benefit of participants violates this requirement, and amounts deferred are generally immediately includible in the gross income of plan participants and beneficiaries. Nothing in this paragraph (b) prohibits an eligible plan from permitting participants and their beneficiaries to make an election among different investment options available under the plan, such as an election affecting the investment of the amounts described in paragraph (b)(1) of this section.

§1.457-9 Effect on eligible plans when not administered in accordance with eligibility requirements.

(a) *Eligible governmental plans.* A plan of a state ceases to be an eligible governmental plan on the first day of the first plan year beginning more than 180 days after the date on which the Commissioner notifies the state in writing that the plan is being administered in a manner that is inconsistent with one or more of the requirements of §§1.457-3 through 1.457-8, or §1.457-10. However, the plan may correct the plan inconsistencies specified in the written notification before the first day of that plan year and continue to maintain plan eligibility. If a plan ceases to be an eligible governmental plan, amounts subsequently deferred by participants will be includible in income when deferred, or, if later, when the amounts deferred cease to

be subject to a substantial risk of forfeiture, as provided at §1.457-11. Amounts deferred before the date on which the plan ceases to be an eligible governmental plan, and any earnings thereon, will be treated as if the plan continues to be an eligible governmental plan and will not be includible in participant's or beneficiary's gross income until paid to the participant or beneficiary.

(b) *Eligible plans of tax-exempt entities.* A plan of a tax-exempt entity ceases to be an eligible plan on the first day that the plan fails to satisfy one or more of the requirements of §§1.457-3 through 1.457-8, or §1.457-10. See §1.457-11 for rules regarding the treatment of an ineligible plan.

§1.457-10 Miscellaneous provisions.

(a) *Plan terminations and frozen plans—(1) In general.* An eligible employer may amend its plan to eliminate future deferrals for existing participants or to limit participation to existing participants and employees. An eligible plan may also contain provisions that permit plan termination and permit amounts deferred to be distributed on termination. In order for a plan to be considered terminated, amounts deferred under an eligible plan must be distributed to all plan participants and beneficiaries as soon as administratively practicable after termination of the eligible plan. The mere provision for, and making of, distributions to participants or beneficiaries upon a plan termination will not cause an eligible plan to cease to satisfy the requirements of section 457(b) or the regulations.

(2) *Employers that cease to be eligible employers—(i) Plan not terminated.* An eligible employer that ceases to be an eligible employer may no longer maintain an eligible plan. If the employer was a tax-exempt entity and the plan is not terminated as permitted under paragraph (a)(2)(ii) of this section, the tax consequences to participants and beneficiaries in the previously eligible (unfunded) plan of an ineligible employer are determined in accordance with either section 451 if the employer becomes an entity other than a state or §1.457-11 if the employer becomes a state. If the employer was a state and the plan is neither terminated as permitted under paragraph (a)(2)(ii) of this section nor transferred to another eligible

plan of that state as permitted under paragraph (b) of this section, the tax consequences to participants in the previously eligible governmental plan of an ineligible employer, the assets of which are held in trust pursuant to §1.457-8(a), are determined in accordance with section 402(b) (section 403(c) in the case of an annuity contract) and the trust is no longer to be treated as a trust that is exempt from tax under section 501(a).

(ii) *Plan termination.* As an alternative to determining the tax consequences to the plan and participants under paragraph (a)(2)(i) of this section, the employer may terminate the plan and distribute the amounts deferred (and all plan assets) to all plan participants as soon as administratively practicable in accordance with paragraph (a)(1) of this section. Such distribution may include eligible rollover distributions in the case of a plan that was an eligible governmental plan. In addition, if the employer is a state, another alternative to determining the tax consequences under paragraph (a)(2)(i) of this section is to transfer the assets of the eligible governmental plan to an eligible governmental plan of another eligible employer within the same state under the plan-to-plan transfer rules of paragraph (b) of this section.

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

Example 1. (i) Facts. Employer Y, a corporation that owns a state hospital, sponsors an eligible governmental plan funded through a trust. Employer Y is acquired by a for-profit hospital and Employer Y ceases to be an eligible employer under section 457(e)(1) or §1.457-2(c). Employer Y terminates the plan and, during the next 6 months, distributes to participants and beneficiaries all amounts deferred that were under the plan.

(ii) *Conclusion.* The termination and distribution does not cause the plan to fail to be an eligible governmental plan. Amounts that are distributed as eligible rollover distributions may be rolled over to an eligible retirement plan described in section 402(c)(8)(B).

Example 2. (i) Facts. The facts are the same as in *Example 1*, except that Employer Y decides to continue to maintain the plan.

(ii) *Conclusion.* If Employer Y continues to maintain the plan, the tax consequences to participants and beneficiaries will be determined in accordance with either section 402(b) if the compensation deferred is funded through a trust, section 403(c) if the compensation deferred is funded through annuity contracts, or §1.457-11 if the compensation deferred is not funded through a trust or annuity contract. In addition, if Employer Y continues to maintain the plan, the trust will no longer be treated as exempt from tax under section 501(a).

Example 3. (i) *Facts.* Employer Z, a corporation that owns a tax-exempt hospital, sponsors an unfunded eligible plan. Employer Z is acquired by a for-profit hospital and is no longer an eligible employer under section 457(e)(1) or §1.457-2(e). Employer Z terminates the plan and distributes all amounts deferred under the eligible plan to participants and beneficiaries within a one-year period.

(ii) *Conclusion.* Distributions under the plan are treated as made under an eligible plan of a tax-exempt entity and the distributions of the amounts deferred are includible in the gross income of the participant or beneficiary in the year distributed.

Example 4. (i) *Facts.* The facts are the same as in Example 3, except that Employer Z decides to maintain instead of terminate the plan.

(ii) *Conclusion.* If Employer Z maintains the plan, the tax consequences to participants and beneficiaries in the plan will thereafter be determined in accordance with section 451.

(b) *Plan-to-plan transfers*—(1) *General rule.* An eligible governmental plan may provide for the transfer of amounts deferred by a participant or beneficiary to another eligible governmental plan if the conditions in paragraphs (b)(2), (3), or (4) of this section are met. An eligible plan of a tax-exempt entity may provide for transfers of amounts deferred by a participant to another eligible plan of a tax-exempt entity if the conditions in paragraph (b)(5) of this section are met. In addition, an eligible governmental plan may accept transfers from another eligible governmental plan as described in the first sentence of this paragraph (b)(1), and an eligible plan of a tax-exempt entity may accept transfers from another eligible plan of a tax-exempt entity as described in the preceding sentence. However, a state may not transfer the assets of its eligible governmental plan to a tax-exempt entity's eligible plan and the plan of a tax-exempt entity may not accept such a transfer. Similarly, a tax-exempt entity may not transfer the assets of its eligible plan to an eligible governmental plan and an eligible governmental plan may not accept such a transfer. In addition, if the conditions in paragraph (b)(4) of this section (relating to permissive past service credit and repayments under section 415) are met, an eligible governmental plan of a state may provide for the transfer of amounts deferred by a participant or beneficiary to a qualified plan (under section 401(a)) maintained by a state. However, a qualified plan may not transfer assets to an eligible governmental plan or to an eligible plan of a tax-exempt entity, and an eligible governmental plan

or the plan of a tax-exempt entity may not accept such a transfer.

(2) *Requirements for post-severance plan-to-plan transfers among eligible governmental plans.* A transfer under paragraph (b)(1) of this section from an eligible governmental plan to another eligible governmental plan is permitted if the following conditions are met —

(i) The transferor plan provides for transfers;

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

(iii) The participant or beneficiary whose amounts deferred are being transferred will have an amount deferred immediately after the transfer at least equal to the amount deferred with respect to that participant or beneficiary immediately before the transfer; and

(iv) In the case of a transfer for a participant, the participant has had a severance from employment with the transferring employer and is performing services for the entity maintaining the receiving plan.

(3) *Requirements for plan-to-plan transfers of all plan assets of eligible governmental plans.* A transfer under paragraph (b)(1) of this section from an eligible governmental plan to another eligible governmental plan is permitted if the following conditions are met —

(i) The transfer is from an eligible governmental plan to another eligible governmental plan within the same state;

(ii) All of the assets held by the transferor plan are transferred;

(iii) The transferor plan provides for transfers;

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

(v) The participant or beneficiary whose amounts deferred are being transferred will have an amount deferred immediately after the transfer at least equal to the amount deferred with respect to that participant or beneficiary immediately before the transfer; and

(vi) The participants or beneficiaries whose deferred amounts are being transferred are not eligible for additional annual deferrals in the receiving plan unless they are performing services for the entity maintaining the receiving plan.

(4) *Requirements for plan-to-plan transfers among eligible governmental plans of the same employer.* A transfer

under paragraph (b)(1) of this section from an eligible governmental plan to another eligible governmental plan is permitted if the following conditions are met —

(i) The transfer is from an eligible governmental plan to another eligible governmental plan of the same employer (and, for this purpose, the employer is not treated as the same employer if the participant's compensation is paid by a different entity);

(ii) The transferor plan provides for transfers;

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

(iv) The participant or beneficiary whose amounts deferred are being transferred will have an amount deferred immediately after the transfer at least equal to the amount deferred with respect to that participant or beneficiary immediately before the transfer; and

(v) The participant or beneficiary whose deferred amounts are being transferred is not eligible for additional annual deferrals in the receiving plan unless the participant or beneficiary is performing services for the entity maintaining the receiving plan.

(5) *Requirements for post-severance plan-to-plan transfers among eligible plans of tax-exempt entities.* A transfer under paragraph (b)(1) of this section from an eligible plan of a tax-exempt employer to another eligible plan of a tax-exempt employer is permitted if the following conditions are met —

(i) The transferor plan provides for transfers;

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

(iii) The participant or beneficiary whose amounts deferred are being transferred will have an amount deferred immediately after the transfer at least equal to the amount deferred with respect to that participant or beneficiary immediately before the transfer; and

(iv) In the case of a transfer for a participant, the participant has had a severance from employment with the transferring employer and is performing services for the entity maintaining the receiving plan.

(6) *Treatment of amount transferred following a plan-to-plan transfer between eligible plans.* Following a transfer of any amount between eligible plans under

paragraphs (b)(1) through (b)(5) of this section —

(i) the transferred amount is subject to the restrictions of §1.457-6 (relating to when distributions are permitted to be made to a participant under an eligible plan) in the receiving plan in the same manner as if the transferred amount had been originally been deferred under the receiving plan if the participant is performing services for the entity maintaining the receiving plan, and

(ii) in the case of a transfer between eligible plans of tax-exempt entities, except as otherwise determined by the Commissioner, the transferred amount is subject to §1.457-7(c)(2) (relating to when amounts are considered to be made available under an eligible plan of a tax-exempt entity) in the same manner as if the elections made by the participant or beneficiary under the transferor plan had been made under the receiving plan.

(7) *Examples.* The provisions of paragraphs (b)(1) through (6) of this section are illustrated by the following examples:

Example 1. (i) *Facts.* Participant A, the president of City X's hospital, has accepted a position with another hospital which is a tax-exempt entity. A participant in the eligible governmental plan of City X. A would like to transfer the amounts deferred under City X's eligible governmental plan to the eligible plan of the tax-exempt hospital.

(ii) *Conclusion.* City X's plan may not transfer A's amounts deferred to the tax-exempt employer's eligible plan. In addition, because the amounts deferred would no longer be held in trust for the exclusive benefit of participants and their beneficiaries, the transfer would violate the exclusive benefit rule of section 457(g) and §1.457-8(a).

Example 2. (i) *Facts.* County M, located in State S, operates several health clinics and maintains an eligible governmental plan for employees of those clinics. One of the clinics operated by County M is being acquired by a hospital operated by State S, and employees of that clinic will become employees of State S. County M permits those employees to transfer their balances under County M's eligible governmental plan to the eligible governmental plan of State S.

(ii) *Conclusion.* If the eligible governmental plans of County M and State S provide for the transfer and acceptance of the transfer (and the other requirements of paragraph (b)(1) of this section are satisfied), then the requirements of paragraph (b)(2) of this section are satisfied and, thus, the transfer will not cause either plan to violate the requirements of section 457 or these regulations.

Example 3. (i) *Facts.* City Employer Z, a hospital, sponsors an eligible governmental plan. City Employer Z is located in State B. All of the assets of City Employer Z are being acquired by a tax-exempt hospital. City Employer Z, in accordance with the plan-to-plan transfer rules of paragraph (b) of this

section, would like to transfer the total amount of assets deferred under City Employer Z's eligible governmental plan to the acquiring tax-exempt entity's eligible plan.

(ii) *Conclusion.* City Employer Z may not permit participants to transfer the amounts to the eligible plan of the tax-exempt entity. In addition, because the amounts deferred would no longer be held in trust for the exclusive benefit of participants and their beneficiaries, the transfer would violate the exclusive benefit rule of section 457(g) and §1.457-8(a).

Example 4. (i) *Facts.* The facts are the same as in *Example 3*, except that City Employer Z, instead of transferring all of its assets to the eligible plan of the tax-exempt entity, decides to transfer all of the amounts deferred under City Z's eligible governmental plan to the eligible governmental plan of County B in which City Z is located. County B's eligible plan does not cover employees of City Z, but is willing to allow the assets of City Z's plan to be transferred to County B's plan, a related state government entity, also located in State B.

(ii) *Conclusion.* If City Employer Z's (transferor) eligible governmental plan provides for such transfer and the eligible governmental plan of County B permits the acceptance of such a transfer (and the other requirements of paragraph (b)(1) of this section are satisfied), then the requirements of paragraph (b)(3) of this section are satisfied and, thus, City Employer Z may transfer the total amounts deferred under its eligible governmental plan, prior to termination of that plan, to the eligible governmental plan maintained by County B. However, the participants of City Employer Z whose deferred amounts are being transferred are not eligible to participate in the eligible governmental plan of County B, the receiving plan, unless they are performing services for County B.

Example 5. (i) *Facts.* State C has an eligible governmental plan. Employees of City U in State C are among the eligible employees for State C's plan and City U decides to adopt another eligible governmental plan only for its employees. State C decides to allow employees to elect to transfer all of the amounts deferred for an employee under State C's eligible governmental plan to City U's eligible governmental plan.

(ii) *Conclusion.* If State C's (transferor) eligible governmental plan provides for such transfer and the eligible governmental plan of City U permits the acceptance of such a transfer (and the other requirements of paragraph (b)(1) of this section are satisfied), then the requirements of paragraph (b)(4) of this section are satisfied and, thus, State C may transfer the total amounts deferred under its eligible governmental plan to the eligible governmental plan maintained by City U.

(8) *Purchase of permissive past service credit by plan-to-plan transfers from an eligible governmental plan to a qualified plan—(i) General rule.* An eligible governmental plan of a state may provide for the transfer of amounts deferred by a participant or beneficiary to a defined benefit governmental plan (as defined in section 414(d)), and no amount shall be includible in gross income by reason of the transfer,

if the conditions in paragraph (b)(8)(ii) of this section are met. A transfer under this paragraph (b)(8) is not treated as a distribution for purposes of §1.457-6. Therefore, such a transfer may be made before severance from employment.

(ii) *Conditions for plan-to-plan transfers from an eligible governmental plan to a qualified plan.* A transfer may be made under this paragraph (b)(8) only if the transfer is either—

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

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

(iii) *Example.* The provisions of this paragraph (b)(8) are illustrated by the following example:

Example. (i) *Facts.* Plan X is an eligible governmental plan maintained by County Y for its employees. Plan X provides for distributions only in the event of death, an unforeseeable emergency, or severance from employment with County Y (including retirement from County Y). Plan S is a qualified defined benefit plan maintained by State T for its employees. County Y is within State T. Employee A is an employee of County Y and is a participant in Plan X. Employee A previously was an employee of State T and is still entitled to benefits under Plan S. Plan S includes provisions allowing participants in certain plans, including Plan X, to transfer assets to Plan S for the purchase of past service credit under Plan S and does not permit the amount transferred to exceed the amount necessary to fund the benefit resulting from the past service credit. Although not required to do so, Plan X allows Employee A to transfer assets to Plan S to provide a past service benefit under Plan S.

(ii) *Conclusion.* The transfer is permitted under this paragraph (b)(8).

(c) *Qualified domestic relations orders under eligible plans—(1) General rule.* An eligible plan does not become an ineligible plan described in section 457(f) solely because its administrator or sponsor complies with a qualified domestic relations order as defined in section 414(p), including an order requiring the distribution of the benefits of a participant to an alternate payee in advance of the general rules for eligible plan distributions under §1.457-6. If a distribution or payment is made from an eligible plan to an alternate payee pursuant to a qualified domestic relations order, rules similar to the rules of section 402(e)(1)(A) shall apply to the distribution or payment.

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

Example 1. (i) *Facts.* Participant C and C's spouse D are divorcing. C is employed by State S and is a participant in an eligible plan maintained by State S. C has an account valued at \$100,000 under the plan. Pursuant to the divorce, a court issues a qualified domestic relations order on September 1, 2003, that allocates 50 percent of C's \$100,000 plan account to D and specifically provides for an immediate distribution to D of D's share within 6 months of the order. Payment is made to D in January of 2004.

(ii) *Conclusion.* State S's eligible plan does not become an ineligible plan described in section 457(f) and §1.457-11 solely because its administrator or sponsor complies with the qualified domestic relations order requiring the immediate distribution to D in advance of the general rules for eligible plan distributions under §1.457-6. In accordance with section 402(e)(1)(A), D (not C) must include the distribution in gross income. The distribution is includible in D's gross income in 2004. If the qualified domestic relations order were to provide for distribution to D at a future date, amounts deferred attributable to D's share will be includible in D's gross income when paid to D.

Example 2. (i) *Facts.* The facts are the same as in *Example 1*, except that S is a tax-exempt entity, instead of a state.

(ii) *Conclusion.* State S's eligible plan does not become an ineligible plan described in section 457(f) and §1.457-11 solely because its administrator or sponsor complies with the qualified domestic relations order requiring the immediate distribution to D in advance of the general rules for eligible plan distributions under §1.457-6. In accordance with section 402(e)(1)(A), D (not C) must include the distribution in gross income. The distribution is includible in D's gross income in 2004, assuming that the plan did not make the distribution available to D in 2003. If the qualified domestic relations order were to provide for distribution to D at a future date, amounts deferred attributable to D's share would be includible in D's gross income when paid or made available to D.

(d) *Death benefits and life insurance proceeds.* A death benefit plan under section 457(e)(11) is not an eligible plan. In addition, no amount paid or made available under an eligible plan as death benefits or life insurance proceeds is excludable from gross income under section 101.

(e) *Rollovers to eligible governmental plans—(1) General rule.* An eligible governmental plan may accept contributions that are eligible rollover distributions (as defined in section 402(c)(4)) made from another eligible retirement plan (as defined in section 402(c)(8)(B)) if the conditions in paragraph (e)(2) of this section are met. Amounts contributed to an eligible governmental plan as eligible rollover distributions are not taken into account

for purposes of the annual limit on annual deferrals by a participant in §1.457-4(c) or §1.457-5, but are otherwise treated in the same manner as amounts deferred under section 457 for purposes of §§1.457-3 through 1.457-9 and this section.

(2) *Conditions for rollovers to an eligible governmental plan.* An eligible governmental plan that permits eligible rollover distributions made from another eligible retirement plan to be paid into the eligible governmental plan is required under this paragraph (e)(2) to provide that it will separately account for any eligible rollover distributions it receives. A plan does not fail to satisfy this requirement if it separately accounts for particular types of eligible rollover distributions (for example, if it maintains a separate account for eligible rollover distributions attributable to annual deferrals that were made under other eligible governmental plans and a separate account for amounts attributable to other eligible rollover distributions), but this requirement is not satisfied if any such separate account includes any amount that is not attributable to an eligible rollover distribution.

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

Example. (i) *Facts.* Plan T is an eligible governmental plan that provides that employees who are eligible to participate in Plan T may make rollover contributions to Plan T from amounts distributed to an employee from an eligible retirement plan. An eligible retirement plan is defined in Plan T as another eligible governmental plan, a qualified section 401(a) or 403(a) plan, or a section 403(b) contract, or an individual retirement arrangement (IRA) that holds such amounts. Plan T requires rollover contributions to be paid by the eligible retirement plan directly to Plan T (a direct rollover) or to be paid by the participant within 60 days after the date on which the participant received the amount from the other eligible retirement plan. Plan T does not take rollover contributions into account for purposes of the plan's limits on amounts deferred that conform to §1.457-4(c). Rollover contributions paid to Plan T are invested in the trust in the same manner as amounts deferred under Plan T and rollover contributions (and earnings thereon) are available for distribution to the participant at the same time and in the same manner as amounts deferred under Plan T. In addition, Plan T provides that, for each participant who makes a rollover contribution to Plan T, the Plan T record-keeper is to establish a separate account for the participant's rollover contributions. The record-keeper calculates earnings and losses for investments held in the rollover account separately from earnings and losses on other amounts held under the plan and calculates disbursements from and payments made to the rollover account separately from disbursements

from and payments made to other amounts held under the plan.

(ii) *Conclusion.* Plan T does not lose its status as an eligible governmental plan as a result of the receipt of rollover contributions. The conclusion would not be different if the Plan T record-keeper were to establish two separate accounts, one of which is for the participant's rollover contributions attributable to annual deferrals that were made under an eligible governmental plan and the other of which is for other rollover contributions.

(f) *Deemed IRAs under eligible governmental plans.* See regulations under section 408(q) for guidance regarding the treatment of separate accounts or annuities as individual retirement plans (IRAs).

§1.457-11 Tax treatment of participants if plan is not an eligible plan.

(a) *In general.* Under section 457(f), if an eligible employer provides for a deferral of compensation under any agreement or arrangement that is an ineligible plan—

(1) Compensation deferred under the agreement or arrangement is includible in the gross income of the participant or beneficiary for the first taxable year in which there is no substantial risk of forfeiture (within the meaning of section 457(f)(3)(B)) of the rights to such compensation;

(2) If the compensation deferred is subject to a substantial risk of forfeiture, the amount includible in gross income for the first taxable year in which there is no substantial risk of forfeiture includes earnings thereon to the date on which there is no substantial risk of forfeiture;

(3) Earnings credited on the compensation deferred under the agreement or arrangement that are not includible in gross income under paragraph (a)(2) of this section are includible in the gross income of the participant or beneficiary only when paid or made available to the participant or beneficiary, provided that the interest of the participant or beneficiary in any assets (including amounts deferred under the plan) of the entity sponsoring the agreement or arrangement is not senior to the entity's general creditors; and

(4) Amounts paid or made available to a participant or beneficiary under the agreement or arrangement are includible in the gross income of the participant or beneficiary under section 72, relating to annuities.

(b) *Exceptions.* Paragraph (a) of this section does not apply with respect to—

(1) A plan described in section 401(a) which includes a trust exempt from tax under section 501(a);

(2) An annuity plan or contract described in section 403;

(3) That portion of any plan which consists of a transfer of property described in section 83;

(4) That portion of any plan which consists of a trust to which section 402(b) applies; or

(5) A qualified governmental excess benefit arrangement described in section 415(m).

(c) *Amount included in income.* The amount included in gross income on the applicable date under paragraphs (a)(1) and (a)(2) of this section is equal to the present value of the compensation (including earnings to the extent provided in paragraph (a)(2) of this section) on that date. For purposes of applying section 72 on the applicable date under paragraphs (a)(3) and (4) of this section, the participant is treated as having paid investment in the contract (or basis) to the extent that the deferred compensation has been taken into account by the participant in accordance with paragraphs (a)(1) and (a)(2) of this section.

(d) *Coordination of section 457(f) with section 83—* (1) *General rules.* Under paragraph (b)(3) of this section, section 457(f) and paragraph (a) of this section do not apply to that portion of any plan which consists of a transfer of property described in section 83. For this purpose, a transfer of property described in section 83 means a transfer of property to which section 83 applies. Section 457(f) and paragraph (a) of this section do not apply if the date on which there is no substantial risk of forfeiture with respect to compensation deferred under an agreement or arrangement that is not an eligible plan is on or after the date on which there is a transfer of property to which section 83 applies. However, section 457(f) and paragraph (a) of this section apply if the date on which there is no substantial risk of forfeiture with respect to compensation deferred under an agreement or arrangement that is not an eligible plan precedes the date on which there is a transfer of property to which section 83 applies. If deferred compensation payable in property is includible in gross income under section 457(f), then, as provided in section 72, the amount includible

in gross income when that property is later transferred or made available to the service provider is the excess of the value of the property at that time over the amount previously included in gross income under section 457(f).

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

Example 1. (i) *Facts.* As part of an arrangement for the deferral of compensation, an eligible employer agrees on December 1, 2002, to pay an individual rendering services for the eligible employer a specified dollar amount on January 15, 2005. The arrangement provides for the payment to be made in the form of property having a fair market value equal to the specified dollar amount. The individual's rights to the payment are not subject to a substantial risk of forfeiture (within the meaning of section 457(f)(3)(B)).

(ii) *Conclusion.* In this *Example 1*, because there is no substantial risk of forfeiture with respect to the agreement to transfer property in 2005, the present value (as of December 1, 2002) of the payment is includible in the individual's gross income for 2002. Under paragraph (a)(4) of this section, when the payment is made on January 15, 2005, the amount includible in the individual's gross income is equal to the excess of the fair market value of the property when paid, over the amount that was includible in gross income for 2002 (which is the basis allocable to that payment).

Example 2. (i) *Facts.* As part of an arrangement for the deferral of compensation, individuals A and B rendering services for a tax-exempt entity each receive in 2010 property that is subject to a substantial risk of forfeiture (within the meaning of section 457(f)(3)(B) and within the meaning of section 83(c)(1)). Individual A makes an election to include the fair market value of the property in gross income under section 83(b) and individual B does not make this election. The substantial risk of forfeiture for the property transferred to individual A lapses in 2012 and the substantial risk of forfeiture for the property transferred to individual B also lapses in 2012. Thus, the property transferred to individual A is included in A's gross income for 2010 when A makes a section 83(b) election and the property transferred to individual B is included in B's gross income for 2012 when the substantial risk of forfeiture for the property lapses.

(ii) *Conclusion.* In this *Example 2*, in each case, the compensation deferred is not subject to section 457(f) or this section because section 83 applies to the transfer of property on or before the date on which there is no substantial risk of forfeiture with respect to compensation deferred under the arrangement.

Example 3. (i) *Facts.* In 2004, Z, a tax-exempt entity, grants an option to acquire property to employee C. The option lacks a readily ascertainable fair market value, within the meaning of section 83(e)(3), has a value on the date of grant equal to \$100,000, and is not subject to a substantial risk of forfeiture (within the meaning of section 457(f)(3)(B) and within the meaning of section 83(c)(1)). Z exercises the option in 2012 by paying an exercise price of \$75,000 and receives property that has a fair market value (for purposes of section 83) equal to \$300,000.

(ii) *Conclusion.* In this *Example 3*, under section 83(e)(3), section 83 does not apply to the grant of the option. Accordingly, C has income of \$100,000 in 2004 under section 457(f). In 2012, C has income of \$125,000, which is the value of the property transferred in 2012, minus the allocable portion of the basis that results from the \$100,000 of income in 2004 and the \$75,000 exercise price.

