Bulletin No. 1997–2
January 13, 1997

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. 97–1, page 10.
Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate. For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for January 1997.

Rev. Rul. 97–2, page 8.
Insurance companies; interest rate tables. Prevailing state assumed interest rates are provided for the determination of reserves under section 807 of the Code for contracts issued in 1996 and 1997. Rev. Rul. 92–19 supplemented in part.

Rev. Rul. 97–3, page 5.
SBA guaranteed payment rights; participating securities. The Small Business Administration (SBA) is the primary obligor of the guaranteed payment rights that are created under its participating security program and investors in those rights are treated as owning SBA debt.

T.D. 8697, page 11.
Final regulations under section 7701 of the Code classify certain business organizations under an elective regime.

Notice 97–1, page 22.
Revenue rulings and revenue procedures under T.D. 8697 obsoleted. Revenue rulings and revenue procedures that use the prior classification regulations to differentiate between partnerships and associations are obsolete to the extent that they rely on those prior regulations.

Notice 97–4, page 24.
S corporation subsidiaries. This notice requests comments concerning issues raised by section 1308 of the Small Business Job Protection Act of 1996 which permits an S corporation (1) to own 80 percent or more of the stock of a C corporation, and (2) to elect to own a qualified subchapter S subsidiary (QSSS). This notice also provides temporary guidance on the manner in which a QSSS election must be made and the effective date of the election.

Notice 97–5, page 25.
Electing small business corporations and banks. This notice provides guidance on the effect of the qualified subchapter S subsidiary (QSSS) election under section 1361(b)(3) on banks affiliated with nonbanks; the application of the S corporation passive investment income rule of section 1362(d)(3); the application of the interest expense disallowance rules of section 265; and an automatic change in method of accounting for bad debts.

EMPLOYEE PLANS

Rev. Proc. 97–9, page 55.
Cash or deferred arrangements; amendments; SIMPLEs. This procedure describes how an employer that maintains a qualified cash or deferred arrangement may make the necessary amendment for its qualified cash or deferred arrangement to meet the provision for a savings incentive match plan pursuant to section 1422 of the Small Business Job Protection Act of 1996.

Announcement 97–2, page 62.
Schedule Q; determination letter requests; section 401(a)(26). The instructions for completing Schedule Q for plan years beginning after December 31, 1996, are being changed.

Notice 97–2, page 22.
Cash or deferred arrangements; nondiscrimination. With respect to cash or deferred arrangements, the notice gives transitional relief for certain nondiscrimination tests for the 1997 plan year and describes methods for the determination and distribution of excess contributions.

(Continued on page 4)

Finding Lists begin on page 63.

HIGHLIGHTS OF THIS ISSUE—Continued

EMPLOYEE PLANS—Continued

Notice 97–6, page 26.
Questions and answers; SIMPLE IRAs. A notice, in question and answer format, pertaining to simple IRAs described in section 408(p) of the Code as added by the Small Business Job Protection Act of 1996, is set forth.

Notice 97–10, page 41.
Spousal consent; qualified joint and survivor annuities, etc.; sample language. The Service has developed sample language for inclusion in a form providing spousal consent to a participant's election to waive a qualified joint and survivor annuity or a qualified preretirement survivor annuity, in accordance with section 1457 of the Small Business Job Protection Act of 1996.

Notice 97–11, page 49.
Qualified domestic relations orders; sample language. The Service has developed sample language for qualified domestic relations orders within the meaning of section 414(p) of the Code in accordance with section 1457 of the Small Business Job Protection Act of 1996.

ADMINISTRATIVE

Rev. Proc. 97–10, page 59.
Change in computing depreciation for retail motor fuels outlets. This procedure is provided for making the election under section 1120 of the Small Business Job Protection Act of 1996 to treat retail motor fuels outlets placed in service before August 20, 1996, as 15-year property under section 168 of the Code. Rev. Proc. 92–20 modified.

Notice 97–9, page 35.
Adoption assistance. This notice provides general guidance concerning the tax credit under section 23 for "qualified adoption expenses" paid or incurred by an individual and the exclusion from gross income under section 137 for amounts paid or expenses incurred by an employer for "qualified adoption expenses" under an adoption assistance program.

Announcement 97–1, page 62.
Extension of test of mediation procedure for appeals. This announcement extends the test of the mediation procedure set forth in Announcement 95–86, 1995–44 I.R.B. 27, for an additional one-year period beginning on January 13, 1997. The procedure will allow taxpayers, whose cases are not docketed in any court and already in the Appeals administrative process, to request mediation as a dispute resolution technique.

Announcement 97–3, page 62.
A list is provided of organizations that no longer qualify as organizations to which contributions are deductible under section 170 of the Code.

Mission of the Service

The purpose of the Internal Revenue Service is to collect the proper amount of tax revenue at the least cost; serve the public by continually improving the quality of our products and services; and perform in a manner warranting the highest degree of public confidence in our integrity, efficiency and fairness.

Statement of Principles of Internal Revenue Tax Administration

The function of the Internal Revenue Service is to administer the Internal Revenue Code. Tax policy for raising revenue is determined by Congress.

With this in mind, it is the duty of the Service to carry out that policy by correctly applying the laws enacted by Congress; to determine the reasonable meaning of various Code provisions in light of the Congressional purpose in enacting them; and to perform this work in a fair and impartial manner, with neither a government nor a taxpayer point of view.

At the heart of administration is interpretation of the Code. It is the responsibility of each person in the Service, charged with the duty of interpreting the law, to try to find the true meaning of the statutory provision and not to adopt a strained construction in the belief that he or she is ''protecting the revenue.'' The revenue is properly protected only when we ascertain and apply the true meaning of the statute.

The Service also has the responsibility of applying and administering the law in a reasonable, practical manner. Issues should only be raised by examining officers when they have merit, never arbitrarily or for trading purposes. At the same time, the examining officer should never hesitate to raise a meritorious issue. It is also important that care be exercised not to raise an issue or to ask a court to adopt a position inconsistent with an established Service position.

Administration should be both reasonable and vigorous. It should be conducted with as little delay as possible and with great courtesy and considerateness. It should never try to overreach, and should be reasonable within the bounds of law and sound administration. It should, however, be vigorous in requiring compliance with law and it should be relentless in its attack on unreal tax devices and fraud.

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 of a permanent nature 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 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.
With the exception of the Notice of Proposed Rulemaking and the disbarment and suspension list included in this part, none of these announcements are consolidated in the Cumulative Bulletins.

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

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

Section 42.—Low-Income Housing Credit

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 1997. See Rev. Rul. 97–1, page 10.

Section 56.—Adjustments in Computing Alternative Minimum Taxable Income

If a taxpayer elects to treat a retail motor fuels outlet placed in service before August 20, 1996, as 15-year property for computing depreciation for regular tax purposes, how is the depreciation computed for alternative minimum taxable income purposes? See Rev. Proc. 97–10, page 59.

Section 61.—Gross Income Defined

26 C.F.R. 1.61–1: Gross Income. (Also §§ 851, 856, 895, 7701; 1.851–2, 1.856–2, 1.895–1, 301.7701–13A.)

SBA guaranteed payment rights; participating securities. The Small Business Administration (SBA) is the primary obligor of the guaranteed payment rights that are created under its participating security program and investors in those rights are treated as owning SBA debt.

Rev. Rul. 97–3

ISSUE

For federal tax purposes, is the Small Business Administration (SBA) the primary obligor of certain guaranteed payment rights that are created under its participating security program?

FACTS

The SBA is an independent agency of the United States. Its activities include regulating and providing financial assistance to small business investment companies (SBICs), which furnish venture capital to small business concerns. One way SBICs raise money for investment is by issuing participating securities to the SBA. *See* 15 U.S.C. §§ 683 and 687(*l*) (1994). Participating securities may take the form of preferred stock, preferred limited partnership interests, or similar instruments. 15 U.S.C. § 683(g) (1994).

Regardless of their form, or the rights they may provide under state and local law, all participating securities share the following characteristics. Every participating security entitles the SBA to both a return of capital (Redemption Payments) and priority distributions that equal a fixed percentage of the unreturned capital (Prioritized Payments). Redemption Payments have to be made by the final due date, which in most cases, is approximately 10 years from the day the participating security is issued. Before the final due date, a SBIC may make Redemption Payments at its discretion, or may be required to make Redemption Payments for reasons such as its insolvency. Prioritized Payments are scheduled to be made at least annually, but are due only to the extent that the SBIC has sufficient profits. Any scheduled amount that goes unpaid accumulates. Every participating security also entitles the SBA to receive a portion of the SBIC's remaining profits (Profit Participation Payments) and gives the SBA the right to bar any changes affecting its interests.

Once every quarter, the SBA acquires new participating securities and assembles them into a pool to be securitized. Every security in a newly formed pool has the same final due date for making Redemption Payments and uses the same percentage for calculating Prioritized Payments. The percentage used to calculate the Prioritized Payments is established with reference to current interest rates.

To securitize a pool, the SBA assigns the Redemption Payments and Prioritized Payments to a group of underwriters and simultaneously enters into a guarantee relating to the assigned payments (the Payment Guarantee). All rights in the participating securities, other than the Redemption Payments and Prioritized Payments, are retained by the SBA, and the SBA has no duty to exercise them for anyone else's benefit. The underwriters transfer the assigned payments and the Payment Guarantee to a trust. In exchange, the underwriters receive a single class of marketable trust certificates that in form evidence beneficial ownership of the transferred assets. Proceeds from the underwriters' sale of the trust certificates are paid to the SBICs whose participating securities make up the pool.

Under the Payment Guarantee, the SBA must disburse quarterly the amount by which (1) the Prioritized Payments made by the SBICs and available to the trust fall short of (2) the Prioritized Payments that would be due if Prioritized Payments had to be made regardless of financial condition and were paid in quarterly installments rather than annually. 15 U.S.C. § 683(g) (1994). Thus, if a SBIC's profits are so low that the SBIC has no obligation to make a Prioritized Payment, the SBA nevertheless has to pay, in quarterly installments, the amount that would be owed if the SBIC's profits were unlimited. Making a payment in this case does not entitle the SBA to seek immediate restitution from the SBIC. Instead, the SBA has to recover the payment from whatever future Prioritized Payments the SBIC may generate.

The Payment Guarantee also obligates the SBA to pay any shortfall in a pool's Redemption Payments. The SBA, therefore, has to make up any Redemption Payment that a SBIC fails to pay on the final due date or cannot pay when forced to redeem a participating security (for instance, in the case of insolvency or commencement of receivership proceedings). Under these circumstances, the right to receive the Redemption Payment from the SBIC is released by the trust in favor of the SBA.

By the terms of the Payment Guarantee, the obligations of the SBA are unconditional and must be performed despite any legal or equitable defense. Each time a new pool is created, the SBA will reasonably expect to disburse and not recover, during the pool's first three years, an amount exceeding 15 percent of the Prioritized Payments that would be due on the participating securities in the pool if Prioritized Payments had to be made regardless of financial condition and were paid in quarterly installments rather than annually. The Payment Guarantee cannot be transferred separately from the rights to the Redemption Payments and Prioritized Payments.

The trust that holds the Payment Guarantee and the rights to the Redemption Payments and Prioritized Payments is authorized by statute, 15 U.S.C. § 687*l*(a) (1994), and governed by an agreement among the SBA, the SBA's fiscal agent, and an independent trustee. These parties may amend the agreement without the consent of the certificate holders, provided the amendment does not adversely affect payments on the certificates.

In form, each trust certificate represents a fractional undivided ownership interest in the transferred assets. The SBA guarantees (the Passthrough Guarantee) that the certificate holders will

receive timely an amount equal to their proportionate share of all amounts received by the trust. 15 U.S.C. § 687*l*(b) (1994). The Passthrough Guarantee is enforceable regardless of the defenses available to the SBICs or the trustee. Although the certificate holders can enforce the Passthrough Guarantee, they cannot enforce any obligation of the SBICs. Specifically, the certificate holders have no right to enforce the Prioritized Payments or Redemption Payments, and the underlying SBICs owe no duty to the certificate holders.

The trustee has no duty or authority to enforce collection of the trust assets other than the Payment Guarantee. Instead, the SBA services (at its expense) the Redemption Payments and Prioritized Payments and has the sole right to take action and assert claims with respect to the Redemption Payments and Prioritized Payments. As servicer, the SBA can waive or agree to amend any term of any participating security; those modifications, however, cannot decrease or defer the aggregate payments to the trust. No federal or state law may limit the exercise by the SBA of its ownership rights in the participating securities. 15 U.S.C. § 687*l*(e)(2) (1994).

Because the SBA forms a new pool of participating securities each quarter, several pools may exist at any time. The SBA has the right (but not the obligation) to replace Redemption Payments and Prioritized Payments due on one pool with Redemption Payments and Prioritized Payments due on another. Specifically, if the SBA believes a participating security in a pool is about to make a Redemption Payment, the SBA can exchange the rights to all or part of that Redemption Payment (and related Prioritized Payments) for the rights to all or part of the Redemption Payments and Prioritized Payments due on participating securities in other pools.

The SBA can exercise the right of substitution at any time provided three conditions are met. These conditions ensure an adequate match between the payments relinquished on a redeeming security and the payments to be received in exchange from any "replacement" securities. First, the sum of the Redemption Payments to be received with respect to the replacement securities must equal the amount of the Redemption Payment relinquished with respect to the redeeming security. Second, the final due date for each replacement security must be no later than the final due date for the redeeming security. Third, the percentage used for calculating the Prioritized Payments on each replacement security must be no less than the percentage used for calculating the Prioritized Payments on the redeeming security.

There are common situations in which the SBA can benefit from using the substitution power. For example, if a pool holds a 6 percent security that is about to be redeemed, the SBA can replace it with an 8 percent security from an older pool. Certificate holders in the older pool, after receiving the Redemption Payment from the 6 percent security, will no longer be entitled to Prioritized Payments on the redeemed amount. Certificate holders in the 6 percent pool will receive Prioritized Payments from the 8 percent security, but only at a 6 percent rate. Consequently, the exchange will advance the termination of the older, higher interest rate pool, and allow the SBA to retain the extra 2 percent of Prioritized Payments that are not required to service the 6 percent pool.

LAW

The economic substance of a transaction generally governs its federal tax consequences. *Gregory v. Helvering*, 293 U.S. 465 (1935), XIV–1 C.B. 193. Affixing a label to an undertaking (for example, referring to an arrangement as a "guarantee") does not alone decide its character. *Sun Oil Co. v. Commissioner*, 562 F. 2d 258, 263 (3d Cir. 1977); *Oesterreich v. Commissioner*, 226 F. 2d 798, 801–02 (9th Cir. 1955); *Boulez v. Commissioner*, 83 T.C. 584, 591 (1984); *see also Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958), 1958–1 C.B. 516.

A guarantee of an instrument is a secondary and collateral promise to pay the amounts due under the instrument in the event the primary obligor (ordinarily the issuer) defaults. *Zappo v. Commissioner*, 81 T.C. 87–88 (1983); *Perry v. Commissioner*, 47 T.C. 159, 163 (1966). The Commissioner may recharacterize any transaction that has the preceding attributes in appearance but not in substance. *See Estate of Durkin v. Commissioner*, 99 T.C. 561, 571 (1992). How the transaction may be rechacterized depends on the facts, including the terms of the "guarantee" and any related agreements and the circumstances existing at the time the "guarantee" is made.

For example, at the time a taxpayer "guarantees" an instrument, the finances of the issuer may be so precarious that the taxpayer (rather than the issuer) is expected to pay the instrument. Under such facts, the taxpayer may be, in substance, accepting primary (rather than secondary) responsibility for the instrument. *Lang v. Commissioner*, 32 B.T.A. 522 (1935); *see* Rev. Rul. 94–42, 1994–2 C.B. 15. As another example, under the terms of a "guarantee" and any related agreements, a taxpayer may have to pay regardless of any default on the "guaranteed" instrument and may enjoy beneficial ownership of the instrument. Beneficial ownership may be evidenced by, among other things, a power in the taxpayer to replace the instrument or to exercise for its own advantage any privileges inherent in the instrument. *See Schoellkopf v. Commissioner*, 32 B.T.A. 88 (1935); *cf.* Rev. Rul. 77–137, 1977–1 C.B. 178. Under such facts, the taxpayer may be, in substance, issuing its own primary obligation and using the "guaranteed" instrument to secure that obligation. Rev. Rul. 78–118, 1978–1 C.B. 219; *see Schoellkopf v. Commissioner*. Different facts may support other characterizations. No single fact is conclusive, and all aspects of a transaction must be considered to determine its substance.

ANALYSIS

The trust holds a group of inseparable rights consisting of the rights to the Redemption Payments, the Prioritized Payments, and the amounts paid under the Payment Guarantee. Based on all of the facts and circumstances, this group of rights (the Guaranteed Payment Rights) constitutes, in substance, a primary obligation of the SBA. It does not represent an ownership interest in SBIC securities backed by an SBA guarantee. Among the reasons for this conclusion are not only the differences between the payment obligations of the SBA and the payment obligations of the SBICs but also the continuing interest of the SBA in the participating securities.

The payment obligations of the SBA and the SBICs differ in that the SBA has to make payments even if the SBICs are not in default. A SBIC has to make a Prioritized Payment only if it has sufficient profits, but the SBA must disburse an amount equivalent to that Prioritized Payment in all events. Also, a SBIC has to make Prioritized Payments only on an annual basis, but the SBA must make payments quarterly. These differences are more than a matter of form. Each time a new pool is

created, the SBA will reasonably expect to disburse and not recover, during the pool's first three years, an amount exceeding 15 percent of the Prioritized Payments that would be due on the participating securities in the pool if Prioritized Payments had to be made regardless of financial condition and were paid in quarterly installments rather than annually.

In addition, the SBA retains beneficial ownership of the participating securities. Although, in form, the rights to the Redemption Payments and Prioritized Payments are transferred to the trust, neither the trust nor the certificate holders enjoy any rights of beneficial ownership in the participating securities. No federal or state law can limit the exercise of the SBA's ownership rights in the participating securities, and the SBA makes no promise to exercise these rights for the trust's benefit. 15 U.S.C. § 687*l*(e)(2) (1994). The SBA never transfers its interests in the Profit Participation Payments and continues to service (at its expense) the Redemption Payments and Prioritized Payments. Moreover, neither the trustee nor the certificate holders can force the SBICs to make these payments. The SBA enjoys a right to replace Redemption Payments and Prioritized Payments due on one pool with Redemption Payments and Prioritized Payments due on another. This right allows the SBA to exercise control over a participating security for its own rather than the certificate holders' benefit. It also demonstrates that a certificate does not represent an interest in any identifiable participating security.

HOLDING

For federal tax purposes, the SBA is the primary obligor of the Guaranteed Payment Rights created under its participating security program, and the trust certificate holders are treated as owning indebtedness of the SBA.

This revenue ruling is predicated on the law governing the SBA participating security program as of December 24, 1996. Therefore, before relying on this revenue ruling, taxpayers, Service personnel, and others are cautioned to determine whether the law referred to has materially changed since that date. See § 7.01(6), Rev. Proc. 89–14, 1989–1 C.B. 814.

DRAFTING INFORMATION

The principal author of this revenue ruling is Kenneth Christman of the Office of Assistant Chief Counsel (Financial Institutions & Products). For further information regarding this revenue ruling contact Mr. Christman on (202) 622–3950 (not a toll-free call).

Section 168.—Accelerated Cost Recovery System

How does a taxpayer elect to treat a retail motor fuels outlet placed in service before August 20, 1996, as 15-year property for depreciation purposes? See Rev. Proc. 97–10, page 59.

Section 265.—Expenses and Interest Relating to Tax-exempt Income

26 CFR 1.265–2: Interest relating to tax-exempt income.

In an S corporation context, to the extent indebtedness and tax-exempt obligations are taken into account in applying § 265(b) at the bank level, are they taken into account again in applying § 265(a) at the shareholder level? See Notice 97–5, page 25.

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of January 1997. See Rev. Rul. 97–1, page 10.

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

The adjusted federal long-term rate is set forth for the month of January 1997. See Rev. Rul. 97–1, page 10.

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 1997. See Rev. Rul. 97–1, page 10.

Section 446.—General Rule for Methods of Accounting

If a taxpayer elects to treat a retail motor fuels outlet placed in service before August 20, 1996, as 15-year property for depreciation purposes, is this election a change in method of accounting? See Rev. Proc. 97–10, page 59.

Section 446.—General Rule for Methods of Accounting

26 CFR 1.446–1: General rule for methods of accounting.

If a taxpayer elects to treat a retail motor fuels outlet place in service before August 20, 1996, as 15-year property for depreciation purposes, is this election a change in method of accounting? See Rev. Proc. 97–10, page 59.

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

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 1997. See Rev. Rul. 97–1, page 10.

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

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 1997. See Rev. Rul. 97–1, page 10.

Section 481.—Adjustments Required by Changes in Methods of Accounting

If a taxpayer elects to treat a retail motor fuels outlet placed in service before August 20, 1996, as 15-year property for depreciation purposes, is an adjustment to taxable income required by this change in method of accounting? See Rev. Proc. 97–10, page 59.

Section 483.—Interest on Certain Deferred Payments

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 1997. See Rev. Rul. 97–1, page 10.

Section 807.—Rules for Certain Reserves

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 1997. See Rev. Rul. 97–1, page 10.

Insurance companies; interest rate tables. Prevailing state assumed interest rates are provided for the determination of reserves under section 807 of the Code for contracts issued in 1996 and 1997. Rev. Rul. 92–19 supplemented in part. See Rev. Rul. 97–2 on page 8.

Rev. Rul. 97–2

For purposes of § 807(d)(4) of the Internal Revenue Code, for taxable years beginning after December 31, 1995, this ruling supplements the schedules of prevailing state assumed interest rates set forth in Rev. Rul. 92–19, 1992–1 C.B. 227. This information is to be used by insurance companies in computing their reserves for (1) life insurance and supplementary total and permanent disability benefits, (2) individual annuities and pure endowments, and (3) group annuities and pure endowments. As § 807(d)(2)(B) requires that the interest rate used to compute these reserves be the greater of (1) the applicable federal interest rate, or (2) the prevailing state assumed interest rate, the table of applicable federal interest rates in Rev. Rul. 92–19 is also supplemented.

Following are supplements to schedules A, B, C, and D to Part III of Rev. Rul. 92–19, providing prevailing state assumed interest rates for insurance products with different features issued in 1996 and 1997, and a supplement to the table in Part IV of Rev. Rul. 92–19, providing the applicable federal interest rate under § 807(d) for 1996 and 1997. This ruling does not supplement Parts I and II of Rev. Rul. 92–19.

This is the fifth supplement to the interest rates provided in Rev. Rul. 92–19. Earlier supplements were published in Rev. Rul. 93–58, 1993–2 C.B. 241 (interest rates for insurance products issued in 1992 and 1993), Rev. Rul. 94–11, 1994–1 C.B. 196 (1993 and 1994), Rev. Rul. 95–4, 1995–1 C.B. 141 (1994 and 1995), and Rev. Rul. 96–2, 1996–1 C.B. 141 (1995 and 1996).

Part III. Prevailing State Assumed Interest Rates — Products Issued in Years After 1982.*

Schedule A

STATUTORY VALUATION INTEREST RATES BASED ON THE 1980 AMENDMENTS TO THE NAIC STANDARD VALUATION LAW

A. Life insurance valuation:

Guarantee Duration (years)	*Calendar Year of Issue*
	1997
10 or fewer	5.50**
More than 10 but not more than 20	5.25**
More than 20	4.50**

Source: Rates calculated from the monthly averages, ending June 30, 1996, of Moody's Corporate Bond Yield Average — Monthly Average Corporates.

** As the applicable federal interest rate for 1997 of 6.33 percent exceeds this prevailing state assumed interest rate, the interest rate to be used for this product under § 807 is 6.33 percent.

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* The terms used in the schedules in this ruling and in Part III of Rev. Rul. 92–19 are those used in the Standard Valuation Law; the terms are defined in Rev. Rul. 92–19.

Part III, Schedule B

STATUTORY VALUATION INTEREST RATES BASED ON THE 1980 AMENDMENTS TO THE NAIC STANDARD VALUATION LAW

B. Single premium immediate annuities and annuity benefits involving life contingencies arising from other annuities with cash settlement options and from guaranteed interest contracts with cash settlement options:

Calendar Year of Issue	*Valuation Interest Rate*
1996	6.75*

Source: Rates calculated from the monthly averages, ending June 30, 1996, of Moody's Corporate Bond Yield Average — Monthly Average Corporates. The terms used in this schedule are those used in the Standard Valuation Law as defined in Rev. Rul. 92–19.

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*As this prevailing state assumed interest rate exceeds the applicable federal interest rate for 1996 of 6.63 percent, the interest rate to be used for this product under § 807 is 6.75 percent.

Part III, Schedule C14—1996

STATUTORY VALUATION INTEREST RATES BASED ON NAIC STANDARD VALUATION LAW FOR **1996** CALENDAR YEAR BUSINESS GOVERNED BY THE 1980 AMENDMENTS

C. Valuation interest rates for other annuities and guaranteed interest contracts that are valued on an issue year basis:

Cash Settlement Options?	*Future Interest Guarantee?*	*Guarantee Duration (years)*	*Valuation Interest Rate For Plan Type*		
			A	*B*	*C*
Yes	Yes	5 or fewer	6.75	5.75*	5.25*
		More than 5, but not more than 10	6.50*	5.75*	5.25*
		More than 10, but not more than 20	6.00*	5.25*	5.00*
		More than 20	5.00*	4.50*	4.50*
Yes	No	5 or fewer	6.75	6.00*	5.50*
		More than 5, but not more than 10	6.75	6.00*	5.50*
		More than 10, but not more than 20	6.25*	5.50*	5.25*

				Valuation Interest Rate For Plan Type	
		More than 20	5.25*	4.75*	4.75*
No	Yes or No	5 or fewer	6.75		
		More than 5, but not more than 10	6.50*	NOT	APPLICABLE
		More than 10, but not more than 20	6.00*		
		More than 20	5.00*		

Source: Rates calculated from the monthly averages, ending June 30, 1996 of Moody's Corporate Bond Yield Average — Monthly Average Corporates.

*As the applicable federal interest rate for 1996 of 6.63 percent exceeds this prevailing state assumed interest rate, the interest rate to be used for this product under § 807 is 6.63 percent.

Part III, Schedule D14—1996

STATUTORY VALUATION INTEREST RATES
BASED ON NAIC STANDARD VALUATION LAW
FOR **1996** CALENDAR YEAR BUSINESS
GOVERNED BY THE 1980 AMENDMENTS

D. Valuation interest rates for other annuities and guaranteed interest contracts that are contracts with cash settlement options and that are valued on a change in fund basis:

Cash Settlement Options?	*Future Interest Guarantee?*	*Guarantee Duration (years)*	*Valuation Interest Rate For Plan Type*		
			A	*B*	*C*
Yes	Yes	5 or fewer	7.25	6.75	5.50*
		More than 5, but not more than 10	7.00	6.75	5.50*
		More than 10, but not more than 20	6.75	6.50*	5.25*
		More than 20	5.75*	5.75*	4.75*
Yes	No	5 or fewer	7.50	7.00	5.75*
		More than 5, but not more than 10	7.25	7.00	5.75*
		More than 10, but not more than 20	6.75	6.75	5.50*
		More than 20	6.00*	6.00*	5.00*

Source: Rates calculated from the monthly averages, ending June 30, 1996, of Moody's Corporate Bond Yield Average — Monthly Average Corporates.

*As the applicable federal interest rate for 1996 of 6.63 percent exceeds this prevailing state assumed interest rate, the interest rate to be used for this product under § 807 is 6.63 percent.

Part IV. Applicable Federal Interest Rates.

TABLE OF APPLICABLE
FEDERAL INTEREST RATES
FOR PURPOSES OF § 807

Year	*Interest Rate*
1996	6.63
1997	6.33

Sources: Rev. Rul. 95–79, 1995–2 C.B. 134 for the 1996 rate and Rev. Rul. 96–57, 1996–50 I.R.B. C.B. 5 for the 1997 rate.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 92–19 is supplemented by the addition to Part III of that ruling of prevailing state assumed interest rates under § 807 for certain insurance products issued in 1996 and 1997 and is further supplemented by an addition to the table in Part IV of Rev. Rul. 92–19 listing applicable federal interest rates. Parts I and II of Rev. Rul. 92–19 are not affected by this ruling.

DRAFTING INFORMATION

The principal author of this revenue ruling is Ann H. Logan of the Office of Assistant Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling contact her on (202) 622–3970 (not a toll-free call).

Section 846.—Discounted Unpaid Losses Defined

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 1997. See Rev. Rul. 97–1, this page.

Section 851.—Definition of Regulated Investment Company

26 CFR 1.851–2: Limitations.

Are holders of the guaranteed payment rights that are created by the Small Business Administration (SBA) under its participating security program treated as owning SBA debt? See Rev. Rul. 97–3, page 5.

Section 856.—Definition of Real Estate Investment Trusts

26 CFR 1.856–2: Limitations.

Are holders of the guaranteed payment rights that are created by the Small Business Administration (SBA) under its participating security program treated as owning SBA debt? See Rev. Rul. 97–3, page 5.

Section 895.—Income Derived by a Foreign Central Bank of Issue From Obligations of the United States or From Bank Deposits

26 CFR 1.895–1: Income derived by a foreign central bank of issue, or by Bank for International Settlements, from obligations of the United States or from bank deposits.

Are holders of the guaranteed payment rights that are created by the Small Business Administration (SBA) under its participating security program treated as owning SBA debt? See Rev. Rul. 97–3, page 5.

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

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

Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate. For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for January 1997.

Rev. Rul. 97–1

This revenue ruling provides various prescribed rates for federal income tax purposes for January 1997 (the current month.) Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520. Finally, Table 6 contains the deemed rate of return for transfers made during calendar year 1997 to pooled income funds described in section 642(c)(5) that have been in existence for less than 3 taxable years immediately preceding the taxable year in which the transfer is made.

REV. RUL. 97–1 TABLE 1

Applicable Federal Rates (AFR) for January 1997

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	5.63%	5.55%	5.51%	5.49%
110% AFR	6.20%	6.11%	6.06%	6.03%
120% AFR	6.77%	6.66%	6.61%	6.57%
130% AFR	7.35%	7.22%	7.16%	7.11%
Mid-Term				
AFR	6.10%	6.01%	5.97%	5.94%
110% AFR	6.72%	6.61%	6.56%	6.52%
120% AFR	7.34%	7.21%	7.15%	7.10%
130% AFR	7.96%	7.81%	7.74%	7.69%
150% AFR	9.22%	9.02%	8.92%	8.86%
175% AFR	10.80%	10.52%	10.39%	10.30%
Long-Term				
AFR	6.54%	6.44%	6.39%	6.36%
110% AFR	7.21%	7.08%	7.02%	6.98%
120% AFR	7.88%	7.73%	7.66%	7.61%
130% AFR	8.55%	8.37%	8.28%	8.23%

REV. RUL. 97–1 TABLE 2

Adjusted AFR for January 1997

Period for Compounding

	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	3.64%	3.61%	3.59%	3.58%
Mid-term adjusted AFR	4.45%	4.40%	4.38%	4.36%
Long-term adjusted AFR	5.35%	5.28%	5.25%	5.22%

REV. RUL. 97–1 TABLE 3

Rates Under Section 382 for January 1997

Adjusted federal long-term rate for the current month	5.35%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	5.60%

REV. RUL. 97–1 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for January 1997

Appropriate percentage for the 70% present value low-income housing credit	8.48%
Appropriate percentage for the 30% present value low-income housing credit	3.64%

REV. RUL. 97–1 TABLE 5

Rate Under Section 7520 for January 1997

Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	7.4%

REV. RUL. 97–1 TABLE 6

Deemed Rate for Transfers to New Pooled Income Funds During 1997

Deemed rate of return for transfers during 1997 to pooled income funds that have been in existence for less than 3 taxable years.	7.2%

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

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 1997. See Rev. Rul. 97–1, page 10.

Section 7701.—Definitions

26 CFR 301.7701–13A: Post-1969 domestic building and loan association.

Are holders of the guaranteed payment rights that are created by the Small Business Administration (SBA) under its participating security program treated as owning SBA debt? See Rev. Rul. 97–3, page 5.

26 CFR 301.7701–3: Classification of certain business entities.

T.D. 8697

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1, 301, and 602

Simplification of Entity Classification Rules

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that classify certain business organizations under an elective regime. These regulations replace the existing classification rules.

DATES: These regulations are effective as of January 1, 1997. For dates of applicability of these regulations, see Effective Dates under Supplementary Information.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Mark D. Harris, (202) 622–3050; concerning foreign organizations, William H. Morris or Ronald M. Gootzeit, (202) 622–3880 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have 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 1545–1486. Responses to these collections of information are required to obtain a benefit (to choose an entity's classification by election).

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.

The estimates of the reporting burden in these final regulations are reflected in the burden estimates in Form 8832 (Entity Classification Election).

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, T:FP, 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 these collections 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

On April 3, 1995, Notice 95–14 (1995–1 C.B. 297), relating to classification of business organizations under section 7701 of the Code, was published in the Internal Revenue Bulletin. A notice of public hearing was published in the Federal Register on May 10, 1995 (60 FR 24813). Written comments were received and a public hearing was held on July 20, 1995.

On May 13, 1996, the IRS and Treasury issued a notice of proposed rulemaking (61 FR 21989 [PS–43–95, 1996–24 I.R.B. 20]) under section 7701. The regulations proposed to replace the existing regulations for classifying certain business organizations with an elective regime. Comments responding to the notice were received, and a public hearing was held on August 21, 1996. After considering the comments that were received in response to the notice of proposed rulemaking and the statements made at the public hearing, the proposed regulations are adopted as revised by this Treasury decision. The revisions are discussed below.

Explanation of Provisions

Section 7701(a)(2) of the Code defines a partnership to include a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and that is not a trust or estate or a corporation. Section 7701(a)(3) defines a corporation to include associations, joint-stock companies, and insurance companies.

The existing regulations for classifying business organizations as associations (which are taxable as corporations under section 7701(a)(3)) or as partnerships under section 7701(a)(2) are based on the historical differences under local law between partnerships and corporations. Treasury and the IRS believe that those rules have become increasingly formalistic. This document replaces those rules with a much simpler approach that generally is elective.

As stated in the preamble to the proposed regulations, in light of the increased flexibility under an elective regime for the creation of organizations classified as partnerships, Treasury and the IRS will continue to monitor carefully the uses of partnerships in the international context and will take appropriate action when partnerships are used to achieve results that are inconsistent with the policies and rules of particular Code provisions or of U.S. tax treaties.

A. Summary of the Regulations

Section 301.7701–1 provides an overview of the rules applicable in determining an organization's classification for federal tax purposes. The first step in the classification process is to determine whether there is a separate entity for federal tax purposes. The regulations explain that certain joint undertakings that are not entities under local law may nonetheless constitute separate entities for federal tax purposes; however, not all entities formed under local law are recognized as separate entities for federal tax purposes. Whether an organization is treated as an entity for federal tax purposes is a matter of federal tax law, and does not affect the rights and obligations of its owners under local law. For example, if a domestic limited liability company with a single individual owner is disregarded as an entity separate from its owner under § 301.7701–3, its individual owner is subject to federal income tax as if the company's business was operated as a sole proprietorship.

An organization that is recognized as a separate entity for federal tax purposes is either a trust or a business entity (unless a provision of the Code expressly provides for special treatment, such as the Qualified Settlement Fund rules (§ 1.468B) or the Real Estate Mortgage Investment Conduit (REMIC) rules, see section 860A(a)). The regulations provide that trusts generally do not have associates or an objective to carry on business for profit. The distinctions between trusts and business entities, although restated, are not changed by these regulations.

Section 301.7701–2 clarifies that business entities that are classified as corporations for federal tax purposes include corporations denominated as such under applicable law, as well as associations, joint-stock companies, insurance companies, organizations that conduct certain banking activities, organizations wholly owned by a State, organizations that are taxable as corporations under a provision of the Code other than section 7701(a)(3), and certain organizations formed under the laws of a foreign jurisdiction (including a U.S. possession, territory, or commonwealth).

The regulations in § 301.7701–2 include a special grandfather rule, under which an entity described in the list of foreign entities treated as per se corporations will nevertheless be classified as other than a corporation. The regulations also list certain situations where a grandfathered entity would lose its grandfathered status.

Any business entity that is not required to be treated as a corporation for federal tax purposes (referred to in the regulation as an *eligible entity*) may choose its classification under the rules of § 301.7701–3. Those rules provide that an eligible entity with at least two members can be classified as either a partnership or an association, and that an eligible entity with a single member can be classified as an association or can be disregarded as an entity separate from its owner. However, if the single owner of a business entity is a bank (as

defined in section 581), then the special rules applicable to banks will continue to apply to the single owner as if the wholly owned entity were a separate entity.

In order to provide most eligible entities with the classification they would choose without requiring them to file an election, the regulations provide default classification rules that aim to match taxpayers' expectations (and thus reduce the number of elections that will be needed). The regulations adopt a passthrough default for domestic entities, under which a newly formed eligible entity will be classified as a partnership if it has at least two members, or will be disregarded as an entity separate from its owner if it has a single owner. The default for foreign entities is based on whether the members have limited liability. Thus a foreign eligible entity will be classified as an association if all members have limited liability. A foreign eligible entity will be classified as a partnership if it has two or more members and at least one member does not have limited liability; the entity will be disregarded as an entity separate from its owner if it has a single owner and that owner does not have limited liability. Finally, the default classification for an existing entity is the classification that the entity claimed immediately prior to the effective date of these regulations. An entity's default classification continues until the entity elects to change its classification by means of an affirmative election.

An eligible entity may affirmatively elect its classification on Form 8832, Entity Classification Election. The regulations require that the election be signed by each member of the entity or any officer, manager, or member of the entity who is authorized to make the election and who represents to having such authorization under penalties of perjury. An election will not be accepted unless it includes all of the required information, including the entity's taxpayer identifying number (TIN).

Taxpayers are reminded that a change in classification, no matter how achieved, will have certain tax consequences that must be reported. For example, if an organization classified as an association elects to be classified as a partnership, the organization and its owners must recognize gain, if any, under the rules applicable to liquidations of corporations.a

B. Discussion of Comments on the General Approach and Scope of the Regulations

Several comments requested clarification with regard to the rules for determining when an owner of an interest in an organization will be respected as a bona fide owner for federal tax purposes. Some commentators were concerned, for example, that certain owners would be required to maintain certain net worth requirements. Other commentators, relying on Rev. Rul. 93–4, 1993–1 C.B. 225, suggested that if two wholly-owned subsidiaries of a common parent were the owners of an organization, those owners would not be respected as bona fide owners and the organization would be treated as having only one owner (the common parent). Although the determination of whether an organization has more than one owner is based on all the facts and circumstances, the fact that some or all of the owners of an organization are under common control does not require the common parent to be treated as the sole owner. Consistent with this approach, Rev. Rul. 93–4 treated two wholly owned subsidiaries as associates and then classified the foreign entity based on the four corporate characteristics under section 7701. While these four factors will no longer apply with the adoption of the regulations, determining whether the subsidiaries are associates continues to be an issue.

The IRS has received a number of comments asking for clarification of the tax treatment of entities that are wholly owned by an Indian tribe and incorporated under tribal law. Treasury and the IRS are currently studying this issue and will, if necessary, issue separate guidance regarding this issue.

Most commentators agreed that inclusion of the list of foreign business entities treated as corporations per se was appropriate. However, several commentators requested clarification about certain foreign business entities on the per se list. Other commentators requested clarification whether and how the list of such corporations might be updated in the future. The regulations are clarified with respect to entities formed in the following jurisdictions: Aruba, Canada, People's Republic of China, Republic of China (Taiwan), India, Indonesia, Netherlands Antilles, and Sweden. Any further modifications will be announced in a notice of proposed rulemaking and will be prospective only.

Commentators also raised the issue of how to determine if a joint venture or other contractual arrangement that is considered a separate entity under these regulations is considered a foreign or domestic entity. This issue is outside the scope of these regulations and thus is not addressed in the final regulations.

Some commentators raised issues relating to the application of the grandfather rule for certain existing entities organized under foreign statutes included on the list of per se corporations. In particular, commentators requested clarification regarding existing entities that would be listed on the per se list. Commentators have asked whether an existing entity on the per se list which had claimed non-corporate status could retain that status, and, if so, whether it could subsequently elect to be treated as a corporation. Commentators also asked for clarification as to the effect of a deemed termination under section 708(b)(1)(B) or a division under section 708(b)(2)(B) on a grandfathered per se entity.

In response to these comments, the grandfather rules clarify that an entity on the list which was previously disregarded as a separate entity (i.e., treated as a branch) or was treated as a partnership may continue to be treated as such when the regulations become effective. Moreover, entities on the list which continue to treat themselves as branches or partnerships after the effective date of the regulations may subsequently elect to be treated as corporations. However, after such election they may not subsequently elect to be treated as a partnership or a branch. Finally, any termination under section 708(b)(1)(B) (except in the case of a sale or exchange of interests in an entity described in § 301.7701–2(d)(2) where the sale or exchange is to a related person within the meaning of sections 267(b) and 707(b) and occurs no later than 12 months after the date the entity is formed) or division under section 708(b)(2)(B) will end the grandfathered status of any entity on the per se list, and therefore the successor entity (or entities) will thereafter be permanently treated as a corporation.

Other commentators suggested that the requirement that an existing entity included on the per se list must have claimed passthrough treatment for all prior periods is burdensome and precludes grandfather treatment for entities that restructured in the past and recognized the resulting tax consequences. In

response to these comments, the regulations are modified to indicate that an existing entity can continue to be treated as a non-corporate entity if it was in existence on May 8, 1996, and was reasonably treated as a non-corporate entity on that date (or formed thereafter pursuant to a written binding contract in effect on May 8, 1996, in which the parties agreed to engage (directly or indirectly) in an active and substantial business operation in the jurisdiction in which the entity is formed, and which would otherwise meet the grandfather rules if the date the entity is formed is substituted for May 8, 1996). If the entity changed its claimed tax status within the sixty months prior to May 8, 1996, the entity and its members must have recognized the tax consequences that resulted from that change in tax status. Moreover, the regulations clarify that the grandfather treatment applies if no person for whom the entity's classification was relevant on May 8, 1996, treats the entity as a corporation for purposes of filing such person's federal income tax returns, information returns, and withholding documents for the period including May 8, 1996.

One commentator suggested that it was unclear when the classification of a foreign entity is ''relevant'' for federal tax purposes. This determination is important, as it affects whether the grandfather rule, the default rule for existing entities, or the default rule for a newly formed foreign entity applies. In general, an entity's classification is relevant when its classification affects the liability of any person for federal tax or information purposes. The date that the classification of a foreign entity is relevant is the date an event occurs that causes an obligation to file a return or statement for which the classification of the entity must be determined.

C. Discussion of Comments Relating to the Elective Regime

Most of the commentators agreed that the default rules included in the proposed regulations generally would match taxpayers' expectations. However, some commentators expressed concern over the application of the default rule for newly formed foreign eligible entities which would treat such entities as associations if no member had unlimited liability. Specifically, certain commentators noted that under the definition of unlimited liability in the proposed regulations, certain contractual joint ventures which, under current law, would generally be classified as partnerships, would be treated as associations under the default rule. The members of these contractual joint ventures are not jointly and severally liable for all debts of the entity; rather, each member has unlimited liability for a certain proportion of the debts of the entity. To simplify the default rules, the regulations are modified to provide that a newly formed foreign eligible entity will— (1) be treated as a partnership if it has at least two members and at least one member does not have limited liability; (2) be treated as an association if all members of the entity have limited liability; and (3) be disregarded as an entity separate from its owner if it has a single owner that does not have limited liability.

The regulations are modified to provide that a member does not have limited liability if the member, by virtue of being a member, has personal liability for all or any portion of the debts of the entity.

Certain commentators asked for clarification of the default rule in the case where the relevant statute or law of a particular country provides for limited or unlimited liability. Generally, the regulations specify that only the statute or law is relevant. Where, however, the underlying statute allows the entity to specify in its organizational documents whether the members will have limited liability, the organizational documents may be relevant.

Some commentators requested that taxpayers be allowed to make classification elections with their first tax returns. The regulations retain the requirement that elections be made at the beginning of the taxable year. Treasury and the IRS continue to believe that it is appropriate to determine an entity's classification at the time that it begins its operations. Taxpayers can specify the date on which an election will be effective, provided that date is not more than 75 days prior to the date on which the election is filed (irrespective of when the interest was acquired) and not more than 12 months after the date the election was filed. If a taxpayer specifies an effective date more than 75 days prior to the date on which the election is filed, the election will be effective 75 days prior to the date on which the election was filed. If a taxpayer specifies an effective date more than 12 months from the filing date, the election will be effective 12 months after the date the election was filed. No election, whenever filed, will be effective before January 1, 1997.

One commentator expressed concern about the ability to make protective elections where there is uncertainty, for example, about an entity's status as a business entity. Such protective elections are not prohibited under the regulations.

The regulations limit the ability of an entity to make multiple classification elections by prohibiting more than one election to change an entity's classification during any sixty month period. One commentator suggested that the regulations be amended to waive application of this rule in certain circumstances, particularly when there has been a substantial change in ownership of the entity. In response to this comment, the regulations permit the Commissioner to waive the application of the sixty month limitation by letter ruling. However, waivers will not be granted unless there has been more than a fifty percent ownership change. The sixty month limitation only applies to a change in classification by election; the limitation does not apply if the organization's business is actually transferred to another entity.

Several commentators requested clarification concerning the classification of a foreign entity when the classification of the entity becomes relevant for federal tax purposes after a period during which the classification of the entity was not relevant. Generally, such an entity will retain its prior classification. However, if the classification of a foreign eligible entity which was previously relevant for federal tax purposes ceases to be relevant for sixty consecutive months, the entity's classification will be determined initially under the default classification when the classification of the foreign eligible entity again becomes relevant.

Some commentators requested clarification regarding the rule permitting elections to be signed by any authorized officer, manager, or member of the electing entity. The regulations retain this rule, as it provides taxpayers with flexibility in complying with the election requirements. The determination of whether a person is authorized to make an election is based on local law. Thus, the election can be made by anyone authorized to act on behalf of the entity.

Several commentators asked for guidance regarding the necessary signatures on the classification election. The regulations are modified to provide that if

the election is made by all of the members, each person who is an owner at the time the election is made must consent to the election. However, if an election is to be effective for any period prior to the date it is filed, each person who was an owner between the date the election is to be effective and the date the election is filed (even if by an authorized person), and who is not an owner at the time the election is filed, must also consent to the election.

Several commentators requested that the classification election be coordinated with the election under section 856(c)(1) to be a real estate investment trust (REIT). Because the latter election is required to be made with the REIT's first tax return, the regulations are modified to provide that an election by an eligible entity to be a REIT will be treated as a deemed election to be classified as an association, effective for the entire period during which REIT status is claimed.

Some commentators suggested that the regulations should not require an entity or its direct or indirect owners to attach a copy of the entity's election to their federal tax returns. Specifically, some commentators were concerned that the failure of one owner to attach a copy of the election to the owner's return would void an otherwise valid election. The regulations retain the requirement that taxpayers must attach a copy of the election to their returns, but clarify that failure to do so will not invalidate an otherwise valid election. Although the failure to attach a copy will not adversely affect an otherwise valid election, taxpayers are reminded that each member of the entity is required to file returns that are consistent with the entity's election. Failure to attach the election form to a federal tax or information return as directed in the regulations may give rise to penalties against the non-filing party. Other applicable penalties may also apply to parties who file federal tax or information returns inconsistent with the entity's election.

One commentator asked for guidance on the treatment of conversions by election from partnership to corporation and from corporation to partnership. This issue is outside the scope of these classification rules and thus is not addressed in these regulations. Treasury and the IRS, however, are actively considering issuing guidance on the treatment of such conversions.

D. Effective Dates

The regulations are effective as of January 1, 1997.

The regulations provide a special transition rule for existing entities. The IRS will not challenge the prior classification of an existing eligible entity, or an existing entity described on the per se list, for periods prior to January 1, 1997, if— (1) the entity had a reasonable basis (within the meaning of section 6662) for its claimed classification; (2) the entity and all members of the entity recognized the federal tax consequences of any change in the entity's classification within the sixty months prior to January 1, 1997; and (3) neither the entity nor any member had been notified in writing on or before May 8, 1996, that the classification of the entity was under examination (in which case the entity's classification will be determined in the examination).

Some commentators were concerned that an entity organized after May 8, 1996, would be excluded from this transition rule for existing entities. Because § 301.7701–3(f)(2) applies to entities that were in existence prior to January 1, 1997, no change is necessary to provide relief for entities organized after May 8, 1996.

Some commentators were concerned about entities that claimed to be trusts for the period prior to January 1, 1997, but are subsequently determined to be business entities. In that case, the entity's claimed classification for purposes of applying the provisions of the special transition rule will be the business entity classification claimed by the entity after it has been determined to be a business entity.

Effect on other documents

The Service has published a number of revenue rulings and revenue procedures interpreting the section 7701 regulations. The Service is currently reviewing these revenue rulings and revenue procedures to determine which are affected by the publication of these regulations. See accompanying Notice 97–1.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that these regulations do not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that the automatic classification rules of § 301.7701–2(b) and the default classification rules of § 301.7701–3(b) will operate in such a manner that only a limited number of entities will need to make an election under § 301.7701–3(c) to determine their classification. 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 Internal Revenue Code, the notice of proposed rulemaking preceding these final regulations has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are Armando Gomez and Mark D. Harris of the Office of Assistant Chief Counsel (Passthroughs and Special Industries) and William H. Morris and Ronald M. Gootzeit of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1, 301, and 602 are amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.581–1 is revised to read as follows:

§ 1.581–1 Banks.

(a) In order to be a bank as defined in section 581, an institution must be a corporation for federal tax purposes. See § 301.7701–2(b) of this chapter for the definition of a corporation.

(b) This section is effective as of January 1, 1997.

Par. 3. Section 1.581–2 is amended as follows:

1. Paragraph (a) is removed.

2. Paragraphs (b) and (c) are redesignated as paragraphs (a) and (b), respectively.

3. Newly designated paragraph (a) is amended by revising the second and last sentences.

The revisions read as follows:

§ 1.581–2 Mutual savings banks, building and loan associations, and cooperative banks.

(a) * * * See section 593 for special rules concerning reserves for bad debts. * * * See also section 594 and § 1.594–1 for special rules governing the taxation of a mutual savings bank conducting a life insurance business.

* * * * *

Par. 4. In § 1.761–1, paragraph (a) is revised to read as follows:

§ 1.761–1 Terms defined.

(a) *Partnership.* The term *partnership* means a partnership as determined under §§ 301.7701–1, 301.7701–2, and 301.7701–3 of this chapter.

* * * * *

PART 301—PROCEDURE AND ADMINISTRATION

Par. 5. The authority citation for part 301 continues to read in part as follows:

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

Par. 6. Section 301.6109–1 is amended as follows:

1. Paragraph (b)(2)(iii) is amended by removing the language "and" at the end of the paragraph.

2. Paragraph (b)(2)(iv) is amended by removing the period at the end of the paragraph, and replacing it with the language "; and".

3. Paragraph (b)(2)(v) is added.

4. The text of paragraph (d)(2) is redesignated as paragraph (d)(2)(i).

5. A paragraph heading is added for newly designated paragraph (d)(2)(i).

6. Paragraph (d)(2)(ii) is added.

The revisions and additions read as follows:

§ 301.6109–1 Identifying numbers.

* * * * *

(b) * * *

(2) * * *

(v) A foreign person that makes an election under § 301.7701–3(c).

* * * * *

(d) * * *

(2) *Employer identification number*—(i) *In general.* * * *

(ii) *Special rule for entities electing to change their federal tax classification under § 301.7701–3(c).* Any entity that has an employer identification number and then elects under § 301.7701–3(c) to change its federal tax classification will retain that employer identification number.

* * * * *

Par. 7. Sections 301.7701–1, 301.7701–2, and 301.7701–3 are revised to read as follows:

§ 301.7701–1 Classification of organizations for federal tax purposes.

(a) *Organizations for federal tax purposes*—(1) *In general.* The Internal Revenue Code prescribes the classification of various organizations for federal tax purposes. Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.

(2) *Certain joint undertakings give rise to entities for federal tax purposes.* A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. For example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. Nevertheless, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they have not created a separate entity for federal tax purposes. Similarly, mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a separate entity for federal tax purposes.

(3) *Certain local law entities not recognized.* An entity formed under local law is not always recognized as a separate entity for federal tax purposes. For example, an organization wholly owned by a State is not recognized as a separate entity for federal tax purposes if it is an integral part of the State. Similarly, tribes incorporated under section 17 of the Indian Reorganization Act of 1934, as amended, 25 U.S.C. 477, or under section 3 of the Oklahoma Indian Welfare Act, as amended, 25 U.S.C. 503, are not recognized as separate entities for federal tax purposes.

(4) *Single owner organizations.* Under §§ 301.7701–2 and 301.7701–3, certain organizations that have a single owner can choose to be recognized or disregarded as entities separate from their owners.

(b) *Classification of organizations.* The classification of organizations that are recognized as separate entities is determined under §§ 301.7701–2, 301.7701–3, and 301.7701–4 unless a provision of the Internal Revenue Code (such as section 860A addressing Real Estate Mortgage Investment Conduits (REMICs)) provides for special treatment of that organization. For the classification of organizations as trusts, see § 301.7701–4. That section provides that trusts generally do not have associates or an objective to carry on business for profit. Sections 301.7701–2 and 301.7701–3 provide rules for classifying organizations that are not classified as trusts.

(c) *Qualified cost sharing arrangements.* A qualified cost sharing arrangement that is described in § 1.482–7 of this chapter and any arrangement that is treated by the Commissioner as a qualified cost sharing arrangement under § 1.482–7 of this chapter is not recognized as a separate entity for purposes of the Internal Revenue Code. See § 1.482–7 of this chapter for the proper treatment of qualified cost sharing arrangements.

(d) *Domestic and foreign entities.* For purposes of this section and §§ 301.7701–2 and 301.7701–3, an entity is a domestic entity if it is created or organized in the United States or under the law of the United States or of any State; an entity is foreign if it is not domestic. See sections 7701(a)(4) and (a)(5).

(e) *State.* For purposes of this section and § 301.7701–2, the term *State* includes the District of Columbia.

(f) *Effective date.* The rules of this section are effective as of January 1, 1997.

§ 301.7701–2 Business entities; definitions.

(a) *Business entities.* For purposes of this section and § 301.7701–3, a *business entity* is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701–3) that is not

properly classified as a trust under § 301.7701–4 or otherwise subject to special treatment under the Internal Revenue Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.

(b) *Corporations*. For federal tax purposes, the term *corporation* means—

(1) A business entity organized under a Federal or State statute, or under a statute of a federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic;

(2) An association (as determined under § 301.7701–3);

(3) A business entity organized under a State statute, if the statute describes or refers to the entity as a joint-stock company or joint-stock association;

(4) An insurance company;

(5) A State-chartered business entity conducting banking activities, if any of its deposits are insured under the Federal Deposit Insurance Act, as amended, 12 U.S.C. 1811 et seq., or a similar federal statute;

(6) A business entity wholly owned by a State or any political subdivision thereof;

(7) A business entity that is taxable as a corporation under a provision of the Internal Revenue Code other than section 7701(a)(3); and

(8) *Certain foreign entities*—(i) *In general*. Except as provided in paragraphs (b)(8)(ii) and (d) of this section, the following business entities formed in the following jurisdictions:

American Samoa, Corporation
Argentina, Sociedad Anonima
Australia, Public Limited Company
Austria, Aktiengesellschaft
Barbados, Limited Company
Belgium, Societe Anonyme
Belize, Public Limited Company
Bolivia, Sociedad Anonima
Brazil, Sociedade Anonima
Canada, Corporation and Company
Chile, Sociedad Anonima
People's Republic of China, Gufen Youxian Gongsi
Republic of China (Taiwan), Ku-fen Yu-hsien Kung-szu
Colombia, Sociedad Anonima
Costa Rica, Sociedad Anonima
Cyprus, Public Limited Company
Czech Republic, Akciova Spolecnost
Denmark, Aktieselskab
Ecuador, Sociedad Anonima or Compania Anonima
Egypt, Sharikat Al-Mossahamah
El Salvador, Sociedad Anonima
Finland, Osakeyhtio/Aktiebolag
France, Societe Anonyme
Germany, Aktiengesellschaft
Greece, Anonymos Etairia
Guam, Corporation
Guatemala, Sociedad Anonima
Guyana, Public Limited Company
Honduras, Sociedad Anonima
Hong Kong, Public Limited Company
Hungary, Reszvenytarsasag
Iceland, Hlutafelag
India, Public Limited Company
Indonesia, Perseroan Terbuka
Ireland, Public Limited Company
Israel, Public Limited Company
Italy, Societa per Azioni
Jamaica, Public Limited Company
Japan, Kabushiki Kaisha
Kazakstan, Ashyk Aktsionerlik Kogham
Republic of Korea, Chusik Hoesa
Liberia, Corporation
Luxembourg, Societe Anonyme
Malaysia, Berhad
Malta, Partnership Anonyme
Mexico, Sociedad Anonima
Morocco, Societe Anonyme
Netherlands, Naamloze Vennootschap
New Zealand, Limited Company
Nicaragua, Compania Anonima
Nigeria, Public Limited Company
Northern Mariana Islands, Corporation
Norway, Aksjeselskap
Pakistan, Public Limited Company
Panama, Sociedad Anonima
Paraguay, Sociedad Anonima
Peru, Sociedad Anonima
Philippines, Stock Corporation
Poland, Spolka Akcyjna
Portugal, Sociedade Anonima
Puerto Rico, Corporation
Romania, Societe pe Actiuni
Russia, Otkrytoye Aktsionernoy Obshchestvo
Saudi Arabia, Sharikat Al-Mossahamah
Singapore, Public Limited Company
Slovak Republic, Akciova Spolocnost
South Africa, Public Limited Company
Spain, Sociedad Anonima
Surinam, Naamloze Vennootschap
Sweden, Publika Aktiebolag
Switzerland, Aktiengesellschaft
Thailand, Borisat Chamkad (Mahachon)
Trinidad and Tobago, Public Limited Company
Tunisia, Societe Anonyme
Turkey, Anonim Sirket
Ukraine, Aktsionerne Tovaristvo Vidkritogo Tipu
United Kingdom, Public Limited Company
United States Virgin Islands, Corporation
Uruguay, Sociedad Anonima
Venezuela, Sociedad Anonima or Compania Anonima

(ii) *Exceptions in certain cases*. The following entities will not be treated as corporations under paragraph (b)(8)(i) of this section:

(A) With regard to Canada, any corporation or company formed under any federal or provincial law which provides that the liability of all of the members of such corporation or company will be unlimited; and

(B) With regard to India, a company deemed to be a public limited company solely by operation of Section 43A(1) (relating to corporate ownership of the company), section 43A(1A) (relating to annual average turnover), or section 43A(1B) (relating to ownership interests in other companies) of the Companies Act, 1956 (or any combination of these), provided that the organizational documents of such deemed public limited company continue to meet the requirements of section 3(1)(iii) of the Companies Act, 1956.