Example 4. (i) *Facts.* In 2010, X, a tax-exempt entity, agrees to pay deferred compensation to employee D. The amount payable is \$100,000 to be paid 10 years later in 2020. The commitment to make the \$100,000 payment is not subject to a substantial risk of forfeiture. In 2010, the present value of the \$100,000 is \$50,000. In 2018, X transfers to D property having a fair market value (for purposes of section 83) equal to \$70,000. The transfer is in partial settlement of the commitment made in 2010 and, at the time of the transfer in 2018, the present value of the commitment is \$80,000. In 2020, X pays D the \$12,500 that remains due.

(ii) *Conclusion.* In this *Example 4*, D has income of \$50,000 in 2010. In 2018, D has income of \$30,000, which is the amount transferred in 2018, minus the allocable portion of the basis that results from the \$50,000 of income in 2010. (Under section 72(e)(2)(B), income is allocated first. The income is equal to \$30,000 (\$80,000 minus the \$50,000 basis), with the result that the allocable portion of the basis is equal to \$40,000 (\$70,000 minus the \$30,000 of income.) In 2020, D has income of \$2,500 (\$12,500 minus \$10,000, which is the excess of the original \$50,000 basis over the \$40,000 basis allocated to the transfer made in 2018).

§ 1.457-12 Effective dates.

(a) *General effective date.* Except as otherwise provided in this section, §§1.457-1 through 1.457-11 apply for taxable years beginning after December 31, 2001.

(b) *Transition period for eligible plans to comply with EGTRRA.* For taxable years beginning after December 31, 2001, and before January 1, 2004, a plan does not fail to be an eligible plan as a result of requirements imposed by the Economic Growth and Tax Relief Reconciliation Act of 2001 (115 Stat. 385) (EGTRRA) (Public Law 107-16) June 7, 2001, if it is operated in accordance with a reasonable, good faith interpretation of EGTRRA.

(c) *Special rule for distributions from rollover accounts.* The last sentence of §1.457-6(a) (relating to distributions of amounts held in a separate account for eligible rollover distributions) applies for taxable years beginning after December 31, 2003.

(d) *Special rule for options.* Section 1.457-11(d) does not apply with respect to an option without a readily ascertainable fair market value (within the meaning of

section 83(e)(3)) that was granted on or before May 8, 2002.

(e) *Special rule for qualified domestic relations orders.* Section 1.457-10(c) (relating to qualified domestic relations orders) applies for transfers, distributions, and payments made after December 31, 2001.

Part 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

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

Authority: 26 U.S.C. 7805.

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

§602.101 OMB Control numbers.

* * * * *
(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.457-8	1545-1580
* * * * *	

Robert E. Wenzel,
Deputy Commissioner for Services and Enforcement.

Approved July 2, 2003.

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

(Filed by the Office of the Federal Register on July 10, 2003, 8:45 a.m., and published in the issue of the Federal Register for July 11, 2003, 68 F.R. 41230)

Section 645.—Certain Revocable Trusts Treated as Part of Estate

A testamentary trust under section 1.1361-1(h)(iv) includes a trust that receives S corporation stock from a qualified revocable trust for which an election under section 645 is made. See T.D. 9078, page 630.

Section 1361.—S Corporation Defined

26 CFR 1.1361-1: S corporation defined.

T.D. 9078

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Qualified Subchapter S Trust Election for Testamentary Trusts

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to a qualified subchapter S trust election for testamentary trusts under section 1361 of the Internal Revenue Code. The Small Business Job Protection Act of 1996 and the Taxpayer Relief Act of 1997 made changes to the applicable law. The final regulations affect S corporations and their shareholders.

DATES: *Effective Date:* These regulations are effective July 17, 2003.

Applicability Date: For dates of applicability of these regulations, see §1.1361-1(k)(2)(i) and (ii).

FOR FURTHER INFORMATION CONTACT: Concerning the final regulations, Deane M. Burke, (202) 622-3070 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document amends section 1361 of the Income Tax Regulations (26 CFR part 1) regarding a qualified subchapter S trust (QSST) election for testamentary trusts and the definition of testamentary trusts.

On August 24, 2001, a notice of proposed rulemaking (REG-106431-01, 2001-2 C.B. 272 [66 FR 44565]) relating to QSST elections for testamentary trusts and the period for which former qualified subpart E trusts and testamentary trusts may be permitted shareholders under section 1361 was published in the **Federal Register**. No public hearing was requested. Comments responding to the proposed regulations were received. After

consideration of the comments, the proposed regulations are adopted as revised by this Treasury decision.

Section 1361(a) defines an S corporation as a small business corporation for which an election under section 1362(a) is in effect for the year. Section 1361(b) provides, in part, that a small business corporation is a domestic corporation that is not an ineligible corporation and that does not have as a shareholder a person (other than an estate, a trust described in section 1361(c)(2), or an organization described in section 1361(c)(6)) who is not an individual. Under section 1361(c)(2), qualified subpart E trusts and testamentary trusts are permitted S corporation shareholders. A qualified subpart E trust is a trust, all of which is treated (under subpart E of part I of subchapter J, chapter 1) as owned by an individual who is a citizen or resident of the United States. A qualified subpart E trust that continues in existence after the death of the deemed owner (former qualified subpart E trust) is a permitted shareholder, but only for the 2-year period beginning on the day of the deemed owner's death. A testamentary trust is a trust to which S corporation stock is transferred pursuant to the terms of a will, but only for the 2-year period beginning on the day the stock is transferred to the trust.

Summary of Comments and Explanation of Provisions

These final regulations are substantially the same as the proposed regulations, but reflect certain revisions based on the comments that were received. The revisions are discussed below.

The proposed regulations provide that a former qualified subpart E trust is a permitted shareholder of an S corporation for the 2-year period beginning on the day of the deemed owner's death. In addition, the proposed regulations provide that a testamentary trust is also a permitted shareholder of an S corporation for the 2-year period beginning on the day the stock is transferred to the testamentary trust. If a former qualified subpart E trust or a testamentary trust continues to own stock after the expiration of the 2-year period during which it is a permitted shareholder, the corporation's S election will terminate unless the trust otherwise qualifies as a permitted shareholder. The trust might otherwise qualify as a permitted shareholder if, for example, the trust is a QSST that has an election under section 1361(d)(2) in effect at the end of the 2-year period (an electing QSST).

One commentator suggested that certain sections of the proposed regulations should be clarified because those sections indicate that if a former qualified subpart E trust or a testamentary trust continues to own stock of an S corporation after the 2-year period and is not otherwise a qualified subpart E trust or an electing QSST, the trust is not a permitted shareholder. The commentator noted that a former qualified subpart E trust or a testamentary trust that continues to own stock after the 2-year period could also be a permitted shareholder if the trust is an electing small business trust (ESBT) at the end of the 2-year period. The sections of the proposed regulations for which the commentator suggested clarification, however, address rules regarding QSSTs. Section 1.1361-1(m) of the Income Tax Regulations addresses rules regarding ESBTs. The final regulations clarify that if a former qualified subpart E trust or a testamentary trust continues to own stock of an S corporation after the 2-year period and is not otherwise a qualified subpart E trust, an electing QSST, or an ESBT, the trust is not a permitted shareholder. Additionally, the final regulations clarify that a QSST or an ESBT election may be made for a former qualified subpart E trust or a testamentary trust that qualifies as a QSST or an ESBT.

Another commentator suggested that after August 5, 1997, the effective date of section 645, a testamentary trust should

also include a trust that receives S corporation stock from a qualified revocable trust (QRT) for which an election under section 645 has been made (an electing trust). Under section 645, an electing trust is treated and taxed as part of the decedent's estate (and not as a separate trust) for purposes of subtitle A of the Code for all taxable years of the estate during the section 645 election period. The section 645 election period begins on the date of the decedent's death and generally terminates on the day before the applicable date described in section 645(b)(2). Section 1.645-1(h)(1) provides that on the close of the last day of the election period the share comprising the electing trust is deemed to be distributed to a new trust.

Thus, according to the commentator, the final regulations should clarify that testamentary trusts include trusts to which S corporation stock is transferred pursuant to the terms of the electing trust during the section 645 election period as well as new trusts to which S corporation stock is deemed to be distributed at the end of the section 645 election period. The commentator noted that the purpose of section 645 is to create parity between electing trusts and wills. In furtherance of this purpose, the commentator reasoned that if an electing trust transfers or is deemed to distribute S corporation stock to a new trust, the new trust should be a permitted shareholder for the 2-year period beginning on the day the stock is transferred or deemed distributed to the new trust. The final regulations adopt the commentator's suggestion to clarify that a testamentary trust also includes a trust that receives S corporation stock from an electing trust.

The IRS is considering issuing guidance on whether a trust that has a QSST or an ESBT election in effect may make an election under section 645.

Effective Date

Except where otherwise specifically provided, these final regulations are applicable on and after July 17, 2003. In addition, the IRS will not challenge the treatment of certain testamentary trusts that receive S corporation stock from an electing trust under section 645 as permitted shareholders of the S corporation for periods after August 5, 1997, and before the earlier of July 17, 2003, or the effective

date of any QSST or ESBT election for the trust.

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 also has been determined that section 533(b) of the Administrative Procedures Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Deane M. Burke, Office of the Associate Chief Counsel (Passthroughs & Special Industries). However, other personnel from the IRS and the Treasury Department participated in their development.

* * * * *

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 * * *

Par. 2. Section 1.1361-1 is amended as follows:

1. Paragraphs (b)(1)(ii), (f), (h)(1)(ii), (h)(1)(iv), (h)(3)(i)(B), (h)(3)(i)(D), (h)(3)(ii)(A), (h)(3)(ii)(B), (j)(6)(iii)(C), (j)(7)(ii), the fourth and last sentences of paragraph (k)(1) *Example 2(ii)*, (k)(1) *Examples 3 and 4(iii)*, and (k)(2)(i) are revised.

2. The undesignated paragraph following paragraph (h)(3)(i)(B) is removed.

3. Paragraph (j)(6)(iii)(D) is redesignated as paragraph (j)(6)(iii)(E).

4. New paragraph (j)(6)(iii)(D) is added.

5. Paragraph (k)(2)(ii) is redesignated as paragraph (k)(2)(iii).

6. New paragraph (k)(2)(ii) is added.

The revisions and additions read as follows:

§1.1361-1 S corporation defined.

* * * * *

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

(ii) As a shareholder, a person (other than an estate, a trust described in section 1361(c)(2), or, for taxable years beginning after December 31, 1997, an organization described in section 1361(c)(6)) who is not an individual;

* * * * *

(f) *Shareholder must be an individual or estate.* Except as otherwise provided in paragraph (e)(1) of this section (relating to nominees), paragraph (h) of this section (relating to certain trusts), and, for taxable years beginning after December 31, 1997, section 1361(c)(6) (relating to certain exempt organizations), a corporation in which any shareholder is a corporation, partnership, or trust does not qualify as a small business corporation.

* * * * *

(h)* * *(1)* * *

(ii) *Subpart E trust ceasing to be a qualified subpart E trust after the death of deemed owner.* A trust that was a qualified subpart E trust immediately before the death of the deemed owner and that continues in existence after the death of the deemed owner, but only for the 2-year period beginning on the day of the deemed owner's death. A trust is considered to continue in existence if the trust continues to hold the stock pursuant to the terms of the will or the trust agreement, or if the trust continues to hold the stock during a period reasonably necessary to wind up the affairs of the trust. See §1.641(b)-3 for rules concerning the termination of trusts for federal income tax purposes.

* * * * *

(iv) *Testamentary trusts.* A trust (other than a qualified subpart E trust, an electing QSST, or an electing small business trust) to which S corporation stock is—

(A) Transferred pursuant to the terms of a will, but only for the 2-year period beginning on the day the stock is transferred to the trust except as otherwise provided in paragraph (h)(3)(i)(D) of this section; or

(B) Transferred pursuant to the terms of an electing trust as defined in §1.645-1(b)(2) during the election period as defined in §1.645-1(b)(6), or deemed to be distributed at the close of the last day of the election period pursuant to §1.645-1(h)(1), but in each case only for the 2-year period beginning on the day the stock is transferred or deemed distributed to the trust except as otherwise provided in paragraph (h)(3)(i)(D) of this section.

* * * * *

(3)* * *(i)* * *

(B) If stock is held by a trust defined in paragraph (h)(1)(ii) of this section, the estate of the deemed owner is generally treated as the shareholder as of the day of the deemed owner's death. However, if stock is held by such a trust in a community property state, the decedent's estate is the shareholder only of the portion of the trust included in the decedent's gross estate (and the surviving spouse continues to be the shareholder of the portion of the trust owned by that spouse under the applicable state's community property law). The estate ordinarily will cease to be treated as the shareholder upon the earlier of the transfer of the stock by the trust or the expiration of the 2-year period beginning on the day of the deemed owner's death. If the trust qualifies and becomes an electing QSST, the beneficiary and not the estate is treated as the shareholder as of the effective date of the QSST election, and the rules provided in paragraph (j)(7) of this section apply. If the trust qualifies and becomes an ESBT, the shareholders are determined under paragraphs (h)(3)(i)(F) and (h)(3)(ii) of this section as of the effective date of the ESBT election, and the rules provided in paragraph (m) of this section apply.

* * * * *

(D) If stock is transferred or deemed distributed to a testamentary trust described in paragraph (h)(1)(iv) of this section (other than a qualified subpart E trust, an electing QSST, or an ESBT), the estate of the testator is treated as the shareholder until the earlier of the transfer of that stock by the trust or the expiration

of the 2-year period beginning on the day that the stock is transferred or deemed distributed to the trust. If the trust qualifies and becomes an electing QSST, the beneficiary and not the estate is treated as the shareholder as of the effective date of the QSST election, and the rules provided in paragraph (j)(7) of this section apply. If the trust qualifies and becomes an ESBT, the shareholders are determined under paragraphs (h)(3)(i)(F) and (h)(3)(ii) of this section as of the effective date of the ESBT election, and the rules provided in paragraph (m) of this section apply.

* * * * *

(ii)* * *

(A) If stock is held by a trust as defined in paragraph (h)(1)(ii) of this section (other than an electing QSST or an ESBT), the trust is treated as the shareholder. If the trust continues to own the stock after the expiration of the 2-year period, the corporation's S election will terminate unless the trust is otherwise a permitted shareholder.

(B) If stock is transferred or deemed distributed to a testamentary trust described in paragraph (h)(1)(iv) of this section (other than a qualified subpart E trust, an electing QSST, or an ESBT), the trust is treated as the shareholder. If the trust continues to own the stock after the expiration of the 2-year period, the corporation's S election will terminate unless the trust otherwise qualifies as a permitted shareholder.

* * * * *

(j)* * *

(6)* * *

(iii)* * *

(C) If a trust ceases to be a qualified subpart E trust, satisfies the requirements of a QSST, and intends to become a QSST, the QSST election must be filed within the 16-day-and-2-month period beginning on the date on which the trust ceases to be a qualified subpart E trust. If the estate of the deemed owner of the trust is treated as the shareholder under paragraph (h)(3)(i) of this section, the QSST election may be filed at any time, but no later than the end of the 16-day-and-2-month period beginning on the date on which the estate of the deemed owner ceases to be treated as a shareholder.

(D) If a testamentary trust is a permitted shareholder under paragraph (h)(1)(iv) of this section, satisfies the requirements of a

QSST, and intends to become a QSST, the QSST election may be filed at any time, but no later than the end of the 16-day-and-2-month period beginning on the day after the end of the 2-year period.

* * * * *

(7)* * *

(ii) If, upon the death of an income beneficiary, the trust continues in existence, continues to hold S corporation stock but no longer satisfies the QSST requirements, is not a qualified subpart E trust, and does not qualify as an ESBT, then, solely for purposes of section 1361(b)(1), as of the date of the income beneficiary's death, the estate of that income beneficiary is treated as the shareholder of the S corporation with respect to which the income beneficiary made the QSST election. The estate ordinarily will cease to be treated as the shareholder for purposes of section 1361(b)(1) upon the earlier of the transfer of that stock by the trust or the expiration of the 2-year period beginning on the day of the income beneficiary's death. During the period that the estate is treated as the shareholder for purposes of section 1361(b)(1), the trust is treated as the shareholder for purposes of sections 1366, 1367, and 1368. If, after the 2-year period, the trust continues to hold S corporation stock and does not otherwise qualify as a permitted shareholder, the corporation's S election terminates. If the termination is inadvertent, the corporation may request relief under section 1362(f).

* * * * *

(k)(1)* * *

Example 2. * **

(ii)* * * A's estate will cease to be treated as the shareholder for purposes of section 1361(b)(1) upon the earlier of the transfer of the Corporation M stock by the trust (other than to A's estate), the expiration of the 2-year period beginning on the day of A's death, or the effective date of a QSST or ESBT election if the trust qualifies as a QSST or ESBT.* * * If no QSST or ESBT election is made effective upon the expiration of the 2-year period, the corporation ceases to be an S corporation, but the trust continues as the shareholder of a C corporation.

* * * * *

Example 3.(i) 2-year rule under section 1361(c)(2)(A)(ii) and (iii). F owns stock of Corporation P, an S corporation. In addition, F is the deemed owner of a qualified subpart E trust that holds stock in Corporation O, an S corporation. F dies on July 1, 2003. The trust continues in existence after F's death but is no longer a qualified subpart E trust. On

August 1, 2003, F's shares of stock in Corporation P are transferred to the trust pursuant to the terms of F's will. Because the stock of Corporation P was not held by the trust when F died, section 1361(c)(2)(A)(ii) does not apply with respect to that stock. Under section 1361(c)(2)(A)(iii), the last day on which the trust could be treated as a permitted shareholder of Corporation P is July 31, 2005 (that is, the last day of the 2-year period that begins on the date of the transfer from the estate to the trust). With respect to the shares of stock in Corporation O held by the trust at the time of F's death, section 1361(c)(2)(A)(ii) applies and the last day on which the trust could be treated as a permitted shareholder of Corporation O is June 30, 2005 (that is, the last day of the 2-year period that begins on the date of F's death).

(ii) *Section 645 electing trust and successor trust.* Assume the same facts as in paragraph (i) of this *Example 3*, except that F's trust is a qualified revocable trust for which a valid section 645 election is made on October 1, 2003 (electing trust). Because under section 645 the electing trust is treated and taxed for purposes of subtitle A of the Code as part of F's estate, the trust may continue to hold the O stock pursuant to §1361(b)(1)(B), without causing the termination of Corporation O's S election, for the duration of the section 645 election period. However, on January 1, 2004, during the election period, the shares of stock in Corporation O are transferred pursuant to the terms of the electing trust to a successor trust. Because the successor trust satisfies the definition of a testamentary trust under paragraph (h)(1)(iv) of this section, the successor trust is a permitted shareholder until the earlier of the expiration of the 2-year period beginning on January 1, 2004, or the effective date of a QSST or ESBT election for the successor trust.

Example 4. * **

(iii) *QSST when a person other than the current income beneficiary may receive trust corpus.* Assume the same facts as in paragraph (i) of this *Example 4*, except that the events occur in 2003 and H dies on November 1, 2003, and the trust does not qualify as an ESBT. Under the terms of the trust, after H's death, L is the income beneficiary of the trust and the trustee is authorized to distribute trust corpus to L as well as to J. The trust ceases to be a QSST as of November 1, 2003, because corpus distributions may be made to someone other than L, the current (successive) income beneficiary. Under section 1361(c)(2)(B)(ii), H's estate (and not the trust) is considered to be the shareholder for purposes of section 1361(b)(1) for the 2-year period beginning on November 1, 2003. However, because the trust continues in existence after H's death and will receive any distributions from the corporation, the trust (and not H's estate) is treated as the shareholder for purposes of sections 1366, 1367, and 1368, during that 2-year period. After the 2-year period, the S election terminates and the trust continues as a shareholder of a C corporation. If the termination is inadvertent, Corporation Q may request relief under section 1362(f). However, the S election would not terminate if the trustee distributed all Corporation Q shares to L, J, or both on or before October 31, 2005, (the last day of the 2-year period) assuming that neither L nor J becomes the 76th shareholder of Corporation Q as a result of the distribution.

* * * * *

(2)* * *(i) *In general.* Paragraph (a) of this section, and paragraphs (c) through (k) of this section (as contained in the 26 CFR edition revised April 1, 2003) apply to taxable years of a corporation beginning after July 21, 1995. For taxable years beginning on or before July 21, 1995, to which paragraph (a) of this section and paragraphs (c) through (k) of this section (as contained in the 26 CFR edition revised April 1, 2003) do not apply, see §18.1361-1 of this chapter (as contained in the 26 CFR edition revised April 1, 1995). However, paragraphs (h)(1)(vi), (h)(3)(i)(F), (h)(3)(ii), and (j)(12) of this section (as contained in the 26 CFR edition revised April 1, 2003) are applicable for taxable years beginning on and after May 14, 2002. Otherwise, paragraphs (b)(1)(ii), (f), (h)(1)(ii), (h)(1)(iv), (h)(3)(i)(B), (h)(3)(i)(D), (h)(3)(ii)(A), (h)(3)(ii)(B), (j)(6)(iii)(C), (j)(6)(iii)(D), (j)(7)(ii), and (k)(1) *Example 2(ii)* fourth and last sentences, *Example 3*, and *Example 4(iii)* of this section apply on and after July 17, 2003.

(ii) *Transition rules.* Taxpayers may apply paragraph (h)(1)(iv)(B) of this section on and after December 24, 2002, and before July 17, 2003, to treat a trust as a testamentary trust, but not during any period for which a QSST or ESBT election was in effect for the trust. In addition, the Internal Revenue Service will not challenge the treatment of a trust described in paragraph (h)(1)(iv)(B) of this section as a permitted shareholder of an S corporation for periods after August 5, 1997, and before the earlier of July 17, 2003, or the effective date of any QSST or ESBT election for that trust.

* * * * *

Robert E. Wenzel,
Deputy Commissioner for
Services and Enforcement.

Approved July 9, 2003.

Pamela F. Olson,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on July 16, 2003, 8:45 a.m., and published in the issue of the Federal Register for July 17, 2003, 68 FR. 42251)

Section 2519.—Dispositions of Certain Life Estates

26 CFR 25.2519-1: Disposition of certain life estates.

T.D. 9077

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 20 and 25

Net Gift Treatment Under Section 2519

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating both to the amount treated as a transfer under section 2519 of the Internal Revenue Code when there is a right to recover gift tax under section 2207A(b) and to the related gift and estate tax consequences if the right to recover the gift tax is not exercised. The final regulations will affect donee spouses who make lifetime dispositions of all or part of a qualifying income interest in qualified terminable interest property.

EFFECTIVE DATE: These regulations are effective July 18, 2003.

FOR FURTHER INFORMATION CONTACT: DeAnn K. Malone, (202) 622-7830 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On July 22, 2002, the IRS and the Treasury Department published in the **Federal Register** a notice of proposed rulemaking (REG-123345-01, 2002-2 C.B. 321 [67 FR 47755]) relating to the amount treated as a transfer under section 2519 of the Internal Revenue Code when there is a right to recover gift tax under section 2207A(b) and the related gift tax consequences if the right to recover the gift tax is not exercised. Written comments responding to the notice were received. No public hearing was requested or held. This document adopts final regulations with respect to the

notice of proposed rulemaking. The principal comments received and revisions in response to those comments are discussed below.

Explanation of Provisions

Under the proposed regulations, any delay in the exercise of the right of recovery was treated as an interest-free loan with the resulting federal tax consequences. One commentator suggested that the regulations be revised to provide a thirty-day safe harbor to ease the administrative burden to taxpayers and to avoid complex loan calculations. Accordingly, the commentator suggested that section 7872 would not apply if the transferor received reimbursement of the amount of gift tax within thirty days after paying the tax.

Whether a transaction involves a below-market loan subject to section 7872 depends on all the facts and circumstances of the particular case. Section 1.7872-5T(b)(14) of the Temporary Income Tax Regulations exempts from the application of section 7872 loans the interest arrangements of which the taxpayer is able to show have no significant effect on any federal tax liability of the lender or the borrower, as described in §1.7872-5T(c)(3). Section 1.7872-5T(c)(3) provides that whether a loan is without significant effect is determined according to all of the facts and circumstances. Among the factors to be considered are: (1) whether items of income and deduction generated by the loan offset each other; (2) the amount of such items; (3) the cost to the taxpayer of complying with the provisions of section 7872 if the section were applied; and (4) any non-tax reasons for deciding to structure the transaction as a below-market loan rather than a loan with interest at a rate equal to or greater than the applicable federal rate and a payment by the lender to the borrower. The Treasury Department and the IRS believe that, in most cases, a reasonable delay in the exercise of the right of recovery will result in a loan without significant tax effect under the facts and circumstances test in §1.7872-5T(c)(3). Accordingly, these final regulations do not create an additional safe harbor for a payment received within thirty days of payment of the tax.

The final regulations have been revised to more completely describe the interrelation of section 2207A and section 7872. Specifically, the final regulations provide that a delay in the exercise of the right of recovery (that is, the request for and receipt of the amount of the tax) will be treated as a below-market loan if the loan does not provide for the payment of sufficient interest. Depending on the facts and circumstances as described in §1.7872-5T(c)(3), a loan arising from the delay may be a loan exempt from the application of section 7872 because it is a loan the interest arrangements of which do not have a significant effect on any federal tax liability of the lender or the borrower. The estate tax regulations under section 2207A are revised to be consistent with the gift tax regulations.

In response to a comment, the final regulations clarify that the enforceability of the right of recovery is determined under applicable law.

Commentators requested simplification of the method of determining when a right to recovery is no longer enforceable. One commentator suggested adopting a three-year period for determining whether or not the right of recovery is enforceable, and thus whether the gift is complete for gift tax purposes if the right of recovery is not exercised. The final regulations instead provide that the transferor may waive the right of recovery thus causing the gift from the transferor to the donee to be complete upon the later of the date of the waiver or the date of the payment of the federal gift tax. The Treasury Department and the IRS believe that the waiver allows for the certainty requested by the commentators, and is more efficient for a taxpayer who will not exercise the right of recovery because the gift of the unrecovered tax can be completed simultaneously with the lifetime disposition of the qualifying income interest.

Special Analyses

It has been determined that these final 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 these regulations do not impose a

collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the proposed regulations preceding this final rule were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is DeAnn K. Malone, Office of the Chief Counsel, IRS. Other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 20 and 25 are amended as follows:

PART 20—ESTATE TAX; ESTATES OF DECEDENTS DYING AFTER AUGUST 16, 1954

Par. 1. The authority citation for part 20 continues to read in part as follows:

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

Par. 2. Section 20.2207A-1 is amended by removing the last two sentences of paragraph (a)(2) and adding three sentences in their place to read as follows:

§20.2207A-1 Right of recovery of estate taxes in the case of certain marital deduction property.

(a) * * *

(2) * * * The transfer is considered made when the right of recovery is no longer enforceable under applicable law. A delay in the exercise of the right of recovery without payment of sufficient interest is a below-market loan. Section 1.7872-5T of this chapter describes factors that are used to determine, based on the facts and circumstances of a particular case, whether a loan otherwise subject to imputation under section 7872 (relating to the treatment of below-market loans) is exempted from its provisions.

* * * * *

PART 25—GIFT TAX; GIFTS MADE AFTER DECEMBER 31, 1954

Par. 3. The authority citation for part 25 continues to read in part as follows:

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

Par. 4. Section 25.2207A-1 is amended by adding the text of paragraph (b) to read as follows:

§25.2207A-1 Right of recovery of gift taxes in the case of certain marital deduction property.