(iii) *Public companies*. With regard to Cyprus, Hong Kong, Jamaica, and Trinidad and Tobago, the term public limited company includes any limited company which is not a private limited company under the laws of those jurisdictions.

(iv) *Limited companies*. Any reference to a limited company (whether public or private) in paragraph (b)(8)(i) of this section includes, as the case may be, companies limited by shares and companies limited by guarantee.

(v) *Multilingual countries*. Different linguistic renderings of the name of an entity listed in paragraph (b)(8)(i) of this section shall be disregarded. For example, an entity formed under the laws of Switzerland as a Societe Anonyme will be a corporation and treated in the same manner as an Aktiengesellschaft.

(c) *Other business entities*. For federal tax purposes—

(1) The term *partnership* means a business entity that is not a corporation under paragraph (b) of this section and that has at least two members.

(2) *Wholly owned entities*—(i) *In general*. A business entity that has a

single owner and is not a corporation under paragraph (b) of this section is disregarded as an entity separate from its owner.

(ii) *Special rule for certain business entities*. If the single owner of a business entity is a bank (as defined in section 581), then the special rules applicable to banks will continue to apply to the single owner as if the wholly owned entity were a separate entity.

(d) *Special rule for certain foreign business entities*—(1) *In general*. Except as provided in paragraph (d)(3) of this section, a foreign business entity described in paragraph (b)(8)(i) of this section will not be treated as a corporation under paragraph (b)(8)(i) of this section if—

(i) The entity was in existence on May 8, 1996;

(ii) The entity's classification was relevant (as defined in § 301.7701–3(d)) on May 8, 1996;

(iii) No person (including the entity) for whom the entity's classification was relevant on May 8, 1996, treats the entity as a corporation for purposes of filing such person's federal income tax returns, information returns, and withholding documents for the taxable year including May 8, 1996;

(iv) Any change in the entity's claimed classification within the sixty months prior to May 8, 1996, occurred solely as a result of a change in the organizational documents of the entity, and the entity and all members of the entity recognized the federal tax consequences of any change in the entity's classification within the sixty months prior to May 8, 1996;

(v) A reasonable basis (within the meaning of section 6662) existed on May 8, 1996, for treating the entity as other than a corporation; and

(vi) Neither the entity nor any member was notified in writing on or before May 8, 1996, that the classification of the entity was under examination (in which case the entity's classification will be determined in the examination).

(2) *Binding contract rule*. If a foreign business entity described in paragraph (b)(8)(i) of this section is formed after May 8, 1996, pursuant to a written binding contract (including an accepted bid to develop a project) in effect on May 8, 1996, and all times thereafter, in which the parties agreed to engage (directly or indirectly) in an active and substantial business operation in the jurisdiction in which the entity is formed, paragraph (d)(1) of this section will be applied to that entity by substituting the date of the entity's formation for May 8, 1996.

(3) *Termination of grandfather status*—(i) *In general*. An entity that is not treated as a corporation under paragraph (b)(8)(i) of this section by reason of paragraph (d)(1) or (d)(2) of this section will be treated permanently as a corporation under paragraph (b)(8)(i) of this section from the earliest of:

(A) The effective date of an election to be treated as an association under § 301.7701–3;

(B) A termination of the partnership under section 708(b)(1)(B) (regarding sale or exchange of 50 percent or more of the total interest in an entity's capital or profits within a twelve month period); or

(C) A division of the partnership under section 708(b)(2)(B).

(ii) *Special rule for certain entities*. For purposes of paragraph (d)(2) of this section, paragraph (d)(3)(i)(B) of this section shall not apply if the sale or exchange of interests in the entity is to a related person (within the meaning of sections 267(b) and 707(b)) and occurs no later than twelve months after the date of the formation of the entity.

(e) *Effective date*. The rules of this section are effective as of January 1, 1997.

§ 301.7701–3 Classification of certain business entities.

(a) *In general*. A business entity that is not classified as a corporation under § 301.7701–2(b)(1), (3), (4), (5), (6), (7), or (8) (an *eligible entity*) can elect its classification for federal tax purposes as provided in this section. An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under § 301.7701–2(b)(2)) or a partnership, and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner. Paragraph (b) of this section provides a default classification for an eligible entity that does not make an election. Thus, elections are necessary only when an eligible entity chooses to be classified initially as other than the default classification or when an eligible entity chooses to change its classification. An entity whose classification is determined under the default classification retains that classification (regardless of any changes in the members' liability that occurs at any time during the time that the entity's classification is relevant as defined in paragraph (d) of this section) until the entity makes an election to change that classification under paragraph (c)(1) of this section. Paragraph (c) of this section provides rules for making express elections. Paragraph (d) of this section provides special rules for foreign eligible entities. Paragraph (e) of this section provides special rules for classifying entities resulting from partnership terminations and divisions under section 708(b). Paragraph (f) of this section sets forth the effective date of this section and a special rule relating to prior periods.

(b) *Classification of eligible entities that do not file an election*—(1) *Domestic eligible entities*. Except as provided in paragraph (b)(3) of this section, unless the entity elects otherwise, a domestic eligible entity is—

(i) A partnership if it has two or more members; or

(ii) Disregarded as an entity separate from its owner if it has a single owner.

(2) *Foreign eligible entities*—(i) *In general*. Except as provided in paragraph (b)(3) of this section, unless the entity elects otherwise, a foreign eligible entity is—

(A) A partnership if it has two or more members and at least one member does not have limited liability;

(B) An association if all members have limited liability; or

(C) Disregarded as an entity separate from its owner if it has a single owner that does not have limited liability.

(ii) *Definition of limited liability*. For purposes of paragraph (b)(2)(i) of this section, a member of a foreign eligible entity has limited liability if the member has no personal liability for the debts of or claims against the entity by reason of being a member. This determination is based solely on the statute or law pursuant to which the entity is organized, except that if the underlying statute or law allows the entity to specify in its organizational documents whether the members will have limited liability, the organizational documents may also be relevant. For purposes of this section, a member has personal liability if the creditors of the entity may seek satisfaction of all or any portion of the debts or claims against the entity from the member as such. A member has personal liability for purposes of this paragraph even if the member makes an agreement under which another person (whether or not a member of the entity) assumes

such liability or agrees to indemnify that member for any such liability.

(3) *Existing eligible entities*—(i) *In general*. Unless the entity elects otherwise, an eligible entity in existence prior to the effective date of this section will have the same classification that the entity claimed under §§ 301.7701–1 through 301.7701–3 as in effect on the date prior to the effective date of this section; except that if an eligible entity with a single owner claimed to be a partnership under those regulations, the entity will be disregarded as an entity separate from its owner under this paragraph (b)(3)(i). For special rules regarding the classification of such entities for periods prior to the effective date of this section, see paragraph (f)(2) of this section.

(ii) *Special rules*. For purposes of paragraph (b)(3)(i) of this section, a foreign eligible entity is treated as being in existence prior to the effective date of this section only if the entity's classification was relevant (as defined in paragraph (d) of this section) at any time during the sixty months prior to the effective date of this section. If an entity claimed different classifications prior to the effective date of this section, the entity's classification for purposes of paragraph (b)(3)(i) of this section is the last classification claimed by the entity. If a foreign eligible entity's classification is relevant prior to the effective date of this section, but no federal tax or information return is filed or the federal tax or information return does not indicate the classification of the entity, the entity's classification for the period prior to the effective date of this section is determined under the regulations in effect on the date prior to the effective date of this section.

(c) *Elections*—(1) *Time and place for filing*—(i) *In general*. Except as provided in paragraphs (c)(1)(iv) and (v) of this section, an eligible entity may elect to be classified other than as provided under paragraph (b) of this section, or to change its classification, by filing Form 8832, Entity Classification Election, with the service center designated on Form 8832. An election will not be accepted unless all of the information required by the form and instructions, including the taxpayer identifying number of the entity, is provided on Form 8832. See § 301.6109–1 for rules on applying for and displaying Employer Identification Numbers.

(ii) *Further notification of elections*. An eligible entity required to file a federal tax or information return for the taxable year for which an election is made under paragraph (c)(1)(i) of this section must attach a copy of its Form 8832 to its federal tax or information return for that year. If the entity is not required to file a return for that year, a copy of its Form 8832 must be attached to the federal income tax or information return of any direct or indirect owner of the entity for the taxable year of the owner that includes the date on which the election was effective. An indirect owner of the entity does not have to attach a copy of the Form 8832 to its return if an entity in which it has an interest is already filing a copy of the Form 8832 with its return. If an entity, or one of its direct or indirect owners, fails to attach a copy of a Form 8832 to its return as directed in this section, an otherwise valid election under paragraph (c)(1)(i) of this section will not be invalidated, but the non-filing party may be subject to penalties, including any applicable penalties if the federal tax or information returns are inconsistent with the entity's election under paragraph (c)(1)(i) of this section.

(iii) *Effective date of election*. An election made under paragraph (c)(1)(i) of this section will be effective on the date specified by the entity on Form 8832 or on the date filed if no such date is specified on the election form. The effective date specified on Form 8832 can not be more than 75 days prior to the date on which the election is filed and can not be more than 12 months after the date on which the election is filed. If an election specifies an effective date more than 75 days prior to the date on which the election is filed, it will be effective 75 days prior to the date it was filed. If an election specifies an effective date more than 12 months from the date on which the election is filed, it will be effective 12 months after the date it was filed. If an election specifies an effective date before January 1, 1997, it will be effective as of January 1, 1997.

(iv) *Limitation*. If an eligible entity makes an election under paragraph (c)(1)(i) of this section to change its classification (other than an election made by an existing entity to change its classification as of the effective date of this section), the entity cannot change its classification by election again during the sixty months succeeding the effective date of the election. However, the Commissioner may permit the entity to change its classification by election within the sixty months if more than fifty percent of the ownership interests in the entity as of the effective date of the subsequent election are owned by persons that did not own any interests in the entity on the filing date or on the effective date of the entity's prior election.

(v) *Deemed elections*—(A) *Exempt organizations*. An eligible entity that has been determined to be, or claims to be, exempt from taxation under section 501(a) is treated as having made an election under this section to be classified as an association. Such election will be effective as of the first day for which exemption is claimed or determined to apply, regardless of when the claim or determination is made, and will remain in effect unless an election is made under paragraph (c)(1)(i) of this section after the date the claim for exempt status is withdrawn or rejected or the date the determination of exempt status is revoked.

(B) *Real estate investment trusts*. An eligible entity that files an election under section 856(c)(1) to be treated as a real estate investment trust is treated as having made an election under this section to be classified as an association. Such election will be effective as of the first day the entity is treated as a real estate investment trust.

(vi) *Examples*. The following examples illustrate the rules of this paragraph (c)(1):

Example 1. On July 1, 1998, X, a domestic corporation, purchases a 10% interest in Y, an eligible entity formed under Country A law in 1990. The entity's classification was not relevant to any person for federal tax or information purposes prior to X's acquisition of an interest in Y. Thus, Y is not considered to be in existence on the effective date of this section for purposes of paragraph (b)(3) of this section. Under the applicable Country A statute, all members of Y have limited liability as defined in paragraph (b)(2)(ii) of this section. Accordingly, Y is classified as an association under paragraph (b)(2)(i)(B) of this section unless it elects under this paragraph (c) to be classified as a partnership. To be classified as a partnership as of July 1, 1998, Y must file a Form 8832 by September 13, 1998. See paragraph (c)(1)(i) of this section. Because an election cannot be effective more than 75 days prior to the date on which it is filed, if Y files its Form 8832 after September 13, 1998, it will be classified as an association from July 1, 1998, until the effective date of the election. In that case, it could not change its classification by election under this paragraph (c) during the sixty months succeeding the effective date of the election.

Example 2. (i) Z is an eligible entity formed under Country B law and is in existence on the effective date of this section within the meaning of paragraph (b)(3) of this section. Prior to the effective date of this section, Z claimed to be classified as an association. Unless Z files an

election under this paragraph (c), it will continue to be classified as an association under paragraph (b)(3) of this section.

(ii) Z files a Form 8832 pursuant to this paragraph (c) to be classified as a partnership, effective as of the effective date of this section. Z can file an election to be classified as an association at any time thereafter, but then would not be permitted to change its classification by election during the sixty months succeeding the effective date of that subsequent election.

(2) *Authorized signatures*—(i) *In general*. An election made under paragraph (c)(1)(i) of this section must be signed by—

(A) Each member of the electing entity who is an owner at the time the election is filed; or

(B) Any officer, manager, or member of the electing entity who is authorized (under local law or the entity's organizational documents) to make the election and who represents to having such authorization under penalties of perjury.

(ii) *Retroactive elections*. For purposes of paragraph (c)(2)(i) of this section, if an election under paragraph (c)(1)(i) of this section is to be effective for any period prior to the time that it is filed, each person who was an owner between the date the election is to be effective and the date the election is filed, and who is not an owner at the time the election is filed, must also sign the election.

(d) *Special rules for foreign eligible entities*—(1) For purposes of this section, a foreign eligible entity's classification is relevant when its classification affects the liability of any person for federal tax or information purposes. For example, a foreign entity's classification would be relevant if U.S. income was paid to the entity and the determination by the withholding agent of the amount to be withheld under chapter 3 of the Internal Revenue Code (if any) would vary depending upon whether the entity is classified as a partnership or as an association. Thus, the classification might affect the documentation that the withholding agent must receive from the entity, the type of tax or information return to file, or how the return must be prepared. The date that the classification of a foreign eligible entity is relevant is the date an event occurs that creates an obligation to file a federal tax return, information return, or statement for which the classification of the entity must be determined. Thus, the classification of a foreign entity is relevant, for example, on the date that an interest in the entity is acquired which will require a U.S. person to file an information return on Form 5471.

(2) *Special rule when classification is no longer relevant. If the classification of a foreign eligible entity which was previously relevant for federal tax purposes ceases to be relevant for sixty consecutive months, the entity's classification will initially be determined under the default classification when the classification of the foreign eligible entity again becomes relevant. The date that the classification of a foreign entity ceases to be relevant is the date an event occurs that causes the classification to no longer be relevant, or, if no event occurs in a taxable year that causes the classification to be relevant, then the date is the first day of that taxable year.*

(e) *Coordination with section 708(b)*. Except as provided in § 301.7701–2(d)(3) (regarding termination of grandfather status for certain foreign business entities), an entity resulting from a transaction described in section 708(b)(1)(B) (partnership termination due to sales or exchanges) or section 708(b)(2)(B) (partnership division) is a partnership.

(f) *Effective date*—(1) *In general*. The rules of this section are effective as of January 1, 1997.

(2) *Prior treatment of existing entities*. In the case of a business entity that is not described in § 301.7701–2(b)(1), (3), (4), (5), (6), or (7), and that was in existence prior to January 1, 1997, the entity's claimed classification(s) will be respected for all periods prior to January 1, 1997, if—

(i) The entity had a reasonable basis (within the meaning of section 6662) for its claimed classification;

(ii) The entity and all members of the entity recognized the federal tax consequences of any change in the entity's classification within the sixty months prior to January 1, 1997; and

(iii) Neither the entity nor any member was notified in writing on or before May 8, 1996, that the classification of the entity was under examination (in which case the entity's classification will be determined in the examination).

Par. 8. Section 301.7701–4 is amended as follows:

1. The last sentence of paragraphs (b), (c)(1), (c)(2) *Example 1*, and (c)(2) *Example 3* are revised.

2. Paragraph (f) is added.

The revisions and addition read as follows:

§ 301.7701–4 Trusts.

* * * * *

(b) *Business trusts*. * * * The fact that any organization is technically cast in the trust form, by conveying title to property to trustees for the benefit of persons designated as beneficiaries, will not change the real character of the organization if the organization is more properly classified as a business entity under § 301.7701–2.

(c) * * * (1) * * * An investment trust with multiple classes of ownership interests ordinarily will be classified as a business entity under § 301.7701–2; however, an investment trust with multiple classes of ownership interests, in which there is no power under the trust agreement to vary the investment of the certificate holders, will be classified as a trust if the trust is formed to facilitate direct investment in the assets of the trust and the existence of multiple classes of ownership interests is incidental to that purpose.

(2) * * *

Example 1. * * * As a consequence, the existence of multiple classes of trust ownership is not incidental to any purpose of the trust to facilitate direct investment, and, accordingly, the trust is classified as a business entity under § 301.7701–2.

* * * * *

Example 3. * * * Accordingly, the trust is classified as a business entity under § 301.7701–2.

* * * * *

(f) *Effective date*. The rules of this section generally apply to taxable years beginning after December 31, 1960. Paragraph (e)(5) of this section contains rules of applicability for paragraph (e) of this section. In addition, the last sentences of paragraphs (b), (c)(1), and (c)(2) *Example 1* and *Example 3* of this section are effective as of January 1, 1997.

Par. 9. Section 301.7701–6 is revised to read as follows:

§ 301.7701–6 Definitions; person, fiduciary.

(a) *Person*. The term *person* includes an individual, a corporation, a partnership, a trust or estate, a joint-stock company, an association, or a syndicate, group, pool, joint venture, or other unincorporated organization or group. The term also includes a guardian, commit-

tee, trustee, executor, administrator, trustee in bankruptcy, receiver, assignee for the benefit of creditors, conservator, or any person acting in a fiduciary capacity.

(b) *Fiduciary*—(1) *In general*. Fiduciary is a term that applies to persons who occupy positions of peculiar confidence toward others, such as trustees, executors, and administrators. A fiduciary is a person who holds in trust an estate to which another has a beneficial interest, or receives and controls income of another, as in the case of receivers. A committee or guardian of the property of an incompetent person is a fiduciary.

(2) *Fiduciary distinguished from agent*. There may be a fiduciary relationship between an agent and a principal, but the word agent does not denote a fiduciary. An agent having entire charge of property, with authority to effect and execute leases with tenants entirely on his own responsibility and without consulting his principal, merely turning over the net profits from the property periodically to his principal by virtue of authority conferred upon him by a power of attorney, is not a fiduciary within the meaning of the Internal Revenue Code. In cases when no legal trust has been created in the estate controlled by the agent and attorney, the liability to make a return rests with the principal. (c) *Effective date*. The rules of this section are effective as of January 1, 1997.

§ 301.7701–7 [Removed]

Par. 10. Section 301.7701–7 is removed.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 11. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

§ 602.101 [Amended]

Par. 12. In § 602.101, paragraph (c) is amended by adding a new entry in numerical order to the table to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified or described	Current OMB control No.
* * * * *	
301.7701–3	1545–1486
* * * * *	

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved December 10, 1996.

Donald C. Lubick,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 17, 1996, 8:45 a.m., and published in the issue of the Federal Register for December 18, 1996, 61 F.R. 66584)

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 1997. See Rev. Rul. 97–1, page 10.

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

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 1997. See Rev. Rul. 97–1, page 10.

Obsolescence of Revenue Rulings and Revenue Procedures Under TD 8697, Simplification of Entity Classification Regulations (Check the Box)

Notice 97–1

This notice accompanies TD 8697, Simplification of Entity Classification Regulations (published in the Federal Register on December 18, 1996). The purpose of this notice is to alert taxpayers to the effect of the regulations on existing revenue rulings and revenue procedures that apply the prior classification regulations under § 7701 of the Internal Revenue Code. Effective January 1, 1997, such revenue rulings and revenue procedures are obsolete to the extent that they use the prior classification regulations to distinguish between partnerships and associations.

The Internal Revenue Service is compiling a list of these obsolete documents that will be published in the Internal Revenue Bulletin.

The principal author of this notice is Mark D. Harris of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice contact Mr. Harris at (202) 622-3050 (not a toll-free call).

Cash or Deferred Arrangements; Nondiscrimination

Notice 97–2

This notice provides guidance and transition relief relating to the revised nondiscrimination rules under § 401(k) and § 401(m) of the Internal Revenue Code. The rules applicable to qualified cash or deferred arrangements under § 401(k) and matching and employee contributions under § 401(m) were changed by the Small Business Job Protection Act of 1996 (SBJPA), Pub. L. 104–188.

Under § 401(k) and § 401(m) of the Code, the actual deferral percentage (ADP) and the actual contribution percentage (ACP) of highly compensated employees (HCEs) are compared with those of nonhighly compensated employees (NHCEs). Section 1433(c) of the SBJPA amends § 401(k)(3)(A) and § 401(m)(2)(A), effective for plan years beginning after December 31, 1996, to provide for the use of prior year data in determining the ADP and ACP of NHCEs, while current year data is used for HCEs. Alternatively, an employer may elect to use current year data for determining the ADP and ACP for both HCEs and NHCEs, but this election may only be changed as provided by the Secretary. Prior to the effective date of these amendments, plans must use current year data in determining the ADP and ACP for both HCEs and NHCEs.

Section 1433(e) of the SBJPA amends § 401(k)(8)(C) and § 401(m)(6)(C), effective for plan years beginning after December 31, 1996, to provide that the distribution of excess contributions and excess aggregate contributions will be made on the basis of the amount of contributions by, or on behalf of, each HCE. Prior to the effective date of these amendments, plans must distribute excess contributions and excess aggregate contributions using a method based on the actual deferral ratio or actual contribution ratio of each HCE.

This notice provides guidance regarding the determination of the ADP and ACP for NHCEs under § 401(k)(3)(A)(ii) and § 401(m)(2)(A) for plan years beginning after December 31, 1996; transition relief for plans that elect to use current year ADP or ACP data for the 1997 plan year; and guidance regarding the distribution of excess contributions and excess aggregate contributions under § 401(k)(8)(C) and § 401(m)(6)(C) for plan years beginning after December 31, 1996.

I. DETERMINATION OF ADP AND ACP FOR NHCEs USING PRIOR YEAR DATA

Section 401(k)(3)(A)(ii), as amended, provides that a cash or deferred arrangement will not be treated as a qualified cash or deferred arrangement unless the actual deferral percentage for eligible HCEs for the plan year meets a nondiscrimination test when compared to the actual deferral percentage for all other eligible employees for the preceding plan year. Thus, as amended, § 401(k)(3)(A)(ii) generally requires the comparison of the current year's ADP for HCEs to the prior year's ADP for NHCEs.

For purposes of § 401(k)(3)(A)(ii), the actual deferral percentage for all other eligible employees for the preceding plan year is the ADP for the preceding plan year for the group of employees who were NHCEs in the preceding plan year, using the definition of HCE in effect for the preceding plan year. Thus, for purposes of § 401(k)(3)(A)(ii), the individuals taken into account in determining the prior year's ADP for NHCEs are those individuals who were NHCEs during the preceding year, without regard to the individuals' status in the current year. For example, an individual who was an NHCE for the preceding plan year is included in this calculation even if the individual is no longer employed by the employer or has become an HCE in the current plan year.

As a result, the prior year's ADP for NHCEs can be calculated as soon as the necessary data on prior year status, contributions and compensation become available. For example, for the 1997 plan year, if a plan does not provide for matching contributions described in § 401(m)(4)(A) or qualified nonelective contributions described in § 401(m)(4)(C), the ADP for the 1997 plan year of HCEs will be compared with the ADP for the 1996 plan year of NHCEs in 1996, i.e., with the same ADP used in nondiscrimination testing for the 1996 plan year under prior law. Future guidance will address the conditions under which and the extent to which matching contributions described in § 401(m)(4)(A) and qualified nonelective contributions described in § 401(m)(4)(C) may be taken into account in determining the current or prior year's ADP or ACP for NHCEs in nondiscrimination testing for the 1997 plan year and future plan years.

For purposes of determining the prior year's ACP for NHCEs under § 401(m)(2)(A), as amended, rules similar to those used in determining the prior year's ADP for NHCEs under § 401(k)(3)(A)(ii) will apply.

II. TRANSITION RELIEF FOR PLANS USING CURRENT YEAR ADP OR ACP DATA FOR THE 1997 PLAN YEAR

Under § 401(k)(3)(A)(ii) and § 401(m)(2)(A), as amended, an employer that elects to use current year data in determining the ADP or ACP of NHCEs for the 1997 plan year or for later plan years must continue to use current year data for all future plan years, unless the election is changed in a manner provided by the Secretary.

Under the transition relief provided by this notice, a plan that uses current

year data in determining the ADP or ACP of NHCEs for the 1997 plan year will be permitted to use prior year data for the 1998 plan year without receiving approval from the Service. For the 1997 plan year, no plan amendment or formal election is required to be made in 1996 or 1997 in order to continue to use current year data in determining the ADP of NHCEs. The Treasury and the Service intend to issue guidance regarding the conditions under which employers that elect to use current year data for the 1998 or a later plan year may switch to using prior year data for subsequent plan years.

III. DISTRIBUTION OF EXCESS CONTRIBUTIONS AND EXCESS AGGREGATE CONTRIBUTIONS

Section 401(k)(8), as amended, provides a new procedure for correcting a plan's failure to meet the nondiscrimination test of § 401(k)(3). Under § 401(k)(8)(B), which was not amended by the SBJPA, an excess contribution is determined for each HCE. Section 401(k)(8)(C), prior to amendment, and § 1.401(k)-1(f)(2) of the Income Tax Regulations provided for the distribution of this amount to each HCE. Parallel rules applied to correction of failure to satisfy the nondiscrimination test of § 401(m).

The SBJPA amended § 401(k)(8)(C) to provide that distributions of excess contributions for any plan year are made to HCEs on the basis of the amount of contributions by, or on behalf of, each HCE. This amendment does not affect the total amount of the excess contributions to be distributed, but merely reallocates the distributions among the HCEs.

Accordingly, in order to distribute excess contributions under § 401(k)(8), as amended, the following procedure is used:

1. Calculate the dollar amount of excess contributions for each affected HCE in a manner described in § 401(k)(8)(B) and § 1.401(k)-1(f)(2). However, in applying these rules, rather than distributing the amount necessary to reduce the actual deferral ratio (ADR) of each affected HCE in order of these employees' ADRs, beginning with the highest ADR, the plan uses these amounts in step 2.
2. Determine the total of the dollar amounts calculated in step 1.

This total amount in step 2 (total excess contributions) should be distributed in accordance with steps 3 and 4 below:

3. The elective contributions of the HCE with the highest dollar amount of elective contributions are reduced by the amount required to cause that HCE's elective contributions to equal the dollar amount of the elective contributions of the HCE with the next highest dollar amount of elective contributions. This amount is then distributed to the HCE with the highest dollar amount. However, if a lesser reduction, when added to the total dollar amount already distributed under this step, would equal the total excess contributions, the lesser reduction amount is distributed.
4. If the total amount distributed is less than the total excess contributions, step 3 is repeated.

If these distributions are made, the cash or deferred arrangement is treated as meeting the nondiscrimination test of § 401(k)(3) regardless of whether the ADP, if recalculated after distributions, would satisfy § 401(k)(3).

A parallel method is used for the purpose of recharacterizing excess contributions under § 401(k)(8)(A)(ii) and for distributing excess aggregate contributions under § 401(m)(6)(C), as amended.

After excess and excess aggregate contributions, if any, have been distributed using the method described above, the multiple use test of § 401(m)(9) is applied. For purposes of § 401(m)(9), if a corrective distribution of excess contributions has been made, or a recharacterization has occurred, the ADP for HCEs is deemed to be the largest amount permitted under § 401(k)(3). Similarly, if a corrective distribution of excess aggregate contributions has been made, the ACP for HCEs is deemed to be the largest amount permitted under § 401(m)(2).

The method described above for distributing excess contributions is illustrated by the following example:

For the 1997 plan year, HCE 1 has elective contributions of $8,500 and $85,000 in compensation, for an ADR of 10%, and HCE 2 has elective contributions of $9,500 and compensation of $158,333, for an ADR of 6%. As a result, the ADP for the 2 HCEs under the plan (HCE 1 and HCE 2) is 8%. The ADP for the NHCEs is 3%. Under the ADP test of § 401(k)(3)(A)(ii), the ADP of the two HCEs under the plan may not exceed 5% (i.e., 2 percentage points more than the ADP of the NHCEs under the plan).

Pursuant to § 401(k)(8)(B), § 1.401-(k)-1(f)(2), and this notice, the total excess contributions for the HCEs is determined as follows:

Step 1. The elective contributions of HCE 1 (the HCE with the highest ADR) are reduced by $3,400 in order to reduce the ADR of HCE 1 to 6% ($5,100/$85,000), which is the ADR of HCE 2. Because the ADP of the HCEs still exceeds 5%, the ADP test of § 401(k)(3)(A)(ii) is not satisfied and further reductions in elective contributions are necessary. The elective contributions of HCE 1 and HCE 2 are each reduced by one percent of compensation ($850 and $1,583 respectively). Because the ADP of the HCEs now equals 5%, the ADP test of § 401(k)(3)(A)(ii) is satisfied, and no further reductions in elective contributions are necessary.

Step 2. The total excess contributions for the HCEs that must be distributed equal $5,833, the total reductions in elective contributions under step 1 ($3,400 + $850 + $1,583).

Pursuant to § 401(k)(8)(C), the $5,833 in total excess contributions for the 1997 plan year would then be distributed as follows:

Step 3. The plan distributes $1,000 in elective contributions to HCE 2 (the HCE with the highest dollar amount of elective contributions) in order to reduce the dollar amount of the elective contributions of HCE 2 to $8,500, which is the dollar amount of the elective contributions of HCE 1.

Step 4. Because the total amount distributed ($1,000) is less than the total excess contributions ($5,833), step 3 must be repeated. As the dollar amounts of remaining elective contributions for both HCE 1 and HCE 2 are equal, the remaining $4,833 of excess contributions is then distributed equally to HCE 1 and HCE 2 in the amount of $2,416.50 each.

Under this example, HCE 1 must receive a total distribution of $2,416.50 of excess contributions, and HCE 2 must receive a total distribution of $3,416.50 of excess contributions. This is true even though the ADR of HCE 1 exceeded the ADR of HCE 2. The plan is now treated as satisfying the nondiscrimination test of § 401(k)(3) even

though the ADP would fail to satisfy § 401(k)(3), if recalculated after distributions.

COMMENTS REQUESTED

The Treasury and the Service invite comments and suggestions regarding the matters discussed in this notice. Comments are specifically requested concerning:

—The use of qualified matching and qualified nonelective contributions in computing the prior year's ADP for NHCEs, including methods of preventing inappropriate double counting.

—The appropriate determination of the prior year's ADP for NHCEs when the group of employees tested is significantly different in the current year than in the prior year.

Comments can be addressed to CC:DOM:CORP:R (Notice 97–2), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, comments may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (Notice 97–2), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. Alternatively, taxpayers may transmit comments electronically via the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments/html.

DRAFTING INFORMATION

The principal authors of this notice are Kenneth Conn of the Employee Plans Division and Catherine Fernandez of the Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations). For further information regarding this notice, contact the Employee Plans Division's telephone assistance service between 1:30 and 4:00 p.m., Eastern Time, Monday through Thursday at (202) 622–6074/75 or Kenneth Conn at (202) 622–6214. (These telephone numbers are not toll-free numbers.)

Subchapter S Corporation Subsidiaries

Notice 97–4

PURPOSE

Section 1308 of the Small Business Job Protection Act of 1996, Pub. L. No. 104–188, 110 Stat. 1755 (the Act) modified § 1361 of the Internal Revenue Code to permit an S corporation (1) to own 80 percent or more of the stock of a C corporation, and (2) to elect to own a qualified subchapter S subsidiary (QSSS).

To help taxpayers comply with the law, the Department of the Treasury and the Internal Revenue Service intend to issue regulations interpreting § 1308 of the Act. This notice solicits comments from taxpayers and practitioners regarding the issues listed below. However, any other comments concerning the changes made by § 1308 of the Act will be considered in developing regulatory guidance. This notice also provides temporary guidance on the manner in which a QSSS election must be made and the effective date of the election.

BACKGROUND

Prior law prohibited a subchapter S corporation from owning 80 percent or more of the stock of another corporation. Furthermore, an S corporation could not have a corporation as a shareholder. Congress modified these constraints by enacting § 1308 of the Act, effective for taxable years beginning after December 31, 1996. The Act added new §§ 1361(b)(3), 1362(d)(3)(F), and 1504(b)(8) to the Code, while removing § 1361(b)(2)(A) and 1361(c)(6).

By removing § 1361(b)(2)(A), the Act permits an S corporation to own 80 percent or more of a C corporation. At the same time, new § 1504(b)(8) prevents an S corporation from joining in the filing of a consolidated return with its affiliated C corporations, but does not prevent the C corporation subsidiary from filing a consolidated return with its affiliated C corporations. *See* H.R. Conf. Rep. No. 737, 104th Cong., 2d Sess. 224 (1996).

Under prior law, the S election of a corporation with C earnings and profits terminated if that S corporation received passive income, including dividends, in excess of 25 percent of gross receipts for 3 consecutive years. Section 1363(d)(3)(F) modifies that general rule by excluding dividends from passive investment income to the extent that the dividends are attributable to the active conduct of a trade or business of a C corporation in which the S corporation has an 80 percent or greater ownership interest. However, neither the Act nor the legislative history provides rules for determining the attribution of dividends to an active trade or business.

New § 1361(b)(3)(B) defines the term "qualified subchapter S subsidiary" as a domestic corporation that is not an ineligible corporation, if (1) an S corporation holds 100 percent of the stock of the corporation, and (2) that S corporation elects to treat the subsidiary as a QSSS. Section 1361(b)(3)(A) provides that a corporation that is a QSSS is not treated as a separate corporation, and all assets, liabilities, and items of income, deduction, and credit of the QSSS are treated as assets, liabilities, and items of income, deduction, and credit of the parent S corporation.

The statutory provisions do not provide guidance on how the corporation makes the election, the effective date of the election, or how the commingling of assets, liabilities, and other items occurs after the election is made. The legislative history, however, indicates that when the parent corporation makes the election, the subsidiary will be deemed to have liquidated under §§ 332 and 337 immediately before the election is effective. *See* S. Rep. No. 281, 104th Cong., 2d Sess. 53 (1996)(Senate Report); H.R. Rep. No. 586, 104th Cong., 2d Sess. 89 (1996)(House Report). Where the S corporation acquires the stock of the subsidiary in a qualified stock purchase, the corporation may make an election under § 338 with respect to the subsidiary.

Section 1361(b)(3)(C) provides that any QSSS that ceases to meet the requirements of § 1361(b)(3)(B) will be treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the cessation from its S corporation parent in a deemed exchange for the subsidiary's stock. Upon the termination, § 1361(b)(3)(D) provides that the former QSSS (and any successor corporation) is not eligible to make either a QSSS election or an election to be treated as an S corporation before its fifth taxable year that begins after the first taxable year for which the termination is effective, unless the Secretary consents to the election.

REQUEST FOR COMMENTS

The Service and Treasury invite comments from the public on issues that should be addressed in proposed regulations implementing § 1308 of the Act. The Service is particularly interested in receiving comments on the following:

1) The attribution of dividends received by an S corporation from an 80

percent or greater owned C corporation between earnings and profits attributable to the active conduct of a trade or business or to passive investments of the C corporation, particularly in situations where the C corporation is a member of an affiliated group that files a consolidated return;

2) Issues arising upon the formation of a QSSS, including those arising from the operation of §§ 332 and 337 or § 338;

3) Issues arising upon the termination of a QSSS; and

4) Issues arising when a QSSS election is made for a subsidiary that is a member of a consolidated group. Written comments should be sent to the following address:

Internal Revenue Service
CC:DOM:CORP (NT 97–4;
CC:DOM:P&SI:1)
P.O. Box 7604, Ben Franklin Station
Washington, DC 20044

In the alternative, comments may be hand delivered between the hours of 8:00 a.m. and 5:00 p.m. to the courier's desk at 1111 Constitution Avenue, NW., Washington, DC, or submitted electronically via the IRS internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html.

TEMPORARY QSSS ELECTION PROCEDURE

The legislative history supporting § 1308 of the Act indicates that when a parent corporation makes an election to treat a subsidiary as a QSSS, the subsidiary will be deemed to have liquidated under §§ 332 and 337 immediately before the election is effective. *See* Senate Report at 53; House Report at 89. When a corporation liquidates under § 332, that corporation must file a Corporate Dissolution or Liquidation Form 966 within 30 days of the adoption of a liquidating plan or resolution. In addition, that corporation must file a return for the short period ending on the date that it goes out of existence.

The Service and Treasury intend to issue regulations describing the manner in which a QSSS election must be made and the effective date of the election. Until regulations are issued, however, taxpayers should follow the procedures listed in this notice to satisfy the election requirements.

To make the QSSS election, the parent corporation should file a Form 966 with the Service Center. When completing the form, the parent corporation should follow the instructions applicable to that form with the following modifications:

1. At the top of the Form 966, print "FILED PURSUANT TO NOTICE 97–4."
2. In the box labeled "Employer identification number" (EIN), enter the subsidiary's EIN (if applicable). If the subsidiary was not in existence prior to the time of election and does not have an EIN, there will be no need to obtain a taxpayer identification number for the subsidiary. In this case, insert "QSSS" in the box. (If the parent corporation chooses to obtain an EIN for the newly-formed QSSS, the parent should check "Other" when asked the "Type of entity" on the SS–4, and specify that the entity is a QSSS.)
3. In Box 4 on Form 966, enter the desired effective date for the election. The election may be effective on the date Form 966 is filed or up to 75 days prior to the filing of Form 966, provided that date is not before the effective date of § 1308 of the Act and that the subsidiary otherwise qualified as a QSSS for the entire period for which the retroactive election is in effect. For these purposes, the requirement that Form 966 be filed within 30 days of the date in Box 4 is ignored.
4. In Box 7c on Form 966, enter the name of the parent. The parent's EIN should be included in Box 7d.
5. In Box 10 on Form 966, enter "§ 1361(b)(3)(B)."
6. Form 966 must be signed by a corporate officer authorized to sign the PARENT's tax return.

Banks and bank holding companies should consult Notice 97–5, 1997–2 I.R.B., before filing an election under the procedures listed above.

DRAFTING INFORMATION

The principal author of this notice is Deanna L. Walton of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice contact Ms. Walton at (202) 622–3050 (not a toll-free call).

Subchapter S Banks — Sections 1362 and 265

Notice 97–5

BACKGROUND

Section 1315 of the Small Business Job Protection Act of 1996 (the Act), P.L. 104–188, amended § 1361(b)(2) of the Internal Revenue Code to allow banks (as defined in § 581) that do not use the reserve method of accounting for bad debts to qualify as small business corporations (and therefore qualify to elect S corporation status), effective for tax years beginning after December 31, 1996.

Section 1308(b) of the Act added new § 1361(b)(3) to allow an S corporation to own a qualified subchapter S subsidiary (QSSS). A subsidiary qualifies as a QSSS if (1) the subsidiary would be eligible to elect subchapter S status if its stock were owned directly by the shareholders of its S corporation parent; (2) the S corporation parent owns 100 percent of the subsidiary's stock; and (3) the parent elects to treat the subsidiary as a QSSS. If the QSSS election is made, the subsidiary is not treated as a separate corporation, and all the assets, liabilities, and items of income, deduction, and credit of the subsidiary are treated as the assets, liabilities, and items of income, deduction, and credit of the parent S corporation.

This notice provides guidance on the effect of the QSSS election under § 1361(b)(3) on banks affiliated with nonbanks; the application of the S corporation passive investment income rules of § 1362(d)(3); the application of the interest expense disallowance rules of § 265; and an automatic change in method of accounting for bad debts.

BANKS AFFILIATED WITH NONBANKS

The Department of the Treasury and the Internal Revenue Service are concerned that the interaction of § 1315 and § 1308(b) of the Act creates unintended and inappropriate results for banks that are affiliated with nonbank entities. Treasury and the IRS believe that the special provisions of the Code that apply to banks should apply only to the specific state-law entity that qualifies as a bank under § 581 of the Code; such special bank treatment should not apply to nonbanks, even if the nonbank is affiliated with a bank and the parent elects to treat the subsidiary as a QSSS.

Treasury intends to work with Congress on appropriate technical corrections to the Act to clarify the tax treatment of banks affiliated with nonbanks. It is anticipated that any technical corrections will be effective as of the effective date of the Act. In the interim, banks (including banks for which QSSS elections are made) should continue to comply with applicable information reporting and filing requirements of the Code (e.g., § 6049 (Returns Regarding Payments of Interest)).

PASSIVE INVESTMENT INCOME

Under § 1362(d)(3)(A), the S election of a corporation with accumulated earnings and profits terminates if the passive investment income of the corporation constitutes more than 25 percent of its gross receipts for each of three consecutive tax years. In general, § 1362(d)(3) defines "passive investment income" as gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities. Passive investment income does not include gross receipts directly derived from the active and regular conduct of a lending or finance business, provided the corporation meets the requirements of § 542(c)(6) (lending or finance company excluded from the definition of personal holding company).

Similarly, § 1.1362–2(c)(5)(iii)(B)(*1*)-(*i*) provides that passive investment income does not include gross receipts directly derived in the ordinary course of a trade or business of lending or financing. Under § 1.1362–2(c)(5)(iii)-(B)(*2*), gross receipts directly derived in the ordinary course of a trade or business of lending or financing include gain (as well as interest income) from loans originated in a lending business; however, interest earned from the investment of idle funds in short-term securities does not constitute gross receipts directly derived in the ordinary course of business.

The Service will treat income earned by an S corporation on the following banking assets as gross receipts directly derived from the active and regular conduct of a banking business—

* All loans and REMIC regular interests owned, or considered to be owned, by the bank regardless of whether the loan originated in the bank's business. For these purposes, securities described in § 165(g)(2)(C) are not considered loans.
* Assets required to be held to conduct a banking business (such as Federal Reserve Bank, Federal Home Loan Bank, or Federal Agricultural Mortgage Bank stock or participation certificates issued by a Federal Intermediate Credit Bank which represent nonvoting stock in the bank).
* Assets pledged to a third party to secure deposits or business for the bank (such as assets pledged to qualify as a depository for federal taxes or state funds).
* Investment assets (other than assets specified in the preceding paragraphs) that are held by the bank to satisfy reasonable liquidity needs (including funds needed to meet anticipated loan demands).

As a result, income and gain from these assets will not be considered subject to the passive investment income limitation applicable to S corporations.

INTEREST EXPENSE DISALLOWANCE

Section 265(a)(2) denies taxpayers (including banks) a deduction for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from federal income taxes.

Section 265(b) denies banks and other financial institutions a deduction for the portion of a bank's interest expense that is allocable to tax-exempt interest and not otherwise disallowed by § 265(a). The portion of a bank's interest expense that is allocable to tax-exempt interest is an amount that bears the same ratio to the interest expense as (1) the bank's average adjusted bases of tax-exempt obligations acquired after August 7, 1986, bears to (2) the average adjusted bases for all assets of the bank.

Section 1366(a)(1) requires S corporation shareholders to determine their tax liability by taking into account their pro rata share of the corporation's nonseparately computed income or loss and their share of the items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder.

Because § 265(b) provides a special disallowance rule for banks, the Service will apply § 265(b) only at the bank level in determining the amount, if any, of the bank's interest expense that is disallowed. To the extent indebtedness and tax-exempt obligations are taken into account in applying § 265(b) at the bank level, they are not taken into account again in applying § 265(a) at the shareholder level.

AUTOMATIC CHANGE IN METHOD OF ACCOUNTING

The Service will issue further guidance granting permission for an automatic change in method of accounting for banks that change from the reserve method of accounting for bad debts. This guidance will permit changes to be effective as of the bank's first taxable year beginning after December 31, 1996. A bank that wishes to be an S corporation effective January 1, 1997, must file the change in method of accounting and the S election by March 15, 1997.

The principal authors of this notice are Martin Schäffer and Deane Burke of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact Martin Schäffer or Deane Burke at (202) 622–3080 (not a toll-free call).

SIMPLE IRAs; Questions and Answers

Notice 97–6

PURPOSE

The purpose of this notice is to provide guidance, in the form of questions and answers, with respect to the SIMPLE plan provisions that are part of the Small Business Job Protection Act of 1996 ("SBJPA"), Pub. Law. 104–188.

Section 1421 of the SBJPA established a simplified tax-favored retirement plan for small employers ("SIMPLE plan") under section 408(p) of the Internal Revenue Code. Contributions under a SIMPLE plan are made to individual retirement accounts or annuities ("SIMPLE IRAs") that are established pursuant to the SIMPLE plan adopted by the employer.

This notice provides guidance solely with respect to certain issues relating to SIMPLE plans under section 1421 of the SBJPA. No inference should be drawn, however, regarding issues not specifically addressed in this notice that may be suggested by a particular question and answer or as to why certain questions, and not others, are included. This notice does not provide guidance with respect to section 1422 of the

SBJPA, which provides for a simplified 401(k) arrangement within a qualified plan that shares many characteristics with the SIMPLE plans described in this notice.

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QUESTIONS AND ANSWERS

A. SIMPLE PLANS IN GENERAL

Q. A–1: What is a SIMPLE plan?

A. A–1: A SIMPLE plan is a written arrangement established under section 408(p) of the Code that provides a simplified tax-favored retirement plan for small employers. If an employer establishes a SIMPLE plan, each employee may choose whether to have the employer make payments as contributions under the SIMPLE plan or to receive these payments directly in cash. An employer that chooses to establish a SIMPLE plan must make either matching contributions or nonelective contributions. All contributions under a SIMPLE plan are made to SIMPLE IRAs.

Q. A–2: Can contributions made under a SIMPLE plan be made to any type of IRA?

A. A–2: Contributions under a SIMPLE plan may only be made to a SIMPLE IRA, not to any other type of IRA. A SIMPLE IRA is an individual retirement account described in section 408(a), or an individual retirement annuity described in section 408(b), to which the only contributions that can be made are contributions under a SIMPLE plan and rollovers or transfers from another SIMPLE IRA.

Q. A–3: Can a SIMPLE plan be maintained on a fiscal year basis?

A. A–3: A SIMPLE plan may only be maintained on a calendar year basis. Thus, for example, employer eligibility to establish a SIMPLE plan (see Q&As B–1 through B–5) and SIMPLE plan contributions (see Q&As D–1 through D–6) are determined on a calendar year basis.

B. EMPLOYERS THAT CAN ESTABLISH SIMPLE PLANS

Q. B–1: Can any employer establish a SIMPLE plan?

A. B–1: SIMPLE plans may be established only by employers that had no more than 100 employees who earned $5,000 or more in compensation during the preceding calendar year (the ''100–employee limitation''). See Q&As C–4 and C–5 for the definition of compensation. For purposes of the 100-employee limitation, all employees employed at any time during the calendar year are taken into account, regardless of whether they are eligible to participate in the SIMPLE plan. Thus, employees who are excludable under the rules of section 410(b)(3) or who have not met the plan's minimum eligibility requirements must be taken into account. Employees also include self-employed individuals described in section 401(c)(1) who received earned income from the employer during the year.

Q. B–2: Is there a grace period that can be used by an employer that ceases to satisfy the 100-employee limitation?

A. B–2: An employer that previously maintained a SIMPLE plan is treated as satisfying the 100-employee limitation for the two calendar years immediately following the calendar year for which it last satisfied the 100-employee limitation. However, if the failure to satisfy the 100-employee limitation is due to an acquisition, disposition or similar transaction involving the employer, then the two-year grace period will apply only in accordance with rules similar to the rules of section 410(b)(6)(C)(i).

Q. B–3: Can an employer make contributions under a SIMPLE plan for a calendar year if it maintains another qualified plan?

A. B–3: An employer cannot make contributions under a SIMPLE plan for a calendar year if the employer, or a predecessor employer, maintains a qualified plan under which any of its employees receives an allocation of contributions (in the case of a defined contribution plan) or has an increase in a benefit accrued or treated as an accrued benefit under section 411(d)(6) (in the case of a defined benefit plan) for any plan year beginning or ending in that calendar year. For this purpose, a ''qualified plan'' means a plan, contract, pension or trust described in section 219(g)(5) and includes a qualified plan (described in section 401(a)), a qualified annuity plan (described in section 403(a)), an annuity contract (described in section 403(b)), a plan established for employees of a state, a political subdivision or by an agency or instrumentality of any state or political subdivision (other than an eligible deferred compensation plan described in section 457(b)), a simplified employee pension (''SEP'') (described in section 408(k)) and a trust described in section 501(c)(18). In applying these rules, transfers, rollovers or forfeitures are disregarded, except to the extent forfeitures replace otherwise required contributions.

Q. B–4: Are tax-exempt employers and governmental entities permitted to maintain SIMPLE plans?

A. B–4: Yes. Excludable contributions may be made to the SIMPLE IRA of employees of tax-exempt employers and governmental entities on the same basis as contributions may be made to employees of other eligible employers.

Q. B–5: Do the employer aggregation and leased employee rules apply for purposes of the SIMPLE plan rules under section 408(p)?

A. B–5: For purposes of applying the SIMPLE plan rules under section 408(p), certain related employers (trades or businesses under common control) are treated as a single employer. These related employers include controlled groups of corporations under section 414(b), partnerships or sole proprietorships under common control under section 414(c), and affiliated service groups under section 414(m). In addition, leased employees described in section 414(n) are treated as employed by the employer.

Example: Individual P owns Business A, a computer rental agency, that has 80 employees who received more than $5,000 in compensation in 1996. Individual P also owns Business B, which repairs computers and has 60 employees who received more than $5,000 in compensation in 1996. Individual P is the sole proprietor of both businesses. Section 414(c) provides that the employees of partnerships and sole proprietorships that are under common control are treated as employees of a single employer. Thus,

for purposes of the SIMPLE plan rules, all 140 employees are treated as employed by Individual P. Therefore, neither Business A nor Business B is eligible to establish a SIMPLE plan for 1997.

C. EMPLOYEE ELIGIBILITY TO PARTICIPATE IN A SIMPLE PLAN

Q. C–1: Which employees of an employer must be eligible to participate under the SIMPLE plan?

A. C–1: If an employer establishes a SIMPLE plan, all employees of the employer who received at least $5,000 in compensation from the employer during any 2 preceding calendar years (whether or not consecutive) and who are reasonably expected to receive at least $5,000 in compensation during the calendar year, must be eligible to participate in the SIMPLE plan for the calendar year.

An employer, at its option, may exclude from eligibility employees described in section 410(b)(3). These employees are:

(1) Employees who are included in a unit of employees covered by an agreement that the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers, if there is evidence that retirement benefits were the subject of good faith bargaining between such employee representatives and such employer or employers;

(2) In the case of a trust established or maintained pursuant to an agreement that the Secretary of Labor finds to be a collective bargaining agreement between air pilots represented in accordance with Title II of the Railway Labor Act and one or more employees, all employees not covered by that agreement; and

(3) Employees who are nonresident aliens and who received no earned income (within the meaning of section 911(d)(2)) from the employer that constitutes income from sources within the United States (within the meaning of section 861(a)(3)).

As noted in Q&A B–5, the employer aggregation and leased employee rules apply for purposes of section 408(p). Thus, for example, if two related employers must be aggregated under the rules of section 414(b), all employees of either employer who satisfy the eligibility criteria must be allowed to participate in the SIMPLE plan.

Q. C–2: May an employer impose less restrictive eligibility requirements?

A. C–2: An employer may impose less restrictive eligibility requirements by eliminating or reducing the prior year compensation requirements, the current year compensation requirements, or both, under its SIMPLE plan. For example, the employer could allow participation for employees who received $3,000 in compensation during any preceding calendar year. However, the employer cannot impose any other conditions on participating in a SIMPLE plan.

Q. C–3: May an employee participate in a SIMPLE plan if he or she also participates in a plan of a different employer for the same year?

A. C–3: An employee may participate in a SIMPLE plan even if he or she also participates in a plan of a different employer for the same year. However, the employee's salary reduction contributions are subject to the limitations of section 402(g), which provides an aggregate limit on the exclusion for elective deferrals for any individual. Similarly, an employee who participates in a SIMPLE plan and an eligible deferred compensation plan described in section 457(b) is subject to the limitations described in section 457(c). An employer that establishes a SIMPLE plan is not responsible for monitoring compliance with either of these limitations.

Q. C–4: What definition of compensation applies for purposes of the SIMPLE plan rules in the case of an individual who is not a self-employed individual?

A. C–4: For purposes of the SIMPLE plan rules, in the case of an individual who is not a self-employed individual, compensation means the amount described in section 6051(a)(3) (wages, tips, and other compensation from the employer subject to income tax withholding under section 3401(a)), and amounts described in section 6051(a)(8), including elective contributions made under a SIMPLE plan, and compensation deferred under a section 457 plan. For purposes of applying the 100-employee limitation, and in determining whether an employee is eligible to participate in a SIMPLE plan (i.e., whether the employee had $5,000 in compensation for any 2 preceding years), an employee's compensation also includes the employee's elective deferrals under a section 401(k) plan, a salary reduction SEP and a section 403(b) annuity contract.

Q. C–5: What definition of compensation applies for purposes of the SIMPLE plan rules in the case of a self-employed individual?

A. C–5: For purposes of the SIMPLE plan rules, in the case of a self-employed individual, compensation means net earnings from self-employment determined under section 1402(a), prior to subtracting any contributions made under the SIMPLE plan on behalf of the individual.

D. SIMPLE PLAN CONTRIBUTIONS

Q. D–1: What contributions must an employer make under a SIMPLE plan?

A. D–1: If an employer establishes a SIMPLE plan, it must make salary reduction contributions, as described in Q&A D–2, to the extent elected by employees. In addition, the employer must make employer matching contributions, as described in Q&As D–4 and D–5, or employer nonelective contributions, as described in Q&A D–6. These are the only contributions that may be made under a SIMPLE plan.

Q. D–2: What is a salary reduction contribution?

A. D–2: A salary reduction contribution is a contribution made pursuant to an employee's election to have an amount contributed to his or her SIMPLE IRA, rather than have the amount paid directly to the employee in cash. An employee must be permitted to elect to have salary reduction contributions made at the level specified by the employee, expressed as a percentage of compensation for the year. Additionally, an employer may permit an employee to express the level of salary reduction contributions as a specific dollar amount. An employer may not place any restrictions on the amount of an employee's salary reduction contributions (e.g., by limiting the contribution percentage), except to the extent needed to comply with the annual limit on the amount of salary reduction contributions described in Q&A D–3.

Q. D–3: What is the annual limit on the amount of salary reduction contributions under a SIMPLE plan?

A. D–3: For 1997, the maximum annual amount of salary reduction contributions that can be made on behalf of any employee under a SIMPLE plan is $6,000. This amount will be adjusted by the Service to reflect any changes in the cost of living.

Q. D–4: What employer matching contribution is generally required under a SIMPLE plan?

A. D–4: Under a SIMPLE plan, an employer is generally required to make a contribution on behalf of each eligible employee in an amount equal to the employee's salary reduction contributions, up to a limit of 3 percent of the employee's compensation for the entire calendar year.

Q. D–5: Can the 3-percent limit on matching contributions be reduced?

A. D–5: The 3-percent limit on matching contributions is permitted to be reduced for a calendar year at the election of the employer, but only if:

(1) The limit is not reduced below 1 percent;

(2) The limit is not reduced for more than 2 years out of the 5-year period that ends with (and includes) the year for which the election is effective; and

(3) Employees are notified of the reduced limit within a reasonable period of time before the 60-day election period during which employees can enter into salary reduction agreements. See Q&A E–1.

For purposes of applying the rule described in paragraph (2) of this Q&A D–5, in determining whether the limit was reduced below 3 percent for a year, any year before the first year in which an employer (or a predecessor employer) maintains a SIMPLE plan will be treated as a year for which the limit was 3 percent. If an employer chooses to make nonelective contributions for a year (see Q&A D–6), that year also will be treated as a year for which the limit was 3 percent.