* * * * *

(b) *Failure of a person to exercise the right of recovery.* (1) The failure of a person to exercise a right of recovery provided by section 2207A(b) upon a lifetime transfer subject to section 2519 is treated as a transfer for federal gift tax purposes of the unrecovered amounts to the person(s) from whom the recovery could have been obtained. See §25.2511-1. The transfer is considered to be made when the right to recovery is no longer enforceable under applicable law and is treated as a gift even if recovery is impossible. A delay in the exercise of the right of recovery without payment of sufficient interest is a below-market loan. Section 1.7872-5T of this chapter describes factors that are used to determine, based on the facts and circumstances of a particular case, whether a loan otherwise subject to imputation under section 7872 (relating to the treatment of below-market loans) is exempted from its provisions.

(2) The transferor subject to section 2519 may execute a written waiver of the right of recovery arising under section 2207A before that right of recovery becomes unenforceable. If a waiver is executed, the transfer of the unrecovered amounts by the transferor is considered to be made on the later of —

(i) The date of the valid and irrevocable waiver rendering the right of recovery no longer enforceable; or

(ii) The date of the payment of the tax by the transferor.

* * * * *

Par. 5. Section 25.2519-1 is amended as follows:

1. Paragraph (c)(1) is amended by adding a sentence to the end of the paragraph.

2. The paragraph heading for paragraph (c)(4) is revised and the text of paragraph (c)(4) is added.

3. Paragraph (g) introductory text is revised.

The additions and revisions read as follows:

§25.2519-1 Disposition of certain life estates.

* * * * *

(c) * * *(1) * * * See paragraph (c)(4) of this section for the effect of gift tax that the donee spouse is entitled to recover under section 2207A.

* * * * *

(4) *Effect of gift tax entitled to be recovered under section 2207A on the amount of the transfer.* The amount treated as a transfer under paragraph (c)(1) of this section is further reduced by the amount the donee spouse is entitled to recover under section 2207A(b) (relating to the right to recover gift tax attributable to the remainder interest). If the donee spouse is entitled to recover gift tax under section 2207A(b), the amount of gift tax recoverable and the value of the remainder interest treated as transferred under section 2519 are determined by using the same interrelated computation applicable for other transfers in which the transferee assumes the gift tax liability. The gift tax consequences of failing to exercise the right of recovery are determined separately under §25.2207A-1(b).

* * * * *

(g) *Examples.* The following examples illustrate the application of paragraphs (a) through (f) of this section. Except as provided otherwise in the examples, assume that the decedent, D, was survived by spouse, S, that in each example the section 2503(b) exclusion has already been fully utilized for each year with respect to the donee in question, that section 2503(e) is not applicable to the amount deemed transferred, and that the gift taxes on the amount treated as transferred under paragraph (c) are offset by S's unified credit. The examples are as follows:

* * * * *

Robert E. Wenzel,
Deputy Commissioner for
Services and Enforcement.

Approved July 9, 2003.

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

(Filed by the Office of the Federal Register on July 17, 2003, 8:45 a.m., and published in the issue of the Federal Register for July 18, 2003, 68 F.R. 42593)

Section 6621.—Determination of Interest Rate

26 CFR 301.6621-1: Interest Rate.

Interest rates; underpayments and overpayments. The rate of interest determined under section 6621 of the Code for the calendar quarter beginning October 1, 2003, will be 4 percent for overpayments (3 percent in the case of a corporation), 4 percent for underpayments, and 6 percent for large corporate underpayments. The rate of interest paid on the portion of a corporate overpayment exceeding \$10,000 will be 1.5 percent.

Rev. Rul. 2003-104

Section 6621 of the Internal Revenue Code establishes the rates for interest on tax overpayments and tax underpayments. Under section 6621(a)(1), the overpayment rate beginning October 1, 2003, is the sum of the federal short-term rate plus 3 percentage points (2 percentage points in the case of a corporation), except the rate for the portion of a corporate overpayment of tax exceeding \$10,000 for a taxable period is the sum of the federal short-term rate plus 0.5 of a percentage point for interest computations made after December 31, 1994. Under section 6621(a)(2),

the underpayment rate is the sum of the federal short-term rate plus 3 percentage points.

Section 6621(c) provides that for purposes of interest payable under section 6601 on any large corporate underpayment, the underpayment rate under section 6621(a)(2) is determined by substituting "5 percentage points" for "3 percentage points." See section 6621(c) and section 301.6621-3 of the Regulations on Procedure and Administration for the definition of a large corporate underpayment and for the rules for determining the applicable date. Section 6621(c) and section 301.6621-3 are generally effective for periods after December 31, 1990.

Section 6621(b)(1) provides that the Secretary will determine the federal short-term rate for the first month in each calendar quarter.

Section 6621(b)(2)(A) provides that the federal short-term rate determined under section 6621(b)(1) for any month applies during the first calendar quarter beginning after such month.

Section 6621(b)(3) provides that the federal short-term rate for any month is the federal short-term rate determined during such month by the Secretary in accordance with § 1274(d), rounded to the nearest full percent (or, if a multiple of 1/2 of 1 percent, the rate is increased to the next highest full percent).

Notice 88-59, 1988-1 C.B. 546, announced that, in determining the quarterly interest rates to be used for overpayments and underpayments of tax under section 6621, the Internal Revenue Service will use the federal short-term rate based on daily compounding because that rate is most consistent with section 6621 which,

pursuant to section 6622, is subject to daily compounding.

Rounded to the nearest full percent, the federal short-term rate based on daily compounding determined during the month of July 2003 is 1 percent. Accordingly, an overpayment rate of 4 percent (3 percent in the case of a corporation) and an underpayment rate of 4 percent are established for the calendar quarter beginning October 1, 2003. The overpayment rate for the portion of a corporate overpayment exceeding \$10,000 for the calendar quarter beginning October 1, 2003, is 1.5 percent. The underpayment rate for large corporate underpayments for the calendar quarter beginning October 1, 2003, is 6 percent. These rates apply to amounts bearing interest during that calendar quarter.

Interest factors for daily compound interest for annual rates of 1.5 percent, 3 percent, 4 percent, and 6 percent are published in Tables 8, 11, 13, and 17 of Rev. Proc. 95-17, 1995-1 C.B. 556, 562, 565, 567, and 571.

Annual interest rates to be compounded daily pursuant to section 6622 that apply for prior periods are set forth in the tables accompanying this revenue ruling.

DRAFTING INFORMATION

The principal author of this revenue ruling is Crystal Foster of the Office of Associate Chief Counsel (Procedure & Administration). For further information regarding this revenue ruling, contact Ms. Foster at (202) 622-7326 (not a toll-free call).

TABLE OF INTEREST RATES

PERIODS BEFORE JUL. 1, 1975 – PERIODS ENDING DEC. 31, 1986

OVERPAYMENTS AND UNDERPAYMENTS

PERIOD	RATE	In 1995-1 C.B. DAILY RATE TABLE
Before Jul. 1, 1975	6%	Table 2, pg. 557
Jul. 1, 1975—Jan. 31, 1976	9%	Table 4, pg. 559
Feb. 1, 1976—Jan. 31, 1978	7%	Table 3, pg. 558
Feb. 1, 1978—Jan. 31, 1980	6%	Table 2, pg. 557
Feb. 1, 1980—Jan. 31, 1982	12%	Table 5, pg. 560

TABLE OF INTEREST RATES
PERIODS BEFORE JUL. 1, 1975 – PERIODS ENDING DEC. 31, 1986
OVERPAYMENTS AND UNDERPAYMENTS — Continued

PERIOD	RATE	In 1995-1 C.B. DAILY RATE TABLE
Feb. 1, 1982—Dec. 31, 1982	20%	Table 6, pg. 560
Jan. 1, 1983—Jun. 30, 1983	16%	Table 37, pg. 591
Jul. 1, 1983—Dec. 31, 1983	11%	Table 27, pg. 581
Jan. 1, 1984—Jun. 30, 1984	11%	Table 75, pg. 629
Jul. 1, 1984—Dec. 31, 1984	11%	Table 75, pg. 629
Jan. 1, 1985—Jun. 30, 1985	13%	Table 31, pg. 585
Jul. 1, 1985—Dec. 31, 1985	11%	Table 27, pg. 581
Jan. 1, 1986—Jun. 30, 1986	10%	Table 25, pg. 579
Jul. 1, 1986—Dec. 31, 1986	9%	Table 23, pg. 577

TABLE OF INTEREST RATES
FROM JAN. 1, 1987 – Dec. 31, 1998

PERIOD	OVERPAYMENTS			UNDERPAYMENTS		
	1995-1 C.B.			1995-1 C.B.		
	RATE	TABLE	PG	RATE	TABLE	PAGE
Jan. 1, 1987—Mar. 31, 1987	8%	21	575	9%	23	577
Apr. 1, 1987—Jun. 30, 1987	8%	21	575	9%	23	577
Jul. 1, 1987—Sep. 30, 1987	8%	21	575	9%	23	577
Oct. 1, 1987—Dec. 31, 1987	9%	23	577	10%	25	579
Jan. 1, 1988—Mar. 31, 1988	10%	73	627	11%	75	629
Apr. 1, 1988—Jun. 30, 1988	9%	71	625	10%	73	627
Jul. 1, 1988—Sep. 30, 1988	9%	71	625	10%	73	627
Oct. 1, 1988—Dec. 31, 1988	10%	73	627	11%	75	629
Jan. 1, 1989—Mar. 31, 1989	10%	25	579	11%	27	581
Apr. 1, 1989—Jun. 30, 1989	11%	27	581	12%	29	583
Jul. 1, 1989—Sep. 30, 1989	11%	27	581	12%	29	583
Oct. 1, 1989—Dec. 31, 1989	10%	25	579	11%	27	581
Jan. 1, 1990—Mar. 31, 1990	10%	25	579	11%	27	581
Apr. 1, 1990—Jun. 30, 1990	10%	25	579	11%	27	581
Jul. 1, 1990—Sep. 30, 1990	10%	25	579	11%	27	581
Oct. 1, 1990—Dec. 31, 1990	10%	25	579	11%	27	581
Jan. 1, 1991—Mar. 31, 1991	10%	25	579	11%	27	581
Apr. 1, 1991—Jun. 30, 1991	9%	23	577	10%	25	579
Jul. 1, 1991—Sep. 30, 1991	9%	23	577	10%	25	579

TABLE OF INTEREST RATES
FROM JAN. 1, 1987 – Dec. 31, 1998 – Continued

	OVERPAYMENTS			UNDERPAYMENTS		
	1995-1 C.B.			1995-1 C.B.		
	RATE	TABLE	PG	RATE	TABLE	PAGE
Oct. 1, 1991—Dec. 31, 1991	9%	23	577	10%	25	579
Jan. 1, 1992—Mar. 31, 1992	8%	69	623	9%	71	625
Apr. 1, 1992—Jun. 30, 1992	7%	67	621	8%	69	623
Jul. 1, 1992—Sep. 30, 1992	7%	67	621	8%	69	623
Oct. 1, 1992—Dec. 31, 1992	6%	65	619	7%	67	621
Jan. 1, 1993—Mar. 31, 1993	6%	17	571	7%	19	573
Apr. 1, 1993—Jun. 30, 1993	6%	17	571	7%	19	573
Jul. 1, 1993—Sep. 30, 1993	6%	17	571	7%	19	573
Oct. 1, 1993—Dec. 31, 1993	6%	17	571	7%	19	573
Jan. 1, 1994—Mar. 31, 1994	6%	17	571	7%	19	573
Apr. 1, 1994—Jun. 30, 1994	6%	17	571	7%	19	573
Jul. 1, 1994—Sep. 30, 1994	7%	19	573	8%	21	575
Oct. 1, 1994—Dec. 31, 1994	8%	21	575	9%	23	577
Jan. 1, 1995—Mar. 31, 1995	8%	21	575	9%	23	577
Apr. 1, 1995—Jun. 30, 1995	9%	23	577	10%	25	579
Jul. 1, 1995—Sep. 30, 1995	8%	21	575	9%	23	577
Oct. 1, 1995—Dec. 31, 1995	8%	21	575	9%	23	577
Jan. 1, 1996—Mar. 31, 1996	8%	69	623	9%	71	625
Apr. 1, 1996—Jun. 30, 1996	7%	67	621	8%	69	623
Jul. 1, 1996—Sep. 30, 1996	8%	69	623	9%	71	625
Oct. 1, 1996—Dec. 31, 1996	8%	69	623	9%	71	625
Jan. 1, 1997—Mar. 31, 1997	8%	21	575	9%	23	577
Apr. 1, 1997—Jun. 30, 1997	8%	21	575	9%	23	577
Jul. 1, 1997—Sep. 30, 1997	8%	21	575	9%	23	577
Oct. 1, 1997—Dec. 31, 1997	8%	21	575	9%	23	577
Jan. 1, 1998—Mar. 31, 1998	8%	21	575	9%	23	577
Apr. 1, 1998—Jun. 30, 1998	7%	19	573	8%	21	575
Jul. 1, 1998—Sep. 30, 1998	7%	19	573	8%	21	575
Oct. 1, 1998—Dec. 31, 1998	7%	19	573	8%	21	575

TABLE OF INTEREST RATES
FROM JANUARY 1, 1999 – PRESENT
NONCORPORATE OVERPAYMENTS AND UNDERPAYMENTS

	In 1995-1 C.B.		
	RATE	TABLE	PAGE
Jan. 1, 1999—Mar. 31, 1999	7%	19	573
Apr. 1, 1999—Jun. 30, 1999	8%	21	575
Jul. 1, 1999—Sep. 30, 1999	8%	21	575
Oct. 1, 1999—Dec. 31, 1999	8%	21	575
Jan. 1, 2000—Mar. 31, 2000	8%	69	623
Apr. 1, 2000—Jun. 30, 2000	9%	71	625
Jul. 1, 2000—Sep. 30, 2000	9%	71	625
Oct. 1, 2000—Dec. 31, 2000	9%	71	625
Jan. 1, 2001—Mar. 31, 2001	9%	23	577
Apr. 1, 2001—Jun. 30, 2001	8%	21	575
Jul. 1, 2001—Sep. 30, 2001	7%	19	573
Oct. 1, 2001—Dec. 31, 2001	7%	19	573
Jan. 1, 2002—Mar. 31, 2002	6%	17	571
Apr. 1, 2002—Jun. 30, 2002	6%	17	571
Jul. 1, 2002—Sep. 30, 2002	6%	17	571
Oct. 1, 2002—Dec. 31, 2002	6%	17	571
Jan. 1, 2003—Mar. 31, 2003	5%	15	569
Apr. 1, 2003—Jun. 30, 2003	5%	15	569
Jul. 1, 2003—Sep. 30, 2003	5%	15	569
Oct. 1, 2003—Dec. 31, 2003	4%	13	567

TABLE OF INTEREST RATES
FROM JANUARY 1, 1999 – Present
CORPORATE OVERPAYMENTS AND UNDERPAYMENTS

	OVERPAYMENTS			UNDERPAYMENTS		
	1995-1 C.B.			1995-1 C.B.		
	RATE	TABLE	PG	RATE	TABLE	PAGE
Jan. 1, 1999—Mar. 31, 1999	6%	17	571	7%	19	573
Apr. 1, 1999—Jun. 30, 1999	7%	19	573	8%	21	575
Jul. 1, 1999—Sep. 30, 1999	7%	19	573	8%	21	575
Oct. 1, 1999—Dec. 31, 1999	7%	19	573	8%	21	575
Jan. 1, 2000—Mar. 31, 2000	7%	67	621	8%	69	623
Apr. 1, 2000—Jun. 30, 2000	8%	69	623	9%	71	625
Jul. 1, 2000—Sep. 30, 2000	8%	69	623	9%	71	625
Oct. 1, 2000—Dec. 31, 2000	8%	69	623	9%	71	625

TABLE OF INTEREST RATES
FROM JANUARY 1, 1999 – Present
CORPORATE OVERPAYMENTS AND UNDERPAYMENTS – Continued

	OVERPAYMENTS			UNDERPAYMENTS		
	1995–1 C.B.			1995–1 C.B.		
	RATE	TABLE	PG	RATE	TABLE	PAGE
Jan. 1, 2001—Mar. 31, 2001	8%	21	575	9%	23	577
Apr. 1, 2001—Jun. 30, 2001	7%	19	573	8%	21	575
Jul. 1, 2001—Sep. 30, 2001	6%	17	571	7%	19	573
Oct. 1, 2001—Dec. 31, 2001	6%	17	571	7%	19	573
Jan. 1, 2002—Mar. 31, 2002	5%	15	569	6%	17	571
Apr. 1, 2002—Jun. 30, 2002	5%	15	569	6%	17	571
Jul. 1, 2002—Sep. 30, 2002	5%	15	569	6%	17	571
Oct. 1, 2002—Dec. 31, 2002	5%	15	569	6%	17	571
Jan. 1, 2003—Mar. 31, 2003	4%	13	567	5%	15	569
Apr. 1, 2003—Jun. 30, 2003	4%	13	567	5%	15	569
Jul. 1, 2003—Sep. 30, 2003	4%	13	567	5%	15	569
Oct. 1, 2003—Dec. 31, 2003	3%	11	565	4%	13	567

TABLE OF INTEREST RATES FOR
LARGE CORPORATE UNDERPAYMENTS
FROM JANUARY 1, 1991 – PRESENT

	In 1995–1 C.B.		
	RATE	TABLE	PAGE
Jan. 1, 1991—Mar. 31, 1991	13%	31	585
Apr. 1, 1991—Jun. 30, 1991	12%	29	583
Jul. 1, 1991—Sep. 30, 1991	12%	29	583
Oct. 1, 1991—Dec. 31, 1991	12%	29	583
Jan. 1, 1992—Mar. 31, 1992	11%	75	629
Apr. 1, 1992—Jun. 30, 1992	10%	73	627
Jul. 1, 1992—Sep. 30, 1992	10%	73	627
Oct. 1, 1992—Dec. 31, 1992	9%	71	625
Jan. 1, 1993—Mar. 31, 1993	9%	23	577
Apr. 1, 1993—Jun. 30, 1993	9%	23	577
Jul. 1, 1993—Sep. 30, 1993	9%	23	577
Oct. 1, 1993—Dec. 31, 1993	9%	23	577
Jan. 1, 1994—Mar. 31, 1994	9%	23	577
Apr. 1, 1994—Jun. 30, 1994	9%	23	577
Jul. 1, 1994—Sep. 30, 1994	10%	25	579
Oct. 1, 1994—Dec. 31, 1994	11%	27	581

TABLE OF INTEREST RATES FOR
LARGE CORPORATE UNDERPAYMENTS
FROM JANUARY 1, 1991 – PRESENT – Continued

		In 1995-1 C.B.	
	RATE	TABLE	PAGE
Jan. 1, 1995—Mar. 31, 1995	11%	27	581
Apr. 1, 1995—Jun. 30, 1995	12%	29	583
Jul. 1, 1995—Sep. 30, 1995	11%	27	581
Oct. 1, 1995—Dec. 31, 1995	11%	27	581
Jan. 1, 1996—Mar. 31, 1996	11%	75	629
Apr. 1, 1996—Jun. 30, 1996	10%	73	627
Jul. 1, 1996—Sep. 30, 1996	11%	75	629
Oct. 1, 1996—Dec. 31, 1996	11%	75	629
Jan. 1, 1997—Mar. 31, 1997	11%	27	581
Apr. 1, 1997—Jun. 30, 1997	11%	27	581
Jul. 1, 1997—Sep. 30, 1997	11%	27	581
Oct. 1, 1997—Dec. 31, 1997	11%	27	581
Jan. 1, 1998—Mar. 31, 1998	11%	27	581
Apr. 1, 1998—Jun. 30, 1998	10%	25	579
Jul. 1, 1998—Sep. 30, 1998	10%	25	579
Oct. 1, 1998—Dec. 31, 1998	10%	25	579
Jan. 1, 1999—Mar. 31, 1999	9%	23	577
Apr. 1, 1999—Jun. 30, 1999	10%	25	579
Jul. 1, 1999—Sep. 30, 1999	10%	25	579
Oct. 1, 1999—Dec. 31, 1999	10%	25	579
Jan. 1, 2000—Mar. 31, 2000	10%	73	627
Apr. 1, 2000—Jun. 30, 2000	11%	75	629
Jul. 1, 2000—Sep. 30, 2000	11%	75	629
Oct. 1, 2000—Dec. 31, 2000	11%	75	629
Jan. 1, 2001—Mar. 31, 2001	11%	27	581
Apr. 1, 2001—Jun. 30, 2001	10%	25	579
Jul. 1, 2001—Sep. 30, 2001	9%	23	577
Oct. 1, 2001—Dec. 31, 2001	9%	23	577
Jan. 1, 2002—Mar. 31, 2002	8%	21	575
Apr. 1, 2002—Jun. 30, 2002	8%	21	575
Jul. 1, 2002—Sep. 30, 2002	8%	21	575
Oct. 1, 2002—Dec. 30, 2002	8%	21	575
Jan. 1, 2003—Mar. 31, 2003	7%	19	573
Apr. 1, 2003—Jun. 30, 2003	7%	19	573
Jul. 1, 2003—Sep. 30, 2003	7%	19	573
Oct. 1, 2003—Dec. 31, 2003	6%	17	571

TABLE OF INTEREST RATES FOR CORPORATE
OVERPAYMENTS EXCEEDING \$10,000
FROM JANUARY 1, 1995 – PRESENT

	In 1995-1 C.B.		
	RATE	TABLE	PAGE
Jan. 1, 1995—Mar. 31, 1995	6.5%	18	572
Apr. 1, 1995—Jun. 30, 1995	7.5%	20	574
Jul. 1, 1995—Sep. 30, 1995	6.5%	18	572
Oct. 1, 1995—Dec. 31, 1995	6.5%	18	572
Jan. 1, 1996—Mar. 31, 1996	6.5%	66	620
Apr. 1, 1996—Jun. 30, 1996	5.5%	64	618
Jul. 1, 1996—Sep. 30, 1996	6.5%	66	620
Oct. 1, 1996—Dec. 31, 1996	6.5%	66	620
Jan. 1, 1997—Mar. 31, 1997	6.5%	18	572
Apr. 1, 1997—Jun. 30, 1997	6.5%	18	572
Jul. 1, 1997—Sep. 30, 1997	6.5%	18	572
Oct. 1, 1997—Dec. 31, 1997	6.5%	18	572
Jan. 1, 1998—Mar. 31, 1998	6.5%	18	572
Apr. 1, 1998—Jun. 30, 1998	5.5%	16	570
Jul. 1, 1998—Sep. 30, 1998	5.5%	16	570
Oct. 1, 1998—Dec. 31, 1998	5.5%	16	570
Jan. 1, 1999—Mar. 31, 1999	4.5%	14	568
Apr. 1, 1999—Jun. 30, 1999	5.5%	16	570
Jul. 1, 1999—Sep. 30, 1999	5.5%	16	570
Oct. 1, 1999—Dec. 31, 1999	5.5%	16	570
Jan. 1, 2000—Mar. 31, 2000	5.5%	64	618
Apr. 1, 2000—Jun. 30, 2000	6.5%	66	620
Jul. 1, 2000—Sep. 30, 2000	6.5%	66	620
Oct. 1, 2000—Dec. 31, 2000	6.5%	66	620
Jan. 1, 2001—Mar. 31, 2001	6.5%	18	572
Apr. 1, 2001—Jun. 30, 2001	5.5%	16	570
Jul. 1, 2001—Sep. 30, 2001	4.5%	14	568
Oct. 1, 2001—Dec. 31, 2001	4.5%	14	568
Jan. 1, 2002—Mar. 31, 2002	3.5%	12	566
Apr. 1, 2002—Jun. 30, 2002	3.5%	12	566
Jul. 1, 2002—Sep. 30, 2002	3.5%	12	566
Oct. 1, 2002—Dec. 31, 2002	3.5%	12	566
Jan. 1, 2003—Mar. 31, 2003	2.5%	10	564
Apr. 1, 2003—Jun. 30, 2003	2.5%	10	564
Jul. 1, 2003—Sep. 30, 2003	2.5%	10	564
Oct. 1, 2003—Dec. 31, 2003	1.5%	8	562

Part III. Administrative, Procedural, and Miscellaneous

Collection Issues Related to Entireties Property

Notice 2003–60

PURPOSE

This notice provides guidance on collection from property held in a tenancy by the entirety, where only one spouse (referred to here as the taxpayer) is liable for the outstanding taxes, in light of the Supreme Court decision in *United States v. Craft*, 535 U.S. 274 (2002).

BACKGROUND

On April 17, 2002, the Supreme Court issued its decision in *United States v. Craft*, 535 U.S. 274 (2002) (2002–38 I.R.B. 548), and held that the federal tax lien that arises under section 6321 of the Internal Revenue Code on “all property and rights to property” of a delinquent taxpayer attaches to the rights of the taxpayer in property held as a tenancy by the entirety (entireties property), even though local Michigan law insulates entireties property from the claims of creditors of only one spouse. The Court stated that while state law determines what rights a taxpayer has in property, federal law determines whether the state-defined rights are “property” or “rights to property” for purposes of section 6321. The Court’s decision in *Craft* has consequences in the approximately twenty-six jurisdictions that recognize tenancy by the entirety as a form of property ownership.

While state law governing property ownership varies by jurisdiction, there are a number of principles generally applicable to a tenancy by the entirety. Tenancy by the entirety is a form of property ownership, including personal property in some jurisdictions, available only to a husband and wife as a marital unit. A key feature of the tenancy is the right of survivorship—the surviving spouse becomes the fee simple owner of the property upon the death of the other spouse. The tenancy also is terminated by the transfer of the property or upon the spouses’ divorce.

Entireties property is subject to the claims of the joint creditors of the spouses. However, the majority of jurisdictions

that recognize tenancy by the entirety, so-called full bar jurisdictions, completely prohibit creditors from attaching entireties property to satisfy the debts of only one spouse. The state law rationale is that a spouse individually has no interest in the property; rather, the property is held by the marital unit. The other jurisdictions that recognize tenancy by the entirety, so-called modified or partial bar jurisdictions, permit creditors to attach one spouse’s interest in entireties property for the debts of only that spouse, subject to the rights of the non-liable spouse.

Issues related to entireties property can arise in a number of areas, including enforcing collection through administrative and judicial means, evaluating offers in compromise and proposed installment agreements, valuing the Service’s secured claim in bankruptcy, applications for discharge and subordination, and determining the nature of the Service’s rights vis-a-vis a transferee in a transfer in which the federal tax lien has not been discharged.

OVERVIEW

The Service will rely on a number of general principles in addressing issues raised as a result of the Court’s decision in *Craft*:

(1) Under section 6321, the federal tax lien attaches to all the property and rights to property of the taxpayer. The Court’s decision confirms that, for purposes of section 6321, a taxpayer’s property and rights to property have always included any rights that taxpayer may have in entireties property under state law. The Court’s decision, therefore, does not represent new law and does not affect other law applicable to federal tax liens and federal tax collection. For example, the *Craft* decision does not change any limitation on the ability of the Service to rescind an accepted offer in compromise or terminate an accepted installment agreement.

(2) As a matter of administrative policy, the Service will, under certain circumstances, not apply *Craft*, with respect to certain interests created before *Craft*, to the detriment of third parties who may have reasonably relied on the belief that state law prevents the attachment of the federal tax lien.

(3) The administrative sale of entireties property subject to the federal tax lien presents practical problems that limit the usefulness of the Service’s seizure and sale procedures. Levying on cash and cash equivalents held as entireties property is considerably less problematic and will be used by the Service in appropriate cases.