Q. D–6: May an employer make nonelective contributions instead of matching contributions?

A. D–6: As an alternative to making matching contributions under a SIMPLE plan (as described in Q&A D–4 and D–5), an employer may make nonelective contributions equal to 2 percent of each eligible employee's compensation for the entire calendar year. The employer's nonelective contributions must be made for each eligible employee regardless of whether the employee elects to make salary reduction contributions for the calendar year. The employer may, but is not required to, limit nonelective contributions to eligible employees who have at least $5,000 (or some lower amount selected by the employer) of compensation for the year.

For purposes of the 2-percent nonelective contribution, the compensation taken into account must be limited to the amount of compensation that may be taken into account under section 401(a)(17) for the year. The section 401(a)(17) limit for 1997 is $160,000. This amount will be adjusted by the Service for subsequent years to reflect changes in the cost of living.

An employer may substitute the 2-percent nonelective contribution for the matching contribution for a year, only if:

(1) Eligible employees are notified that a 2-percent nonelective contribution will be made instead of a matching contribution; and

(2) This notice is provided within a reasonable period of time before the 60-day election period during which employees can enter into salary reduction agreements. See Q&A E–1.

E. EMPLOYEE ELECTIONS

Q. E–1: When must an employee be given the right to enter into a salary reduction agreement?

A. E–1: During the 60-day period immediately preceding January 1 of a calendar year (i.e., November 2 to December 31 of the preceding calendar year), an eligible employee must be given the right to enter into a salary reduction agreement for the calendar year, or to modify a prior agreement (including reducing the amount subject to this agreement to $0). However, for the year in which the employee becomes eligible to make salary reduction contributions, the period during which the employee may enter into a salary reduction agreement or modify a prior agreement is a 60-day period that includes either the date the employee becomes eligible or the day before that date. For example, if an employer establishes a SIMPLE plan effective as of July 1, 1997, each eligible employee becomes eligible to make salary reduction contributions on that date and the 60-day period must begin no later than July 1 and cannot end before June 30, 1997.

During these 60-day periods, employees have the right to modify their salary reduction agreements without restrictions. In addition, for the year in which an employee becomes eligible to make salary reduction contributions, the employee must be able to commence these contributions as soon as the employee becomes eligible, regardless of whether the 60-day period has ended.

Q. E–2: Can a SIMPLE plan provide additional or longer election periods?

A. E–2: Nothing precludes a SIMPLE plan from providing additional or longer periods for permitting employees to enter into salary reduction agreements or to modify prior agreements. For example, a SIMPLE plan can provide a 90-day election period instead of the 60-day period described in Q&A E–1. Similarly, in addition to the 60-day period described in Q&A E–1, a SIMPLE plan can provide quarterly election periods during the 30 days before each calendar quarter.

Q. E–3: Does an employee have the right to terminate a salary reduction agreement outside a SIMPLE plan's normal election period?

A. E–3: An employee must be given the right to terminate a salary reduction agreement for a calendar year at any time during the year. A SIMPLE plan may provide that an employee who terminates a salary reduction agreement at any time other than the periods described in Q&A E–1 or E–2 is not eligible to resume participation until the beginning of the next calendar year.

Q. E–4: Must an employer allow an employee to select the financial institution to which the employer will make all SIMPLE plan contributions on behalf of the employee?

A. E–4: Generally, under section 408(p), an employer must permit an employee to select the financial institution for the SIMPLE IRA to which the employer will make all contributions on behalf of the employee. If an employer uses Form 5305-SIMPLE as modified in Q&A K–3, the employer may modify page 3 of Form 5305–SIMPLE (October 1996) (Model Salary Reduction Agreement) to include a section for employees to indicate the financial institution they have selected and any additional information necessary to facilitate transmittal of the contribution to that institution. Alternatively, under the exception described in Q&A J–1, an employer may require that all contributions be made to a designated financial institution.

F. VESTING REQUIREMENTS

Q. F–1: Must contributions under a SIMPLE plan be nonforfeitable?

A. F–1: Yes. All contributions under a SIMPLE plan must be fully vested and nonforfeitable when made.

Q. F–2: May amounts held in a SIMPLE IRA be withdrawn at any time?

A. F–2: Yes. An employer may not require an employee to retain any portion of the contributions in his or her

SIMPLE IRA or otherwise impose any withdrawal restrictions.

G. EMPLOYER ADMINISTRATIVE AND NOTIFICATION REQUIREMENTS

Q. G–1: What notification requirements apply to employers?

A. G–1: An employer must notify each employee, immediately before the employee's 60-day election period described in Q&A E–1, of the employee's opportunity to enter into a salary reduction agreement or to modify a prior agreement. If applicable, this notification must disclose an employee‘‘s ability to select the financial institution that will serve as the trustee of the employee''s SIMPLE IRA as described in Q&A E–4. If an employer uses Form 5305–SIMPLE as modified in Q&A K–3, the employer may modify page 3 of Form 5305–SIMPLE (October 1996) (Model Notification to Eligible Employees) to disclose an employee‘‘s ability to select the financial institution that will serve as the trustee of the employee''s SIMPLE IRA as described in Q&A E–4. The notification must also include the summary description described in Q&A H–1. In the case of a SIMPLE plan established using Form 5305–SIMPLE, the summary description requirement may be satisfied by providing a completed copy of pages one and two of Form 5305–SIMPLE that reflects the terms of the employer's plan (including the materials provided by the trustee for completion of Article VI).

Q. G–2: May the notifications regarding a reduced matching contribution (described in Q&A D–5) and a nonelective contribution in lieu of a matching contribution (described in Q&A D–6) be provided at the same time as the notification of an employee's opportunity to enter into a salary reduction agreement and the summary description?

A. G–2: Yes. An employer is deemed to provide the notification regarding a reduced matching contribution or a nonelective contribution in lieu of a matching contribution within a reasonable period of time before the 60-day election period if, immediately before the 60-day election period, this notification is included with the notification of an employee's opportunity to enter into a salary reduction agreement.

Q. G–3: What reporting penalties under the Code apply if an employer fails to provide one or more of the required notices?

A. G–3: If the employer fails to provide one or more of the required notices described in Q&A G–1, the employer will be liable, under the Code, for a penalty of $50 per day until the notices are provided. If the employer shows that the failure was due to reasonable cause, the penalty will not be imposed. To the extent that each employee is permitted to select the trustee for his or her SIMPLE IRA pursuant to Q&A E–4, and is so notified in accordance with Q&A G–1, and the information with respect to the trustee (the name and address of the trustee and its withdrawal procedures) is not available at the time the employer is required to provide the summary description, the employer is deemed to have shown reasonable cause for failure to provide this information to eligible employees, but only if the employer sees to it that this information is provided to the employee as soon as administratively feasible once the trustee has been selected.

Q. G–4: What if an eligible employee is unwilling or unable to establish a SIMPLE IRA?

A. G–4: If an eligible employee who is entitled to a contribution under a SIMPLE plan is unwilling or unable to establish a SIMPLE IRA with any financial institution prior to the date on which the contribution is required to be made to the SIMPLE IRA of the employee under Q&A G–5 or G–6, an employer may execute the necessary documents to establish a SIMPLE IRA on the employee‘‘s behalf with a financial institution selected by the employer.

Q. G–5: When must an employer make salary reduction contributions under a SIMPLE plan?

A. G–5: The employer must make salary reduction contributions to the financial institution maintaining the SIMPLE IRA no later than the close of the 30-day period following the last day of the month in which amounts would otherwise have been payable to the employee in cash. The Department of Labor has indicated that most SIMPLE plans are also subject to Title I of the Employee Retirement Income Security Act of 1974 (ERISA). The Department of Labor has informed the Treasury Department and the Service that, as a matter of enforcement policy, for these plans, salary reduction contributions must be made to the SIMPLE IRA as of the earliest date on which the contributions can reasonably be segregated from the employer's general assets, but in no event later than the 30-day deadline described above.

Q. G–6: When must an employer make matching and nonelective contributions under a SIMPLE plan?

A. G–6: Matching and nonelective employer contributions must be made to the financial institution maintaining the SIMPLE IRA no later than the due date for filing the employer's income tax return, including extensions, for the taxable year that includes the last day of the calendar year for which the contributions are made.

H. TRUSTEE ADMINISTRATIVE REQUIREMENTS

Q. H–1: What information must a SIMPLE IRA trustee provide to an employer?

A. H–1: Each year, a SIMPLE IRA trustee must provide the employer sponsoring the SIMPLE plan with a summary description containing the following information:

(1) The name and address of the employer and the trustee.

(2) The requirements for eligibility for participation.

(3) The benefits provided with respect to the arrangement.

(4) The time and method of making elections with respect to the arrangement.

(5) The procedures for, and effects of, withdrawals (including rollovers) from the arrangement.

The trustee must provide the summary description to the employer early enough to allow the employer to meet its notification obligation described in Q&A G–1. However, a trustee is not required to provide the summary description prior to agreeing to be the trustee of a SIMPLE IRA for the SIMPLE plan.

A trustee that fails to provide the employer with a summary plan description incurs a $50 penalty, under the Code, for each day the failure continues, unless the trustee shows that the failure is due to reasonable cause. To the extent that the employer or trustee provides the information described in paragraphs (1) through (5) of this Q&A H–1 within the time period prescribed in Q&A G–1 to the employee for whom the SIMPLE IRA is established, the trustee of that SIMPLE IRA is deemed to have shown reasonable cause for failure to provide that information to the employer. For example, if the employer provides its

name and address and the information described in paragraphs (2) through (4) of this Q&A H–1, and the effects of withdrawal to all eligible employees in a SIMPLE plan in accordance with Q&A G–1, and the trustee provides its name and address and its procedures for withdrawal to each eligible employee for whom a SIMPLE IRA is established with the trustee under the SIMPLE plan, the trustee will be deemed to have shown reasonable cause for failing to provide the employer the information described in paragraphs (1) through (5) of this Q&A H–1.

In the case of a SIMPLE plan established using Form 5305–SIMPLE, a trustee may satisfy this obligation by providing an employer with a current copy of Form 5305–SIMPLE, with instructions, the information required for completion of Article VI, and the name and address of the financial institution. The trustee should provide guidance to the employer concerning the need to complete the first two pages of Form 5305–SIMPLE in accordance with its plan's terms and to distribute completed copies to eligible employees.

The trustee of a transfer SIMPLE IRA is not required to provide the summary description described in the preceding paragraph. A SIMPLE IRA is a transfer SIMPLE IRA if it is not a SIMPLE IRA to which the employer has made contributions under the SIMPLE plan.

Q. H–2: What information must a SIMPLE IRA trustee provide to participants in the SIMPLE plan?

A. H–2: Within 30 days after the close of each calendar year, a SIMPLE IRA trustee must provide each individual on whose behalf an account is maintained with a statement of the individual''s account balance as of the close of that calendar year and the account activity during that calendar year. A trustee who fails to provide individuals with this statement incurs a $50 penalty, under the Code, for each day the failure continues, unless the trustee shows that the failure is due to reasonable cause. However, no penalty will apply if a trustee provides this statement not later than January 31 following the calendar year to which the statement relates. The trustee must also provide any other information required to be furnished to IRA holders (e.g., disclosure statements for individual retirement plans as referred to in section 1.408–6 of the regulations).

Q. H–3: What information must a SIMPLE IRA trustee provide to the Service?

A. H–3: Section 408(i) requires the trustee of an individual retirement account to make reports regarding these accounts to the Service. The Service intends to modify Form 5498, *Individual Retirement Arrangement Information*, to require that the amount of contributions to a SIMPLE IRA, rollover contributions, and the fair market value of the account be reported, and that contributions to a SIMPLE IRA be identified as such. A trustee who fails to file these reports incurs a $50 penalty under the Code for each failure, unless it is shown that the failure is due to reasonable cause.

Q. H–4: Are distributions from a SIMPLE IRA required to be reported on Form 1099–R?

A. H–4: Pursuant to section 6047 of the Code and section 35.3405–1 of the regulations, the payor of a designated distribution from an IRA must report the distribution on Form 1099–R. A distribution from a SIMPLE IRA is a designated distribution from an IRA and thus must be reported on Form 1099–R. The IRS intends to revise Form 1099–R, *Distributions From Pensions, Annuities, Retirement or Profit-sharing Plans, IRAs, Insurance Contracts, Etc.*, to reflect the requirements that apply to SIMPLE IRAs. The penalty, under the Code, for failure to report a designated distribution from an IRA (including a SIMPLE IRA) is determined under sections 6721–6724.

Q. H–5: Is a SIMPLE IRA trustee responsible for reporting whether a distribution to a participant occurred during the two-year period described in Q&A I–2?

A. H–5: Yes. A SIMPLE IRA trustee is required to report on Form 1099–R whether a distribution to a participant occurred during the two-year period described in Q&A I–2. A trustee is permitted to prepare this report on the basis of its own records with respect to the SIMPLE IRA account. A trustee may, but is not required to, take into account other adequately substantiated information regarding the date on which an individual first participated in any SIMPLE plan maintained by the individual's employer. See Q&A I–2 on the effect of distributions within this two-year period.

I. TAX TREATMENT OF SIMPLE PLANS

Q. I–1: What are the tax consequences of SIMPLE plan contributions?

A. I–1: Contributions to a SIMPLE IRA are excludable from federal income tax and not subject to federal income tax withholding. Salary reduction contributions to a SIMPLE IRA are subject to tax under the Federal Insurance Contributions Act (''FICA''), the Federal Unemployment Tax Act (''FUTA''), and the Railroad Retirement Act (''RRTA''), and must be reported on Form W–2, Wage and Tax Statement. Matching and nonelective contributions to a SIMPLE IRA are not subject to FICA, FUTA, or RRTA taxes, and are not required to be reported on Form W–2.

Q. I–2: What are the tax consequences when amounts are distributed from a SIMPLE IRA?

A. I–2: Generally, the same tax results apply to distributions from a SIMPLE IRA as to distributions from a regular IRA (i.e., an IRA described in section 408(a) or (b)). However, a special rule applies to a payment or distribution received from a SIMPLE IRA during the two-year period beginning on the date on which the individual first participated in any SIMPLE plan maintained by the individual's employer (the ''two-year period'').

Under this special rule, if the additional income tax on early distributions under section 72(t) applies to a distribution within this two-year period, section 72(t)(6) provides that the rate of additional tax under this special rule is increased from 10 percent to 25 percent. If one of the exceptions to application of the tax under section 72(t) applies (e.g., for amounts paid after age 59 1/2, after death, or as part of a series of substantially equal payments), the exception also applies to distributions within the two-year period and the 25-percent additional tax does not apply.

Q. I–3: Are there any special rollover rules that apply to a distribution from a SIMPLE IRA?

A. I–3: Section 408(d)(3)(G) provides that the rollover provisions of section 408(d)(3) apply to a distribution from a SIMPLE IRA during the two-year period described in Q&A I–2 only if the distribution is paid into another SIMPLE IRA. Thus, a distribution from a SIMPLE IRA during that two-year period qualifies as a rollover contribution (and thus is not includable in gross income) only if the distribution is paid

into another SIMPLE IRA and satisfies the other requirements of section 408(d)(3) for treatment as a rollover contribution.

Q. I–4: Can an amount be transferred from a SIMPLE IRA to another IRA in a tax-free trustee-to-trustee transfer?

A. I–4: During the two-year period described in Q&A I–2, an amount in a SIMPLE IRA can be transferred to another SIMPLE IRA in a tax-free trustee-to-trustee transfer. If, during this two-year period, an amount is paid from a SIMPLE IRA directly to the trustee of an IRA that is not a SIMPLE IRA, the payment is neither a tax-free trustee-to-trustee transfer nor a rollover contribution; the payment is a distribution from the SIMPLE IRA and a contribution to the other IRA that does not qualify as a rollover contribution. After the expiration of the two-year period, an amount in a SIMPLE IRA can be transferred in a tax-free trustee-to-trustee transfer to an IRA that is not a SIMPLE IRA.

Q. I–5: When does the two-year period described in Q&A I–2 begin?

A. I–5: The two-year period described in Q&A I–2 begins on the first day on which contributions made by the individual''s employer are deposited in the individual''s SIMPLE IRA.

Q. I–6: Do the qualification rules of section 401(a) apply to contributions under a SIMPLE plan?

A. I–6: None of the qualification rules of section 401(a) apply to SIMPLE plans. For example, the section 415 and 416 rules do not apply to contributions under a SIMPLE plan. Similarly, the section 401(a)(17) limit does not apply to salary reduction contributions and matching contributions. However, as noted in Q&A D–6, the amount of compensation that may be taken into account for purposes of the 2-percent nonelective contribution is limited to the amount that may be taken into account under section 401(a)(17) for the year.

Q. I–7: What rules apply to an employer's ability to deduct contributions under a SIMPLE plan?

A. I–7: Pursuant to section 404(m), contributions under a SIMPLE plan are deductible in the taxable year of the employer with or within which the calendar year for which contributions were made ends (without regard to the limitations of section 404(a)). For example, if an employer has a June 30 taxable year end, contributions under the SIMPLE plan for the calendar year 1997 (including contributions made in 1997 before June 30, 1997) are deductible in the taxable year ending June 30, 1998. Contributions will be treated as made for a particular taxable year if they are made on account of that taxable year and are made by the due date (including extensions) prescribed by law for filing the return for the taxable year.

J. EXCEPTION FOR USE OF DESIGNATED FINANCIAL INSTITUTION

Q. J–1: Can an employer designate a particular financial institution to which all contributions under the SIMPLE plan will be made?

A. J–1: Yes. In accordance with section 408(p)(7), instead of making SIMPLE plan contributions to the financial institution selected by each eligible employee (see Q&A E–4), an employer may require that all contributions on behalf of all eligible employees under the SIMPLE plan be made to SIMPLE IRAs at a particular financial institution if the following requirements are met: (1) the employer and the financial institution agree that the financial institution will be a designated financial institution under section 408(p)(7) (''DFI'') for the SIMPLE plan; (2) the financial institution agrees that, if a participant so requests, the participant's balance will be transferred without cost or penalty to another SIMPLE IRA (or, after the two-year period described in Q&A I–2, to any IRA) at a financial institution selected by the participant; and (3) each participant is given written notification describing the procedures under which, if a participant so requests, the participant's balance will be transferred without cost or penalty to another SIMPLE IRA (or, after the two-year period described in Q&A I–2, to any IRA) at a financial institution selected by the participant.

This Q&A J–1 is illustrated by the following examples:

Example 1: A representative of Financial Institution L approaches Employer B concerning the establishment of a SIMPLE plan. Employer B agrees to establish a SIMPLE plan for its eligible employees. Employer B would prefer to avoid writing checks to more than one financial institution on behalf of employees, and is interested in making all contributions under the SIMPLE plan to a single financial institution. Employer B and Financial Institution L agree that Financial Institution L will be a DFI and Financial Institution L agrees that, if a participant so requests, it will transfer the participant's balance, without cost or penalty, to another SIMPLE IRA (or, after the two-year period described in Q&A I–2, to any IRA) at a financial institution selected by the participant. A SIMPLE IRA is established for each participating employee of Employer B at Financial Institution L. Each participant is provided with a written description of how and when the participant may direct that the participant's balance attributable to contributions made to Financial Institution L be transferred without cost or penalty to a SIMPLE IRA (or, after the two-year period described in Q&A I–2, to any IRA) at another financial institution selected by the participant. Financial Institution L is a DFI, and Employer B may require that all contributions on behalf of all eligible employees be made to SIMPLE IRAs at Financial Institution L.

Example 2: A representative of Financial Institution M approaches Employer C concerning the establishment of a SIMPLE plan. Employer C invites Financial Institution M to make a presentation on its investment options for SIMPLE IRAs to Employer C's employees. Each eligible employee receives notification that the employer must permit the employee to select which financial institution will serve as the trustee of the employee's SIMPLE IRA (see Q&A G–1). All eligible employees of Employer C voluntarily select Financial Institution M to serve as the trustee of the SIMPLE IRAs to which Employer C will make all contributions on behalf of the employees. Financial Institution M is not a DFI merely because all eligible employees of Employer C selected Financial Institution M to serve as the trustee of their SIMPLE IRAs and Employer C consequently makes all contributions to Financial Institution M. Therefore, Financial Institution M is not required to transfer SIMPLE IRA balances without cost or penalty.

Example 3: Assume the same facts as *Example 2*, except that Employee X and Employee Y, who made salary reduction elections, failed to establish SIMPLE IRAs to receive SIMPLE plan contributions on their behalf before the first date on which Employer C is required to make a contribution to their SIMPLE IRAs. Employer C establishes SIMPLE IRAs at Financial

Institution M for these employees and contributes the amount required to their accounts. Financial Institution M is not a DFI merely because Employer C establishes SIMPLE IRAs on behalf of Employee X and Employee Y while all other employees voluntarily select Financial Institution M to serve as the trustee of the SIMPLE IRAs to which Employer C will make contributions on their behalf.

Q. J–2: May the time and manner in which a participant may transfer his or her balance without cost or penalty be limited without violating the requirements of section 408(p)(7)?

A. J–2: Yes. Section 408(p)(7) will not be violated merely because a participant is given only a reasonable period of time each year in which to transfer his or her balance without cost or penalty. A participant will be deemed to have been given a reasonable period of time in which to transfer his or her balance without cost or penalty if, for each calendar year, the participant has until the end of the 60-day period described in Q&A E–1 to request to transfer, without cost or penalty, his or her balance attributable to SIMPLE plan contributions for the calendar year following that 60-day period (or, for the year in which an employee becomes eligible to make salary reduction contributions, for the balance of that year) and subsequent calendar years.

If the time or manner in which a participant may transfer his or her balance without cost or penalty is limited, any such limitation must be disclosed as part of the written notification described in Q&A J–1. In the case of a SIMPLE plan established using Form 5305–SIMPLE, if the summary description requirement is being satisfied by providing a completed copy of pages one and two of Form 5305–SIMPLE, Article VI (Procedures for Withdrawal) must contain a clear explanation of any such limitation.

This Q&A J–2 is illustrated by the following examples:

Example 1: Employer A first establishes a SIMPLE plan effective January 1, 1998, and intends to make all contributions to Financial Institution M, which has agreed to serve as a DFI. For the 1998 calendar year, Employer A provides the 60-day election period described in Q&A E–1 beginning November 2, 1997, and notifies each participant that he or she may request that his or her balance attributable to future contributions be transferred from Financial Institution M to a SIMPLE IRA at a financial institution that the participant selects. The notification states that the transfer will be made without cost or penalty if the participant contacts Financial Institution M prior to January 1, 1998. For the 1998 calendar year, the requirements of section 408(p)(7) will not be violated merely because participants are given only a 60-day period in which to request to transfer their balances without cost or penalty.

Example 2: Assume the same facts as Example 1. Participant X does not request a transfer of her balance by December 31, 1997, but requests a transfer of her current balance to another SIMPLE IRA on July 1, 1998. Participant X''s current balance would not be required to be transferred without cost or penalty because Participant X did not request such a transfer prior to January 1, 1998. However, during the 60-day period preceding the 1999 calendar year, Participant X may request a transfer, without cost or penalty, of her balance attributable to contributions made for the 1999 calendar year and, if she so elects, for all future calendar years (but not her balance attributable to contributions for the 1998 calendar year).

Example 3: Assume the same facts as *Example 1*. Under the terms of the SIMPLE plan, Participant Y becomes an eligible employee on June 1, 1998, and, for Participant Y, the 60-day period described in Q&A E–1 begins on that date. For the 1998 calendar year, Participant Y will be deemed to have been given a reasonable amount of time in which to request to transfer, without cost or penalty, his balance attributable to contributions for the balance of the 1998 calendar year if Financial Institution M allows such a request to be made prior to July 31, 1998.

Q. J–3: Is there a limit on the frequency with which a participant's balance must be transferred without cost or penalty?

A. J–3: In order to satisfy Section 408(p)(7), if a participant acts, within applicable reasonable time limits, if any, to request a transfer of his or her balance, the participant's balance must be transferred on a reasonably frequent basis. A participant's balance will be deemed to be transferred on a reasonably frequent basis if it is transferred on a monthly basis.

Q. J–4: How does a DFI transfer a participant's balance without cost or penalty?

A. J–4: In order to satisfy section 408(p)(7), a participant's balance must be transferred in a trustee-to-trustee transfer directly to a SIMPLE IRA (or, after the two-year period described in Q&A I–2, to any IRA) at the financial institution specified by the participant.

A transfer is deemed to be made without cost or penalty if no liquidation, transaction, redemption or termination fee, or any commission, load (whether front-end or back-end) or surrender charge, or similar fee or charge is imposed with respect to the balance being transferred. A transfer will not fail to be made without cost or penalty merely because contributions that a participant has elected to have transferred without cost or penalty are required to be invested in one specified investment option until transferred, even though a variety of investment options are available with respect to contributions that participants have not elected to transfer. This Q&A J–4 is illustrated by the following examples:

Example 1: Financial Institution Q agrees to be a DFI for the SIMPLE plan maintained by Employer D. Employer D provides the 60-day election period described in Q&A E–1 beginning on November 2 of each year and each participant is notified that he or she may request, before the end of the 60-day period, a transfer of his or her future contributions from Financial Institution Q without cost or penalty to a SIMPLE IRA (or, after the two-year period described in Q&A I–2, to any IRA) at a financial institution selected by the participant. The notification states that a participant's contributions that are to be transferred without cost or penalty will be invested in a specified investment option and will be transferred to the financial institution selected by the participant on a monthly basis.

Financial Institution Q offers various investment options to account holders of IRA SIMPLE accounts, including investment options with a sales charge. Any participant who does not elect to have his or her balance transferred to another financial institution may invest the contributions made on his or her behalf in any investment option available to account

holders of SIMPLE IRA accounts at Financial Institution Q. However, contributions that a participant has elected to have transferred are automatically invested, prior to transfer, in a specified investment option that has no sales charge. The requirement that a participant's balance be transferred without cost or penalty will not be violated merely because contributions that have been designated to be transferred pursuant to a participant''s election are automatically invested in one specified investment option and transferred on a monthly basis to the financial institution selected by the participant.

Example 2: Assume the same facts as in Example 1. Financial Institution Q generally charges its IRA accounts a reasonable annual administration fee. Financial Institution Q also charges this annual administration fee with respect to SIMPLE IRA accounts, including SIMPLE IRA accounts from which balances must be transferred in accordance with participants' transfer elections. The requirement that participants'' balances be transferred without cost or penalty will not be violated merely because a reasonable annual administration fee is charged to SIMPLE IRA accounts from which balances must be transferred in accordance with participants'' transfer elections.

Q. J–5: Is the ''without cost or penalty'' requirement violated if a DFI charges an employer for a participant''s transfer of his or her balance?

A. J–5: The ''without cost or penalty'' requirement of section 408(p)(7) is not violated merely because a DFI charges an employer an amount that takes into account the financial institution's responsibility to transfer balances upon participants' requests or otherwise charges an employer for transfers requested participants, provided that the charge is not passed through to the participants who request the transfer.

K. SIMPLE PLAN ESTABLISHMENT

Q. K–1: Must an employer establish a SIMPLE plan on January 1?

A. K–1: An existing employer may establish a SIMPLE plan effective on any date between January 1 and October 1 of a year beginning after December 31, 1996, provided that the employer (or any predecessor employer) did not previously maintain a SIMPLE plan. This requirement does not apply to a new employer that comes into existence after October 1 of the year the SIMPLE plan is established if the employer establishes the SIMPLE plan as soon as administratively feasible after the employer comes into existence. If an employer (or predecessor employer) previously maintained a SIMPLE plan, the employer may establish a SIMPLE plan effective only on January 1 of a year.

Q. K–2: When must a SIMPLE IRA be established for an employee?

A. K–2: A SIMPLE IRA is required to be established for an employee prior to the first date by which a contribution is required to be deposited into the employee''s SIMPLE IRA (see Q&As G–5 and G–6).

Q. K–3: Will the Service issue model forms employers can use to establish SIMPLE plans?

A. K–3: Yes. On October 31, 1996, the Service issued Form 5305–SIMPLE, which is a form that may be used by an employer establishing a SIMPLE plan with a financial institution that is a DFI. The Service also intends to issue a model form that may be used by an employer establishing a SIMPLE plan that does not use a DFI. (The Service issued Form 5304–SIMPLE on December 30, 1996.) Until the Service issues this model form, an employer establishing a SIMPLE plan that does not use a DFI and wishes to use a model form may use Form 5305–SIMPLE (October 1996), subject to the following modifications:

A. Modifications to the Form:

(1) Form Title: strike the parenthetical ''(for Use With a Designated Financial Institution)'';

(2) Item 1 of Article I: strike ''SIMPLE individual retirement account or annuity established at the designated financial institution (SIMPLE IRA) for'' and substitute ''SIMPLE IRA established by'';

(3) Item 3 of Article III: strike ''to the designated financial institution for the IRAs established under this SIMPLE plan'' each time it appears and substitute ''for each eligible employee to the SIMPLE IRA established at the financial institution selected by that employee'';

(4) Item 4 of Article IV: strike this Item and substitute ''**Selection of IRA Trustee**. The employer must permit each eligible employee to select the financial institution that will serve as trustee, custodian or issuer of the SIMPLE IRA to which the employer will make all contributions on behalf of that employee.'';

(5) Item 4 of Article V: strike this Item; substitute ''**SIMPLE IRA**. A SIMPLE IRA is an individual retirement account described in section 408(a), or an individual retirement annuity described in section 408(b), to which the only contributions that can be made are contributions under a SIMPLE plan and rollovers or transfers from another SIMPLE IRA.'';

(6) Article VI, heading: strike everything after the title and substitute ''(The employer will provide each employee with the procedures for withdrawals of contributions received by the financial institution selected by that employee unless that financial institution provides the procedures directly to the employee.)''; and

(7) Article VII: strike the paragraph pertaining to the agreement to be a designated financial institution (i.e., the paragraph that begins ''The undersigned agrees . . .'') and the related name, address, and signature block.

B. Modifications to the Instructions:

(1) Under heading ''**What is a SIMPLE Plan?**'': strike ''designated financial institution named in Article VII'' and substitute ''financial institution selected by each eligible employee'';

(2) Under heading ''**When to Use Form 5305–SIMPLE**'': strike Item 1 and renumber Items 2 and 3 accordingly;

(3) Under heading ''**Completing Form 5305–SIMPLE**'': strike ''and the designated financial institution'';

(4) Under heading ''**Contributions (Article III)**'', subheading ''**Salary Reduction Contributions**'': strike ''designated financial institution for the employee's SIMPLE IRA'' and substitute ''financial institution selected by each eligible employee'';

(5) Under heading ''**Other Important Information About Your SIMPLE Plan**'', subheading ''**Timing of Salary Reduction Contributions**'':

(a) Strike ''designated financial institution for the SIMPLE IRAs of all eligible employees'' and substitute ''financial institution selected by each eligible employee for his or her SIMPLE IRA''; and

(b) Strike "the SIMPLE IRA at the designated financial institution" and substitute "each participant's SIMPLE IRA";

(6) Under heading "**Other Important Information About Your SIMPLE Plan**", subheading "**Employee Notification**": strike everything after the title and substitute "You must notify each eligible employee prior to the employee's 60-day election period described above that he or she can make or change salary reduction elections and select the financial institution that will serve as the trustee, custodian, or issuer of the employee's SIMPLE IRA. In this notification, you must indicate whether you will provide:

1. A matching contribution equal to your employees' salary reduction contributions up to a limit of 3% of their compensation;
2. A matching contribution equal to your employees' salary reduction contributions subject to a percentage limit that is between 1% and 3% of their compensation; or
3. A nonelective contribution equal to 2% of your employees' compensation.

You can use the **Model Notification to Eligible Employees** on page 3 to satisfy these employee notification requirements for this SIMPLE plan, provided you either: (1) modify the model to disclose employees' ability to select the financial institution that will serve as the trustee, custodian, or issuer of the employee's SIMPLE IRA or (2) provide this same disclosure in a separate document. A **Summary Description** must also be provided to eligible employees at this time. This summary description requirement may be satisfied by providing a completed copy of pages 1 and 2 of Form 5305–SIMPLE (including the Article VI Procedures for Withdrawals).

If you fail to provide the employee notification (including the summary description) described above, you will be liable for a penalty of $50 per day until the notification is provided. If you can show that the failure was due to reasonable cause, the penalty will not be imposed.

If the summary description information with respect to the financial institution (i.e., the name and address of the financial institution and its withdrawal procedures) is not available at the time the employee must be given the summary description, you must provide the summary description without this information. In such a case, you will have reasonable cause for not including this information with respect to the financial institution in the summary description.";

(7) Under heading "**Other Important Information About Your SIMPLE Plan**": strike subheading "**Choosing the Designated Financial Institution**" and the following three paragraphs;

(8) Strike the heading "**Instructions for the Designated Financial Institution**" and the subheading "**Completing Form 5305–SIMPLE**" and the following paragraph; and

(9) Under the subheading "**Summary Description**":

(a) In the first paragraph, strike "you" and substitute "the financial institution for the SIMPLE IRA of each eligible employee";

(b) In the first paragraph, strike "your procedures for withdrawals and transfers from the SIMPLE IRAs established under this SIMPLE plan" and substitute "that financial institution"s procedures for withdrawals from SIMPLE IRAs established at that financial institution, including the financial institution"s name and address"; and

(c) Strike the second paragraph and substitute "There is a penalty of $50 per day for each failure to provide the summary description described above. However, if the failure was due to reasonable cause, the penalty will not be imposed."

REQUEST FOR COMMENTS

The Service and Treasury request comments on the guidance provided in these questions and answers for use in developing any future guidance on SIMPLE plans.

Comments can be addressed to CC:DOM:CORP:R (Notice 97–6), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, comments may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (Notice 97–6), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. Alternatively, taxpayers may transmit comments electronically via the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html

PAPERWORK REDUCTION ACT

The collections of information contained in this notice have been reviewed and approved by the Office of Management and Budget for review in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1502.

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.

The collections of information in this notice are in the sections headed: *Employee Elections*, *Employer Administrative And Notification Requirements*, *Trustee Administrative Requirements*, and *SIMPLE Plan Establishments*. This information is required by the IRS to assure compliance with the new provisions of the Small Business Job Protection Act of 1996. The likely respondents are individuals, business or other for-profit institutions, and not-for-profit institutions.

The estimated total annual reporting burden is 769,000 hours. The estimated average annual burden per respondent is 2 hours and 34 minutes. The estimated number of respondents is 300,000.

The estimated annual frequency of responses is annually.

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

DRAFTING INFORMATION

The principal author of this notice is Carlton Watkins of the Employee Plans Division. For further information regarding this notice, please contact the Employee Plans Division's taxpayer assistance telephone service at (202) 622–6074/6075 (not a toll-free number), between the hours of 1:30 and 4:00 p.m. Eastern Time, Monday through Thursday.

Adoption Assistance

Notice 97–9

Sections 23 and 137, relating to certain adoption expenses, were added to the Internal Revenue Code by the Small Business Job Protection Act of 1996, Pub. L. 104–188. This notice provides general guidance concerning the tax

credit under § 23 for qualified adoption expenses paid or incurred by an individual, and the exclusion from gross income under § 137 for amounts paid or expenses incurred by an employer for qualified adoption expenses under an adoption assistance program. Both the credit and the exclusion are effective for taxable years beginning after December 31, 1996. They both generally terminate after December 31, 2001 (except for the credit with respect to a child with special needs).

This notice is divided into six sections. Section I explains the adoption credit. Section II explains the exclusion from gross income under an adoption assistance program. Section III describes the coordination of the credit and the exclusion. Sections IV and V cover filing and reporting requirements and the effective dates of the credit and the exclusion, respectively. Section VI invites comments on future guidance regarding the credit and the exclusion.

I. Adoption Credit.

A. In General.

Section 23 provides an income tax credit for qualified adoption expenses paid or incurred by an individual in connection with the adoption of an eligible child. The phrase "paid or incurred" refers to the method of accounting (i.e., cash or accrual) of the individual. Under a dollar limitation, the maximum credit is $5,000 ($6,000 in the case of an adoption of a child with special needs). See section I.D.1. The credit is also subject to an income limitation which may reduce or eliminate the credit for any particular year. See section I.D.2. For the effective date and partial expiration date of the credit, see section V.

B. Eligible Child and Child with Special Needs.

1. In general.

An eligible child is any individual who, at the time a qualified adoption expense is paid or incurred, is under the age of 18, or is physically or mentally incapable of caring for himself or herself. For qualified adoption expenses paid or incurred after December 31, 2001, an eligible child must also be a child with special needs.

2. Child with Special Needs.

A child with special needs is an otherwise eligible child who meets two additional requirements. First, a state must have determined that (1) the child cannot or should not be returned to the parents' home, and (2) it is reasonable to conclude the child cannot be placed with adoptive parents without adoption assistance because of a specific factor or condition. Examples of a specific factor or condition include a child's ethnic background, age, membership in a minority or sibling group, medical condition, or handicap. Second, a child with special needs must be a citizen or resident of the United States. The term "United States" includes any possession of the United States.

C. Qualified Adoption Expenses.

"Qualified adoption expenses" include the reasonable and necessary adoption fees, court costs, attorney's fees, traveling expenses (including amounts expended for meals and lodging) while away from home, and other expenses that are directly related to, and the principal purpose of which is for, the legal adoption of an eligible child by the taxpayer. Qualified adoption expenses do not include any expense (1) for which a deduction or credit is allowed under any other provision of the Code, (2) to the extent that funds for the expense are received under any federal, state, or local program, (3) that is incurred in violation of federal or state law, (4) that is incurred in carrying out any surrogate parenting arrangement, (5) that is incurred in connection with the adoption of a child of the taxpayer's spouse, or (6) for which reimbursement is made under an employer program or otherwise. In addition, an expense paid (by a cash basis taxpayer) or incurred (by an accrual basis taxpayer) in a taxable year beginning before 1997 is not a qualified adoption expense eligible for the credit.

D. Limitations on the Credit.

The credit for qualified adoption expenses is subject to a dollar limitation and an income limitation.

1. Dollar Limitation.

The maximum amount of qualified adoption expenses that may be taken into account for the credit is $5,000 ($6,000 in the case of an adoption of a child with special needs). The legislative history to this provision clarifies that the $5,000 (or $6,000) limitation is with respect to the adoption of each child and is cumulative over all taxable years (rather than an annual limitation). See section I.G., Examples 1 and 2. Therefore, the maximum amount that may be taken into account in connection with a taxpayer's effort to adopt an eligible child is $5,000 (or $6,000), including qualified adoption expenses paid or incurred in any unsuccessful attempt to adopt an eligible child before successfully finalizing the adoption of another eligible child. See section I.G., Example 3. The $5,000 (or $6,000) limitation on qualified adoption expenses applies both to married individuals and to unmarried individuals adopting an eligible child. Therefore, an unmarried couple that seeks to adopt an eligible child must apply the $5,000 (or $6,000) limitation to the couple's combined qualified adoption expenses.

2. Income Limitation.

If a taxpayer's modified adjusted gross income (modified AGI, as defined in section I.D.3. below) is $75,000 or less, the income limitation does not apply and the taxpayer's allowable credit is not reduced. If a taxpayer's modified AGI is $115,000 or more, no credit is available. If a taxpayer's modified AGI is between $75,000 and $115,000, the allowable credit is ratably reduced (but not below zero) as follows:

$$\text{ALLOWABLE CREDIT} = \text{QAE(YR)} - \left[\text{QAE(YR)} \times \left(\frac{\text{modified AGI} - \$75{,}000}{\$40{,}000}\right)\right]$$

"QAE(YR)" is the amount of qualified adoption expenses taken into account for the taxable year after applying the dollar limitation.

For example, assume that in 1997 an unmarried individual has modified AGI of $85,000 and pays $5,000 for qualified adoption expenses. The adoption becomes final in 1997. The individual's reduction percentage is 25% ($85,000 minus $75,000 equals $10,000; $10,000 divided by $40,000 equals 25%). The maximum credit available is $3,750 ($5,000 times 25% equals $1,250; $5,000 minus $1,250 equals $3,750) and is claimed in 1997. In addition, see section I.G., Example 4.

3. Modified Adjusted Gross Income.

Modified AGI for the taxable year in which qualified adoption expenses are

taken into account is adjusted gross income for that year determined after applying the income exclusion under § 137, but without applying § 911 (the foreign earned income exclusion or the foreign housing exclusion), § 931 (the exclusion for income from Guam, American Samoa, and the Northern Mariana Islands), and § 933 (the exclusion for income from Puerto Rico).

E. Year of Credit.

1. Domestic adoptions.

The credit for qualified adoption expenses paid or incurred in connection with the adoption of an eligible child who is a citizen or resident of the United States at the time the adoption commenced (including such amounts paid or incurred in an unsuccessful effort to adopt such a child) is allowed in the next taxable year unless the expenses are paid or incurred in the taxable year the adoption becomes final. The credit for expenses paid or incurred in the taxable year an adoption becomes final is allowed in that year.

2. Foreign adoptions.

A special rule applies in the case of the adoption of an eligible child who is not a citizen or resident of the United States at the time the adoption commenced. The credit is only available for adoptions that become final. Qualified adoption expenses paid or incurred in any taxable year before the taxable year in which the adoption becomes final are treated as paid or incurred in the taxable year in which the adoption becomes final. Therefore, the credit for qualified adoption expenses paid or incurred in the taxable year in which the adoption becomes final, or in any earlier taxable year, is allowed in the taxable year the adoption becomes final.

For example, assume that in 1997 and 1998 an unmarried individual pays $1,000 and $3,000, respectively, of qualified adoption expenses in connection with the adoption of an eligible child who is not a citizen or resident of the United States. In 1999, the year the adoption becomes final, the individual pays an additional $4,000 of such expenses. The individual's modified adjusted gross income for 1999 is less than $75,000 (and thus the income limitation does not apply). The individual may claim a credit of $5,000 (the maximum credit permitted) on his or her 1999 federal income tax return (the year the adoption becomes final).

3. Pre-1997 Expenses.

An expense paid (by a cash basis taxpayer) or incurred (by an accrual basis taxpayer) in a taxable year beginning before 1997 in connection with the adoption (either domestic or foreign) of an eligible child does not qualify for the credit. See section V.A.

F. Carryforward of Unused Credit.

The adoption credit allowable under § 23 is a nonrefundable credit that, along with credits allowable under § 21 (relating to dependent care), § 22 (relating to the elderly and the disabled), and § 25 (relating to interest on home mortgages), is limited under § 26 to the excess of the taxpayer's regular tax liability for the taxable year over the tentative minimum tax for the taxable year (determined without regard to the alternative minimum tax foreign tax credit). If § 26 limits the amount of an adoption credit otherwise allowable in a particular year, the excess may be carried forward to the succeeding taxable year, but not beyond the fifth taxable year following the taxable year in which the credit arose.

G. Examples.

The following examples illustrate the rules described in section I. For purposes of these examples, except as otherwise provided, assume that each eligible child is a citizen of the United States who is not a child with special needs, and that H and *W* are a married couple who file a joint federal income tax return on the cash basis and seek to adopt one child.

Example 1. Dollar limitation. In an effort to adopt an eligible child, *H* and *W* pay $4,000 of qualified adoption expenses in 1997 and an additional $2,000 of qualified adoption expenses in 1998. The adoption becomes final in 1998. For 1998, *H* and *W* have modified AGI of $75,000 or less (and thus the income limitation does not apply). *H* and *W* may not claim any qualified adoption expenses as a credit in 1997 because of the 1-year delay rule in section I.E.1. *H* and *W*, on their joint federal income tax return for 1998, may claim $5,000 of qualified adoption expenses as a credit. The remaining $1,000 of qualified adoption expenses *H* and *W* paid may never be claimed as a credit.

Example 2. Dollar Limitation. Assume the same facts as in Example 1, except that the child is a child with special needs. H and W, on their joint federal income tax return for 1998, may claim $6,000 of qualified adoption expenses as a credit.

Example 3. Dollar limitation. In an effort to adopt an eligible child, *H* and *W* pay $3,000 of qualified adoption expenses in January 1997 to Agency *1*. Although Agency *1* was able to identify an eligible child for *H* and *W* to adopt, the adoption ultimately was unsuccessful. *H* and *W* then paid $4,000 of qualified adoption expenses to Agency *2* in September 1997 in a further effort to adopt a child. This time, the effort was successful and *H* and *W* finalized the adoption of *A*, an eligible child, in December 1997. *H* and *W* have modified AGI of $75,000 or less (and thus the income limitation does not apply). The total amount that *H* and *W* may take into account in connection with the adoption of an eligible child is limited to $5,000. See section I.D.1. Thus, *H* and *W*, on their 1997 joint federal income tax return, may claim $5,000 of qualified adoption expenses as a credit. The remaining $2,000 of qualified adoption expenses *H* and *W* paid may never be claimed as a credit.

Example 4. Income limitation. In an effort to adopt an eligible child, *H* and *W* pay $1,000 of qualified adoption expenses in 1997, an additional $2,000 of those expenses in 1998, and $4,000 of those expenses in 1999 when the adoption becomes final. *H* and *W* have modified AGI of $85,000 for all taxable years and thus the income limitation applies. *H* and *W* may not claim any qualified adoption expenses as a credit in 1997 because of the 1-year delay rule in section I.E.1. *H* and *W*, on their 1998 joint federal income tax return, may take into account the $1,000 of qualified adoption expenses paid in 1997, subject to any reduction under the income limitation. *H* and *W*'s reduction percentage for 1998 under the income limitation is 25% ($85,000 minus $75,000 equals $10,000; $10,000 divided by $40,000 equals 25%). *H* and *W*'s allowable credit for 1998 is $750 ($1,000 times 25% equals $250; $1,000 minus $250 equals $750).

H and *W*, on their joint federal income tax return for 1999, first reduce the dollar limitation ($5,000) by the amount of qualified adoption expenses taken into account in all prior years ($5,000 minus $1,000 equals $4,000) before applying the income limitation. Thus, *H* and *W* may take into account only $4,000 of the $6,000 of qualified adoption expenses paid in 1998 and 1999 on their 1999 joint federal income tax return before applying the income limitation. *H* and *W*'s reduction percentage for 1999 under the income limitation is 25% and their allowable credit for 1999 is $3,000 ($4,000 times 25% equals $1,000; $4,000 minus $1,000 equals $3,000). The remaining $2,000 of qualified adoption expenses that *H* and *W* paid in 1998 and 1999 ($6,000 minus $4,000 equals $2,000) may never be claimed as a credit.

II. Adoption Assistance Program.

A. In General.

Section 137 provides an exclusion from an employee's gross income for amounts paid or expenses incurred by an employer for qualified adoption expenses in connection with the adoption of an eligible child by an employee if such amounts are furnished pursuant to an adoption assistance program. See section II.D., which describes the requirements of an adoption assistance program. Under a dollar limitation, the maximum exclusion from gross income is $5,000 ($6,000 in the case of an adoption of a child with special needs). See section II.F.1. The exclusion is also subject to an income limitation, which may reduce or eliminate the exclusion for any particular year. See section II.F.2. For the effective date and expiration date of the exclusion, see section V.

B. Eligible Child and Child with Special Needs.

1. In General.

An eligible child is any individual who, at the time a qualified adoption expense is paid or incurred, is under the age of 18, or is physically or mentally incapable of caring for himself or herself.

2. Child with Special Needs.

A child with special needs is an otherwise eligible child who meets two additional requirements. First, a state must have determined that (1) the child cannot or should not be returned to the parents' home, and (2) it is reasonable to conclude the child cannot be placed with adoptive parents without adoption assistance because of a specific factor or condition. Examples of a specific factor or condition include a child's ethnic background, age, membership in a minority or sibling group, medical condition, or handicap. Second, a child with special needs must be a citizen or resident of the United States. The term "United States" includes any possession of the United States.

C. Qualified Adoption Expenses.

"Qualified adoption expenses" include the reasonable and necessary adoption fees, court costs, attorney's fees, traveling expenses (including amounts expended for meals and lodging) while away from home, and other expenses that are directly related to, and the principal purpose of which is for, the legal adoption of an eligible child by the taxpayer. Qualified adoption expenses do not include any expense (1) that is incurred in violation of federal or state law, (2) that is incurred in carrying out any surrogate parenting arrangement, (3) that is incurred in connection with the adoption of a child of the taxpayer's spouse, or (4) that is reimbursed other than under an adoption assistance program that satisfies the requirements of § 137.

D. Adoption Assistance Program Requirements.

1. In General.

An adoption assistance program is a separate written plan of an employer for the exclusive benefit of its employees under which the employer provides adoption assistance and which meets the requirements described below. The exclusion is not available unless, before adoption expenses are incurred by either the employer or employee, the written plan is in existence and the employee receives notification of the existence of the plan. An adoption assistance program may be part of a more comprehensive benefit plan and is not required to be funded. In addition, an employer is not required to apply to the Internal Revenue Service for a determination that the plan is a qualified program.

2. Plan Requirements.

A brief description of the plan requirements follows:

(a) all employees who are eligible to participate in the program are required to be given reasonable notice of the terms and availability of the program;

(b) an adoption assistance program must benefit the employer's employees generally and eligibility requirements may not discriminate in favor of highly compensated employees or their dependents;

(c) shareholders or owners (or their spouses or dependents) may receive no more than five percent of all the adoption assistance reimbursements or expenses paid by the employer during the year (for this purpose, a shareholder or owner is someone who owns on any day of the year more than five percent of the stock, or capital or profits interest of the employer); and

(d) an employee receiving payments under an adoption assistance program must provide the employer reasonable substantiation that payments or reimbursements made under the program constitute qualified adoption expenses.

Without regard to whether the foregoing requirements are satisfied, adoption reimbursement programs under § 1052 of title 10, United States Code (relating to the armed forces) or § 514 of title 14, United States Code (relating to members of the Coast Guard) are treated as adoption assistance programs for purposes of the exclusion.

E. Cafeteria Plans.

An adoption assistance program that meets the requirements of § 137 (described in section II.D.) constitutes a qualified benefit under § 125 of the Code. Consequently, the program may be offered through a cafeteria plan.

F. Limitations on the Exclusion.

The exclusion from gross income for qualified adoption expenses under an adoption assistance program is subject to a dollar limitation and an income limitation.

1. Dollar Limitation.

The maximum amount of qualified adoption expenses that may be taken into account is $5,000 ($6,000 in the case of an adoption of a child with special needs). The $5,000 (or $6,000) limitation is with respect to the adoption of each child and is cumulative over all taxable years (rather than an annual limitation). See section II.J., Examples 1 and 2. Therefore, the maximum amount that may be taken into account in connection with a taxpayer's effort to adopt an eligible child is $5,000 (or $6,000), including amounts paid or expenses incurred for qualified adoption expenses in connection with any unsuccessful attempt to adopt an eligible child before successfully finalizing the adoption of another eligible child. See section II.J., Example 3. The $5,000 (or $6,000) limitation on qualified adoption expenses applies both to married individuals and to unmarried individuals adopting an eligible child. Therefore, an unmarried couple that seeks to adopt an eligible child must apply the $5,000 (or $6,000) limitation to the couple's combined qualified adoption expenses.

2. Income Limitation.

If a taxpayer's modified adjusted gross income (modified AGI) (as defined in section II.F.3. below) is $75,000 or less, the income limitation does not apply and the taxpayer's allowable exclusion is not reduced. If a taxpayer's modified AGI is $115,000 or more, no exclusion is available. If a taxpayer's modified AGI is between $75,000 and $115,000, the allowable exclusion is ratably reduced (but not below zero) as follows:

$$\text{ALLOWABLE EXCLUSION} = \text{QAE(YR)} - \left[\text{QAE(YR)} \times \left(\frac{\text{modified AGI} - \$75{,}000}{\$40{,}000}\right)\right]$$

"QAE(YR)" is the amount of qualified adoption expenses taken into account for the taxable year after applying the dollar limitation.

For example, assume that in 1997 an unmarried employee has modified AGI of $85,000 and is reimbursed $5,000 by his or her employer under an adoption assistance program for qualified adoption expenses. The employee's reduction percentage is 25% ($85,000 minus $75,000 equals $10,000; $10,000 divided by $40,000 equals 25%). The maximum amount of the exclusion from the employee's gross income in 1997 is $3,750 ($5,000 times 25% equals $1,250; $5,000 minus $1,250 equals $3,750). The remaining $1,250 is included in the employee's gross income for 1997. In addition, see section II.J., Example 4. For the employee's tax filing obligations and responsibilities, see section II.G.2.

3. Modified adjusted gross income.

Modified AGI for the taxable year in which the exclusion may be claimed is adjusted gross income for that year, but without applying § 137 (the exclusion for adoption assistance program payments), § 911 (the foreign earned income exclusion or the foreign housing exclusion), § 931 (the exclusion for income from Guam, American Samoa, and the Northern Mariana Islands), and § 933 (the exclusion for income from Puerto Rico). Modified AGI as defined for the exclusion is different from modified AGI as defined for the credit.

G. Tax Withholding, Reporting, and Filing Obligations.

1. Employer's Withholding and Reporting Obligations.

Amounts paid or expenses incurred by an employer for qualified adoption expenses under an adoption assistance program are not subject to income tax withholding. However, these amounts are subject to social security and Medicare taxes (FICA), federal unemployment tax (FUTA), and railroad retirement tax withholding. Employers are to report amounts paid or expenses incurred for qualified adoption expenses in accordance with appropriate forms (for example, Form W–2) and instructions or other guidance issued by the Internal Revenue Service. See Announcement 96–134, 1996–53 I.R.B. 1, for instructions relating to reporting adoption assistance program payments on Form W–2.

2. Employee's Tax Filing Obligations and Responsibilities.

As described above, amounts paid or expenses incurred for qualified adoption expenses by an employer under an adoption assistance program are not subject to income tax withholding. Therefore, an employee who receives reimbursements or payments that do not qualify, or only partially qualify, for the exclusion from gross income (see sections II.F.2. and II.H.2.) must make an appropriate adjustment on Form 1040 (in accordance with the form and its instructions) to include in gross income the taxable portion of the reimbursement. In addition, the employee may need to make an adjustment to his or her income tax withholding (on Form W–4) or make estimated tax payments (see Publication 505, Tax Withholding and Estimated Tax) to avoid potential penalties for underpayment of tax on the taxable portion of a reimbursement.

H. Year of Exclusion.

1. Domestic Adoptions.

In general, amounts are excludable from the employee's gross income for the year in which the employer pays the qualified adoption expense in connection with the adoption of an eligible child who is a citizen or resident of the United States at the time the adoption commenced.

2. Foreign Adoptions.

A special rule applies in the case of the adoption of an eligible child who is not a citizen or resident of the United States at the time the adoption commenced. The exclusion is only available for adoptions that become final. Amounts paid or expenses incurred by the employer for qualified adoption expenses before the taxable year in which the adoption becomes final are excludable from the employee's gross income in the taxable year in which the adoption becomes final. Therefore, amounts paid or expenses incurred by the employer under an adoption assistance program in a taxable year prior to a final adoption are includible in the employee's gross income in that year. The employee must make an appropriate adjustment on the employee's Form 1040. Provided the adoption becomes final before January 1, 2002, the employee may claim the exclusion in the taxable year in which the adoption becomes final by making an appropriate adjustment on the employee's Form 1040 for that year. See section II.J., Example 5. See also section II.G. for employer and employee tax withholding, reporting, and filing obligations.

I. Reserved.

J. Examples.

The following examples illustrate the rules described in section II. For purposes of these examples, except as otherwise provided, assume that each eligible child is a citizen of the United States who is not a child with special needs, that Employee *Y* is married, is a cash method taxpayer, and files a joint federal income tax return with *Y*'s spouse. *Y* and *Y*'s spouse seek to adopt one child. Also assume that Employer *X* establishes an adoption assistance program that meets the requirements of § 137 on January 1, 1997, and that *Y* is a plan participant.

Example 1. Dollar limitation. In 1997, pursuant to the adoption assistance program, *X* pays $5,000 of qualified adoption expenses on behalf of *Y* in connection with *Y*'s effort to adopt an eligible child. *Y* and *Y*'s spouse have modified AGI of $75,000 or less for 1997 and 1998 (and thus the income limitation does not apply). In 1997, *Y* can exclude $5,000 from gross income. In 1998, *X* pays an additional $2,000 of qualified adoption expenses on behalf of *Y*. *Y* must include the additional amounts in gross income in 1998. See section II.G. for *X* and *Y*'s tax withholding, reporting, and filing obligations.

Example 2. Dollar limitation. Assume the same facts as in Example 1, except that the child is a child with special needs. In 1997, *Y* can exclude $5,000 from gross income. In 1998, *Y* can exclude an additional $1,000 from gross income. *Y* must include the remaining $1,000 in gross income in 1998. See section II.G. for *X* and *Y*'s tax withholding, reporting, and filing obligations.

Example 3. Dollar limitation. In 1997, pursuant to the adoption assistance program, *X* pays $7,000 of qualified adoption expenses on behalf of *Y* in connection with *Y*'s effort to adopt an eligible child ($3,000 of qualified adoption expenses to Agency *1 for an unsuccessful attempt to adopt A* and $4,000 of qualified adoption expenses to Agency *2* for the final adoption of *B*). *Y* and *Y*'s spouse have modified AGI of $75,000 or less for 1997 (and thus the income limitation does not apply). The total amount that *Y* may take into account in connection with the adoption of an eligible child is limited to $5,000. Thus, in 1997, *Y* can exclude $5,000 from gross income. See section II.F.1. The remaining $2,000 of qualified adoption expenses *X* paid on behalf of *Y* are includible in *Y*'s gross income in 1997. See section II.G. for *X* and *Y*'s tax withholding, reporting, and filing obligations.