(4) Because of the potential adverse consequences to the non-liable spouse of the taxpayer, the use of lien foreclosure for entireties property subject to the federal tax lien will be determined on a case-by-case basis.

(5) As a general rule, the value of the taxpayer’s interest in entireties property will be deemed to be one-half.

(6) Where there has been a sale or other transfer of entireties property subject to the federal tax lien that does not provide for the discharge of the lien, whether the transfer is to the non-liable spouse or a third party, the lien thereafter encumbers a one-half interest in the property held by the transferee.

QUESTIONS AND ANSWERS

The following questions and answers illustrate how the Service will apply *Craft*. The first two Q&As address the application of *Craft* with respect to interests in entireties property acquired before the date of the decision, while the remaining questions and answers address its application with respect to interests acquired after the date of the decision.

Q1. If the Service has filed a notice of federal tax lien with respect to the taxpayer before *Craft* and an interest in entireties property was later acquired by a purchaser, a holder of a security interest, a mechanic’s lienor, or a judgment lien creditor within the meaning of section 6323, then will the Service assert lien priority over the subsequently acquired interest? What if the entireties property was transferred, before *Craft*, to the non-taxpayer spouse in a divorce? Does the result differ if, before *Craft*, the transfer was to a donee, such as a family trust? Do the results differ depending on whether the jurisdiction at issue is one that recognizes tenancy by the entirety and completely prohibits the attachment of entireties property for separate debts of one spouse (*i.e.*, a full bar jurisdiction) or one that permits attachment to

entireties property in connection with the separate debts of one spouse (*i.e.*, a modified or partial bar jurisdiction)?

A1. *Application of Section 6323.* Section 6323 provides that “[t]he lien imposed by section 6321 shall not be valid as against any purchaser, holder of a security interest, mechanic’s lienor, or judgment lien creditor until notice thereof which meets the requirements of subsection (f) has been filed by the Secretary.” Section 6323(a). The rule of *Craft*, with respect to entireties property, applies to federal tax liens regardless of when they arose. A federal tax lien, therefore, has priority over any interest of a purchaser, a holder of a security interest, a mechanic’s lienor, or a judgment lien creditor (*i.e.*, the class of persons protected by section 6323(a)) if notice of the federal tax lien was filed before such other interest arose.

As a matter of administrative policy, the Service will not assert its federal tax lien rights where doing so may disturb the settled expectations of certain classes of persons who may have been under the belief that a federal tax lien arising from the liability of only one spouse does not attach to entireties property. Accordingly, with respect to entireties property located in full bar jurisdictions, the Service will not assert its federal tax lien priority over the interests of the class of persons protected under section 6323(a), if the section 6323(a) interests were created before *Craft* was decided. For example, if a purchaser acquired entireties property before *Craft* was decided and meets the definition of a purchaser under section 6323(h)(6), the Service will not assert lien priority even though a notice of federal tax lien had been filed prior to the purchase.

In contrast to full bar jurisdictions, there are no settled expectations in modified or partial bar jurisdictions, where a creditor is permitted to attach some or all of a debtor-spouse’s interest in entireties property. For example, while Oklahoma law recognizes tenancy by the entireties as a form of property ownership, creditors collecting the debt of one spouse can force the sale of entireties property, severing the tenancy. In modified or partial bar jurisdictions, the Service will assert its lien priority against the class of persons protected under section 6323(a) regardless of when those persons may have acquired interests

in entireties property, so long as those interests were acquired after a notice of federal tax lien had been filed.

Divorce. A spouse of the taxpayer who obtained entireties property in a divorce acquires the property subject to the federal tax lien. In the context of a divorce, a spouse is not in the class of persons protected by section 6323(a). Consequently, if the assessment giving rise to the federal tax lien under section 6321 had occurred prior to the divorce, then the lien also attached to the taxpayer’s rights in the entireties property. As a general rule, if the transfer occurred before *Craft*, then the Service will treat the transfer as one for value and will not assert its lien against the property in the hands of the ex-spouse of the taxpayer. This will not apply if the Service determines that, notwithstanding the divorce, the transfer was fraudulent.

Donation. A donee who obtains entireties property acquires the property subject to the federal tax lien. As in the case of a transfer pursuant to a divorce, the donee is not in the class of persons protected by section 6323(a). Transfers to donees that occurred before *Craft* will be evaluated on a case-by-case basis to determine whether the equities favor or disfavor the Service asserting the federal tax lien against property held by a donee. There may be circumstances where, although the donee gave nothing of value in exchange for the property, it would be inequitable for the Service to assert the federal tax lien because of the donee’s reliance on the mistaken view that the property was unencumbered. For example, if the transfer was of real property to which the donee has made substantial improvements, the equities may favor not asserting the federal tax lien (or agreeing to limit its reach by carving out the value of the improvements). On the other hand, the absence of such reliance may warrant assertion of the federal tax lien.

The identity of the donee is also a factor that will be considered by the Service. The federal tax lien is more appropriately not asserted where the donee is a disinterested person, having no relation to the taxpayer, than where the donee and taxpayer are closely related. For example, the Service may decide to assert the federal tax lien where the taxpayer transferred entireties property to a family trust, but may

decide not to assert the lien where the taxpayer transferred entireties property to a charitable organization.

Q2. Does the *Craft* decision provide a basis for the Service to rescind offers in compromise, terminate installment agreements, or revoke certificates of discharge and subordination? Will the Service amend bankruptcy proofs of claim? Can the Service revisit a determination that an account is currently not collectible?

A2. The decision in *Craft* does not provide legal authority to rescind any accepted offer in compromise, terminate an installment agreement, or revoke any certificate of subordination or discharge.

With respect to bankruptcy proofs of claim, the Service has made an administrative decision not to routinely amend such proofs of claim to adjust the amount of the Government’s secured claim to reflect the federal tax lien on the taxpayer’s interest in entireties property. There may be circumstances, however, where the Service elects to amend the claim to assert the federal tax lien on entireties property, depending on the value of the property and the status of the bankruptcy case. The existence of entireties property will be considered in filing new proofs of claim and in future investigations related to determining whether there is any property subject to post-bankruptcy collection.

Finally, based on an evaluation of a taxpayer’s interest in entireties property, the Service may revisit a prior determination that an account is currently not collectible.

Q3. If entireties property subject to the federal tax lien is sold or transferred after *Craft* and the Service does not discharge the lien, is the property subject to the federal tax lien in the hands of the transferee?

A3. A conveyance of entireties property terminates the entireties estate with respect to that property. Accordingly, after *Craft*, unless the Service discharges the property from the federal tax lien, the lien will encumber a one-half interest in the hands of the transferee, regardless of whether the transferee is a donee or gives value. As explained below, the Service generally will deem the value of the taxpayer’s interest in entireties property to be one-half of the total value of the property.

Q4. Does the federal tax lien on entireties property survive the death of the taxpayer? What effect does the death of

the non-taxpayer have on the federal tax lien?

A4. As is the case with joint tenancy with the right of survivorship, if a taxpayer's interest in entireties property is extinguished by operation of law at the death of the taxpayer, then there is no longer an interest of the taxpayer to which the federal tax lien attaches. When a taxpayer dies, the surviving non-liable spouse takes the property unencumbered by the federal tax lien.

When a non-liable spouse predeceases the taxpayer, the property ceases to be held in a tenancy by the entirety, the taxpayer takes the entire property in fee simple, and the federal tax lien attaches to the entire property.

The rule that the federal tax lien does not survive the death of the taxpayer does not apply if the entireties estate previously has been terminated. For example, if the property has been conveyed to a third party, the federal tax lien will be deemed to encumber a one-half interest in the hands of the transferee and will not be affected by the subsequent death of either spouse.

Q5. Does the federal tax lien remain on entireties property awarded to a non-liable spouse in a divorce decree?

A5. Entireties property subject to the federal tax lien and then transferred after *Craft* to a non-liable spouse pursuant to a divorce remains encumbered in the hands of the ex-spouse.

Q6. After a notice of federal tax lien is filed, the taxpayer and spouse jointly mortgage entireties property to a bank. What effect would the death of either spouse have on the respective rights of the Government and the bank? Where the property is transferred either to a third party or as a result of a divorce, does the federal tax lien have priority over the bank?

A6. Under section 6323, the federal tax lien has priority over the bank's interest with respect to the taxpayer's interest in the entireties property.

If the taxpayer survives the spouse, the federal tax lien will be a senior lien against the whole property. The taxpayer's interest in the entireties property to which the federal tax lien attaches includes the taxpayer's right of survivorship. With the death of the taxpayer's spouse, the taxpayer becomes the fee simple owner of the property, and the federal tax lien attaches

to that interest in the property, which is senior to the bank's interest.

As discussed in Q&A 4, if the taxpayer predeceases the spouse and his or her interest is extinguished by operation of law, the federal tax lien will be extinguished. The mortgage lien becomes the first lien on the property.

Since a divorce or transfer to a third party terminates the entireties estate (and, with it, the spouses' rights of survivorship), if the property is transferred to a third-party or to either spouse as a result of a divorce, then the federal tax lien generally will have priority with respect to a one-half interest in the property over the bank's subsequent security interest.

Q7. Will the Service administratively seize and sell the taxpayer's interest in entireties property?

A7. The Service can administratively seize and sell a taxpayer's interest in real and personal property held in a tenancy by the entirety. Because of the nature of entireties property, it would be very difficult to gauge what market there would be for the taxpayer's interest in the property. The amount of any bid would in all likelihood be depressed to the extent that the prospective purchaser, given the rights of survivorship, would take the risk that the taxpayer may not outlive his or her spouse. In addition, a prospective purchaser would not know with any certainty if, how, and the extent to which the rights acquired in an administrative sale could be enforced. For example, rights acquired would include the right to use the property and the right to exclude others from the property. It is not clear how the rights of a prospective purchaser ultimately would be balanced with the co-existing rights of the spouse of the taxpayer. Therefore, the Service has determined that an administrative sale is not a preferable method of collection with respect to entireties property.

Levying on cash and cash equivalents held as entireties property does not present the same impediments as seizing and selling entireties property. For example, where the Service levies on a bank account that a taxpayer holds as entireties property and has the right to withdraw the funds in the account, the bank is obligated to turn over the funds in response to the levy. While the taxpayer's spouse, as the other account holder, may have an administrative or judicial claim under sections

6343(b) or 7426, respectively, *see United States v. National Bank of Commerce*, 472 U.S. 713 (1985), the amount realizable by the Service is not, at the outset, depressed as it is in the case of administrative sales.

Q8. Will the Service foreclose the federal tax lien against entireties property?

A8. The Service will foreclose the federal tax lien against entireties property in appropriate cases. While in an administrative sale the Service can sell only the taxpayer's interest in entireties property (*i.e.*, not the entire property itself), in a foreclosure action, pursuant to section 7403, the district court has discretion to order the sale of the entire property, even where a non-liable spouse has a protected interest in the property. *See United States v. Rodgers*, 461 U.S. 677 (1983) (principle applied with respect to the sale of homestead property). If the court orders the sale of the property, then the non-liable spouse must be compensated for his or her interest: section 7403 requires "a distribution of the proceeds of such sale according to the findings of the court in respect to the interests of the parties and the United States." Section 7403(c).

Q9. How is the Government's federal tax lien interest in entireties property valued for the purposes of discharge and subordination under section 6325? After private foreclosure on entireties property, what is the value of the Government's interest in proceeds left after the satisfaction of senior liens? How is entireties property valued for bankruptcy purposes? How is entireties property valued in offers in compromise?

A9. *Discharge and Subordination.* Under section 6325(b)(2)(A), the Service may issue a certificate of discharge of property subject to a federal tax lien upon payment of an amount not less than the value of the Government's interest in that property to be discharged. If a taxpayer applies for a certificate of discharge when entireties property is to be sold by the taxpayer and the taxpayer's spouse, then the taxpayer generally must pay the Service one-half the proceeds of the sale in partial satisfaction of the liability secured by the federal tax lien.

Foreclosing mortgagees with interests that are senior to the federal tax lien often seek a certificate of discharge, rather than joining the United States in a judicial proceeding. By obtaining a discharge

of the mortgaged property, the mortgagee eliminates the Service's right under section 2410(c) of Title 28 to redeem the property from the purchaser after the foreclosure sale. As in the case of a taxpayer who seeks a certificate of discharge of the entireties property, the Service generally will determine the value of the Government's interest to be one-half the value of the property, which is determined for this purpose by first taking into account the amount of senior liens.

Under 6325(b)(4), an owner of property subject to a tax lien (for example, a subsequent purchaser), other than the taxpayer whose liability gave rise to the lien, may seek a certificate of discharge by making a deposit or posting a bond equal to the value of the interest of the Government in the property. In connection with an application for discharge of former entireties property under section 6325(b)(4), the Service generally will determine the value of the Government's interest to be one-half the value of the property.

In light of the *Craft* decision, taxpayers and taxpayers' spouses will seek subordination of the federal tax lien in connection with refinancing mortgages on entireties property. If the requested subordination is for the purpose of securing a loan to refinance a senior lien, the Service will apply section 6325(d)(2). The Service will generally issue a certificate of subordination if the terms of the refinance loan, as compared to the terms of the loan secured by the senior lien, ultimately will enhance the taxpayer's equity or facilitate the collection of the tax from other property or income of the taxpayer.

If a taxpayer and a taxpayer's spouse seek a certificate of subordination for the purpose of obtaining cash or paying other debts not secured by a senior lien on the property (for example, in the case of a home equity loan), the Service will apply section 6325(d)(1). The Service generally will treat the value of the taxpayer's interest as one-half of the value of the entireties property. The Service would issue a certificate of subordination upon payment of one-half the amount of the lien or interest to which the federal tax lien will be subordinated.

Private Foreclosure. Where a senior creditor is foreclosing a mortgage or other lien on the property, the Service generally will determine the value of the taxpayer's

interest to be one-half of the excess of the value of the property over the amount of the senior lien.

Bankruptcy. In bankruptcy cases, the Service, in determining the value of its secured claim, generally will value the debtor's interest in entireties property to be one-half of the total value of the property.

Offers in Compromise. Procedures for valuing entireties property for offer in compromise purposes are set forth in the Offer in Compromise Handbook, IRM 5.8.5.3.11.

The principal author of this notice is Deborah Grogan of the Office of Associate Chief Counsel (Procedure and Administration). For further information regarding this notice, contact Ms. Grogan at (202) 622-3610 (not a toll-free call).

Section 45D.—New Markets Tax Credit

Notice 2003-64

PURPOSE

The purpose of this notice is to announce that the Treasury Department and the Internal Revenue Service will amend the definition of a qualified low-income community investment under § 1.45D-1T(d)(1)(iv) of the temporary Income Tax Regulations to include investments through two additional qualified community development entities (CDEs) described in § 45D(c) of the Internal Revenue Code.

BACKGROUND

Section 45D(a)(1) provides a new markets tax credit on certain credit allowance dates described in § 45D(a)(3) with respect to a qualified equity investment in a CDE.

Section 45D(b)(1) provides that an equity investment in a CDE is a "qualified equity investment" if, among other requirements: (A) the investment is acquired by the taxpayer at its original issue (directly or through an underwriter) solely in exchange for cash; (B) substantially all of the cash is used by the CDE to make qualified low-income community investments; and (C) the investment is designated for purposes of § 45D by the CDE.

Section 45D(b)(2) provides that the maximum amount of equity investments issued by a CDE that may be designated by the CDE as qualified equity investments shall not exceed the portion of the new markets tax credit limitation set forth in § 45D(f)(1) that is allocated to the CDE by the Secretary under § 45D(f)(2).

Section 45D(c)(1) provides that an entity is a CDE only if, among other requirements, the entity is certified by the Secretary of the Treasury Department as a CDE.

Section 45D(d)(1) provides that the term "qualified low-income community investment" means: (A) any capital or equity investment in, or loan to, any qualified active low-income community business (as defined in § 45D(d)(2)); (B) the purchase from another CDE of any loan made by the entity that is a qualified low-income community investment; (C) financial counseling and other services to businesses located in, and residents of, low-income communities; and (D) any equity investment in, or loan to, any CDE.

Section 1.45D-1T(d)(1)(iv) provides that the term qualified low-income community investment includes any equity investment in, or loan to, another CDE by a CDE, but only to the extent that the CDE in which the equity investment or loan is made uses the proceeds of the investment or loan in a manner: (A) that is described in § 1.45D-1T(d)(1)(i) (relating to certain investments in a qualified active low-income community business) or § 1.45D-1T(d)(1)(iii) (relating to certain financial counseling and other services); and (B) that would constitute a qualified low-income community investment if it were made directly by the CDE making the equity investment or loan.

DISCUSSION

Comments have been received suggesting that § 1.45D-1T(d)(1)(iv) should be amended to permit CDEs to make investments through multiple tiers of CDEs. For example, commentators state that some CDEs have reasons relating to bank regulatory requirements for lending to bank holding company CDEs that invest in bank subsidiary CDEs. In response to comments, § 1.45D-1T(d)(1)(iv) will be amended to include investments through two additional CDEs by providing that the term "qualified low-income community

investment” includes any equity investment in, or loan to, any CDE (the second CDE) by a CDE (the primary CDE), but only to the extent that the second CDE uses the proceeds of the investment or loan:

1. In a manner that is described in § 1.45D-1T(d)(1)(i) (relating to certain investments in a qualified active low-income community business) or § 1.45D-1T(d)(1)(iii) (relating to certain financial counseling and other services), and that would constitute a qualified

low-income community investment if it were made directly by the primary CDE;

2. To make an equity investment in, or a loan to, a third CDE that uses the proceeds in a manner described in the above paragraph 1; or

3. To make an equity investment in, or loan to, a third CDE that uses the proceeds to make an equity investment in, or loan to, a fourth CDE that uses the proceeds in a manner described in the above paragraph 1.

The temporary regulations will be revised to incorporate the guidance set forth

in this notice. Taxpayers may rely on this notice prior to the issuance of the revised temporary regulations.

DRAFTING INFORMATION

The principal author of this notice is Paul Handleman of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact Mr. Handleman at (202) 622-3040 (not a toll-free call).

NOTE: This revenue procedure will be reprinted as the next revision of IRS Publication 1167, *General Rules and Specifications for Substitute Forms and Schedules*.

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Part 1

Introduction to Substitute Forms

Section 1.1 — Overview of Revenue Procedure 2003–73

1.1.1 Purpose

The purpose of this revenue procedure is to provide guidelines and general requirements for the development, printing, and approval of substitute tax forms. Approval will be based on these guidelines. After review and approval, submitted forms will be accepted as substitutes for official IRS forms.

1.1.2 Unique Forms

Certain unique specialized forms require the use of other additional revenue procedures to supplement this publication. See Part 4.

1.1.3 Scope

The IRS accepts quality substitute tax forms that are consistent with the official forms and do not have an adverse impact on our processing. The IRS Substitute Forms Unit administers the formal acceptance and processing of these forms nationwide. While this program deals primarily with paper documents, it also reviews for approval other processing and filing forms such as those used in electronic filing.

Only those substitute forms that comply fully with the requirements set forth are acceptable. Exhibit E lists the form numbers mentioned in this document, their titles, and where their references are made. This revenue procedure is updated as required to reflect pertinent tax year form changes and to meet processing and/or legislative requirements.

1.1.4 Forms Covered by This Revenue Procedure

The following types of forms are covered by this revenue procedure:

- IRS tax forms and their related schedules.
 - Worksheets as they appear in instruction packages.
 - Applications for permission to file returns electronically and forms used as required documentation for electronically filed returns.
 - Powers of Attorney.
 - Over-the-counter estimated tax payment vouchers.
 - Forms and schedules relating to partnerships, exempt organizations, and employee plans.
-

1.1.5 Forms NOT Covered by This Revenue Procedure

The following types of forms are not covered by this revenue procedure:

- W–2 and W–3 (see Publication 1141 for information on these forms).
 - W–2c and W–3c (see Publication 1223 for information on these forms).
 - 1096, 1098 series, 1099 series, 5498 series, and W–2G (see Publication 1179 for information on these forms).
 - Federal Tax Deposit (FTD) coupons, which may not be reproduced.
 - Forms 1040–ES (OCR) and 1041–ES (OCR), which may not be reproduced.
 - Forms 5500, 5500–EZ, and associated schedules (see the Department of Labor web site (www.dol.gov) for information on these forms).
 - Requests for information or documentation initiated by the IRS.
 - Forms used internally by the IRS.
 - State tax forms.
 - Forms developed outside the IRS (except for Form TD F 90–22.1, *Report of Foreign Bank and Financial Accounts*).
 - General and Specific Instructions are not reviewed by Substitute Forms Program Unit.
-

Section 1.2 — IRS Contacts

1.2.1 Where to Send Substitute Forms

Send your substitute forms for approval to the following offices (DO NOT send forms with taxpayer data):

Form	Office and Address
4789, 8300, 8362, 8852, TD F 90–22.1, TD F 90–22.47	IRS Computing Center BSA Compliance Branch P.O. Box 32063 Detroit, MI 48232-0063
5500, 5500–EZ, and Schedules A through I, P, R, SSA, and T for Form 5500	Check EFAST information at the Department of Labor’s Website at www.efast.dol.gov
All others (except W–2, W–2c, W–3, W–3c, 1096, 1098, 1099, 5498, and W–2G)	Internal Revenue Service Attn: Substitute Forms Program W:CAR:MP:T:T:SP 1111 Constitution Avenue, NW Room 6411 Washington, DC 20224

In addition, the Substitute Forms Program Unit can be contacted via e-mail at **tax-forms@irs.gov*. Please enter “Substitute Forms” on the subject line. Use this e-mail address only to inquire about forms covered by this revenue procedure. DO NOT attach graphic files for approval with e-mail.

For questions about Forms W–2 and W–3, refer to IRS Publication 1141, *General Rules and Specifications for Substitute Forms W–2 and W–3*. For Forms W–2c and W–3c, refer to IRS Publication 1223, *General Rules and Specifications for Substitute Forms W–2c and W–3c*. For Forms 1096, 1098, 1099, 5498, W–2G, and 1042–S refer to Internal Revenue Service Publication 1179, *General Rules and Specifications Substitute Forms 1096, 1098, 1099, 5498, W–2G and 1042–S*.

Section 1.3 — Nature of Changes

1.3.1 Changes to the Revenue Procedure

The following changes have been made to the Revenue Procedure for 2003:

- The Substitute Forms Program office symbols have changed to W:CAR:MP:T:T:SP.
 - Chapters 1 through 8 have been renamed Parts.
 - Part 7, Section 7.1 Paper Substitutes for Form 1042–S has been deleted. This information can be found in Publication 1179.
 - Part 7, Sections 7.1.1 through 7.1.5 have been revised to include requirements for Schedules K–1 with two-dimensional (2–D) bar-codes.
-

Section 1.4 — Definitions

1.4.1 Substitute Form

A tax form (or related schedule) that differs in any way from the official version and is intended to replace the form that is printed and distributed by the IRS. This term also covers those approved substitute forms exhibited in this revenue procedure.

1.4.2 Printed/Pre-printed Form

A form produced using conventional printing processes. Also, a printed form which has been reproduced by photocopying or a similar process.

1.4.3 Preprinted Pin-Fed Form

A printed form that has marginal perforations for use with automated and high-speed printing equipment.

1.4.4 Computer-Prepared Substitute Form

A preprinted form in which the taxpayer's tax entry information has been inserted by a computer, computer-printer, or other computer type equipment such as word-processing equipment.

1.4.5 Computer-Generated Substitute Tax Return or Form

A tax return or form that is entirely designed and printed using a computer printer such as a laser printer, etc., on plain white paper. This return or form must conform to the physical layout of the corresponding IRS form, although the typeface may differ. The text should match the text on the officially printed form as closely as possible. Condensed text and abbreviations will be considered on a case-by-case basis.

Exception: All jurat (perjury statements) must be reproduced verbatim.

1.4.6 Manually-Prepared Form

A preprinted reproduced form in which the taxpayer's tax entry information is entered by an individual using a pen, pencil, typewriter, or other non-automated equipment.

1.4.7 Graphics

Parts of a printed tax form that are not tax amount entries or required information. Examples of graphics are line numbers, captions, shadings, special indicators, borders, rules, and strokes created by typesetting, photo-graphics, photo-composition, etc.

1.4.8 Acceptable Reproduced Form

A legible photocopy of an original form.

1.4.9 Supporting Statement (Supplemental Schedule)

A document providing detailed information to support a line entry on an official or approved substitute form and filed with (attached to) a tax return.

Note: *A supporting statement is not a tax form and does not take the place of an official form unless specifically permitted elsewhere in this procedure.*

1.4.10 Specific Form Terms

The following specific terms are used throughout this revenue procedure in reference to all substitute forms: format, sequence, line reference, item caption, and data entry field.

1.4.11 Format

The overall physical arrangement and general layout of a substitute form.

1.4.12 Sequence

Sequence is an integral part of the total format requirement. The substitute form should show the same numeric and logical placement order of data, as shown on the official form.

1.4.13 Line Reference

The line numbers, letters, or alphanumerics used to identify each captioned line on an official form. These line references are printed to the immediate left of each caption or data entry field.

1.4.14 Item Caption

The text on each line of a form, which identifies the data required.

1.4.15 Data Entry Field

Designated areas for the entry of data such as dollar amounts, quantities, responses and checkboxes, etc.

1.4.16 Advance Draft

A draft version of a new or revised form may be posted to the IRS Internet site for information purposes. Substitute forms may be submitted based on these advance drafts, but any company that receives forms approval based on these early drafts is responsible for monitoring and revising forms to mirror any revisions in the final forms provided by the IRS.

Section 1.5 — Agreement

1.5.1 Important Stipulation of this Revenue Procedure

Any person or company who uses substitute forms and makes all or part of the changes specified in this revenue procedure agrees to the following stipulations:

- The IRS presumes the changes are made in accordance with these procedures and will not be disruptive to the processing of the tax return.
 - Should any of the changes prove to be not exactly as described, and as a result become disruptive to the IRS's processing of the tax return, the person or company agrees to accept the determination of the IRS as to whether or not the form may continue to be used during the filing season.
 - The person or company agrees to work with the IRS in correcting noted deficiencies. Notification of deficiencies may be made by any combination of fax, letter, e-mail, or phone contact and may include the return of unacceptable forms for re-submission of acceptable forms.
-

Part 2 General Guidelines for Submissions and Approvals

Section 2.1 — General Specifications for Approval

2.1.1 Overview

If you produce any tax forms using IRS guidelines on permitted changes, you can generate your own substitutes without further approval. If your changes are more extensive, you must get IRS approval before using substitute forms. These changes include the use of typefaces and sizes other than those found on the official form and the condensing of line item descriptions to save space.

2.1.2 Schedules

Schedules are considered to be an integral part of a complete tax return. A schedule may be included as part of a form or printed separately.

2.1.3 Examples of Schedules That Must be Submitted With the Return

Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*, is an example of this situation. Its Schedules A through U have pages numbered as part of the basic return. For Form 706 to be approved, the entire form including Schedules A through U must be submitted.

2.1.4 Examples of Schedules That Can be Submitted Separately

However, Schedules 1, 2, and 3 of Form 1040A are examples of schedules that can be submitted separately. Although printed by the IRS as a supplement to Form 1040A, none of these schedules are required to be filed with Form 1040A. These schedules may be separated from Form 1040A and submitted as substitute forms.

2.1.5 Use and Distribution of Unapproved Forms

The IRS is continuing a program to identify and contact tax return preparers, forms developers, and software publishers who use or distribute unapproved forms that do not conform to this revenue procedure. The use of unapproved forms, hinders the processing of the returns.

Section 2.2 — Highlights of Permitted Changes and Requirements

2.2.1 Methods of Reproducing Internal Revenue Service Forms

Official IRS tax forms are supplied by the IRS. These forms are provided in the taxpayer's tax package, over-the-counter, and are printed in the revenue procedures. Forms can also be picked up at many IRS offices, post offices, libraries, and are available on CD-ROM and on-line via the Internet.

There are methods of reproducing IRS printed tax forms suitable for use as substitutes without prior approval.

- You can photocopy most tax forms and use them instead of the official ones. The entire substitute form, including entries, must be legible.
 - You can reproduce any current tax form as cut sheets, snap sets, and marginally punched, pin-fed forms as long as you use an official IRS version as the master copy.
 - You can reproduce a "signature form" as a valid substitute form. Many tax forms (including returns) have a taxpayer signature requirement as part of the form layout. **The jurat/perjury statement/signature line areas must be retained and worded exactly as on the official form.** The requirement for a signature by itself does not prohibit a tax form from being properly computer-generated.
-

Section 2.3 — Vouchers

2.3.1 Overview

All payment vouchers (Forms 940-V, 940-EZ (V), 941-V, 943-V, 945-V, 1040-V, and 2290-V) must be reproduced. Substitute vouchers must be the same size as the officially printed vouchers. Vouchers that are prepared for printing on a laser printer may include a scan line.

2.3.2 Scan Line Specifications

NNNNNNNNN AA AAAA NN N NNNNNN NNN

Item: A B C D E F G

- A. Social Security Number/Employer Identification Number (SSN/EIN) has 9 numeric spaces.
 - B. Check Digit has 2 alpha spaces.
 - C. Name Control has 4 alphanumeric spaces.
 - D. Master File Tax (MFT) Code has 2 numeric spaces (see below).
 - E. Taxpayer Identification Number (TIN) Type has 1 numeric space (see below)
 - F. Tax Period has six numeric spaces in year/month format (YYYYMM).
 - G. Transaction Code has 3 numeric spaces.
-

2.3.3 MFT Code

Code Number for Forms:

- 1040 family – 30;
 - 940/940-EZ – 10;
 - 941 – 01;
 - 943 – 11;
 - 945 – 16; and
 - 2290 – 60.
-

2.3.4 TIN Type

Type Number for:

- Form 1040 family – 0; and
 - Forms 940, 940-EZ, 941, 943, 945, and 2290-2.
-

2.3.5 Voucher Size

The voucher size must be exactly 8.0" x 3.25" (Forms 1040-ES and 1041-ES must be 7.625" x 3.0"). The document scan line must be vertically positioned 0.25 inches from the bottom of the scan line to the bottom of the voucher. The last character on the right of the scan line must be placed 3.5 inches from the right leading edge of the document. The minimum required horizontal clear space between characters is .014 inches. The line to be scanned must have a clear band 0.25 inches in height from top to bottom of the scan line, and from border to border of the document. "Clear band" means no printing except for dropout ink.

2.3.6 Print and Paper Weight

Vouchers must be imaged in black ink using OCR A, OCR B, or Courier 10. These fonts may not be mixed in the scan line. The horizontal character pitch is 10 CPI. The paper must be 20 to 24 pound OCR bond paper weight.

Section 2.4 — Restrictions on Changes

2.4.1 What You CANNOT Do to Forms Suitable for Substitute Tax Forms

You cannot, without prior IRS approval, change any IRS tax form or use your own (non-approved) versions including graphics, unless specifically permitted by this revenue procedure.

You cannot adjust any of the graphics on Forms 1040, 1040A, and 1040EZ (except in those areas specified in Part 5 of this revenue procedure) without prior approval from the IRS Substitute Forms Unit.

You cannot use your own preprinted label on tax returns filed with the IRS unless you fully comply with the criteria specified in the section in this revenue procedure on the use of pre-addressed IRS labels.

Section 2.5 — Guidelines for Obtaining IRS Approval

2.5.1 Basic Requirements

Preparers who submit substitute privately-designed, privately-printed, computer generated, or computer-prepared tax forms must develop these substitutes using the guidelines established in this part. These forms, unless excepted by the revenue procedure, must be approved by the IRS before being filed.

2.5.2 Conditional Approval Based on Advanced Drafts

The IRS cannot grant final approval of your substitute form until the official form has been published. However, the IRS has established a location on the Internet for posting advance draft forms. This site can be reached in the "Tax Professionals" area at:

We encourage submission of proposed substitutes of these advance draft forms, and will grant conditional approval based solely on these early drafts. These advance drafts are subject to significant change before forms are finalized. If these advance drafts are used as the basis for your substitute forms, you will be responsible for subsequently updating your final forms to agree with the final official version. These revisions need not be submitted for further approval.

Note: *Approval of forms based on advance drafts will not be granted after the final version of an official form is published.*

2.5.3 Submission Procedures

Please follow these general guidelines when submitting substitute forms for approval:

- Any alteration of forms must be within the limits acceptable to the IRS. It is possible that, from one filing period to another, a change in law or a change in internal need (processing, audit, compliance, etc.) may change the allowable limits for the alteration of the official form.
 - When specific approval of any substitute form (other than those specified in Part 1, Section 1.2 — IRS Contacts) is desired, a sample of the proposed substitute form should be forwarded for consideration by letter to the Substitute Forms Unit at the address shown in Section 1.2.
 - To expedite multiple forms approval, we prefer that your proposed forms be submitted in separate sets by return. For example, Forms 1040 and their normally related schedules or attachments should be submitted separately from Forms 1120 and 1065 if possible. Schedules and forms (e.g., Forms 3468, 4136, etc.) that can be used with more than one type of return (e.g., 1040, 1041, 1120, etc.) should be submitted only once for approval, regardless of the number of different tax returns with which they may be associated. Also, all pages of multi-page forms or returns should be submitted in the same package.
-

2.5.4 Approving Offices

Because only the Substitute Forms Unit is authorized to approve substitute forms, unnecessary delays may occur if forms are sent to the wrong office. The Substitute Forms Unit may then coordinate the response with the initiator responsible for revising that particular form. Such coordination may include allowing the initiator to officially approve the form. No IRS office is authorized to allow deviations from this revenue procedure.

2.5.5 IRS Review of Software Programs, etc.

The IRS does not review or approve the logic of specific software programs, nor does the IRS confirm the calculations on the forms produced by these programs. The accuracy of the program remains the responsibility of the software package developer, distributor, or user.

The Substitute Forms Unit is primarily concerned with the pre-filing quality review of the final forms, produced by whatever means, that are expected to be processed by IRS field offices. For these, you should submit forms without including any taxpayer information such as names, addresses, monetary amounts, etc.

2.5.6 When To Send Proposed Substitutes

Proposed substitutes, which are required to be submitted per this revenue procedure, should be sent as much in advance of the filing period as possible. This is to allow adequate time for analysis and response.

2.5.7 Accompanying Statement

When submitting sample substitutes, you should include an accompanying statement that lists each form number and its changes from the official form (position, arrangement, appearance, line numbers, additions, deletions, etc.). With each of the items you should include a detailed reason for the change.

When requesting approval, please include a checklist. Checklists expedite the approval process. The checklist may look like example Exhibit D displayed in the back of this procedure or may be one of your own design. Please include your fax number on the checklist.

2.5.8 Approval/Non-Approval Notice

The Substitute Forms Unit will fax the checklist or an approval letter to the originator if a fax number has been provided, unless:

- The requester has asked for a formal letter; or
- Significant corrections to the submitted forms are required.

Notice of approval may contain qualifications for use of the substitutes. Notices of unapproved letters may specify the changes required for approval, and may also require re-submission of the form(s) in question. Telephone contact is used when possible.

2.5.9 Duration of Approval

Most signature tax returns and many of their schedules and related forms have the tax (liability) year printed in the upper right corner. Approvals for these forms are usually good for one calendar year (January through December of the year of filing). Quarterly tax forms in the 940 series and Form 720 require approval for any quarter in which the form has been revised.

Because changes are made to a form every year, each new filing season generally requires a new submission of a form. Very rarely is updating the preprinted year the only change made to a form.

2.5.10 Limited Continued Use of an Approved Change

Limited changes approved for one tax year may be allowed for the same form in the following tax year. Examples of such limitations and requirements are the use of abbreviated words, revised form spacing, compressed text lines, and shortened captions, etc., which do not change the consistency of lines or text on the official forms.

If substantial changes are made to the form, new substitutes must be submitted for approval. If only minor editorial changes are made to the form, it is not subject to review. It is the responsibility of each vendor who has been granted permission to use substitute forms to monitor and revise forms to mirror any revisions to official forms made by the Service. If there are any questions, please contact the Substitute Forms Unit.

2.5.11 When Approval Is Not Required

If you received written approval for a specific change on a form last year, such as deleting the vertical lines used to separate dollars and cents, you may make the same change this year if the item is still present on the official form.

- The new substitute form does not have to be sent to the IRS and written approval is not required.
- However, the new substitute form must conform to the official current year IRS form in other respects: date, Office of Management and Budget (OMB) approval number, attachment sequence number, Paperwork Reduction Act Notice statement, arrangement, item caption, line number, line reference, data sequence, etc.
- The new substitute must also comply with this revenue procedure. The procedure may have eliminated, added to, or otherwise changed the guideline(s) that affected the change approved last year.
- An approved change is authorized only for the period from a prior tax year substitute form to a current tax year substitute form.

Exception: Forms with temporary, limited, or interim approvals (or with approvals that state a change is not allowed in any other tax year) are subject to review in subsequent years.

2.5.12 Continuous Use Forms

Forms without preprinted tax years are called “continuous use” forms. Continuous use forms are revised when a legislative change affects the form or a change will facilitate processing. These forms may have revision dates that are valid for longer than one year.

2.5.13 Internet Program Chart

A chart of print dates (for annual and quarterly forms) and most current revision dates (for continuous use forms) will be maintained on the Internet. For further details, see Section 4.3.1 on access for the Internet and the Official Forms Release Schedule.

2.5.14 Required Copies

Generally, you must send us one copy of each form being submitted for approval. However, if you are producing forms for different computer systems (*e.g.*, IBM compatible vs. Macintosh) or different types of printers (*e.g.*, laser vs. inkjet), and these forms differ significantly in appearance, submit one copy for each type of system or printer.

2.5.15 Requestor’s Responsibility

Following receipt of an initial approval for a substitute forms package or a software output program to print substitute forms, it is the responsibility of the originator (designer or distributor) to provide client firms or individuals with forms that meet the IRS’s requirements for continuing acceptability. Examples of this responsibility include:

- Using the prescribed print paper, font size, legibility, state tax data deletion, etc.
 - Informing all users of substitute forms of the legal requirements of the Paperwork Reduction Act Notice, which is generally found in the instructions for the official IRS forms.
-

2.5.16 Source Code

The Substitute Forms Unit, W:CAR:MP:T:T:SP, will assign a unique source code to each firm that submits substitute paper forms for approval. This source code will be a permanent identifier that should be used on every submission by a particular firm.

The source code:

- Consists of three alpha characters.
 - Should be printed at the bottom left margin area on the first page of every approved substitute form.
 - Should not be used on optically scanned (OCR) forms.
-

Section 2.6 — Office of Management and Budget (OMB) Requirements for All Substitute Forms

2.6.1 OMB Requirements for All Substitute Forms

There are legal requirements of the Paperwork Reduction Act of 1995 (The Act). Public Law 104–13 requires that:

- OMB approve all IRS tax forms that are subject to the Act,
- Each IRS form contains (in the upper right corner) the OMB number, if any, and
- Each IRS form (or its instructions) states why the IRS needs the information, how it will be used, and whether or not the information is required to be furnished.

This information must be provided to every user of official or substitute tax forms.

2.6.2 Application of the Paperwork Reduction Act

On forms that have been assigned OMB numbers:

- All substitute forms must contain in the upper right corner the OMB number that is on the official form.
- The required format is: **OMB No. XXXX-XXXX** (Preferred) or **OMB # XXXX-XXXX** (Acceptable).

2.6.3 Required Explanation to Users

You must inform the users of your substitute forms of the IRS use and collection requirements stated in the instructions for official IRS forms.

- If you provide your users or customers with the official IRS instructions, each form must retain either the Paperwork Reduction Act Notice (or Disclosure, Privacy Act, and Paperwork Reduction Act Notice), or a reference to it as the IRS does on the official forms (usually in the lower left corner of the forms).
- This notice reads, in part, “We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax...”

Note: *If the IRS instructions are not provided to users of your forms, the exact text of the Paperwork Reduction Act Notice (or Disclosure, Privacy Act, and Paperwork Reduction Act Notice) must be furnished separately or on the form.*

2.6.4 Finding the OMB number and Paperwork Reduction Act Notice

The OMB number and the Paperwork Reduction Act Notice, or references to it, may be found printed on an official form (or its instructions). The number and the notice are included on the official paper format and in other formats produced by the IRS (*e.g.*, compact disc (CD) or Internet download).

Part 3 Physical Aspects and Requirements

Section 3.1 — General Guidelines for Substitute Forms

3.1.1 General Information

The official form is the standard. Because a substitute form is a variation from the official form, you should know the requirements of the official form for the year of use before you modify it to meet your needs. The IRS provides several means of obtaining the most frequently used tax forms. These include the Internet, fax-on-demand, and CD-ROM (see Part 4).

3.1.2 Design

Each form must follow the design of the official form as to format arrangement, item caption, line numbers, line references, and sequence.

3.1.3 State Tax Information Prohibited

State tax information must not appear on the federal tax return, associated form, or schedule that is filed with the IRS. Exceptions occur when amounts are claimed on, or required by, the federal return (*e.g.*, state and local income taxes, on Schedule A of Form 1040).

3.1.4 Vertical Alignment of Amount Fields

IF a form is to be...	THEN...
Manually prepared	<ol style="list-style-type: none"> 1. The column must have a vertical line or some type of indicator in the amount field to separate dollars from cents if the official form has a vertical line. 2. The cents column must be at least 3/10" wide.
Computer-generated	<ol style="list-style-type: none"> 1. Vertically align the amount entry fields where possible. 2. Use one of the following amount formats: <ol style="list-style-type: none"> a. 0,000,000 b. 0,000,000.00
Computer-prepared	<ol style="list-style-type: none"> 1. You may remove the vertical line in the amount field that separates dollars from cents. 2. Use one of the following amount formats: <ol style="list-style-type: none"> a. 0,000,000 b. 0,000,000.00

3.1.5 Attachment Sequence Number

Many individual income tax forms have a required "attachment sequence number" located just below the year designation in the upper right corner of the form. The IRS uses this number to indicate the order in which forms are to be attached to the tax return for processing. Some of the attachment sequence numbers may change from year to year.

On computer-prepared forms:

- The sequence number may be printed in no less than 12-point boldface type and centered below the form's year designation.
- The sequence number may also be placed following the year designation for the tax form and separated with an asterisk.
- The actual number may be printed without labeling it the "Attachment Sequence Number."

3.1.6 Paid Preparer's Information and Signature Area

On Forms 1040EZ, 1040A, 1040, and 1120, etc., the "Paid Preparer's Use Only" area may not be rearranged or relocated. You may, however, add three extra lines to the paid preparer's address area without prior approval. This applies to other tax forms as well.

3.1.7 Assembly of Forms

If developing software or forms for use by others, please inform your customers/clients that the order in which the forms are arranged may affect the processing of the package. A return must be arranged in the order indicated below.

IF the form is...	THEN the sequence is...
1040	<ul style="list-style-type: none"> • Form 1040. • Schedules and forms in sequence number order.
Any other tax return (Form 1120, 1120S, 1065, 1041, etc.)	<ul style="list-style-type: none"> • The tax returns. • Directly associated schedules (Schedule D, etc.). • Directly associated forms. • Additional schedules in alphabetical order. • Additional forms in numerical order.

Supporting statements should then follow in the same sequence as the forms they support. Additional information required should be attached last.

In this way, the forms are received in the order in which they must be processed. If you do not send returns to us in order, processing may be delayed.

Section 3.2 — Paper

3.2.1 Paper Content

The paper must be:

- Chemical wood writing paper that is equal to or better than the quality used for the official form,
 - At least 18 pound (17" x 22", 500 sheets), or
 - At least 50 pound offset book (25" x 38", 500 sheets).
-

3.2.2 Paper With Chemical Transfer Properties

There are several kinds of paper prohibited for substitute forms. These are:

1. Carbon-bonded paper
 2. Chemical transfer paper except when the following specifications are met:
 - a. Each ply within the chemical transfer set of forms must be labeled.
 - b. Only the top ply (ply one and white in color), the one that contains chemical on the back only (coated back), may be filed with the IRS.
-

3.2.3 Example

A set containing three plies would be constructed as follows: ply one (coated back), "Federal Return, File with IRS"; ply two (coated front and back), "Taxpayer's copy"; and ply three (coated front), "Preparer's copy."

The file designation, "Federal Return, File with IRS," for ply one must be printed in the bottom right margin (just below the last line of the form) in 12-point, bold-face type.

It is not mandatory, but recommended, that the file designation "Federal Return, File with IRS," be printed in a contrasting ink for visual emphasis.

3.2.4 Carbon Paper

Do not attach any carbon paper to any return you file with the IRS.

3.2.5 Paper and Ink Color

We prefer that the color and opacity of paper substantially duplicates that of the original form. This means that your substitute must be printed in black ink and may be on white or on the colored paper the IRS form is printed on. Forms 1040A and 1040 substitute reproductions may be in black ink without the colored shading. The only exception to this rule is Form 1041-ES, which should always be printed with a very light gray shading in the color screened area. This is necessary to assist us in expeditiously separating this form from the very similar Form 1040-ES.

3.2.6 Page Size

Substitute or reproduced forms and computer prepared/generated substitutes may be the same size as the official form or they may be the standard commercial size (8 1/2" x 11"). The thickness of the stock cannot be less than .003 inches.

Section 3.3 — Printing

3.3.1 Printing Medium

The private printing of all substitute tax forms must be by conventional printing processes, photocopying, computer-graphics, or similar reproduction processes.

3.3.2 Legibility

All forms must have a high standard of legibility as to printing, reproduction, and fill-in matter. Entries of taxpayer data may be no smaller than eight points. The IRS reserves the right to reject those with poor legibility. The ink and printing method used must ensure that no part of a form (including text, graphics, data entries, etc.) develops "smears" or similar quality

deterioration. This includes any subsequent copies or reproductions made from an approved master substitute form, either during preparation or during IRS processing.

3.3.3 Type Font

Many federal tax forms are printed using “Helvetica” as the basic type font. We request that you use this type font when composing substitute forms.

3.3.4 Print Spacing

Substitute forms should be printed using a 6 lines/inch vertical print option. They should also be printed horizontally in 10 pitch pica (*i.e.*, 10 print characters per inch) or 12 pitch elite (*i.e.*, 12 print positions per inch).

3.3.5 Image Size

The image size of a printed substitute form should be as close as possible to that of the official form. You may omit any text on both computer-prepared and computer-generated forms that is solely instructional.

3.3.6 Title Area Changes

To allow a large top margin for marginal printing and more lines per page, the title line(s) for all substitute forms (not including the form’s year designation and sequence number, when present), may be photographically reduced by 40 percent or reset as one line of type. When reset as one line, the type size may be no smaller than 14-point. You may omit “Department of the Treasury, Internal Revenue Service” and all reference to instructions in the form’s title area.

3.3.7 Remove Government Printing Office Symbol and IRS Catalog Number

When privately printing substitute tax forms, the Government Printing Office (GPO) symbol and/or jacket number must be removed. In the same place, using the same type size print the Employer Identification Number (EIN), the Social Security Number (SSN) of the printer or designer, or the IRS-assigned source code. (We prefer this last number be printed in the lower left area of the first page of each form.) Also, remove the IRS Catalog Number (Cat. No.) if one is present in the bottom center margin, and the recycle symbol if the substitute is not produced on recycled paper.

3.3.8 Printing on One Side of Paper

While it is preferred that both sides of the paper be used for substitutes and reproduced forms, resulting in the same page arrangement as that of the official form or schedule, the IRS will not reject your forms if only one side of the paper is used.

3.3.9 Photocopy Equipment

The IRS does not undertake to approve or disapprove the specific equipment or process used in reproducing official forms. Photocopies of forms must be entirely legible and satisfy the conditions stated in this and other revenue procedures.

3.3.10 Reproductions

Reproductions of official forms and substitute forms that do not meet the requirements of this revenue procedure may not be filed instead of the official forms. Illegible photocopies are subject to being returned to the filer for re-submission of legible copies.

3.3.11 Removal of Instructions

You may remove references to instructions. No prior approval is needed.

Exception: *The words “For Paperwork Reduction Act Notice, see instructions” must be retained or a similar statement provided on each form. Some forms refer the taxpayer to a page number in the instructions for information on the Paperwork Reduction Act Notice.*

Section 3.4 — Margins

3.4.1 Margin Size

The format of a reproduced tax form when printed on the page must have margins on all sides at least as large as the margins on the official form. This allows room for IRS employees to make the necessary entries on the form during processing.

- A 1/2-inch to 1/4-inch margin must be maintained across the top, bottom, and both sides of all substitute forms.
 - The marginal, perforated strips containing the pin-fed holes must be removed from all forms prior to filing with the IRS.
-

3.4.2 Marginal Printing

Prior approval is not required for the marginal printing allowed when printed on an official form or on a photocopy of an official form.

- With the exception of the actual tax forms (*i.e.*, Forms 1040, 1040A, 1040EZ, 1120, 940, 941, etc.), you may print in the left vertical margin and in the left half of the bottom margin.
 - Printing is never allowed in the top right margin of the tax form (*i.e.*, Forms 1040, 1040A, 1040EZ, 1120, 940, 941, etc.). The Service uses this area to imprint a Document Locator Number for each return. There are no exceptions to this requirement.
-

Section 3.5 — Examples of Approved Formats

3.5.1 Examples of Approved Formats From the Exhibits

Three sets of exhibits (Exhibits A-1, 2; B-1, 2; and C-1, 2) are at the end of this revenue procedure as examples of how these guidelines may be used. Vertical spacing is six (6) lines to the inch. A combination of upper and lower-case print font is acceptable in producing substitute forms.

The same logic may be applied to any IRS form that is normally reproducible as a substitute form, with the exception of the tax return forms as discussed elsewhere. These exhibits may be from a prior year and are not to be used as current substitute forms.

Section 3.6 — Miscellaneous Information for Substitute Forms

3.6.1 Filing Substitute Forms

To be acceptable for filing, a substitute form must print out in a format that will allow the filer to follow the same instructions as for filing official forms. These instructions are in the taxpayer's tax package or in the related form instructions. The form must be on the appropriately sized paper, legible, and include a jurat, where one appears on the published form.

3.6.2 Caution to Software Publishers

The IRS has received returns produced by software packages with approved output where either the form heading was altered or the lines were spaced irregularly. This produces an illegible or unrecognizable return or a return with the wrong number of pages. We realize that many of these problems are caused by individual printer differences but they may delay input of return data and, in some cases, generate correspondence to the taxpayer. Therefore, in the instructions to the purchasers of your product, both individual and professional, please stress that their returns will be processed more efficiently if they are properly formatted. This includes:

- Having the correct form numbers and titles at the top of the return, and
 - Submitting the same number of pages as if the form were an official IRS form with the line items on the proper pages.
-

3.6.3 Use Pre-Addressed IRS Label

If you are a practitioner filling out a return for a client or a software publisher who prints instruction manuals, stress the use of the pre-addressed label provided in the tax package the IRS sent to the taxpayer, when available. The use of this label (or its precisely duplicated label information) is extremely important for the efficient, accurate, and economical processing of a taxpayer's return. Labeled returns indicate that a taxpayer is an established filer and permits the IRS to automatically accelerate processing of those returns. This results in quicker refunds, more accurate names/addresses and postal deliveries, and less manual review by IRS functions.

3.6.4 Caution to Producers of Software Packages

If you are producing a software package that generates name and address data onto the tax return, do not under any circumstances program either the IRS preprinted check digits or a practitioner-derived name control to appear on any return prepared and filed with the IRS.

3.6.5 Programming to Print Forms

Whenever applicable:

- Use only the following label information format for single filers:
JOHN Q. PUBLIC
310 OAK DRIVE
HOMETOWN, STATE 94000
 - Use only the following information for joint filers:
JOHN Q. PUBLIC
MARY I. PUBLIC
310 OAK DRIVE
HOMETOWN, STATE 94000
-

Part 4 Additional Resources

Section 4.1 — Guidance From Other Revenue Procedures

4.1.1 General

Guidance for the substitute tax forms not covered in this revenue procedure and the revenue procedures that govern their use are as follows:

- Revenue Procedure 94-79, IRS Publication 1355, *Requirements and Conditions for the Reproduction, Private Design, and Printing of Substitute Forms 1040-ES*.
 - Revenue Procedure 2002-53, IRS Publication 1141, *General Rules and Specifications for Substitute Forms W-2 and W-3*.
 - Revenue Procedure 2003-28, IRS Publication 1179, *General Rules and Specifications for Substitute Forms 1096, 1098, 1099, 5498, W-2G and 1042-S*.
 - Revenue Procedure 2001-40, IRS Publication 1187, *Specifications for Filing Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding Electronically or Magnetically*.
 - Revenue Procedure 2002-34, IRS Publication 1220, *Specifications for Filing Forms 1098, 1099, 5498, and W-2G Electronically or Magnetically*.
 - Revenue Procedure 2003-31, IRS Publication 1223, *General Rules and Specifications for Substitute Forms W-2c and W-3c*.
-

Section 4.2 — Ordering Publications

4.2.1 Sources of Publications

The publications listed below are available either on the IRS web site or may be ordered by calling 1-800-TAX-FORM (1-800-829-3676). Identify the requested document by IRS publication number:

- Pub. 1141, the revenue procedure on specifications for private printing for Forms W-2 and W-3.
 - Pub. 1167, the revenue procedure on substitute printed, computer-prepared, and computer-generated tax forms and schedules.
 - Pub. 1179, the revenue procedure on paper substitute information returns (Forms 1096, 1098, 1099, 5498, W-2G and 1042-S).
 - Pub. 1220, the revenue procedure on electronic or magnetic reporting for information returns (Forms 1098, 1099 series, 5498, and W-2G).
 - Pub. 1223, the revenue procedure on substitute Forms W-2c and W-3c.
 - Pub. 1239, *Specifications for Filing Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips, Magnetically/Electronically*.
 - Pub. 1245, electronic and magnetic reporting for Forms W-4.
 - Pub. 1345, *Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns*. (This is an annual publication; tax year is subject to change).
 - Pub. 1345-A, *Filing Season Supplement For Authorized IRS e-file Providers*. This publication, printed in the late fall, supplements Publication 1345.
 - Pub. 1355, the revenue procedure on the requirements for substitutes Form 1040-ES.
-

4.2.2 Where To Order

If you are mailing your order, the address to use is determined by your location.