Example 4. Income limitation. Pursuant to the adoption assistance program, *X* pays $3,000 of qualified adoption expenses in 1997, and $4,000 of those expenses in 1998 on behalf of *Y* in connection with *Y*'s effort to adopt an eligible child. *Y* and *Y*'s spouse have modified AGI of $85,000 for all taxable years (and thus the income limitation applies). In 1997, *Y* can exclude $2,250 from income. The income limitation reduces the maximum exclusion as follows: *Y*'s reduction percentage is 25% [$85,000 minus $75,000 equals $10,000; $10,000 divided by $40,000 equals 25%]; $3,000 times 25% equals $750; $3,000

minus $750 equals $2,250. In 1998, the income limitation reduces the maximum exclusion as follows: the dollar limitation ($5,000) is reduced by the amount of qualified adoption expenses taken into account for the exclusion in all prior years ($3,000 in 1997). Thus, of the $4,000 of qualified adoption expenses paid in 1998, *Y* may take into account only $2,000 ($5,000 minus $3,000 equals $2,000) before applying the income limitation. *Y*'s reduction percentage is 25% and *Y* can exclude $1,500 from income in 1998 ($2,000 times 25% equals $500; $2,000 minus $500 equals $1,500). See section II.G. for *X* and *Y*'s tax withholding, reporting, and filing obligations.

Example 5. Cafeteria Plan. Assume that for 1997, *Y* elects $2,400 in adoption assistance offered under a calendar year cafeteria plan maintained by *X*. In December 1997, *Y* submits, and *X* reimburses, a claim of $2,400 for qualified adoption expenses incurred by *Y* for services provided in 1997 in connection with a foreign adoption. The adoption becomes final in 1998. *Y* and *Y*'s spouse have modified adjusted gross income of $75,000 or less in 1998 (and thus the income limitation does not apply). *Y* is required to include the $2,400 reimbursement in gross income for the 1997 tax year (because of the rules in section II.H.2.). However, *Y* is entitled to exclude $2,400 (the reimbursement received in 1997) from gross income for the 1998 tax year (the year the adoption becomes final) by making an appropriate adjustment to *Y*'s Form 1040 for 1998. See section II.G. for *X* and *Y*'s tax withholding, reporting, and filing obligations.

III. Coordination of Credit and Exclusion.

A. Credit or Exclusion.

An individual may claim both a credit and an exclusion in connection with the adoption of an eligible child. An individual may not, however, claim both a credit and an exclusion for the same expense. For example, assume that in 1997 an unmarried individual pays $6,500 in qualified adoption expenses to an adoption agency for the final adoption of an eligible child who is not a child with special needs. In that same year, the individual's employer, under an adoption assistance program that satisfies the requirements of § 137, pays an additional $5,000 for other qualified adoption expenses to a private attorney on behalf of the employee for the adoption of the child. In 1997, assuming the individual's modified AGI is $75,000 or less, the individual may exclude $5,000 from gross income, and may claim a credit of $5,000, because the exclusion and credit are not for the same expenses. The remaining $1,500 of qualified adoption expenses may never be claimed as a credit or excluded from gross income.

B. No Credit for Employer Payments.

An individual may not claim a credit for any expense reimbursed by the individual's employer, whether or not reimbursed under an adoption assistance program. See section I.C. For example, assume that in 1997 an unmarried individual pays $1,000 in qualified adoption expenses to a private attorney for the final adoption in that year of an eligible child who is not a child with special needs. In the same year, the individual's employer, under an adoption assistance program that satisfies the requirements of § 137, pays an additional $7,000 in qualified adoption expenses to an adoption agency on behalf of the employee. Assuming the individual's modified AGI for 1997 is $75,000 or less, the individual may exclude $5,000 (of the $7,000 paid by the employer) from gross income, and may claim a credit for the $1,000 paid by the individual. The remaining $2,000 of adoption expenses paid by the employer may never be claimed as a credit (nor excluded), and must be included in the individual's gross income in 1997.

IV. Filing and Reporting.

A. In General.

Taxpayers will be required to provide (on a form to be published by the Internal Revenue Service) available information about the name, age, and taxpayer identification number (TIN) of each eligible child for whom qualified adoption expenses are taken into account for purposes of the credit or exclusion. In lieu of such information, taxpayers may be required to furnish other information, including identification of the agent assisting with the adoption. Taxpayers should maintain records to support any adoption credit or exclusion claimed.

B. Married Individuals.

Individuals who are married at the end of the taxable year must file a joint federal income tax return to claim the credit or the exclusion unless they lived apart from each other for the last six months of the taxable year and the individual claiming the credit or the exclusion (1) maintained as his or her home a household for the eligible child for more than one-half of the taxable year, and (2) furnished over one-half of the cost of maintaining that household in that taxable year. For this purpose, an individual legally separated from his or her spouse under a decree of divorce or separate maintenance will not be considered married.

C. Forms and Instructions.

The Service will publish forms and instructions with respect to the filing requirements for individuals and the reporting requirements for employers.

V. Effective Dates of the Credit and the Exclusion.

A. Effective Date.

Both the credit and the exclusion are effective for taxable years beginning after December 31, 1996.

B. Expiration Date.

The credit under § 23 for qualified adoption expenses in connection with the adoption of an eligible child who is not a child with special needs expires for expenses paid or incurred after December 31, 2001. Therefore, no credit is available for those expenses paid (by a cash method taxpayer) or incurred (by an accrual method taxpayer) after December 31, 2001. The credit for qualified adoption expenses paid or incurred in connection with an adoption of an eligible child with special needs does not expire.

The exclusion under § 137 for adoption assistance expires after December 31, 2001. Therefore, no exclusion from gross income applies to amounts paid or expenses incurred under an adoption assistance program after December 31, 2001.

In the case of a foreign adoption that becomes final after December 31, 2001, taxpayers cannot receive either a credit or an exclusion.

VI. Comments on Future Guidance Invited.

The Service invites comments on future guidance concerning §§ 23 and 137. The Service requests that written comments be submitted by [INSERT DATE THAT IS [90] DAYS AFTER DATE OF PUBLICATION OF THIS DOCUMENT IN THE INTERNAL REVENUE BULLETIN]. Send submissions to: CC:DOM:CORP:R (Notice 97–9), Room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (Notice 97–9), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the internet directly to the IRS internet site at http://www.irs.ustreas.gov/prod/taxregs/comments.html.

The principal authors of this notice are Marilyn E. Brookens of the Office of the Assistant Chief Counsel (Income Tax and Accounting), and Sharon Cohen and Catherine Fuller of the Office of the

Associate Chief Counsel (Employee Benefits and Exempt Organizations). For further information regarding the tax credit portion of the notice, contact Ms. Brookens at (202) 622–4920 (not a toll-free call). For further information regarding the adoption assistance program portion of the notice, contact Ms. Cohen or Ms. Fuller on (202) 622–6080 (not a toll-free call).

Sample Language for a Spouse's Waiver to a QJSA or a QPSA

Notice 97–10

I. PURPOSE

This Notice provides sample language designed to make it easier for spouses of plan participants to understand their rights to survivor annuities under qualified plans. The sample language can be included in a form used for a spouse to consent to a participant's waiver of a qualified joint and survivor annuity (QJSA) or qualified preretirement survivor annuity (QPSA), or to a participant's choice of a non-spouse beneficiary in a defined contribution plan not subject to the QJSA and QPSA requirements.

The language is designed to assist plan administrators in preparing spousal consent forms that meet the statutory requirements. No one is required to use the sample language, and plan administrators that choose to use it are free to incorporate all or any part of it in their spousal consent forms.

II. BACKGROUND

Section 401(a)(11) of the Internal Revenue Code of 1986 provides that, in order to be qualified under section 401(a), all defined benefit plans and certain defined contribution plans must provide benefits in the form of a QJSA and in the form of a QPSA. Section 417 permits a participant to waive the QJSA and to elect another form of retirement benefit, or to waive the right to a QPSA, if the participant's spouse signs a consent form.

Section 417(a)(3) requires that the plan provide an explanation to the participant of the QJSA and of his or her right to waive the QJSA within a reasonable time before the participant's annuity starting date. However, effective for plan years beginning after December 31, 1996, section 417(a)(7)(A) provides that a plan can provide the explanation after the annuity starting date, but the required election period must not end earlier than 30 days after notice was given to the participant. Section 417(a)(3)(B) requires the plan to provide an explanation to the participant of the QPSA and of his or her right to waive the QPSA within the applicable period, as defined in section 417(a)(3)(B)(ii).

Section 417(a)(2)(A)(i) provides that, in order for a participant to elect to waive the QJSA or QPSA, the spouse of the participant must consent in writing to the election. Section 417(a)(2)(A)(ii) provides that, in general, the waiver of, and the consent to a waiver of, a QJSA must state the specific nonspouse beneficiary who will receive the benefit and the particular optional form of benefit. The waiver of, and the consent to a waiver of, a QPSA must state the specific nonspouse beneficiary who will receive the benefit but is not required to state the form of benefit selected (if any). However, a plan may permit a spouse to execute a general consent that allows the participant to waive the QJSA or the QPSA, and change the designated beneficiary or the optional form of benefit payment, without obtaining further consent of the spouse. Section 1.401(a)–20, Q&A–31(c), of the Regulations provides that a general consent must acknowledge that the spouse has the right to limit his or her consent to a specific beneficiary and a specific form of payment (where applicable) and that the spouse elects to relinquish both of these rights. Section 417(a)(2)(A)(iii) requires that the spouse's consent acknowledge the effect of the participant's waiver of the QJSA or QPSA and requires that the consent be witnessed by a plan representative or a notary public.

Under section 401(a)(11), to the extent a defined contribution plan that is not subject to the QJSA and QPSA requirements, the plan must provide that the participant's nonforfeitable account balance be paid in full to the participant's surviving spouse upon the participant's death. The account balance can be paid to another beneficiary if the participant so elects and the spouse consents to the election. In general, the spousal consent must meet the same conditions as a consent to the waiver of a QPSA.

Section 1457 of the Small Business Job Protection Act of 1996, Pub. L. No. 104–188, directs the Secretary of the Treasury (''Secretary'') to develop sample language, written in a manner calculated to be understood by the average person, that can be included in a form used for a spouse to consent to a participant's waiver of a QJSA or a QPSA. This Notice contains the sample language for the spousal consent forms. Section 1457 also directs the Secretary to publish sample language that can be included in a qualified domestic relations order (QDRO). The QDRO sample language is contained in Notice 97–11 in this Bulletin.

III. SAMPLE LANGUAGE

The Appendices to this Notice contain four sets of sample language:

- Appendix A contains sample language that can be included in a spouse's consent to a participant's waiver of a QJSA. This language can be used for a defined benefit plan and for a defined contribution plan to the extent that it is subject to section 401(a)(11).
- Appendix B contains sample language that can be included in a spouse's consent to a participant's waiver of a QPSA, and, if the plan so provides, to the participant's choice of a beneficiary other than the spouse to receive any survivor benefit. This language can be used for a defined benefit plan.
- Appendix C contains sample language that can be included in a spouse's consent to a participant's waiver of a QPSA, and, if the plan so provides, to the participant's choice of a beneficiary other than the spouse to receive any survivor benefit. This language can be used for a defined contribution plan to the extent that it is subject to section 401(a)(11).
- Appendix D contains sample language that can be included in a spouse's consent to a participant's choice of a beneficiary other than the spouse for a participant's account balance. This language can be used for a defined contribution plan to the extent that it is not subject to section 401(a)(11).

If the plan administrator chooses to use the sample language provided in an Appendix, the sample language should be conformed to the terms of the plan. The plan administrator should read the sample language carefully and select only those portions of the sample language that apply to the particular plan. For example, the sample language in Appendix A refers to certain optional forms of benefits under the plan, including a lump sum payment. If a plan administrator decides to include this sample language in the plan's spousal consent form, the sample language

should be compared to the optional forms of benefit payments available under the plan and modified, if necessary, to reflect the plan's optional forms. Further, spousal consent forms for some plans will need additional language discussing issues specific to the plan.

In order for a spouse's consent to be valid, the spousal consent form is not required to include the specific language contained in the Appendices. In all cases, however, spousal consent forms should be written clearly to ensure that the spouse both understands and acknowledges the effect of the participant's waiver of rights.

The Appendix provides sample language for incorporation in a spousal consent form only. The Appendix does not provide sample language for the explanation of the QJSA or QPSA that is required to be provided to the participant or the agreement in which the participant waives the QJSA or QPSA.

IV. COMMENTS

Notice 94–23, 1994–1 C.B. 340, requested comments from the public to aid in the development of additional guidance concerning spousal consent forms. The comments that were made in response to Notice 94–23 have been taken into consideration in drafting the sample language accompanying this Notice.

The Service invites the public to comment on the sample language accompanying this Notice as well as to suggest possible additional sample language. Comments can be addressed to CC:DOM:CORP:R (Notice 97–10), Room 5228, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, comments may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (Notice 97–10), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC. Alternatively, taxpayers may transmit comments electronically via the IRS Internet site at 'http://www.irs.ustreas.gov/prod/tax_regs/comments.html'.

DRAFTING INFORMATION

The principal authors of this Notice are Susan Lennon of the Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations) and Steven Linder of the Employee Plans Division. For further information regarding this Notice, please contact the Employee Plans Division's taxpayer assistance telephone service at (202) 622–6074/6075, between the hours of 1:30 p.m. and 4 p.m. Eastern Time, Monday through Thursday. Alternatively, please call Ms. Lennon at (202) 622–4606 or Mr. Linder at (202) 622–6214. These telephone numbers are not toll-free.

APPENDIX A

SAMPLE LANGUAGE THAT MAY BE INCLUDED IN A SPOUSE'S AGREEMENT TO GIVE UP THE RIGHT TO THE QUALIFIED JOINT AND SURVIVOR ANNUITY (UNDER A DEFINED BENEFIT PLAN OR A DEFINED CONTRIBUTION PLAN)

> ***Instruction:*** *The sample language does not address the one-year-of-marriage rule under section 417(d); if a plan applies the one-year rule, the sample language should be modified to explain this rule.*
>
> *The sample language contains language in brackets that pertains to a participant's selection of a non-spouse beneficiary to receive death benefits. The bracketed language should be deleted if the plan provides death benefits only to the participant's surviving spouse.*

1. What is a Qualified Joint and Survivor Annuity (QJSA)?

Federal law requires the *(name of plan)* to pay retirement benefits in a special payment form unless your spouse chooses a different payment form and you agree to that choice. This special payment form is often called a "qualified joint and survivor annuity" or "QJSA" payment form. The QJSA payment form gives your spouse a *(insert period of QJSA payment, e.g., monthly)* retirement payment for the rest of his or her life. This is often called an "annuity." Under the QJSA payment form, after your spouse dies, each *(insert period of QJSA payment, e.g., month)* the plan will pay you *(insert survivor percentage for the QJSA form under the plan)* percent of the retirement benefit that was paid to your spouse. The benefit paid to you after your spouse dies is often called a "survivor annuity" or a "survivor benefit." You will receive this survivor benefit for the rest of your life.

Example

Pat Doe and Pat's spouse, Robin, receive payments from the plan under the QJSA payment form. Beginning after Pat retires, Pat receives $600 each month from the plan. Pat then dies. The plan will pay Robin $ *(insert applicable dollar amount for the QJSA)* a month for the rest of Robin's life.

2. How Can Your Spouse Change the Way Benefits Are Paid?

Your spouse and you will receive benefits from the plan in the special QJSA payment form required by federal law unless your spouse chooses a different payment form and you agree to the choice. If you agree to change the way the plan's retirement benefits are paid, you give up your right to the special QJSA payments.

3. Do You Have to Give Up Your Right to the QJSA Benefit?

Your choice must be voluntary. It is your personal decision whether you want to give up your right to the special QJSA payment form.

4. What Other Benefit Forms Can My Spouse Choose?

> ***Instruction:*** *The plan administrator may make additions to the paragraph below to explain the plan's optional forms of benefits. For example, the plan administrator could list all optional forms of benefits or provide a cross-reference to a description of benefit options provided to participants. The examples following the paragraph are common optional forms of benefits. The examples should be modified to be consistent with the plan's optional forms of benefits. The plan administrator may give additional examples to explain other available optional forms.*

If you agree, your spouse can choose to have the retirement benefits paid in a different form. Other payment forms may give your spouse larger retirement benefits while he or she is alive, but might not pay you any benefits after your spouse dies.

Example of Single Life Annuity Payment Form

If Pat and Robin Doe receive retirement benefits in the special QJSA payment form, Pat would receive retirement benefits of $600 each month from the plan until Pat dies and Robin would receive $ (insert applicable dollar amount for the QJSA) a month for the rest of Robin's life. Pat and Robin Doe agree not to receive retirement benefits in the special QJSA payment form and decide instead to receive payments only during Pat's life. After Pat retires, Pat will receive more than $600 each month from the plan until Pat's death. Robin

will not receive any payments from the plan after Pat's death.

Example of Lump Sum Payment Form

Pat and Robin Doe agree not to receive the special QJSA payments and decide instead that Pat will receive a single payment equal to the value of all of Pat's retirement benefits. In this case, no further payments will be made to Pat or Robin.

[If you agree, your spouse can name someone other than you to receive all or a part of the survivor benefits from the plan after your spouse dies. The person your spouse selects to receive all or part of the survivor benefits is often called a "beneficiary." If you agree to let your spouse name someone else as the beneficiary for all of the survivor benefits, you will not receive any payments from the plan after your spouse dies. If you agree to let your spouse name someone else as the beneficiary for a part of the survivor benefits, your survivor benefits will be less than you would have received under the special QJSA payment form.

Example of Naming a Beneficiary Who Is Not the Spouse

Pat and Robin Doe select a payment form that has a survivor benefit of $200 a month payable after Pat dies. Pat and Robin agree that 1/2 of the survivor benefit will be paid to Robin and 1/2 will be paid to Pat and Robin's child, Chris. After Pat dies, the plan will pay $100 a month to Robin for the rest of Robin's life. Chris will also receive payments from the plan as long as Chris lives. Chris will receive less than $100 a month because Chris, being younger than Robin, is expected to receive payments over a longer period.]

5. Can Your Spouse Make Future Changes if You Sign this Agreement?

Instruction: *The plan administrator should select Option A if the agreement is a "specific consent," that is, the spouse agrees to the participant's choice of a particular form of benefit and beneficiary. The plan administrator should select Option B if the agreement is a "general consent," that is, the spouse agrees to allow the participant to choose any form of benefit and any beneficiary without telling the spouse the selection.*

Option A

If you sign this agreement, you agree that benefits under the plan will be paid in the form stated in this agreement. [You also agree that the beneficiary named in this agreement will receive all or a part of the survivor benefits from the plan after your spouse has died]. Your spouse cannot change the payment form [or the beneficiary] unless you agree to the change by signing a new agreement. However, your spouse can change to the special QJSA payment form without getting your agreement.

Option B

If you sign this agreement, you agree that your spouse can choose the form of payments that he or she will receive from the plan without telling you and without getting your agreement. [Your spouse can also choose the beneficiary who will receive any survivor benefits from the plan after your spouse dies without telling you and without getting your agreement.] Your spouse does not need to tell you or get your agreement to any future changes in the form of payments [or the beneficiary].

You may limit your agreement to a particular payment form [and a particular beneficiary]. If you want to allow your spouse to select only a particular payment form [and a particular beneficiary], do not sign this form. In that case, contact the plan administrator for more information and to get a new agreement that lets you state the particular payment form [and the particular beneficiary] that you will allow your spouse to select.

6. Can You Change Your Mind After You Sign this Agreement?

Instruction: *The plan administrator should select Option A if the plan does not allow a spouse to revoke his or her consent. The plan administrator should select Option B if the plan allows a spouse to revoke his or her consent. The language in double brackets in Options A and B applies only to general consent forms. For an explanation of a specific consent and a general consent, see the Instruction to section 5.*

Option A

You cannot change this agreement after you sign it. Your decision is final [even if your spouse later chooses a different type of retirement benefit or beneficiary].

Option B

You can change this agreement until *(date)* . After that date, you cannot change the agreement [even if your spouse later chooses a different type of retirement benefit or beneficiary]. If you change your mind, you must notify the plan administrator by (insert the plan procedure for revoking consent) .

7. What Happens to this Agreement if You Become Separated or Divorced?

Legal separation or divorce may end your right to survivor benefits from the plan even if you do not sign this agreement. However, if you become legally separated or divorced, you might be able to get a special court order (which is called a qualified domestic relations order or "QDRO") that would give you rights to receive retirement benefits even if you sign this agreement. If you are thinking about separating or getting a divorce, you should get legal advice on your rights to benefits from the plan.

8. What Should You Know Before Signing this Agreement?

Instruction: *The plan administrator should modify the language below to reflect the plan's administrative procedures and insert the appropriate address or telephone number.*

This is a very important decision. You should think very carefully about whether you want to sign this agreement. Before signing, be sure that you understand what retirement benefits you may get and what benefits you will no longer be able to receive.

Your spouse should have received information on the types of retirement benefits available from the plan. If you have not seen this information, you should get it and read it before you sign this agreement. For additional information, you can contact (name of person or department, such as the Human Resources Department) at the following address (or telephone number).

9. Your Agreement

Instruction: *The plan administrator should select Option A if the agreement is a specific consent. The plan administrator should select Option B if the agreement is a general consent. For an explanation of a specific consent and a general consent, see the Instruction to section 5.*

Option A

I, *(name of participant's spouse)* , am the spouse of *(name of participant)* . I understand that I have the right to have *(name of plan)* pay my spouse's retirement benefits in the special QJSA payment form and I agree to give up that right. I understand that by signing this agreement, I may receive less money than I would have received under the special QJSA payment form and I may receive nothing after my spouse dies, depending on the payment form [or beneficiary] that my spouse chooses.

I agree that my spouse can receive retirement benefits in the form of a *(insert form of benefit selected)* . [I also agree to my spouse's choice of *(name of beneficiary)* as the beneficiary who will receive *(insert percentage of survivor benefit that will be paid to the beneficiary)* of the survivor benefits from the plan after my spouse dies.] I understand that my spouse cannot choose a different form of retirement benefits [or a different beneficiary] unless I agree to the change.

I understand that I do not have to sign this agreement. I am signing this agreement voluntarily.

I understand that if I do not sign this agreement, then my spouse and I will receive payments from the plan in the special QJSA payment form.

Instruction: *The plan administrator should add a line for the spouse's signature and a place for the witness' acknowledgment.*

Option B

I, *(name of participant's spouse)*, am the spouse of *(name of participant)*. I understand that I have the right to have *(name of plan)* pay my spouse's retirement benefits in the special QJSA payment form, and I agree to give up that right. I understand that by signing this agreement, I may receive less money than I would have received under the special QJSA payment form and I may receive nothing after my spouse dies depending on the payment form [or beneficiary] that my spouse chooses.

I understand that by signing this agreement, my spouse can choose any retirement benefit form [and any beneficiary] that is allowed by the plan without telling me and without getting my agreement. I also understand that my spouse can change the retirement benefit form selected [or the name of a beneficiary] at any time before retirement benefits begin without telling me and without getting my agreement.

I understand that I can limit my spouse's choice to a particular retirement benefit form [and a particular beneficiary who will receive payments from the plan after the death of my spouse] and that I am giving up that right.

I understand that I do not have to sign this agreement. I am signing this agreement voluntarily.

I understand that if I do not sign this agreement, then my spouse and I will receive payments from the plan in the special QJSA payment form.

Instruction: *The plan administrator should add a line for the spouse's signature and a place for the witness' acknowledgment.*

APPENDIX B

SAMPLE LANGUAGE THAT MAY BE INCLUDED IN A SPOUSE'S AGREEMENT TO GIVE UP THE RIGHT TO THE QUALIFIED PRERETIREMENT SURVIVOR ANNUITY UNDER A DEFINED BENEFIT PLAN

Instruction: *The sample language does not address the one-year-of-marriage rule under section 417(d); if a plan applies the one-year rule, the sample language should be modified to explain this rule.*

1. What is a Qualified Preretirement Survivor Annuity (QPSA)?

Instruction: *The final sentence in the sample language before the example addresses situations where a plan pays the survivor benefit in a lump sum if the value of the survivor benefit is $3,500 or less. That sentence should be deleted if the plan pays survivor benefits with a value of $3,500 or less as an annuity.*

Federal law gives you the right to receive a special death benefit from *(name of plan)* if your spouse dies before you, unless your spouse chooses to give up this benefit and you agree to that choice. You have this right if your spouse has earned retirement benefits under the plan and dies before he or she begins receiving those benefits (or, if earlier, before the beginning of the period for which the retirement benefits are paid). You have the right to receive this special *(insert period of QPSA payment, e.g., monthly)* death benefit for the rest of your life beginning no later than when your spouse could have begun receiving retirement benefits. The special death benefit is *(insert a percentage that is no less than the survivor percentage for the QJSA form under the plan)* percent of the retirement benefit your spouse earns before death. The special death benefit is often called a ''qualified preretirement survivor annuity'' or ''QPSA'' benefit. (The plan will pay this death benefit in a lump sum, rather than as a QPSA, if the value of the death benefit is $3,500 or less.)

Example

Pat Doe dies at age 45 after earning a retirement benefit. The value of Pat's death benefit is more than $3,500. If Pat had lived, Pat could have retired and begun receiving payments as early as age 55 under the plan's terms. The plan will pay a monthly benefit to Pat's spouse, Robin Doe, for the rest of Robin's life. Robin has the right to begin receiving the benefit no later than when Pat would have been 55 years old.

There is a cost for the QPSA benefit. Your spouse's retirement benefits will be reduced for this cost.

Instruction: *The paragraph above should be deleted if the plan does not reduce a participant's benefit because of the QPSA coverage and does not impose a charge for the QPSA. If the plan imposes the QPSA charge other than by reducing the participant's retirement benefit, this paragraph should be modified accordingly.*

2. What Are Your Rights if You Sign this Agreement?

Your right to the QPSA benefit provided by federal law cannot be taken away unless you agree to give up that benefit.

Instruction: *The plan administrator should select Option A if the agreement is intended to waive the QPSA in a plan that imposes a charge for the QPSA. The plan administrator should select Option B if the participant's spouse is agreeing to allow someone else to receive any death benefits, regardless of whether the plan imposes a charge for the QPSA.*

Option A

If you sign this agreement, you will not receive the QPSA benefit and your spouse's retirement benefits will not be reduced for the cost of the QPSA benefit you give up.

Option B

You can agree to give up all or part of the QPSA benefit. If you agree to give up all of the QPSA benefit, the plan will pay this benefit to another person selected by your spouse. The person your spouse selects to receive this benefit is often called a ''beneficiary''. If you agree to give up part of the QPSA benefit, that part will be paid to the beneficiary named by your spouse, and you will receive the rest of the QPSA benefit. For example, if you agree, your spouse can have the death benefits paid to his or her children instead of you.

Example of Naming a Beneficiary Who is Not the Spouse

Pat and Robin Doe agree that Robin will not receive the QPSA benefit. Pat and Robin also decide that 1/2 of the death benefits under the plan will be paid to Robin and 1/2 of the death benefits will be paid to Pat and Robin's child, Chris. The total death benefits are $200 per month. After Pat dies, the plan will pay $100 a month to Robin for the rest of Robin's life. Chris will also receive payments from the plan as long as Chris lives. Chris will receive less than $100 a month because Chris, being younger than Robin, is expected to receive payments over a longer period.

3. Do You Have to Give Up Your Right to the QPSA Benefit?

Your choice must be voluntary. It is your personal decision whether you want to give up your right to the QPSA benefit.

4. Can Your Spouse Make Future Changes if You Sign this Agreement?

Instruction: *Option A is for use if the plan does not allow a non-spouse beneficiary to receive death benefits. Option B is for use in a "specific consent agreement," that is, where the spouse agrees to the participant's waiver of the QPSA and to the participant's choice of a specific beneficiary to receive death benefits. Option C is for use in a "general consent agreement," that is, where the spouse agrees to the participant's waiver of the QPSA and to allow the participant to select any other beneficiary to receive the death benefits.*

Option A

Even if you sign this agreement, your spouse can later select the QPSA benefit for you without having you sign a new agreement.

Option B

If you sign this agreement, your spouse cannot change the beneficiary named in this agreement unless you agree to the new beneficiary by signing a new agreement. If you agree, your spouse can change the beneficiary at any time before your spouse begins receiving benefits or dies. You do not have to agree to let your spouse change the beneficiary. However, your spouse can later select the QPSA benefit for you without having you sign a new agreement.

Option C

If you sign this agreement, your spouse can choose the beneficiary who will receive the QPSA benefit without telling you and without getting your agreement. Your spouse can change the beneficiary at any time before your spouse begins receiving benefits or dies.

You have the right to agree to allow your spouse to select only a particular beneficiary. If you want to allow your spouse to select only a particular beneficiary, do not sign this form. In that case, contact the plan administrator for more information and to get a new agreement that lets you state the particular beneficiary that you will allow your spouse to select.