IF you live in the...	THEN mail your order to...
Western United States	Western Area Distribution Center Rancho Cordova, CA 95743-0001
Central United States	Central Area Distribution Center P.O. Box 8903 Bloomington, IL 61702-8903
Eastern United States or a foreign country	Eastern Area Distribution Center P.O. Box 85074 Richmond, VA 23261-5074

Section 4.3 — Electronic Tax Products

4.3.1 The Internet

Copies of tax forms with instructions, publications, and other tax-related materials may be obtained via the Internet at www.irs.gov. Forms can be downloaded in several file formats (PDF — Portable Document Format, PS — PostScript, and PCL — Printer Control Language). Those choosing to use PDF files for viewing on a personal computer can also download a free copy of the Adobe Acrobat Reader.

4.3.2 Tax Fax

The most frequently requested tax forms, instructions, and other information are available through IRS Tax Fax at (703) 368-9694. Call from your fax machine and follow the voice prompts. Your request will be transmitted directly back to you. Each call is limited to requesting three items. Users pay the telephone line charges.

4.3.3 Official Forms Release Schedule

The IRS web site provides an Official Forms Release Schedule for the official forms released for use by taxpayers. The schedule has three parts:

- Anticipated print dates of annual returns,
- Anticipated print dates of quarterly returns, and
- Last revision dates for continuous use only forms.

The site address is *www.irs.gov/taxpros/formsch.html*. The site will be updated weekly during peak printing periods and as necessary at other times. The planned dates are subject to change.

Section 4.4 — Federal Tax Forms on CD-ROM

4.4.1 Information About Federal Tax Forms CD-ROM

The CD-ROM contains over 3,000 tax forms and publications for small businesses, return preparers, and others who frequently need current or prior year tax products. Most current tax forms on the CD-ROM may be filled in electronically, then printed out for submission and saved for record keeping. Other products on the CD-ROM include the Internal Revenue Bulletins, Tax Supplements, and Internet resources for the tax professional with links to the World Wide Web.

All necessary software to view the files must be installed from the CD-ROM. Software for Adobe Acrobat Reader is included on the disk. The software will run under Windows 95/98/NT and Macintosh System 7.5 and later versions of these programs. All products are presented in Adobe's Portable Document Format (PDF). In addition, tax publications are provided in the Hyper Text Markup Language (HTML).

4.4.2 System Requirements and How to Order the Federal Tax Forms CD-ROM

For system requirements, contact the National Technical Information Service (NTIS) help desk at 703-487-4608. Prices are subject to change.

The cost of the CD if purchased via the Internet at *http://www.irs.gov/cdorders* from NTIS, is \$22 (with no handling fee).

If purchased using the following methods, the cost for each CD is \$22 (plus a \$5 handling fee). These methods are:

- By phone — 1-877-CDFORMS (1-877-233-6767)
 - By fax — (703) 605-6900
 - By mail using the order form contained in IRS Publication 1045 (Tax Professionals Program)
 - By mail to:
National Technical Information Service
5285 Port Royal Road
Springfield, VA 22161
-

Part 5

Requirements for Specific Tax Returns

Section 5.1 — Tax Returns (Form 1040, 1040A, 1120, etc.)

5.1.1 Acceptable Forms

Tax forms (such as Forms 1040, 1040A, and 1120) require a signature and establish tax liability. Computer-generated versions are acceptable under the following conditions:

- These substitute forms must be printed on plain white paper.
- Substitute forms must conform to the physical layout of the corresponding IRS form although the typeface may differ. The text should match the text on the officially published form as closely as possible. Condensed text and abbreviations will be considered on a case-by-case basis.

Caution: All jurat (perjury statements) must be reproduced verbatim. No text can be added, deleted, or changed in meaning.

- Various computer-graphic print media such as laser printing, inkjet printing, etc., may be used to produce the substitute forms.
- The substitute form must be the same number of pages and contain the same line text as the official form.
- All substitute forms must be submitted for approval prior to their original use. You do not need approval for a substitute form if its only change is the preprinted year and you had received a prior year approval letter.

Exception: *If the approval letter specifies a one-time exception for your form, the next year's form must be approved.*

5.1.2 Prohibited Forms

The following are prohibited:

- Computer-generated tax forms (*e.g.*, Form 1040, etc.) on lined or color barred paper.
 - Tax forms that differ from the official IRS forms in a manner that makes them non-standard or that we are unable to process them.
-

5.1.3 Changes Permitted to Forms 1040 and 1040A

Certain changes (listed in Sections 5.2 through 5.4) are permitted to the graphics of the form without prior approval, but these changes apply to only acceptable preprinted forms. Changes not requiring prior approval are good only for the annual filing period, which is the current tax year. Such changes are valid in subsequent years only if the official form does not change.

5.1.4 Other Changes Not Listed

All changes not listed in Sections 5.2 through 5.4 require approval from the IRS **before** the form can be filed.

Section 5.2 — Changes Permitted to Graphics (Forms 1040A and 1040)

5.2.1 Adjustments

You may make minor vertical and horizontal spacing adjustments to allow for computer or word-processing printing. This includes widening the amount columns or tax entry areas if the adjustments comply with other provisions stated in revenue procedures. No prior approval is needed for these changes.

5.2.2 Name and Address Area

The horizontal rules and instructions within the name and address area may be removed and the entire area left blank. No line or instruction can remain in the area. However, the statement regarding use of the IRS label should be retained. The heavy ruled border (when present) that

outlines the name, address area, and social security number must not be removed, relocated, expanded, or contracted.

5.2.3 Required Format

When the name and address area is left blank, the following format must be used when printing the taxpayer's name and address. Otherwise, unless the taxpayer's preprinted label is affixed over the information entered in this area, the lines must be filled in as shown:

- 1st name line (35 characters maximum).
 - 2nd name line (35 characters maximum).
 - In-care-of name line (35 characters maximum).
 - City, state (25 characters maximum), one blank character, & ZIP code.
-

5.2.4 Conventional Name and Address Data

When there is no in-care-of name line, the name and address will consist of only three lines (single filer) or four lines (joint filer). Name and address (joint filer) with no in-care-of name line:

JOHN Z. JONES
MARY I. JONES
1234 ANYWHERE ST., APT. 111
ANYTOWN, STATE 12321

5.2.5 Example of In-Care-Of Name Line

Name and address (single filer) with in-care-of name line:

JOHN Z. JONES
C/O THOMAS A. JONES
4311 SOMEWHERE AVE.
SAMETOWN, STATE 54345

5.2.6 SSN and Employer Identification Number (EIN) Area

The vertical lines separating the format arrangement of the SSN/EIN may be removed. When the vertical lines are removed, the SSN and EIN formats must be 000-00-0000 or 00-0000000, respectively.

5.2.7 Cents Column

- You may remove the vertical rule that separates the dollars from the cents.
 - All entries in the amount column should have a decimal point following the whole dollar amounts whether or not the vertical line that separates the dollars from the cents is present.
 - You may omit printing the cents, but all amounts entered on the form must follow a consistent format. You are strongly urged to round off the figures to whole dollar amounts, following the official form instructions.
 - When several amounts are summed together, the total should be rounded off after addition (*i.e.*, individual amounts should not be rounded off for computation purposes).
 - When printing money amounts, you must use one of the following ten-character formats: (a) 0,000,000.; (b) 0,000,000.00
 - When there is no entry for a line, leave the line blank.
-

5.2.8 "Paid Preparer's Use Only" Area

On all forms, the paid preparer's information area may not be rearranged or relocated. You may add three lines and remove the horizontal rules in the preparer's address area.

Section 5.3 — Changes Permitted to Form 1040A Graphics

5.3.1 General

No prior approval is needed for the following changes (for use with computer-prepared forms only).

5.3.2 Line 4 of Form 1040A

This line may be compressed horizontally (to allow for same line entry for the name of the qualifying child) by using the following caption: "Head of household; child's name" (name field).

5.3.3 Other Lines

Any line with text that takes up two or more vertical lines may be compressed to one line by using contractions, etc., and by removing instructional references.

5.3.4 Page 2 of Form 1040A

All lines must be present and numbered in the order shown on the official form. These lines may also be compressed.

5.3.5 Color Screening

It is not necessary to duplicate the color screening used on the official form. A substitute Form 1040A may be printed in black and white only with no color screening.

5.3.6 Other Changes Prohibited

No other changes to the Form 1040A graphics are allowed without prior approval except for the removal of instructions and references to instructions.

Section 5.4 — Changes Permitted to Form 1040 Graphics

5.4.1 General

No prior approval is needed for the following changes (for use with computer-prepared forms only). Specific line numbers in the following headings may have changed due to tax law changes.

5.4.2 Line 4 of Form 1040

This line may be compressed horizontally (to allow for a larger entry area for the name of the qualifying child) by using the following caption: "Head of household; child's name" (name field).

5.4.3 Line 6c of Form 1040

The vertical lines separating columns (1) through (4) may be removed. The captions may be shortened to allow a one-line caption for each column.

5.4.4 Other Lines

Any other line with text that takes up two or more vertical lines may be compressed to one line by using contractions, etc., and by removing instructional references.

5.4.5 Line 21—Other Income

The fill-in portion of this line may be expanded vertically to three lines. The amount entry box must remain a single entry.

5.4.6 Line 42 of Form 1040—Tax

You may change the line caption to read "Tax" and computer print the words "Total includes tax from" and either "Form(s) 8814" or "Form 4972." If both forms are used, print both form numbers. This specific line number may have changed.

5.4.7 Line 53 of Form 1040

You may change the caption to read: "Other credits from Form" and computer-print only the form(s) that apply.

5.4.8 Color Screening

It is not necessary to duplicate the color screening used on the official form. A substitute Form 1040 may be printed in black and white only with no color screening.

5.4.9 Other Changes Prohibited

No other changes to the Form 1040 graphics are permitted without prior approval except for the removal of instructions and references to instructions.

Part 6 Format and Content of Substitute Returns

Section 6.1 — Acceptable Formats for Substitute Forms and Schedules

6.1.1 Exhibits and Use of Acceptable Formats

Exhibits of acceptable formats for the schedules (A and B) usually attached to the Form 1040 and Form 2106-EZ are shown in the exhibits section of this revenue procedure.

- If your computer-generated forms appear exactly like the exhibits, no prior authorization is needed.
 - You may computer-generate forms not shown here, but you must design them by following the manner and style of those in the exhibits section. Take care to observe other requirements and conditions in this revenue procedure. The IRS encourages the submission of all proposed forms covered by this revenue procedure.
-

6.1.2 Instructions

The format of each substitute form or schedule must follow the format of the official form or schedule as to item captions, line references, line numbers, sequence, form arrangement and format, etc. Basically, try to make the form look like the official one, with readability and consistency being primary factors. You may use periods and/or other similar special characters to separate the various parts and sections of the form. **DO NOT** use alpha or numeric characters for these purposes. With the exceptions described in paragraph 6.1.3, all line numbers and items must be printed even though an amount is not entered on the line.

6.1.3 Line Numbers

When a line on an official form is designated by a number or a letter, that designation (reference code) must be used on a substitute form. The reference code must be printed to the left of the text of each line and immediately preceding the data entry field, even if no reference code precedes the data entry field on the official form. If an entry field contains multiple lines and shows the line references once on the left and right side of the form, use the same number of line references on the substitute form.

In addition, the reference code that is immediately before the data field must either be followed by a period or enclosed in parentheses. There also must be at least two blank spaces between the period or the right parenthesis and the first digit of the data field. (See example below.)

6.1.4 Decimal Points

A decimal point (*i.e.*, a period) should be used for each money amount regardless of whether the amount is reported in dollars and cents or in whole dollars, or whether or not the vertical line that separates the dollars from the cents is present. The decimal points must be vertically aligned when possible.

Example:

5 STATE & LOCAL INC. TAXES.....5. 495.00
6 REAL ESTATE TAXES.....6.
7 PERSONAL PROPERTY TAXES.....7. 198.00
or
5 STATE & LOCAL INC. TAXES.....(5) 495.00
6 REAL ESTATE TAXES.....(6)
7 PERSONAL PROPERTY TAXES.....(7) 198.00

6.1.5 Multi-Page Forms

When submitting a multi-page form, send all its pages in the same package. If you are not producing certain pages, please note that in your cover letter.

Section 6.2 — Additional Instructions for All Forms

6.2.1 Use of Your Own Internal Control Numbers and Identifying Symbols

You may show the computer prepared internal control numbers and identifying symbols on the substitute if using such numbers or symbols is acceptable to the taxpayer and the taxpayer's representative. Such information must not be printed in the top 1/2 inch clear area of any form or schedule requiring a signature. Except for the actual tax return form (Forms 1040, 1120, 940, 941, etc.), you may print in the left vertical and bottom left margins. The bottom left margin you may use extends 3 1/2 inches from the left edge of the form.

6.2.2 Descriptions for Captions, Lines, etc.

Descriptions for captions, lines, etc., appearing on the substitute forms may be limited to one print line by using abbreviations and contractions, and by omitting articles, prepositions, etc. However, sufficient key words must be retained to permit ready identification of the caption, line, or item.

6.2.3 Determining Final Totals

Explanatory detail and/or intermediate calculations for determining final line totals may be included on the substitute. We prefer that such calculations be submitted in the form of a supporting statement. If intermediate calculations are included on the substitute, the line on which they appear may not be numbered or lettered. Intermediate calculations may not be printed in the right column. This column is reserved only for official numbered and lettered lines that correspond to the ones on the official form. Generally, you may choose the format for intermediate calculations or subtotals on supporting statements to be submitted.

6.2.4 Instructional Text on the Official Form

Text on the official form, which is solely instructional (e.g., "Attach this schedule to Form 1040," "See instructions," etc.), may generally be omitted from the substitute form.

6.2.5 Mixing Forms on the Same Page Prohibited

You may not show more than one form or schedule on the same printout page. Both sides of the paper may be printed for multi-page official forms, but it is unacceptable to intermix single-page schedules of forms except for Schedules A and B (Form 1040), which are printed back to back by the IRS.

For instance, Schedule E can be printed on both sides of the paper because the official form is multi-page, with page 2 continued on the back. However, do not print Schedule E on the front page and Schedule SE on the back, or Schedule A on the front and Form 8615 on the back, etc. Both pages of a substitute form must match the official form. The back page may be left blank if the official form contains only the instructions.

6.2.6 Identifying Substitutes

Identify all computer-prepared substitutes clearly. Print the form designation 1/2 inch from the top margin and 1 1/2 inches from the left margin. Print the title centered on the first line of

print. Print the taxable year and, where applicable, the sequence number on the same line 1/2 inch to 1 inch from the right margin. Include the taxpayer's name and SSN on all forms and attachments. Also, print the OMB number as reflected on the official form.

6.2.7 Negative Amounts

Negative (or loss) amount entries should be enclosed in brackets or parentheses or include a minus sign. This assists in accurate computation and input of form data. The IRS preprints parentheses in negative data fields on many official forms. These parentheses should be retained or inserted on affected substitute forms.

Part 7 Miscellaneous Forms and Programs

Section 7.1 — Specifications for Substitute Schedules K-1

7.1.1 Requirements for Schedules K-1 That Accompany Forms 1041, 1065, 1065-B, and 1120S

Prior approval is not required for substitute Schedules K-1 that accompany Form 1041 (for estates and trusts), Form 1065 (for partnerships), Form 1065-B (for electing large partnerships), or Form 1120S (for S corporations) if they are exact copies of the official IRS schedules or exact copies that contain only those lines that taxpayers are required to use. Schedules that are 2-D bar-coded require prior approval (See Sections 7.1.3 through 7.1.5). Schedules K-1 that accompany Forms 1041, 1065, 1065-B, or 1120S must meet all of the following requirements:

- The Schedule K-1 must contain the name, address, and SSN or EIN of both the entity (estate, trust, partnership, or S corporation) and the recipient (beneficiary, partner, or shareholder).
 - The Schedule K-1 must contain the tax year, the OMB number, the schedule number (K-1), the related form number (1041, 1065, 1065-B, or 1120S), and the official schedule name in substantially the same position and format as shown on the official IRS schedule.
 - The Schedule K-1 must contain all the items required for use by the recipient.
 - The line items that are used must be in the same order and arrangement as those on the official form.
 - Each recipient's information must be on a separate sheet of paper. Therefore, all continuously-printed substitutes must be separated, by recipient, before filing with the IRS.
 - The amount of each recipient's share of each line item must be shown. Furnishing a total amount of each line item and a percentage (or decimal equivalent) to be applied to such total amount by the recipient does not satisfy the law and the specifications of this revenue procedure.
 - State or local tax-related information may not be included on the Schedules K-1 filed with the IRS.
 - The entity may have to pay a penalty if substitute Schedules K-1 are filed that do not conform to the above specifications. In addition, the IRS may consider the Schedules K-1 as not processable and return Forms 1041, 1065, 1065-B, or 1120S to the entity to be filed correctly.
-

7.1.2 Special Requirements for Recipient Copies of Schedules K-1

Increased standardization for reporting information is now required for recipient copies of substitute Schedules K-1 of Forms 1041, 1065, 1065-B, and 1120S. The more uniform visual standards are provided to increase compliance by allowing recipients to more easily recognize a substitute Schedule K-1. The entity must furnish to each recipient a copy of Schedule K-1 that meets the following requirements:

- The Schedule K–1 must contain the name, address, and SSN or EIN of both the entity and recipient.
- The Schedule K–1 must contain the tax year, the OMB number, the schedule number (K–1), the related form number (1041, 1065, 1065–B, or 1120S), and the official schedule name in substantially the same position and format as shown on the official IRS schedule.
- All applicable amounts and information required to be reported must be titled and numbered in the same manner as shown on the official IRS schedule. Line numbers are to be shown in the same order as those on the official schedule.
- The Schedule K–1 must contain all items required for use by the recipient, but line items that are not required for the particular recipient may be omitted. If line items are omitted or skipped, the remaining line items must be labeled in the same manner and shown in the same order as they are on the official IRS schedule. The instructions to the schedule must clearly indicate that the number and order of the items relate to the official IRS schedule.
- The amount of each recipient’s share of each line item must be shown. Furnishing a total amount of each line item and a percentage (or decimal equivalent) to be applied to such total amount by the recipient does not satisfy the law and the specifications of this revenue procedure.
- Instructions to the recipient that are substantially similar to those on the official IRS schedule must be provided to aid in the proper reporting of the items on the recipient’s income tax return. Where items have been omitted because they are not required for use by a recipient, the related instructions may also be omitted.
- The quality of the ink or other material used to generate recipients’ schedules must produce clearly legible documents. In general, black chemical transfer inks are preferred.
- In order to assure uniformity of substitute Schedules K–1, the paper size must fall within the following dimensions:
 - Minimum dimensions: 8.5” x 3.67”
 - Maximum dimensions: 8.5” x 11” (The international standard (A4) of 8.27” x 11.69” may be substituted for the maximum dimensions.)
- The paper weight, paper color, font type, font size, font color, and page layout must be such that the average recipient can easily decipher the information on each page.
- Entity logos are permitted on substitute Schedules K–1 provided the placement of the logos does not interfere with the purpose of the schedules.
- State or local tax-related information may be included on a substitute Schedule K–1. All non-tax-related information should be separated from the tax information on the substitute schedule to avoid confusion for the recipient.
- The legend “Important Tax Return Document Enclosed” must appear in a bold and conspicuous manner on the outside of the envelope that contains the substitute recipient copy of Schedule K–1.
- The entity may have to pay a penalty if a substitute Schedule K–1 furnished to any recipient does not conform to the specifications of this revenue procedure.

7.1.3 Requirements For Schedules K–1 with Two-Dimensional (2-D) Bar Codes

In an effort to reduce the burden of manually transcribing tax documents, improve quality, and increase government efficiency, the IRS is pleased to introduce specifications for 2-D bar-coded substitute Schedules K–1 for **Forms 1041, 1065, and 1120S**. The Service encourages voluntary participation in adding 2-D bar-coding. See Exhibits F, G, and H for examples of draft bar-coded Schedules K–1.

***Note:** If software vendors do not want to produce bar-coded Schedules K–1, they may produce the official IRS Schedules K–1 without leaving a space for bar-codes and without using the expedited process for approving bar-coded K–1’s and their parent returns as outlined in Section 7.1.5.*

In addition to the above requirements, the bar-coded Schedules K-1 must meet the following specifications.

- The bar code should print in the space labeled “For Official Use Only” in the upper right corner of the schedule. The entire bar code must print within the “For Official Use Only” box surrounded by a white space of at least 1/4-inch.
- Bar codes will print in PDF 417 format.
- Although substitute Schedules K-1 generally allow omitting unused lines, the bar codes must always be in the specified format with every field represented by at least a field delimiter (carriage return). Leaving out a field in a bar code will cause every subsequent field to be misread.

7.1.4 Approval Process for Bar-Coded Schedules K-1

Prior to releasing commercially available tax software that creates bar-coded Schedules K-1, the printed schedule and the bar code must both be tested. Bar code testing must be done using the final official IRS Schedule K-1. **Bar code approval requests must be resubmitted for any subsequent changes to the official IRS form that would affect the bar-code.** Below are instructions and a sequence of events that will comprise the testing process.

- The IRS will release the final Schedule K-1 bar-code specifications in a news release or in the Internal Revenue Bulletin. The exact release or bulletin number will be determined after this revenue procedure is published.
- The IRS will publish a set of test documents (based on e-File PATS) that will be used to test the ability of tax preparation software to create bar codes in the correct format.
- Software developers will submit two identical copies of the test documents — one to the IRS and one to a contracted testing vendor.
- The IRS will use one set to ensure the printed schedules comply with standard substitute forms specifications.
 - If the printed forms fail to meet the substitute form criteria, the IRS will inform the software developer of the reason for non-compliance.
 - The software developer must resubmit the Schedule(s) K-1 until they pass the substitute forms criteria.
- The testing vendor will review the bar codes to ensure they meet the published bar-code specifications.
 - If the bar code(s) does not meet published specifications, the testing vendor will contact the software developer directly informing them of the reason for noncompliance.
 - Software developers must submit new bar-coded schedules until they pass the bar-code test.
 - When the bar code passes, the testing vendor will inform the IRS that the developer has passed the bar-code test and the IRS will issue an overall approval for both the substitute form and the bar-code.
- After receiving this consolidated response, the software vendor is free to release software for tax preparation as long as any subsequent revisions to the schedules do not change the fields.
- The mailing address for the testing vendor will be supplied in the news release or Internal Revenue Bulletin as mentioned above. Separate mailings to the IRS and the vendor will reduce testing time.

7.1.5 Procedures for Reducing Testing Time

In order to help provide incentives to the software development community to participate in the Schedule K-1 2-D project, the IRS has committed to expedite the testing of bar-coded Schedules K-1 and their associated parent returns. To receive this expedited service, closely follow the bullets below.

- Mail the parent returns (Forms 1065, 1120S, 1041) and associated bar-coded Schedule(s) K-1 to the address below in a package separate from all other approval requests.

Internal Revenue Service
 Attn: Bar-Coded K-1
 W:CAR:MP:T:T:SP
 1111 Constitution Avenue, NW
 Room 6411
 Washington, D.C. 20224

- While the IRS can expedite bar-coded Schedules K-1 and their associated parent returns, it cannot expedite the approval of non-associated tax returns.
- Mail one copy of the parent form(s) and Schedule(s) K-1 to the IRS and a copy of the bar-coded Schedule(s) K-1 only to the testing vendor.
- Include multiple e-mail and phone contact points in the packages.

Section 7.2 — Procedures for Printing IRS Envelopes

7.2.1 Procedures for Printing IRS Envelopes

Organizations are permitted to produce substitute tax return envelopes. Use of substitute return envelopes that comply with the requirements set forth in this section will assist in delivery of mail by the U.S. Postal Service and facilitate internal sorting at the Internal Revenue Service Centers.

Use the following five-digit ZIP codes when mailing returns to the IRS Service Centers:

Service Center	ZIP Code
Atlanta, GA	39901
Kansas City, MO	64999
Austin, TX	73301
Philadelphia, PA	19255
Memphis, TN	37501
Andover, MA	05501
Cincinnati, OH	45999
Holtsville, NY	00501
Ogden, UT	84201
Fresno, CA	93888

7.2.2 Sorting Returns by Form Type

Sorting returns by form type is accomplished by the preprinted bar codes on return envelopes included in each specific type of form or package mailed to the taxpayers. The 32 bit bar code on the left of the address on each envelope identifies the type of form the taxpayer is filing, and it assists in consolidating like returns for processing. Failure to use the envelopes furnished by the IRS results in additional processing time and effort, and possibly delays the timely deposit of funds, processing of returns, and issuance of refund checks.

7.2.3 ZIP+4 or 9-Digit ZIP Codes

The IRS will not furnish or sell bulk quantities of preprinted tax return envelopes to taxpayers or tax practitioners. A suitable alternative has been developed that will accommodate the sorting needs of both the IRS and the United States Postal Service (USPS). The alternative is

based on the use of ZIP + 4, or 9-digit ZIP codes for mailing various types of tax returns to the IRS Service Centers. The IRS uses the last four digits to identify and sort the various form types into separate groups for processing. The list of 4-digit extensions with the related form designations is provided below.

ZIP+FOUR	Package
XXXXX-0002	1040
XXXXX-0005	941
XXXXX-0006	940
XXXXX-0008	943
XXXXX-0011	1065
XXXXX-0012	1120
XXXXX-0013	1120S
XXXXX-0014	1040EZ
XXXXX-0015	1040A
XXXXX-0027	990
XXXXX-0031	2290

7.2.4 Guidelines for Having Envelopes Preprinted

You may use the preparer's company names, addresses, and logos as long as you do not interfere with the clear areas. The government recommends that the envelope stocks have an average opacity of not less than 89 percent and contain a minimum of 50 percent waste paper. Use of carbon based ink is essential for effective address and bar-code reading. Envelope construction can be of side seam or diagonal seam design. The government recommends that the size of the envelope should be 5³/₄ inches by 9 inches. Continuous pin-fed construction is not desirable but is permissible if the glued edge is at the top. This requirement is firm because mail opening equipment is designed to open the bottom edge of each envelope.

7.2.5 Envelopes/ZIP Codes

The above procedures or guidelines are written for the user having envelopes preprinted. Many practitioners may not wish to have large quantities of envelopes with differing ZIP codes/form designations preprinted due to low volume, warehousing, waste, etc. In this case, the practitioner can type or machine print the addresses with the appropriate ZIP codes to accommodate sorting. If the requirements/guidelines outlined in this section cannot be met, then use only the appropriate five-digit service center ZIP code.

Section 7.3 — Procedures for Substitute Forms 5471 and 5472

7.3.1 Forms 5471 and 5472

This section covers instructions for producing substitutes for:

- Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*, and accompanying Schedules J, M, N, and O.
- Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*.

7.3.2 Paper and Computer-Generated Substitutes

Substitutes for Form 5471 and the accompanying Schedules J, M, N, and O, and Form 5472 that totally conform to the specifications contained in this procedure may be privately printed, but must have prior approval and are subject to annual review from the IRS.

7.3.3 Where to get the Official Forms

Copies of the official Forms 5471 and 5472 for the reporting year may be obtained from most IRS offices. The IRS provides only cut sheets of these forms.

7.3.4 Quality Substitute Forms

The IRS will accept quality substitute tax forms that are consistent with the official forms they represent AND that do not have an adverse impact on processing. Therefore, only those substitute forms that conform to, and do not deviate from, the corresponding official forms are acceptable.

7.3.5 Computer-Prepared Tax Forms

If the substitute returns and schedules meet the guidelines in this revenue procedure, the IRS will (for filing purposes) accept computer-prepared Forms 5471 and 5472 filled in by a computer, word processor, or similar automated equipment. The IRS will also accept a combination of computer-prepared/generated and filled-in information. They may be filed separately or attached to individual or business income tax returns.

7.3.6 Format Arrangement

The specifications for Forms 5471 and 5472 are as follows:

- The substitute must follow the design of the official form as to format, arrangement, item caption, line numbers, line references, and sequence. It must be an exact textual and graphic mirror image of the official form.
 - The filer must use one of the official ten character amount formats. All entries in the amount column should have a decimal point following the whole dollar amounts whether or not the vertical line that separates the dollars from the cents is present. It must follow a consistent format.
 - The reference code must be printed to the left of the corresponding captioned line and also immediately preceding the data entry field even if there is no reference code preceding the data entry field on the official form. The reference code that is immediately before the data field must either be followed by a period or enclosed in parentheses. There also must be at least two blank spaces between the period or the right parenthesis and the first digit of the data field.
 - The size of the page must be the same as the official form (8½" x 11").
 - The acceptable type is Helvetica.
 - The spacing of the type must be 6 lines per inch vertically, 10 or 12 print characters per inch horizontally.
 - A ¼ inch to ½ inch margin must be maintained across the top, bottom, and both sides.
 - The substitute form must be the same number of pages as the official one.
 - The preprinted parentheses in the money fields should be retained.
 - The filer must completely fill in all the specified numbers or referenced lines as they appear on the official form (not just totals) before attaching any supporting statement.
 - Supporting statements are never to be used until the required official form they support are completely filled in. A blank or incomplete form that refers to a supporting statement, in lieu of completing a tax return, is unacceptable.
 - Descriptions for captions, lines, etc., appearing in the substitute forms may be limited to one print line by using abbreviations and contractions, and by omitting articles, prepositions, etc. However, sufficient key words must be retained to permit ready identification of the caption, line, or item.
 - Text prescribed for the official form, which is solely instructional (*e.g.*, "Attach this schedule to Form 1120," "See instructions", etc.) may be omitted from the form.
-

7.3.7 Filing Instructions

Instructions for filing substitute forms are the same as for filing official forms.

Part 8 Alternative Methods of Filing

Section 8.1 — Forms for Electronically Filed Returns

8.1.1 Electronic Filing Program

Electronic filing is a method by which qualified filers transmit tax return information directly to an IRS Service Center over telephone lines in the format of the official IRS forms. The IRS accepts both refund and balance due individual tax returns that are filed electronically.

8.1.2 Applying for the Electronic Filing Program

Anyone wishing to participate in the IRS *e-file* program for individual income tax returns must submit a Form 8633, Application to Participate in the IRS *e-file* Program.

Note: For business returns, prospective participants must submit a Form 9041, Application for Electronic/Magnetic Media Filing of Business Returns.

8.1.3 Mailing Instructions

IF an application filed is...	THEN mail it to...
Form 8633 for individual income taxes (regular mail)	Internal Revenue Service Andover Submission Processing Center Attn: EFU Acceptance – Testing Stop 983 P.O. Box 4099 Woburn, MA 01888-4099
Form 8633 for individual income taxes (overnight mail)	Internal Revenue Service Andover Submission Processing Center Attn: EFU Acceptance – Testing Stop 983 310 Lowell Street Andover, MA 05501-0001
Form 9041 for Forms 940, 941, and 1065	Internal Revenue Service Austin Submission Processing Center Attn: EFU, Stop 6380 P.O. Box 1231 Austin, TX 78767
Form 9041 for Forms 1041	Internal Revenue Service Philadelphia Submission Processing Center Attn: DP 2720 11601 Roosevelt Blvd. Philadelphia, PA 19154

8.1.4 Obtaining the Taxpayer Signature

Form 8453, U. S. Individual Income Tax Declaration for an IRS *e-file* Return, is the signature document for an electronically filed 1040, 1040A, or 1040EZ return not filed with an electronic signature. Form 8453, which serves as a transmittal for associated non-electronic (paper) documents, such as Forms 3115, 5713, 8283, 8332, and 8609, is a one-page form and can only be approved through the Substitute Forms Program in that format. Forms 8453–OL and 8453–NR serve the same purpose for taxpayers filing through online services and Form 1040–NR filers, respectively. For specific information about electronic filing, refer to Publication 1345, *Handbook for Electronic Filers of Individual Income Tax returns*.

**8.1.5 Guidelines for
Preparing Substitute Forms in the
Electronic Filing Program**

A participant in the electronic filing program, who wants to develop a substitute form should follow the guidelines throughout this publication and send a sample form for approval to the Substitute Forms Unit at the address in Part 1. If you do not prepare Substitute Form 8453 using a font in which all IRS wording fits on a single page, the form will not be accepted.

Note: *Use of unapproved forms could result in suspension of the participant from the electronic filing program.*

Section 8.2 — Effect on Other Documents

**8.2.1 Effect on Other
Documents**

This revenue procedure supersedes Revenue Procedure 2002–60, I.R.B. 2002–40, 645.

Exhibit A-1 (Preferred Format)

SCHEDULES A&B
(Form 1040)

Schedule A—Itemized Deductions

OMB No. 1545-0074

(Schedule B is on back)

2002

Department of the Treasury
Internal Revenue Service

▶ **Attach to Form 1040.** ▶ See instructions for Schedules A and B (Form 1040).

Attachment
Sequence No. **07**

Name(s) shown on Form 1040

Your social security number

Medical and Dental Expenses	Caution. Do not include expenses reimbursed or paid by others.			
1	Medical and dental expenses (see page A-2)	1		
2	Enter amount from Form 1040, line 36 2 			
3	Multiply line 2 by 7.5% (.075).	3		
4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-			4
Taxes You Paid	5 State and local income taxes	5		
(See page A-2.)	6 Real estate taxes (see page A-2)	6		
	7 Personal property taxes	7		
	8 Other taxes. List type and amount ▶	8		
	9 Add lines 5 through 8			9
Interest You Paid	10 Home mortgage interest and points reported to you on Form 1098	10		
(See page A-3.)	11 Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-3 and show that person's name, identifying no., and address ▶			
	12 Points not reported to you on Form 1098. See page A-3 for special rules	12		
Note. Personal interest is not deductible.	13 Investment interest. Attach Form 4952 if required. (See page A-3.)	13		
	14 Add lines 10 through 13			14
Gifts to Charity	15 Gifts by cash or check. If you made any gift of \$250 or more, see page A-4	15		
If you made a gift and got a benefit for it, see page A-4.	16 Other than by cash or check. If any gift of \$250 or more, see page A-4. You must attach Form 8283 if over \$500	16		
	17 Carryover from prior year	17		
	18 Add lines 15 through 17			18
Casualty and Theft Losses	19 Casualty or theft loss(es). Attach Form 4684. (See page A-5.)			19
Job Expenses and Most Other Miscellaneous Deductions	20 Unreimbursed employee expenses—job travel, union dues, job education, etc. You must attach Form 2106 or 2106-EZ if required. (See page A-5.) ▶			
(See page A-5 for expenses to deduct here.)	21 Tax preparation fees	21		
	22 Other expenses—investment, safe deposit box, etc. List type and amount ▶	22		
	23 Add lines 20 through 22	23		
	24 Enter amount from Form 1040, line 36 24 			
	25 Multiply line 24 by 2% (.02)	25		
	26 Subtract line 25 from line 23. If line 25 is more than line 23, enter -0-			26
Other Miscellaneous Deductions	27 Other—from list on page A-6. List type and amount ▶			27
Total Itemized Deductions	28 Is Form 1040, line 36, over \$137,300 (over \$68,650 if married filing separately)? <input type="checkbox"/> No. Your deduction is not limited. Add the amounts in the far right column for lines 4 through 27. Also, enter this amount on Form 1040, line 36. <input type="checkbox"/> Yes. Your deduction may be limited. See page A-6 for the amount to enter.			28

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Schedule A (Form 1040) 2002

Exhibit A-2 (Acceptable Format)

SCHEDULES A&B
(Form 1040)

Department of the Treasury
Internal Revenue Service

Schedule A—Itemized Deductions

(Schedule B is on back)

► **Attach to Form 1040.** ► **See Instructions for Schedules A and B (Form 1040).**

OMB No. 1545-0074

2002

Attachment
Sequence No. **07**

Name(s) shown on Form 1040

Your social security number

Medical and Dental Expenses	Caution. Do not include expenses reimbursed or paid by others.			
1	Medical and dental expenses (see page A-2)			
2	Enter amount from Form 1040, line 36	2		
3	Multiply line 2 by 7.5% (.075)			
4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-			4
Taxes You Paid	5 State and local income taxes	5		
(See page A-2.)	6 Real estate taxes (see page A-2)	6		
	7 Personal property taxes	7		
	8 Other taxes. List type and amount ►	8		
	9 Add lines 5 through 8			9
Interest You Paid	10 Home mortgage interest and points reported to you on Form 1098	10		
(See page A-3.)	11 Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-3 and show that person's name, identifying no., and address ►			
		11		
Note. Personal interest is not deductible.	12 Points not reported to you on Form 1098. See page A-3 for special rules	12		
	13 Investment interest. Attach Form 4952 if required. (See page A-3.)	13		
	14 Add lines 10 through 13			14
Gifts to Charity	15 Gifts by cash or check. If you made any gift of \$250 or more, see page A-4	15		
If you made a gift and got a benefit for it, see page A-4.	16 Other than by cash or check. If any gift of \$250 or more, see page A-4. You must attach Form 8283 if over \$500	16		
	17 Carryover from prior year	17		
	18 Add lines 15 through 17			18
Casualty and Theft Losses	19 Casualty or theft loss(es). Attach Form 4684. (See page A-5.)			19
Job Expenses and Most Other Misc. Deductions	20 Unreimbursed employee expenses—job travel, union dues, job education, etc. You must attach Form 2106 or 2106-EZ if required. (See page A-5.) ►			
(See page A-5 for expenses to deduct here.)	21 Tax preparation fees	21		
	22 Other expenses—investment, safe deposit box, etc. List type and amount ►	22		
	23 Add lines 20 through 22	23		
	24 Enter amount from Form 1040, line 36	24		
	25 Multiply line 24 by 2% (.02)	25		
	26 Subtract line 25 from line 23. If line 25 is more than line 23, enter -0-			26
Other Misc. Deductions	27 Other—from list on page A-6. List type and amount ►			27
Total Itemized Deductions	28 Is Form 1040, line 36, over \$137,300 (over \$68,650 if married filing separately)?			
	<input type="checkbox"/> No. Your deduction is not limited. Add the amounts in the far right column for lines 4 through 27. Also, enter this amount on Form 1040, line 36.			28
	<input type="checkbox"/> Yes. Your deduction may be limited. See page A-6 for the amount to enter.			

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Schedule A (Form 1040) 2002

Exhibit B-1 (Preferred Format)

Name(s) shown on Form 1040. Do not enter name and social security number if shown on other side.

Your social security number

Schedule B—Interest and Ordinary Dividends

Attachment
 Sequence No. **08**

		Amount	
Part I Interest (See page B-1 and the instructions for Form 1040, line 8a.) Note. If you received a Form 1099-INT, Form 1099-OID, or substitute statement from a brokerage firm, list the firm's name as the payer and enter the total interest shown on that form.	1		
	2 Add the amounts on line 1	2	
	3 Excludable interest on series EE and I U.S. savings bonds issued after 1989 from Form 8815, line 14. You must attach Form 8815	3	
	4 Subtract line 3 from line 2. Enter the result here and on Form 1040, line 8a ▶	4	

Note. If line 4 is over \$1,500, you must complete Part III.

		Amount	
Part II Ordinary Dividends (See page B-1 and the instructions for Form 1040, line 9.) Note. If you received a Form 1099-DIV or substitute statement from a brokerage firm, list the firm's name as the payer and enter the ordinary dividends shown on that form.	5		
	6 Add the amounts on line 5. Enter the total here and on Form 1040, line 9 ▶	6	

Note. If line 6 is over \$1,500, you must complete Part III.

Part III Foreign Accounts and Trusts (See page B-2.)	You must complete this part if you (a) had over \$1,500 of taxable interest or ordinary dividends; OR (b) had a foreign account; or (c) received a distribution from, or were a grantor of, or a transferor to, a foreign trust.			
	7a	At any time during 2002, did you have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account? See page B-2 for exceptions and filing requirements for Form TD F 90-22.1	Yes	No
	7b	If "Yes," enter the name of the foreign country ▶	Yes	No
8	During 2002, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," you may have to file Form 3520. See page B-2	Yes	No	

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Schedule B (Form 1040) 2002

Exhibit B-2 (Acceptable Format)

Name(s) shown on Form 1040. Do not enter name and social security number if shown on other side.

Your social security number

Schedule B—Interest and Ordinary Dividends

Attachment Sequence No. **08**

Part I Interest

(See page B-1 and the instructions for Form 1040, line 8a.)

Note. If you received a Form 1099-INT, Form 1099-OID, or substitute statement from a brokerage firm, list the firm's name as the payer and enter the total interest shown on that form.

1 List name of payer. If any interest is from a seller-financed mortgage and the buyer used the property as a personal residence, see page B-1 and list this interest first. Also, show that buyer's social security number and address ►

.....

Amount	
1	
2	
3	
4	

2 Add the amounts on line 1 **2**

3 Excludable interest on series EE and I U.S. savings bonds issued after 1989 from Form 8815, line 14. You must attach Form 8815 **3**

4 Subtract line 3 from line 2. Enter the result here and on Form 1040, line 8a ► **4**

Note. If line 4 is over \$1,500, you must complete Part III.

Part II Ordinary Dividends

(See page B-1 and the instructions for Form 1040, line 9.)

Note. If you received a Form 1099-DIV or substitute statement from a brokerage firm, list the firm's name as the payer and enter the ordinary dividends shown on that form.

5 List name of payer. Include only ordinary dividends. If you received any capital gain distributions, see the instructions for Form 1040, line 13 ►

.....

Amount	
5	
6	

6 Add the amounts on line 5. Enter the total here and on Form 1040, line 9 . ► **6**

Note. If line 6 is over \$1,500, you must complete Part III.

Part III Foreign Accounts and Trusts

(See page B-2.)

You must complete this part if you **(a)** had over \$1,500 of taxable interest or ordinary dividends; OR **(b)** had a foreign account; or **(c)** received a distribution from, or were a grantor of, or a transferor to, a foreign trust.

- 7a** At any time during 2002, did you have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account? See page B-2 for exceptions and filing requirements for Form TD F 90-22.1
- b** If "Yes," enter the name of the foreign country ►
- 8** During 2002, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," you may have to file Form 3520. See page B-2

Yes	No
X	X
X	X

Exhibit C-1 (Preferred Format)

Form 2106-EZ Department of the Treasury Internal Revenue Service	Unreimbursed Employee Business Expenses ▶ Attach to Form 1040.	OMB No. 1545-1441 2002 Attachment Sequence No. 54A
Your name	Occupation in which you incurred expenses	Social security number

You May Use This Form Only if All of the Following Apply.

- You are an employee deducting ordinary and necessary expenses attributable to your job. An ordinary expense is one that is common and accepted in your field of trade, business, or profession. A necessary expense is one that is helpful and appropriate for your business. An expense does not have to be required to be considered necessary.
- You **do not** get reimbursed by your employer for any expenses (amounts your employer included in box 1 of your Form W-2 are not considered reimbursements).
- If you are claiming vehicle expense, you are using the standard mileage rate for 2002.

Caution: You can use the standard mileage rate for 2002 only if: (a) you owned the vehicle and used the standard mileage rate for the first year you placed the vehicle in service or (b) you leased the vehicle and used the standard mileage rate for the portion of the lease period after 1997.

Part I Figure Your Expenses

1 Vehicle expense using the standard mileage rate. Complete Part II and multiply line 8a by 36½¢ (.365)	1	
2 Parking fees, tolls, and transportation, including train, bus, etc., that did not involve overnight travel or commuting to and from work	2	
3 Travel expense while away from home overnight, including lodging, airplane, car rental, etc. Do not include meals and entertainment	3	
4 Business expenses not included on lines 1 through 3. Do not include meals and entertainment	4	
5 Meals and entertainment expenses: \$ _____ x 50% (.50) (Employees subject to Department of Transportation (DOT) hours of service limits: Multiply meal expenses by 65% (.65) instead of 50%. For details, see instructions.)	5	
6 Total expenses. Add lines 1 through 5. Enter here and on line 20 of Schedule A (Form 1040). (Fee-basis state or local government officials, qualified performing artists, and individuals with disabilities: See the instructions for special rules on where to enter this amount).	6	

Part II Information on Your Vehicle. Complete this part **only** if you are claiming vehicle expense on line 1.

- 7 When did you place your vehicle in service for business use? (month, day, year) ▶ _____ / _____ / _____
- 8 Of the total number of miles you drove your vehicle during 2002, enter the number of miles you used your vehicle for:
 a Business _____ b Commuting _____ c Other _____
- 9 Do you (or your spouse) have another vehicle available for personal use? Yes No
- 10 Was your vehicle available for personal use during off-duty hours? Yes No
- 11a Do you have evidence to support your deduction? Yes No
 b If "Yes," is the evidence written? Yes No

General Instructions

Section references are to the Internal Revenue Code.

Changes To Note

Standard mileage rate. The standard mileage rate has been increased to 36½ cents for each mile of business use in 2002.

Meal expenses. The percentage of meal expenses that may be deducted by employees subject to Department of Transportation (DOT) hours of service limits has been increased to 65% for 2002.

Purpose of Form

You may use Form 2106-EZ instead of Form 2106 to claim your unreimbursed employee business expenses if you meet all the requirements listed above Part I.

Recordkeeping

You cannot deduct expenses for travel (including meals, unless you used the standard meal allowance), entertainment,

gifts, or use of a car or other listed property, unless you keep records to prove the time, place, business purpose, business relationship (for entertainment and gifts), and amounts of these expenses. Generally, you must also have receipts for all lodging expenses (regardless of the amount) and any other expense of \$75 or more.

Additional Information

- For more details about employee business expenses, see:
Pub. 463, Travel, Entertainment, Gift, and Car Expenses
Pub. 529, Miscellaneous Deductions
Pub. 587, Business Use of Your Home (Including Use by Day-Care Providers)
Pub. 946, How To Depreciate Property

Specific Instructions

Part I—Figure Your Expenses

Line 2. See the line 8b instructions for the definition of commuting.

Line 3. Enter lodging and transportation expenses connected with overnight travel away from your tax home (defined below). You cannot deduct expenses for travel away from your tax home for any period of temporary employment of more than 1 year. **Do not** include expenses for meals and entertainment. For more details, including limits, see Pub. 463.

Generally, your **tax home** is your main place of business or post of duty regardless of where you maintain your family home. If you do not have a regular or main place of business because of the nature of your work, then your tax home is the place where you regularly live. If you do not fit in either of these categories, you are considered an itinerant and your tax home is wherever you work. As an itinerant, you are never away from home and cannot claim a travel expense deduction. For more details on your tax home, see Pub. 463.

Line 4. Enter other job-related expenses not listed on any other line of this form. Include expenses for business gifts, education (tuition and books), home office, trade publications,

For Paperwork Reduction Act Notice, see back of form.

Form **2106-EZ** (2002)

Exhibit C-2 (Acceptable Format)

Form **2106-EZ**

Unreimbursed Employee Business Expenses

OMB No. 1545-1441

2002

Department of the Treasury
Internal Revenue Service

▶ **Attach to Form 1040.**

Attachment
Sequence No. **54A**

Your name	Occupation in which you incurred expenses	Social security number : : :
-----------	---	---------------------------------------

You May Use This Form Only if All of the Following Apply.

- You are an employee deducting ordinary and necessary expenses attributable to your job. An ordinary expense is one that is common and accepted in your field of trade, business, or profession. A necessary expense is one that is helpful and appropriate for your business. An expense does not have to be required to be considered necessary.
- You **do not** get reimbursed by your employer for any expenses (amounts your employer included in box 1 of your Form W-2 are not considered reimbursements).
- If you are claiming vehicle expense, you are using the standard mileage rate for 2002.

Caution: You can use the standard mileage rate for 2002 only if: (a) you owned the vehicle and used the standard mileage rate for the first year you placed the vehicle in service or (b) you leased the vehicle and used the standard mileage rate for the portion of the lease period after 1997.

Part I Figure Your Expenses

1 Vehicle expense using the standard mileage rate. Complete Part II and multiply line 8a by 36½¢ (.365)	1	
2 Parking fees, tolls, and transportation, including train, bus, etc., that did not involve overnight travel or commuting to and from work	2	
3 Travel expense while away from home overnight, including lodging, airplane, car rental, etc. Do not include meals and entertainment	3	
4 Business expenses not included on lines 1 through 3. Do not include meals and entertainment	4	
5 Meals and entertainment expenses: \$ _____ x 50% (.50) (Employees subject to Department of Transportation (DOT) hours of service limits: Multiply meal expenses by 65% (.65) instead of 50%. For details, see instructions.)	5	
6 Total expenses. Add lines 1 through 5. Enter here and on line 20 of Schedule A (Form 1040). (Fee-basis state or local government officials, qualified performing artists, and individuals with disabilities: See the instructions for special rules on where to enter this amount).	6	

Part II Information on Your Vehicle. Complete this part **only** if you are claiming vehicle expense on line 1.

7 When did you place your vehicle in service for business use? (month, day, year) ▶ _____ / _____ / _____

8 Of the total number of miles you drove your vehicle during 2002, enter the number of miles you used your vehicle for:
a Business _____ **b** Commuting _____ **c** Other _____

9 Do you (or your spouse) have another vehicle available for personal use? **Yes** **No**

10 Was your vehicle available for personal use during off-duty hours? **Yes** **No**

11a Do you have evidence to support your deduction? **Yes** **No**
b If "Yes," is the evidence written? **Yes** **No**

General Instructions

Section references are to the Internal Revenue Code.

Changes To Note

Standard mileage rate. The standard mileage rate has been increased to 36½ cents for each mile of business use in 2002.

Meal expenses. The percentage of meal expenses that may be deducted by employees subject to Department of Transportation (DOT) hours of service limits has been increased to 65% for 2002.

Purpose of Form

You may use Form 2106-EZ instead of Form 2106 to claim your unreimbursed employee business expenses if you meet all the requirements listed above Part I.

Recordkeeping

You cannot deduct expenses for travel (including meals, unless you used the standard meal allowance), entertainment,

gifts, or use of a car or other listed property, unless you keep records to prove the time, place, business purpose, business relationship (for entertainment and gifts), and amounts of these expenses. Generally, you must also have receipts for all lodging expenses (regardless of the amount) and any other expense of \$75 or more.

Additional Information

For more details about employee business expenses, see:

- Pub. 463,** Travel, Entertainment, Gift, and Car Expenses
- Pub. 529,** Miscellaneous Deductions
- Pub. 587,** Business Use of Your Home (Including Use by Day-Care Providers)
- Pub. 946,** How To Depreciate Property

Specific Instructions

Part I—Figure Your Expenses

Line 2. See the line 8b instructions for the definition of commuting.

Line 3. Enter lodging and transportation expenses connected with overnight travel away from your tax home (defined below). You cannot deduct expenses for travel away from your tax home for any period of temporary employment of more than 1 year. **Do not** include expenses for meals and entertainment. For more details, including limits, see Pub. 463.

Generally, your **tax home** is your main place of business or post of duty regardless of where you maintain your family home. If you do not have a regular or main place of business because of the nature of your work, then your tax home is the place where you regularly live. If you do not fit in either of these categories, you are considered an itinerant and your tax home is wherever you work. As an itinerant, you are never away from home and cannot claim a travel expense deduction. For more details on your tax home, see Pub. 463.

Line 4. Enter other job-related expenses not listed on any other line of this form. Include expenses for business gifts, education (tuition and books), home office, trade publications,

For Paperwork Reduction Act Notice, see back of form.

Form **2106-EZ** (2002)

Exhibit D

Checklist of IRS Substitute Forms Submitted on..... 20 :

Company:

Contact:

Phone:

Fax:

Source Code:.....

Approved	Approved With Corrections	Must Be Resubmitted	Form Number	Comments

Authorized Name:_____

Title:_____

Reviewer's Name:_____

Telephone:_____

Date:_____

Exhibit E — List of Forms Referred to in the Revenue Procedure

<u>Form</u>	<u>Title</u>	<u>Section</u>
706	United States Estate (and Generation-Skipping Transfer) Tax Return	2.1
720	Quarterly Federal Excise Tax Return	2.5
940	Employer's Annual Federal Unemployment Tax (FUTA) Return	2.3; 3.4; 6.2; 7.2; 8.2
940-EZ	Employer's Annual Federal Unemployment Tax (FUTA) Return	2.3
941	Employer's Quarterly Federal Tax Return	2.3; 3.4; 6.2; 7.2; 8.1
941-V	Form 941 Payment Voucher	2.3
943	Employer's Annual Tax Return for Agricultural Employees	2.3; 7.2
943-V	Form 943 Payment Voucher	2.3
945	Annual Return of Withheld Federal Income Tax	2.3
945-V	Form 945 Payment Voucher	2.3
1040	U.S. Individual Income Tax Return	2.3; 2.4; 2.5; 3.1; 3.2; 3.4; 5.1; 5.2; 5.4; 6.1; 6.2; 7.2; 8.1
1040-ES	Estimated Tax for Individuals	1.1; 2.3; 3.2; 4.1; 4.2
1040A	U.S. Individual Income Tax Return	2.1; 2.4; 3.1; 3.2; 3.4; 5.1; 5.2; 5.3; 7.2; 8.1
1040EZ	Income Tax Return for Single and Joint Filers with No Dependents	2.4; 3.1; 3.4; 7.2; 8.1
1040-NR	U.S. Nonresident Alien Income Tax Return	8.1
1040-V	Form 1040 Payment Voucher	2.3
1041	U.S. Income Tax Return for Estates and Trusts	1.3; 2.5; 3.1; 7.2; 8.1
1041-ES	Estimated Income Tax for Estates and Trusts	1.1; 2.3; 3.2
1042-S	Foreign Person's U.S. Source Income Subject to Withholding	1.2; 1.3; 4.1; 4.2
1065	U.S. Partnership Return of Income	2.5; 3.1; 7.1; 8.1
1065-B	U.S. Return of Income for Electing Large Partnerships	7.1
1096	Annual Summary and Transmittal of U.S. Information Returns	1.1; 1.2; 4.1; 4.2
1098	Mortgage Interest Statement	1.1; 1.2; 1.3; 4.1; 4.2
1099	Series	1.1; 1.2; 1.3; 4.1; 4.2
1120	U.S. Corporation Income Tax Return	2.5; 3.1; 3.4; 5.1; 6.2; 7.2; 7.3
1120-S	U.S. Income Tax Return for an S Corporation	3.1; 7.1; 7.2
2106-EZ	Unreimbursed Employee Business Expenses	6.1
2290	Heavy Vehicle Use Tax Return	2.3; 7.2
3468	Investment Credit	2.5
4136	Credit for Federal Tax Paid on Fuels	2.5
4972	Tax on Lump Sum Distributions	5.4
5471	Information Return of U.S. Persons With Respect to Certain Foreign Corporations	7.3
5472	Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business	7.3

Form	Title	Section
5498	Individual Retirement Arrangement Information	1.1; 1.2; 1.3; 4.1; 4.2
5500	Annual Return/Report of Employee Benefit Plan	1.1; 1.2
5500-EZ	Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan	1.1; 1.2
8453	U.S. Individual Income Tax Declaration for an IRS e-file Return	8.1
8453-NR	U.S. Nonresident Alien Income Tax Declaration for Magnetic Media Filing	8.1
8453-OL	U.S. Individual Income Tax Declaration for an e-file Online Return	8.1
8633	Application to Participate in the IRS e-file Program	8.1
8814	Parents' Election To Report Child's Interest and Dividends	5.4
9041	Application for Electronic/Magnetic Media Filing of Business and Employee Benefit Plan Returns	8.1
W-2	Wage and Tax Statement	1.1; 1.2; 4.1; 4.2
W-2c	Corrected Wage and Tax Statement	1.1; 1.2; 4.1; 4.2
W-2G	Certain Gambling Winnings	1.1; 1.2; 1.3; 4.1; 4.2; 8.1
W-3	Transmittal of Income and Tax Statements	1.1; 1.2; 4.1; 4.2
W-3c	Transmittal of Corrected Wage and Tax Statements	1.1; 1.2; 4.1; 4.2
W-4	Employee's Withholding Allowance Certificate	4.2

Exhibit F
SCHEDULE K-1
(Form 1041)

Beneficiary's Share of Income, Deductions, Credits, etc.

6621
OMB No. 1545-0092

Department of the Treasury
Internal Revenue Service

for the calendar year 2003, or fiscal year
beginning _____, 2003, ending _____, 20_____
▶ Complete a separate Schedule K-1 for each beneficiary.

2003

Name of trust or decedent's estate <input type="checkbox"/> Amended K-1 <input type="checkbox"/> Final K-1	FOR OFFICIAL USE ONLY
Beneficiary's identifying number ▶ Beneficiary's name, address, and ZIP code	Estate's or trust's EIN ▶ Fiduciary's name, address, and ZIP code

(a) Allocable share item	(b) Amount	(c) Calendar year 2002 Form 1040 filers enter the amounts in column (b) on:
1 Interest	1	Schedule B, Part I, line 1
2a Qualified dividends	2a	Form 1040, line 9b
b Total ordinary dividends	2b	Form 1040, line 9a
3a Net short-term capital gain (entire year)	3a	Schedule D, line 5, column (f)
b Net short-term capital gain (post 5/5/2003)	3b	Schedule D, line 5, column (g)
4a Net long-term capital gain (entire year)	4a	Schedule D, line 12, column (f)
b Net long-term capital gain (post 5/5/2003)	4b	Schedule D, line 12, column (g)
c Qualified 5-year gain	4c	Line 5 of the worksheet for Schedule D, line 35
d Unrecaptured section 1250 gain	4d	Line 11 of the worksheet for Schedule D, line 19
e 28% rate gain	4e	Line 3 of the worksheet for Schedule D, line 20
5a Annuities, royalties, and other nonpassive income before directly apportioned deductions	5a	Schedule E, Part III, column (f)
b Depreciation	5b	} Include on the applicable line of the appropriate tax form
c Depletion	5c	
d Amortization	5d	
6a Trade or business, rental real estate, and other rental income before directly apportioned deductions (see instructions)	6a	
b Depreciation	6b	} Include on the applicable line of the appropriate tax form
c Depletion	6c	
d Amortization	6d	
7 Income for minimum tax purposes	7	
8 Income for regular tax purposes (add lines 1, 2, 3, 4a, 5a, and 6a)	8	
9 Adjustment for minimum tax purposes (subtract line 8 from line 7)	9	Form 6251, line 14
10 Estate tax deduction (including certain generation-skipping transfer taxes)	10	Schedule A, line 27
11 Foreign taxes	11	Form 1040, line 45 or Schedule A, line 8
12 Adjustments and tax preference items (itemize):		
a Accelerated depreciation	12a	} Include on the applicable line of Form 6251
b Depletion	12b	
c Amortization	12c	
d Exclusion items	12d	
13 Deductions in the final year of trust or decedent's estate:		
a Excess deductions on termination (see instructions)	13a	Schedule A, line 22
b Short-term capital loss carryover	13b ()	Schedule D, line 5
c Long-term capital loss carryover	13c ()	Schedule D, line 12, columns (f) and (g)
d Net operating loss (NOL) carryover for regular tax purposes	13d ()	Form 1040, line 21
e NOL carryover for minimum tax purposes	13e	See the instructions for Form 6251, line 27
f	13f	} Include on the applicable line of the appropriate tax form
g	13g	

Exhibit F (continued)

Schedule K-1 (Form 1041) 2003

6622

Page 2

(a) Allocable share item	(b) Amount	(c) Calendar year 2002 Form 1040 filers enter the amounts in column (b) on:
14 Other (itemize):		
a Payments of estimated taxes credited to you	14a	Form 1040, line 63
b Tax-exempt interest	14b	Form 1040, line 8b
c	14c	} Include on the applicable line of the appropriate tax form
d	14d	
e	14e	
f	14f	
g	14g	
h	14h	

General Instructions

Purpose of Form

The fiduciary of a trust or decedent's estate uses Schedule K-1 to report your share of the trust's or estate's income, credits, deductions, etc. **Keep it for your records. Do not file it with your tax return.** A copy has been filed with the IRS.

Inconsistent Treatment of Items

Generally, you must report items shown on your Schedule K-1 (and any attached schedules) the same way that the estate or trust treated the items on its return.

If the treatment on your original or amended return is inconsistent with the estate's or trust's treatment, or if the estate or trust was required to but has not filed a return, you must file **Form 8082**, Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR), with your original or amended return to identify and explain any inconsistency (or to note that an estate or trust return has not been filed).

If you are required to file Form 8082 but fail to do so, you may be subject to the accuracy-related penalty. This penalty is in addition to any tax that results from making your amount or treatment of the item consistent with that shown on the estate's or trust's return. Any deficiency that results from making the amounts consistent may be assessed immediately.

Errors

If you believe the fiduciary has made an error on your Schedule K-1, notify the fiduciary and ask for an amended or a corrected Schedule K-1. **Do not** change any items on your copy. Be sure that the fiduciary sends a copy of the amended Schedule K-1 to the IRS. **If you are unable to reach an agreement with the fiduciary regarding the inconsistency, you must file Form 8082.**

Tax Shelters

If you receive a copy of **Form 8271**, Investor Reporting of Tax Shelter Registration Number, see the Instructions for Form 8271 to determine your reporting requirements.

Beneficiaries of Generation-Skipping Trusts

If you received **Form 706-GS(D-1)**, Notification of Distribution From a Generation-Skipping Trust, and paid a generation-skipping transfer (GST) tax on **Form 706-GS(D)**, Generation-Skipping Transfer Tax Return for Distributions, you can deduct the GST tax paid on income distributions on Schedule A (Form 1040), line 8. To figure the deduction, see the Instructions for Form 706-GS(D).

Specific Instructions

Lines 3 and 4

If there is an attachment to this Schedule K-1 reporting a disposition of a passive activity, see the Instructions for **Form 8582**, Passive Activity Loss Limitations, for information on the treatment of dispositions of interests in a passive activity.

Lines 6b through 6d

The deductions on lines 6b through 6d may be subject to the passive loss limitations of Internal Revenue Code section 469, which generally limits deductions from passive activities to the income from those activities. The rules for applying these limitations to beneficiaries have not yet been issued. For more details, see **Pub. 925**, Passive Activity and At-Risk Rules.

Line 12d

If you pay alternative minimum tax in 2002, the amount on line 12d will help you figure any minimum tax credit for 2003. See the 2003 **Form 8801**, Credit for Prior Year Minimum Tax—Individuals, Estates, and Trusts, for more information.

Line 14a

To figure any underpayment and penalty on **Form 2210**, Underpayment of Estimated Tax by Individuals, Estates, and Trusts, treat the amount entered on line 14a as an estimated tax payment made on January 15, 2004.

Lines 14c through 14h

The amount of gross farming and fishing income is included on line 6a. This income is also separately stated on line 14 to help you determine if you are subject to a penalty for underpayment of estimated tax. Report the amount of gross farming and fishing income on Schedule E (Form 1040), line 41.

Partner's Share of Income, Credits, Deductions, etc.

2003

▶ See separate instructions.

For calendar year 2003 or tax year beginning _____, 2003, and ending _____, 20

Partner's identifying number ▶

Partner's name, address, and ZIP code

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Partnership's identifying number ▶

Partnership's name, address, and ZIP code

A This partner is a general partner limited partner
 limited liability company member

B What type of entity is this partner? ▶ _____

C Is this partner a domestic or a foreign partner?

D Enter partner's percentage of:

	(i) Before change or termination	(ii) End of year
Profit sharing	_____ %	_____ %
Loss sharing	_____ %	_____ %
Ownership of capital	_____ %	_____ %

E IRS Center where partnership filed return: _____

F Partner's share of liabilities (see instructions):

Nonrecourse	\$ _____
Qualified nonrecourse financing	\$ _____
Other	\$ _____

G Tax shelter registration number . ▶ _____

H Check here if this partnership is a publicly traded partnership as defined in section 469(k)(2)

I Check applicable boxes: (1) Final K-1 (2) Amended K-1

J Analysis of partner's capital account:

(a) Capital account at beginning of year	(b) Capital contributed during year	(c) Partner's share of lines 3, 4, and 7, Form 1065, Schedule M-2	(d) Withdrawals and distributions	(e) Capital account at end of year (combine columns (a) through (d))
			()	

	(a) Distributive share item	(b) Amount	(c) 1040 filers enter the amount in column (b) on:	
Income (Loss)	1 Ordinary income (loss) from trade or business activities	1	See page 6 of Partner's Instructions for Schedule K-1 (Form 1065).	
	2 Net income (loss) from rental real estate activities	2		
	3 Net income (loss) from other rental activities	3		
	4 Portfolio income (loss):		Form 1040, line 8a	
	a Interest income	4a		
	b (1) Qualified dividends	4b(1)		Form 1040, line 9b
	(2) Total ordinary dividends	4b(2)		Form 1040, line 9a
	c Royalty income	4c		Sch. E, Part I, line 4
	d (1) Net short-term capital gain (loss) (post-May 5, 2003)	4d(1)		Sch. D, line 5, col. (g)
	(2) Net short-term capital gain (loss) (entire year)	4d(2)		Sch. D, line 5, col. (f)
	e (1) Net long-term capital gain (loss) (post-May 5, 2003)	4e(1)		Sch. D, line 12, col. (g)
(2) Net long-term capital gain (loss) (entire year)	4e(2)	Sch. D, line 12, col. (f)		
f Other portfolio income (loss) (attach schedule)	4f	See pages 6 and 7 of Partner's Instructions for Schedule K-1 (Form 1065).		
5 Guaranteed payments to partner	5			
6a Net section 1231 gain (loss) (post-May 5, 2003)	6a			
b Net section 1231 gain (loss) (entire year)	6b			
7 Other income (loss) (attach schedule)	7			
Deductions	8 Charitable contributions (see instructions) (attach schedule)	8	Sch. A, line 15 or 16	
	9 Section 179 expense deduction	9	See pages 7 and 8 of Partner's Instructions for Schedule K-1 (Form 1065).	
	10 Deductions related to portfolio income (attach schedule)	10		
	11 Other deductions (attach schedule)	11		

Exhibit G (continued)

6522

Schedule K-1 (Form 1065) 2003

Page 2

	(a) Distributive share item	(b) Amount	(c) 1040 filers enter the amount in column (b) on:
Credits	12a Low-income housing credit:		Form 8586, line 5
	(1) From section 42(j)(5) partnerships	12a(1)	
	(2) Other than on line 12a(1)	12a(2)	See page 8 of Partner's Instructions for Schedule K-1 (Form 1065).
	b Qualified rehabilitation expenditures related to rental real estate activities	12b	
	c Credits (other than credits shown on lines 12a and 12b) related to rental real estate activities	12c	
d Credits related to other rental activities	12d		
13 Other credits	13		
Investment Interest	14a Interest expense on investment debts	14a	Form 4952, line 1
	b (1) Investment income included on lines 4a, 4b, 4c, and 4f	14b(1)	See page 9 of Partner's Instructions for Schedule K-1 (Form 1065).
	(2) Investment expenses included on line 10	14b(2)	
Self-employment	15a Net earnings (loss) from self-employment	15a	Sch. SE, Section A or B
	b Gross farming or fishing income	15b	See page 9 of Partner's Instructions for Schedule K-1 (Form 1065).
	c Gross nonfarm income	15c	
Adjustments and Tax Preference Items	16a Depreciation adjustment on property placed in service after 1986	16a	See page 9 of Partner's Instructions for Schedule K-1 (Form 1065) and Instructions for Form 6251.
	b Adjusted gain or loss	16b	
	c Depletion (other than oil and gas)	16c	
	d (1) Gross income from oil, gas, and geothermal properties	16d(1)	
	(2) Deductions allocable to oil, gas, and geothermal properties	16d(2)	
	e Other adjustments and tax preference items (<i>attach schedule</i>)	16e	
Foreign Taxes	17a Name of foreign country or U.S. possession ▶	17a	Form 1116, Part I
	b Gross income from all sources	17b	
	c Gross income sourced at partner level	17c	
	d Foreign gross income sourced at partnership level:		
	(1) Passive	17d(1)	
	(2) Listed categories (<i>attach schedule</i>)	17d(2)	
	(3) General limitation	17d(3)	
	e Deductions allocated and apportioned at partner level:		
	(1) Interest expense	17e(1)	
	(2) Other	17e(2)	
	f Deductions allocated and apportioned at partnership level to foreign source income:		
	(1) Passive	17f(1)	
	(2) Listed categories (<i>attach schedule</i>)	17f(2)	
(3) General limitation	17f(3)		
g Total foreign taxes (check one): <input type="checkbox"/> Paid <input type="checkbox"/> Accrued	17g	Form 1116, Part II Form 1116, line 12	
h Reduction in taxes available for credit (<i>attach schedule</i>)	17h		
Other	18 Section 59(e)(2) expenditures: a Type ▶	18a	See page 9 of Partner's Instructions for Schedule K-1 (Form 1065).
	b Amount	18b	
	19 Tax-exempt interest income	19	Form 1040, line 8b
	20 Other tax-exempt income	20	See pages 9 and 10 of Partner's Instructions for Schedule K-1 (Form 1065).
	21 Nondeductible expenses	21	
	22 Distributions of money (cash and marketable securities)	22	
	23 Distributions of property other than money	23	Form 8611, line 8
	24 Recapture of low-income housing credit:		
a From section 42(j)(5) partnerships	24a		
b Other than on line 24a	24b		
Supplemental Information	25 Supplemental information required to be reported separately to each partner (<i>attach additional schedules if more space is needed</i>):		

Exhibit H
SCHEDULE K-1
(Form 1120S)

Shareholder's Share of Income, Credits, Deductions, etc.

6721
OMB No. 1545-0130

▶ See separate instructions.
For calendar year 2003 or tax year
, 2003, and ending , 20

2003

Department of the Treasury
Internal Revenue Service

beginning

Corporation's identifying number ▶

Corporation's name, address, and ZIP code

FOR OFFICIAL USE ONLY

Shareholder's identifying number ▶

Shareholder's name, address, and ZIP code

- A** Shareholder's percentage of stock ownership for tax year (see instructions for Schedule K-1) ▶ %
- B** Internal Revenue Service Center where corporation filed its return ▶
- C** Tax shelter registration number (see instructions for Schedule K-1) ▶
- D** Check applicable boxes: **(1)** Final K-1 **(2)** Amended K-1

		(a) Pro rata share items	(b) Amount	(c) Form 1040 filers enter the amount in column (b) on:
Income (Loss)	1	Ordinary income (loss) from trade or business activities	1	See page 4 of the Shareholder's Instructions for Schedule K-1 (Form 1120S).
	2	Net income (loss) from rental real estate activities	2	
	3	Net income (loss) from other rental activities	3	
	4	Portfolio income (loss):		
	a	Interest income	4a	Sch. B, Part I, line 1
	b	(1) Qualified dividends	4b(1)	Form 1040, line 9b
		(2) Total ordinary dividends	4b(2)	Form 1040, line 9a
	c	Royalty income	4c	Sch. E, Part I, line 4
	d	(1) Net short-term capital gain (loss) (post-May 5, 2003)	4d(1)	Sch. D, line 5, col. (g)
		(2) Net short-term capital gain (loss) (entire year)	4d(2)	Sch. D, line 5, col. (f)
	e	(1) Net long-term capital gain (loss) (post-May 5, 2003)	4e(1)	Sch. D, line 12, col. (g)
		(2) Net long-term capital gain (loss) (entire year)	4e(2)	Sch. D, line 12, col. (f)
	f	Other portfolio income (loss) (attach schedule)	4f	(Enter on applicable line of your return.)
	5a	Net section 1231 gain (loss) (post-May 5, 2003)	5a	See Shareholder's Instructions for Schedule K-1 (Form 1120S).
b	Net section 1231 gain (loss) (entire year)	5b		
6	Other income (loss) (attach schedule)	6	(Enter on applicable line of your return.)	
Deductions	7	Charitable contributions (attach schedule)	7	Sch. A, line 15 or 16
	8	Section 179 expense deduction	8	See pages 5 and 6 of the Shareholder's Instructions for Schedule K-1 (Form 1120S).
	9	Deductions related to portfolio income (loss) (attach schedule)	9	
	10	Other deductions (attach schedule)	10	
Investment Interest	11a	Interest expense on investment debts	11a	Form 4952, line 1
	b	(1) Investment income included on lines 4a, 4b, 4c, and 4f above	11b(1)	See Shareholder's Instructions for Schedule K-1 (Form 1120S).
		(2) Investment expenses included on line 9 above	11b(2)	

For Paperwork Reduction Act Notice, see the Instructions for Form 1120S.

Schedule K-1 (Form 1120S) 2003

Exhibit H (continued)

6722

Schedule K-1 (Form 1120S) 2003

Page **2**

		(a) Pro rata share items	(b) Amount	(c) Form 1040 filers enter the amount in column (b) on:
Credits	12a	Credit for alcohol used as fuel	12a	Form 6478, line 10
	b	Low-income housing credit:		
		(1) From section 42(j)(5) partnerships	12b(1)	Form 8586, line 5
		(2) Other than on line 12b(1)	12b(2)	
		c Qualified rehabilitation expenditures related to rental real estate activities	12c	See pages 6 and 7 of the Shareholder's Instructions for Schedule K-1 (Form 1120S).
		d Credits (other than credits shown on lines 12b and 12c) related to rental real estate activities	12d	
		e Credits related to other rental activities	12e	
	13 Other credits	13		
Adjustments and Tax Preference Items	14a	Depreciation adjustment on property placed in service after 1986	14a	See page 7 of the Shareholder's Instructions for Schedule K-1 (Form 1120S) and Instructions for Form 6251
	b	Adjusted gain or loss	14b	
	c	Depletion (other than oil and gas)	14c	
		d (1) Gross income from oil, gas, or geothermal properties	14d(1)	
		(2) Deductions allocable to oil, gas, or geothermal properties	14d(2)	
		e Other adjustments and tax preference items (<i>attach schedule</i>)	14e	
Foreign Taxes	15a	Name of foreign country or U.S. possession ▶	15b	Form 1116, Part I
	b	Gross income from all sources	15c	
	c	Gross income sourced at shareholder level		
		d Foreign gross income sourced at corporate level:		
		(1) Passive	15d(1)	
		(2) Listed categories (<i>attach schedule</i>)	15d(2)	
		(3) General limitation	15d(3)	
		e Deductions allocated and apportioned at shareholder level:		
		(1) Interest expense	15e(1)	
		(2) Other	15e(2)	
		f Deductions allocated and apportioned at corporate level to foreign source income:		
		(1) Passive	15f(1)	
		(2) Listed categories (<i>attach schedule</i>)	15f(2)	
	(3) General limitation	15f(3)		
	g Total foreign taxes (check one): <input type="checkbox"/> Paid <input type="checkbox"/> Accrued	15g	Form 1116, Part II	
	h Reduction in taxes available for credit (<i>attach schedule</i>)	15h	See Instructions for Form 1116	
Other	16	Section 59(e)(2) expenditures: a Type ▶	16b	See Shareholder's Instructions for Schedule K-1 (Form 1120S).
		b Amount	17	Form 1040, line 8b
	17	Tax-exempt interest income	18	See page 7 of the Shareholder's Instructions for Schedule K-1 (Form 1120S).
	18	Other tax-exempt income	19	
	19	Nondeductible expenses	20	
	20	Property distributions (including cash) other than dividend distributions reported to you on Form 1099-DIV	21	Form 8611, line 8
	21	Amount of loan repayments for "Loans From Shareholders"	22a	
		22 Recapture of low-income housing credit:	22b	
	a From section 42(j)(5) partnerships			
	b Other than on line 22a			
Supplemental Information	23	Supplemental information required to be reported separately to each shareholder (<i>attach additional schedules if more space is needed</i>):		
			
			
			
			

Schedule K-1 (Form 1120S) 2003

Part IV. Items of General Interest

Changes to Reporting Requirements for Certain 2002 Forms Because of Changes in the Capital Gains Tax Rates

Announcement 2003–56

BACKGROUND

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (Public Law 108–27) amended section 1(h) of the Internal Revenue Code to change the capital gains tax rates. As a result, there are changes in the reporting requirements for the following 2002 forms (these forms and their instructions do not reflect this legislation) filed by entities with 2002–2003 fiscal years ending after May 5, 2003:

- Form 2439 for regulated investment companies (RICs) and real estate investment trusts (REITs); and
- Schedules K and K–1 for partnerships and S corporations and Schedule K–1 for estates.

Also, the tax computation using maximum capital gains rates (for both the regular tax and the alternative minimum tax) affects individuals and estates with 2002–2003 fiscal years ending after May 5, 2003.

Note: *Dividends received in a tax year beginning in 2002 and ending in 2003 are not qualified dividends, even if the dividends are received during 2003. Therefore, Individuals and estates with 2002–2003 fiscal years cannot have any qualified dividends for that tax year. Partnerships, S corporations, and estates with 2002–2003 fiscal years have no qualified dividends to pass through to their partners, shareholders, or beneficiaries.*

The necessary changes are described in the following sections.

FORM 2439: REPORTING UNDISTRIBUTED LONG-TERM CAPITAL GAINS FOR 2002–2003

RICs and REITs filing the 2002 Form 2439 for fiscal years ending after May 5, 2003, must provide additional information with their notices to shareholders. Filers must provide to shareholders the amount of

post-May 5, 2003, undistributed long-term capital gains, and indicate that this amount must be reported on Schedule D (Form 1040), line 11, column (g) (or on Schedule D (Form 1041), line 7, column (g)). Filers determine this amount by figuring the amount that would be reported in box 1a taking into account only the part of the fiscal year after May 5, 2003. The smaller of that amount or the amount reported in box 1a is the amount of post-May 5, 2003, undistributed long-term capital gain to provide to shareholders. Filers may provide this additional information to shareholders on a substitute statement or on a separate statement. **Do not** report this additional information on 2002 Forms 2439 filed with the IRS. Filers must continue to report the total undistributed long-term capital gains for the entire tax year in box 1a of Form 2439. Also, the amount reported as qualified 5-year gain must be figured taking into account only the portion of the tax year before May 6, 2003.

FISCAL YEAR ESTATES AND INDIVIDUALS: REPORTING CAPITAL GAINS AND LOSSES, AND FIGURING TAX, FOR 2002–2003

Estates and individuals with 2002–2003 fiscal years ending after May 5, 2003, and affected by the new capital gains tax rates, must attach to their 2002 Form 1040 or 1041 a computation similar to that shown in Part IV of the 2003 Schedule D (Form 1040) or Part V of the 2003 Schedule D (Form 1041). A draft of the 2003 Schedule D (Form 1040) is available at www.irs.gov/pub/irsdft/d1040sd.pdf. A draft of the 2003 Schedule D (Form 1041) is available at www.irs.gov/pub/irsdft/d1041sd.pdf. These estates and individuals may use the 2003 Schedule D to figure their 2002 tax provided they modify the computation in Part IV (Part V for Form 1041 filers) to reflect the use of the applicable 2002 tax rate schedules or tax table. Also, when figuring the amount to enter on line 28 of the 2003 Schedule D (Form 1040) or line 25 of the 2003 Schedule D (Form 1041), these filers cannot use the dollar amounts shown on that line. Instead, they must use \$46,700 if married filing jointly or qualifying widow(er); \$27,950 if single; \$37,450 if

head of household; \$23,350 if married filing separately; or \$1,850 if an estate. Finally, line 23 of Schedule D (Form 1040) and line 20 of Schedule D (Form 1041) must be left blank because a fiscal year 2002–2003 taxpayer cannot have any qualified dividends.

Note: *The new capital gains rates also affect the computation of the alternative minimum tax. The above-mentioned filers should attach a computation similar to that shown in Part IV of the 2003 Form 6251 (or Part IV, Schedule I, of the 2003 Form 1041).*

Estates also must continue to report each beneficiary's share of the net short-term capital gain and net long-term capital gain, for the entire tax year, on Schedule K–1. In addition, the estate must provide to its beneficiaries net short-term capital gain and net long-term capital gain for the portion of the tax year after May 5, 2003. Each beneficiary's share of these amounts should be reported on line 14 of Schedule K–1.

FORMS 1065 AND 1120S (SCHEDULES K AND K–1): REPORTING CAPITAL AND SECTION 1231 GAINS AND LOSSES FOR 2002–2003

Partnerships and S corporations completing the 2002 Forms 1065 and 1120S must report, for the portion of the tax year after May 5, 2003, the following additional information:

- Post-May 5, 2003, net short-term capital gain or loss;
- Post-May 5, 2003, net long-term capital gain or loss; and
- Post-May 5, 2003, net section 1231 gain or loss.

These amounts must be reported as an item of information on line 24 of Schedule K (Form 1065) or on line 21 of Schedule K (Form 1120S). Each partner's or shareholder's share should be reported in the "Supplemental Information" space on Schedule K–1 (Form 1065 or 1120S).

In addition, these partnerships and S corporations must continue to report qualified 5-year gain, on line 4e(3) of Schedules K and K–1 (Form 1065 or 1120S), but only

for the portion of the tax year before May 6, 2003. They also must continue to report, for the entire tax year:

- The net short-term capital gain or loss, on line 4d of Schedules K and K-1 (Form 1065 or 1120S);
- The net long-term capital gain or loss on, line 4e of Schedules K and K-1 (Form 1065 or 1120S);
- 28% rate gain or loss, on line 4e(2) of Schedules K and K-1 (Form 1065 or 1120S);
- The net gain or loss under section 1231 (other than due to casualty or theft), on line 6 of Schedules K and K-1 of Form 1065 (line 5 of Schedules K and K-1 of Form 1120S); and
- Other income, on line 7 of Schedules K and K-1 of Form 1065 (line 6 of Schedules K and K-1 of Form 1120S). Partnerships and S corporations should advise partners and shareholders to report post-May 5, 2003, gain or loss amounts on the line of the form to which it relates in the

separate column, if any, provided on that form for post-May 5, 2003, gain or loss.

Note: The 2003 Form 1099-DIV, Dividends and Distributions, and the 2003 Form 1099-B, Broker and Barter Exchange Transactions, and their instructions have been revised to reflect the 2003 legislation and are available at www.irs.gov. All other affected forms, schedules, instructions, and publications will be revised to reflect the 2003 legislation and posted at www.irs.gov when they are finalized later this year.

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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