5. Can You Change Your Mind After You Sign this Agreement?

Instruction: *The plan administrator should select Option A if the plan does not allow a spouse to revoke his or her consent. The plan administrator should select Option B if the plan allows a spouse to revoke his or her consent. The bracketed language in Options A and B applies only to general consent forms. For an explanation of a specific consent and a general consent, see the Instruction to section 4.*

Option A

You cannot change this agreement after you sign it. Your decision is final [even if your spouse later chooses a different beneficiary].

Option B

You can change this agreement until *(date)* . After that date, you cannot change the agreement [even if your spouse later chooses a different beneficiary]. If you change your mind, you must notify the plan administrator by *(the plan procedure for revoking consent)* .

6. What Happens to this Agreement if You Become Separated or Divorced?

You may lose your right to the QPSA benefit if your spouse and you become legally separated or divorced, even if you do not sign this agreement. However, if you become legally separated or divorced, you might be able to get a special court order (which is called a qualified domestic relations order or ''QDRO'') that specifically protects your rights to receive the QPSA benefit or that gives you other benefits under this plan. If you are thinking about separating or getting a divorce, you should get legal advice on your rights to benefits from the plan.

7. Your Agreement

Instruction: *The plan administrator should select Option A if the agreement is a waiver of the QPSA and the plan does not allow a non-spouse beneficiary to receive a QPSA benefit. The plan administrator should select Option B if the agreement is a specific consent to have a different beneficiary receive a QPSA benefit. The plan administrator should select Option C if the agreement is a general consent to have any beneficiary chosen by the participant receive a QPSA benefit. For an explanation of a specific consent and a general consent, see the Instruction to section 4.*

The final sentence in the first and last paragraphs of the sample language in this section address situations where a plan pays the survivor benefit in a lump sum if the value of the death benefit is $3,500 or less. These sentences should be deleted if the plan pays death benefits with a value of $3,500 or less as an annuity.

Option A

I, *(name of participant's spouse)* , am the spouse of *(name of participant)* . I understand that I have a right to the QPSA benefit from *(name of plan)* if my spouse dies before he or she begins receiving retirement benefits (or, if earlier, before the beginning of the period for which the retirement benefits are paid). I also understand that if the value of the QPSA benefit is $3,500 or less,

the plan will pay the benefit to me in one lump sum payment.

I agree to give up my right to the QPSA benefits.

I understand that by signing this agreement, I may receive less money than I would have received under the special QPSA payment form and I may receive nothing from the plan after my spouse dies.

I understand that I do not have to sign this agreement. I am signing this agreement voluntarily.

I understand that if I do not sign this agreement, then I will receive the QPSA benefit if my spouse dies before he or she begins to receive retirement benefits (or, if earlier, before the beginning of the period for which the retirement benefits are paid). I also understand that if the value of the QPSA benefit is $3,500 or less, the plan will pay the benefit to me in one lump sum payment.

Instruction: *The plan administrator should add a line for the spouse's signature and a place for the witness' acknowledgment.*

Option B

I, *(name of participant's spouse)* , am the spouse of *(name of participant)* . I understand that I have a right to the QPSA benefit from *(name of plan)* if my spouse dies before he or she begins receiving retirement benefits (or, if earlier, before the beginning of the period for which the retirement benefits are paid). I also understand that if the value of the QPSA benefit is $3,500 or less, the plan will pay the benefit to me in one lump sum payment.

I agree to give up my right to *(insert percentage)* percent of the QPSA benefit and instead to have that benefit paid to the following beneficiaries:

Name of Beneficiary	Percent of QPSA

I understand that my spouse cannot select a different beneficiary unless I agree to the change.

I understand that by signing this agreement, I may receive less money than I would have received under the special QPSA payment form and I may receive nothing from the plan after my spouse dies.

I understand that I do not have to sign this agreement. I am signing this agreement voluntarily.

I understand that if I do not sign this agreement, then I will receive the QPSA benefit if my spouse dies before he or she begins to receive retirement benefits (or, if earlier, before the beginning of the period for which the retirement benefits are paid). I also understand that if the value of the QPSA benefit is $3,500 or less, the plan will pay the benefit to me in one lump sum payment.

Instruction: *The plan administrator should add a line for the spouse's signature and a place for the witness' acknowledgment.*

Option C

I, *(name of participant's spouse)* , am the spouse of *(name of participant)* . I understand that I have a right to the QPSA benefit from *(name of plan)* if my spouse dies before he or she begins receiving retirement benefits (or, if earlier, before the beginning of the period for which the retirement benefits are paid). I also understand that if the value of the QPSA benefit is $3,500 or less, the plan will pay the benefit to me in one lump sum payment.

I agree to give up my right to *(insert percentage)* percent of the QPSA benefit and to allow my spouse to choose any beneficiary to receive that benefit. I understand by signing this agreement, my spouse can choose the beneficiary without telling me and without getting my agreement. I also understand that my spouse can change the beneficiary at any time before retirement benefits begin without telling me and without getting my agreement.

I understand that I can limit my spouse's choice to a particular beneficiary who will receive payments from the plan after the death of my spouse and that I am giving up that right.

I understand that by signing this agreement, I may receive less money than I would have received under the special QPSA payment form and I may receive nothing from the plan after my spouse dies.

I understand that I do not have to sign this agreement. I am signing this agreement voluntarily.

I understand that if I do not sign this agreement, then I will receive the QPSA benefit from the plan if my spouse dies before he or she begins to receive retirement benefits (or, if earlier, before the beginning of the period for which the retirement benefits are paid). I also understand that if the value of the QPSA benefit is $3,500 or less, the plan will pay the benefit to me in one lump sum payment.

Instruction: *The plan administrator should add a line for the spouse's signature and a place for the witness' acknowledgment.*

Note to plan administrator: *A participant in a plan subject to the survivor annuity requirements of section 401(a)(11) generally may waive the QPSA benefit with spousal consent only on or after the first day of the plan year in which the participant attains age 35. However, a plan may provide for an earlier waiver with spousal consent, provided that a written explanation of the QPSA is given to the participant and that the waiver executed prior to age 35 becomes invalid upon the beginning of the plan year in which the participant's thirty-fifth birthday occurs. If a new waiver and spousal consent is not executed on or after that date, the QPSA benefit must be provided.*

APPENDIX C

SAMPLE LANGUAGE THAT MAY BE INCLUDED IN A SPOUSE'S AGREEMENT TO GIVE UP THE RIGHT TO A QUALIFIED PRERETIREMENT SURVIVOR ANNUITY WITH RESPECT TO A PARTICIPANT IN A DEFINED CONTRIBUTION PLAN TO THE EXTENT THE PLAN IS SUBJECT TO SECTION 401(a)(11)

Instruction: *The sample language does not address the one-year-of-marriage rule under section 417(d); if a plan applies the one-year rule, the sample language should be modified to explain this rule.*

1. What is a Qualified Preretirement Survivor Annuity (QPSA)?

Instruction: *The final sentence of the sample language before the example addresses situations where a plan pays the survivor benefit in a lump sum if the value of the survivor benefit is $3,500 or less. That sentence should be deleted if the plan pays survivor benefits with a value of $3,500 or less as an annuity.*

Your spouse has an account in *(name of plan)* . The money in the account that

your spouse will be entitled to receive is called the vested account. Federal law states that you will receive a special death benefit that is paid from the vested account if your spouse dies before he or she begins receiving retirement benefits (or, if earlier, before the beginning of the period for which the retirement benefits are paid). You have the right to receive this *(insert period of QPSA payment, e.g., monthly)* payment for your life beginning after your spouse dies. The special death benefit is often called a ''qualified preretirement survivor annuity'' or ''QPSA'' benefit. (The plan will pay this death benefit in a lump sum, rather than as a QPSA, if the value of the death benefit is $3,500 or less.)

2. Can Your Spouse Choose Other Beneficiaries to Receive the Account?

Your right to the QPSA benefit provided by federal law cannot be taken away unless you agree to give up that benefit. If you agree, your spouse can choose to have all or a part of the death benefits paid to someone else. The person your spouse chooses to receive the death benefits is usually called the ''beneficiary.'' For example, if you agree, your spouse can have the death benefits paid to his or her children instead of you.

Example

Pat and Robin Doe agree that Robin will not receive the QPSA benefit. Pat and Robin also decide that 1/2 of the death benefits that are paid from Pat's vested account will be paid to Robin and 1/2 of the death benefits will be paid to Pat and Robin's child, Chris. The total death benefits are $200 per month. After Pat dies, the plan will pay $100 a month to Robin for the rest of Robin's life. Chris will also receive payments from the plan as long as Chris lives. Chris will receive less than $100 a month because Chris, being younger than Robin, is expected to receive payments over a longer period.

3. Do You Have to Give Up Your Right to the QPSA Benefit?

Your choice must be voluntary. It is your personal decision whether you want to give up your right to the special QPSA payment form.

4. Can Your Spouse Change the Beneficiary in the Future if You Sign this Agreement?

Instruction: *Option A is for use in a "specific consent agreement," that is, where the spouse agrees to the participant's waiver of the QPSA and to the participant's choice of a specific beneficiary to receive death benefits. Option B is for use in a "general consent agreement," that is, where the spouse agrees to the participant's waiver of the QPSA and to allow the participant to select any other beneficiary to receive the death benefits.*

Option A

If you sign this agreement, your spouse cannot change the beneficiary named in this agreement unless you agree to the new beneficiary by signing a new agreement. If you agree, your spouse can change the beneficiary at any time before your spouse begins receiving benefits or dies. You do not have to agree to let your spouse change the beneficiary. However, your spouse can select the QPSA benefit for you without getting your agreement.

Option B

If you sign this agreement, your spouse can choose the beneficiary who will receive the death benefits without telling you and without getting your agreement. Your spouse can change the beneficiary at any time before he or she begins receiving benefits or dies.

You have the right to agree to allow your spouse to select only a particular beneficiary. If you want to allow your spouse to select only a particular beneficiary, do not sign this form. In that case, contact the plan administrator for more information and to get a new agreement that lets you state the particular beneficiary that you will allow your spouse to select.

5. Can You Change Your Mind After You Sign this Agreement?

Instruction: *The plan administrator should select Option A if the plan does not allow a spouse to revoke his or her consent. The plan administrator should select Option B if the plan allows a spouse to revoke his or her consent. The bracketed language in Options A and B applies only to general consent forms. For an explanation of a specific consent and a general consent, see the Instruction to section 4.*

Option A

You cannot change this agreement after you sign it. Your decision is final [even if your spouse later chooses a different beneficiary].

Option B

You can change this agreement until *(date)*. After that date, you cannot change the agreement [even if your spouse later chooses a different beneficiary]. If you change your mind, you must notify the plan administrator by *(the plan procedure for revoking consent)*.

6. What Happens to this Agreement if You Become Separated or Divorced?

You may lose your right to the QPSA benefit if your spouse and you become legally separated or divorced even if you do not sign this agreement. However, if you become legally separated or divorced, you might be able to get a special court order (which is called a qualified domestic relations order or ''QDRO'') that specifically protects your rights to receive the QPSA benefit or that gives you other benefits under this plan. If you are thinking about separating or getting a divorce, you should get legal advice on your rights to benefits from the plan.

7. Your Agreement

Instruction: *The plan administrator should select Option A if the agreement is a specific consent. The plan administrator should select Option B if the agreement is a general consent. For an explanation of a specific consent and a general consent, see the Instruction to section 4.*

The final sentence in the first and last paragraphs of the sample language in this section address situations where a plan pays the survivor benefit in a lump sum if the value of the death benefit is $3,500 or less. These sentences should be deleted if the plan pays death benefits with a value of $3,500 or less as an annuity.

Option A

I, *(name of participant's spouse)*, am the spouse of *(name of participant)*. I understand that I have a right to the QPSA benefit from *(name of plan)* if my spouse dies before he or she begins receiving retirement benefits (or, if earlier, before the beginning of the period for which the retirement benefits are paid). I also understand that if the value of the QPSA benefit is $3,500 or less, the plan will pay the benefit to me in one lump sum payment.

I agree to give up my right to *(insert percentage)* percent of the QPSA benefit and instead to have that benefit paid to the following beneficiaries:

Name of Beneficiary	Percent of QPSA
________________	________________
________________	________________
________________	________________

I understand that my spouse cannot select a different beneficiary unless I agree to the change.

I understand that by signing this agreement, I may receive less money than I would have received under the special QPSA payment form and I may receive nothing from the plan after my spouse dies.

I understand that I do not have to sign this agreement. I am signing this agreement voluntarily.

I understand that if I do not sign this agreement, then I will receive the QPSA benefit if my spouse dies before he or she begins to receive retirement benefits (or, if earlier, before the beginning of the period for which the retirement benefits are paid). I also understand that if the value of the QPSA benefit is $3,500 or less, the plan will pay the benefit to me in one lump sum payment.

Instruction: *The plan administrator should add a line for the spouse's signature and a place for the witness' acknowledgment.*

Option B

I, *(name of participant's spouse)*, am the spouse of *(name of participant)*. I understand that I have a right to the QPSA benefit from *(name of plan)* if my spouse dies before he or she begins receiving retirement benefits (or, if earlier, before the beginning of the period for which the retirement benefits are paid). I also understand that if the value of the QPSA benefit is $3,500 or less, the plan will pay the benefit to me in one lump sum payment.

I agree to give up my right to *(insert percentage)* percent of the QPSA benefit and to allow my spouse to choose any beneficiary to receive that benefit. I understand that by signing this agreement, my spouse can choose the beneficiary without telling me and without getting my agreement. I also understand that my spouse can change the beneficiary at any time before retirement benefits begin without telling me and without getting my agreement.

I understand that I can limit my spouse's choice to a particular beneficiary who will receive payments from the plan after the death of my spouse and that I am giving up that right.

I understand that by signing this agreement, I may receive less money than I would have received under the special QPSA payment form and I may receive nothing from the plan after my spouse dies.

I understand that I do not have to sign this agreement. I am signing this agreement voluntarily.

I understand that if I do not sign this agreement, then I will receive the QPSA benefit if my spouse dies before he or she begins to receive retirement benefits (or, if earlier, before the beginning of the period for which the retirement benefits are paid). I also understand that if the value of the QPSA benefit is $3,500 or less, the plan will pay the benefit to me in one lump sum payment.

Instruction: *The plan administrator should add a line for the spouse's signature and a place for the witness' acknowledgment.*

Note to plan administrator: *A participant in a plan subject to the survivor annuity requirements of section 401(a)(11) generally may waive the QPSA benefit with spousal consent only on or after the first day of the plan year in which the participant attains age 35. However, a plan may provide for an earlier waiver with spousal consent, provided that a written explanation of the QPSA is given to the participant and that the waiver executed prior to age 35 becomes invalid upon the beginning of the plan year in which the participant's thirty-fifth birthday occurs. If a new waiver and spousal consent is not executed on or after that date, QPSA benefit must be provided.*

APPENDIX D

SAMPLE LANGUAGE THAT MAY BE INCLUDED IN A SPOUSE'S AGREEMENT TO GIVE UP THE RIGHT TO BE THE BENEFICIARY OF A PARTICIPANT IN A DEFINED CONTRIBUTION PLAN TO THE EXTENT THE PLAN IS NOT SUBJECT TO SECTION 401(a)(11)

Instruction: *The sample language does not address the one-year-of-marriage rule under section 417(d); if a plan applies the one-year rule, the sample language should be modified to explain this rule.*

1. What Rights Do You Have to Benefits After Your Spouse Dies?

Your spouse has an account in *(name of plan)*. The money in the account that your spouse will be entitled to receive is called the vested account. Federal law states that you will receive the vested account after your spouse dies.

Example

Pat Doe dies at age 45 and Pat's vested account in the (name of plan) was $10,000 at the time of Pat's death. The plan will pay the $10,000 to Pat's spouse, Robin Doe (adjusted for gains and losses after Pat's death).

2. Can Your Spouse Choose Other Beneficiaries to Receive the Account?

Your right to your spouse's vested account provided by federal law cannot be taken away unless you agree. If you agree, your spouse can elect to have all or part of the vested account paid to someone else. Each person your spouse chooses to receive a part of the vested account is called a "beneficiary." For example, if you agree, your spouse can have the vested account paid to his or her children instead of you.

Example

Pat and Robin Doe agree that 1/2 of the Pat's vested account will be paid to Robin and 1/2 of the vested account will be paid to Pat's child, Chris. If Pat's vested account at the time of his death is $10,000, the plan will pay $5,000 to Robin and $5,000 to Chris (each amount adjusted for gains and losses after Pat's death).

Your spouse cannot have the vested account paid to someone else unless you agree and sign this agreement.

3. Do You Have to Give Up Your Right to Your Spouse's Vested Account?

Your choice must be voluntary. It is your personal decision whether you want to give up your right to your spouse's vested account.

4. Can Your Spouse Change the Beneficiary in the Future if You Sign this Agreement?

Instruction: *The plan administrator should select Option A if the agreement is a "specific consent," that is, where the spouse agrees to the beneficiary selected by the participant. The plan administrator should select Option B if the agreement is a "general consent," that is, where the spouse agrees to allow the participant to select any beneficiary even if the spouse does not know the identity of the beneficiary.*

Option A

If you sign this agreement, your spouse cannot change the beneficiary named in this agreement to anyone other than you, unless you agree to the new beneficiary by signing a new agreement. If you agree, your spouse can change the beneficiary at any time before your spouse dies.

Option B

If you sign this agreement, your spouse can choose the beneficiary who will receive all or part of the vested account without telling you and without getting your agreement. Your spouse can change the beneficiary at any time before the account is paid out.

You have the right to agree to allow your spouse to select only a particular beneficiary. If you want to allow your spouse to select only a particular beneficiary, do not sign this form. In that case, contact the plan administrator for more information and to get a new agreement that lets you state the particular beneficiary that you will allow your spouse to select.

5. Can You Change Your Mind After You Sign this Agreement?

Instruction: *The plan administrator should select Option A if the plan does not allow a spouse to revoke his or her consent. The plan administrator should select Option B if the plan allows a spouse to revoke his or her consent. The bracketed language in Options A and B applies only to general consent forms. For an explanation of a specific consent and a general consent, see the Instruction to section 4.*

Option A

You cannot change this agreement after you sign it. Your decision is final [even if your spouse later chooses a different beneficiary].

Option B

You can change this agreement until *(date)*. After that date, you cannot change the agreement [even if your spouse later chooses a different beneficiary]. If you change your mind, you must notify the plan administrator by *(insert the plan procedure for revoking consent)*. The plan administrator must receive this information before *(date)*.

6. What Happens to this Agreement if You Become Separated or Divorced?

Legal separation or divorce may end your right to the vested account even if you do not sign this agreement. However, if you become legally separated or divorced, you might be able to get a special court order (which is called a qualified domestic relations order or "QDRO") that specifically protects your rights to the vested account. If you are thinking about separating or getting a divorce, you should get legal advice on your rights to benefits from the plan.

7. Your Agreement

Instruction: *The plan administrator should select Option A if the agreement is a specific consent. The plan administrator should select Option B if the agreement is a general consent. For an explanation of a specific consent and a general consent, see the Instruction to section 4.*

Option A

I, *(name of participant's spouse)*, am the spouse of *(name of participant)*. I understand that I have the right to all of my spouse's vested account in the *(name of plan)* after my spouse dies. I agree to give up the right to *(insert percentage)* of the account and to have that amount paid to the following beneficiaries:

Name of Beneficiary	Percent of QPSA
______________	______________
______________	______________
______________	______________

I understand that my spouse cannot change the name of any beneficiary in the future unless I agree to the change.

I understand that by signing this agreement, I may receive less money than I would have received if I had not signed this agreement and I may receive nothing from the plan after my spouse dies.

I understand that I do not have to sign this agreement. I am signing this agreement voluntarily.

I understand that if I do not sign this agreement, then I will receive my spouse's vested account under the plan when my spouse dies.

Instruction: *The plan administrator should add a line for the spouse's signature and a place for the witness' acknowledgment.*

Option B

I, *(name of participant's spouse)*, am the spouse of *(name of participant)*. I understand that I have the right to all of my spouse's vested account in the *(name of plan)* after my spouse dies. I agree to give up *(insert percentage)* percent of the account and to have that amount paid to someone else as the beneficiary. I understand that by signing this agreement, my spouse can choose the beneficiary of the vested account without telling me and without getting my agreement. I also understand that by signing this agreement, my spouse can change the beneficiary of the vested account in the future without telling me and without getting my agreement again.

I understand that by signing this agreement, I may receive less money than I would have received if I had not signed this agreement and I may receive nothing from the plan after my spouse dies.

I understand that I can limit my spouse's choice to a particular beneficiary who will receive the vested account balance and that I am giving up that right.

I understand that I do not have to sign this agreement. I am signing this agreement voluntarily.

I understand that if I do not sign this agreement, then I will receive my spouse's account under the plan when my spouse dies.

Instruction: *The plan administrator should add a line for the spouse's signature and a place for the witness' acknowledgment.*

Sample Language for a Qualified Domestic Relations Order

Notice 97–11

I. PURPOSE

This Notice provides information intended to assist domestic relations attorneys, plan participants, spouses and former spouses of participants, and plan administrators in drafting and reviewing a qualified domestic relations order ("QDRO"). The Notice provides sample language that may be included in a QDRO relating to a plan that is qualified under § 401(a) or § 403(a) of the Internal Revenue Code of 1986 ("qualified plan" or "plan") and that is subject to § 401(a)(13). The Notice also discusses a number of issues that should be considered in drafting a QDRO. A QDRO is a domestic relations order that provides for payment of benefits from a qualified plan to a spouse, former spouse, child or other dependent of a plan participant and that meets certain requirements.

A. Statutory QDRO Requirements

Section 401(a)(13)(A) of the Code provides that benefits under a qualified plan may not be assigned or alienated. Section 401(a)(13)(B) establishes an exception to the antialienation rule for assignments made pursuant to domestic relations orders that constitute QDROs within the meaning of § 414(p). A "domestic relations order" is defined in § 414(p)(1)(B) as any judgment, decree, or order (including approval of a property settlement agreement) that (i) relates to the provision of child support, alimony payments, or marital property rights to a spouse, former spouse, child, or other dependent of a participant, and (ii) is made pursuant to a State domestic relations law (including a community property law). There is no exception to the § 401(a)(13)(A) antialienation rule for assignments made pursuant to domestic relations orders that are not QDROs.

Section 414(p)(1)(A) provides, in general, that a QDRO is a domestic relations order that creates or recognizes the existence of an alternate payee's right, or assigns to an alternate payee the right, to receive all or a portion of the benefits payable with respect to a participant under a plan, and that meets the requirements of paragraphs (2) and (3) of § 414(p). Section 414(p)(2) requires that a QDRO clearly specify: (A) the name and last known mailing address (if any) of the participant and of each alternate payee covered by the order, (B) the amount or percentage of the participant's benefits to be paid by the plan to each alternate payee, or the manner in which that amount or percentage is to be determined, (C) the number of payments or period to which the order applies, and (D) each plan to which the order applies.

Section 414(p)(3) provides that a QDRO cannot require a plan to provide any type or form of benefit, or any option, not otherwise provided under the plan; cannot require a plan to provide increased benefits (determined on the basis of actuarial value); and cannot require the payment of benefits to an alternate payee that are required to be paid to another alternate payee under another order previously determined to be a QDRO. Section 414(p)(4)(A)(i) provides that a domestic relations order shall not be treated as failing to meet the requirements of § 414(p)(3)(A) (and thus will not fail to be a QDRO) solely because the order requires payment of benefits to an alternate payee on or after the participant's earliest retirement age, even if the participant has not separated from service at that time. Section 414(p)(4)(B) defines earliest retirement age as the earlier of (i) the date on which the participant is entitled to a distribution under the plan, or (ii) the later of (I) the date the participant attains age 50, or (II) the earliest date on which the participant could begin receiving benefits under the plan if the participant separated from service.

Section 414(p)(5) permits a QDRO to provide that the participant's former spouse shall be treated as the participant's surviving spouse for purposes of §§ 401(a)(11) and 417 (relating to the right to receive survivor benefits and requirements concerning consent to distributions), and that any other spouse of the participant shall not be treated as a spouse of the participant for these purposes. An alternate payee is defined under § 414(p)(8) as any spouse, former spouse, child or other dependent of a participant who is recognized by a domestic relations order as having a right to receive all, or a portion of, the benefits payable under a plan with respect to the participant. Section 414(p)(10) provides that a plan shall not fail to satisfy the requirements of § 401(a), 401(k) or 403(b) solely by reason of payments made to an alternate payee pursuant to a QDRO.

B. Small Business Job Protection Act of 1996

Section 1457(a)(2) of the Small Business Job Protection Act of 1996 ("SBJPA") directs the Secretary of the Treasury ("Secretary") to develop sample language for inclusion in a form for a QDRO described in § 414(p)(1)(A) of the Code and § 206(d)(3)(B)(i) of the Employee Retirement Income Security Act of 1974 ("ERISA") that meets the requirements contained in those sections, and the provisions of which focus attention on the need to consider the treatment of any lump sum payment, qualified joint and survivor annuity ("QJSA"), or qualified preretirement survivor annuity ("QPSA"). Accordingly, the Service and Treasury are publishing the discussion and sample QDRO language set forth in the Appendix to this Notice.

Section 1457(a)(1) of the SBJPA directs the Secretary to publish sample language that can be included in a form that is used for a spouse to consent to a participant's waiver of a QJSA or QPSA. This sample language for use in spousal consent forms is contained in Notice 97–10 in this Bulletin.

C. Department of Labor Interpretive Authority

Section 206(d)(3) of ERISA (29 U.S.C. § 1056(d)(3)) contains QDRO provisions that are substantially parallel to those of § 414(p) of the Code. The Department of Labor has jurisdiction to interpret these provisions (except to the extent provided in § 401(n) of the Code) and the provisions governing the fiduciary duties owed with respect to domestic relations orders and QDROs. Section 401(n) gives the Secretary of the Treasury the authority to prescribe rules or regulations necessary to coordinate the requirements of §§ 401(a)(13) and 414(p), and the regulations issued by the Department of Labor thereunder, with other Code provisions. The Department of Labor has reviewed this Notice, including its Appendix, and has advised the Service and Treasury that the discussion and sample language are consistent with the views of the Department of Labor concerning the statutory requirements for QDROs. This Notice, including its Appendix, is not intended by the Service or Treasury to convey interpretations of the statutory requirements applicable to QDROs, but only to provide examples of language that may be (but are not required to be) used in drafting a QDRO that satisfies these requirements.

II. SAMPLE LANGUAGE

The Appendix to this Notice has two parts. Part I discusses certain issues that should be considered when drafting a QDRO. Part II contains sample language that will assist in drafting a QDRO. Drafters who use the sample language will need to conform it to the terms of the retirement plan to which the QDRO applies, and to specify the amounts assigned and other terms of the QDRO so as to achieve an appropriate division of marital property or level of family support. A domestic relations order is not required to incorporate the sample language in order to satisfy the requirements for a QDRO, and a domestic relations order that incorporates part of the sample language may omit or modify other parts.

The sample language addresses a variety of matters, but is not designed to address all retirement benefit issues that may arise in each domestic relations matter or QDRO. Further, some of the sample language, while helpful in facili-

tating the administration of a QDRO, is not necessarily required for the order to satisfy the requirements for a QDRO. Alternative formulations would be permissible for use in drafting orders that meet the statutory requirements for a QDRO.

III. OTHER SOURCES OF INFORMATION

The Pension Benefit Guaranty Corporation (''PBGC'') recently published a booklet entitled ''Divorce Orders & PBGC,'' which discusses the special QDRO rules that apply for plans that have been terminated and are trusteed by PBGC, and provides model QDROs for use with those plans. This publication may be obtained by calling PBGC's Customer Service Center at 1–800–400–PBGC or electronically via the PBGC internet site at ''http://www.pbgc.gov''.

Additional information on the rights of participants and spouses to plan benefits can be found in a two-booklet set published by the Service, entitled ''Looking Out for #2.'' These booklets discuss retirement benefit choices under a defined contribution or a defined benefit plan, and may be obtained by calling the Internal Revenue Service at 1–800–TAX–FORM, and asking for Publication 1565 (defined contribution plans) or Publication 1566 (defined benefit plans).

IV. COMMENTS

The Service invites the public to comment on the QDRO discussion and sample language included in the Appendix to this Notice, and welcomes suggestions concerning possible additional sample language. Comments may be submitted to the Internal Revenue Service at CC:DOM:CORP:R (Notice 97–11), Room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, D.C. 20044. Alternatively, taxpayers may hand-deliver comments between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (Notice 97–11), Courier's desk, Internal Revenue Service, 1111 Constitution Ave., N.W., Washington, D.C., or may submit comments electronically via the IRS internet site at ''http://www.irs.ustreas.gov/prod/tax_regs/comments.html''.

DRAFTING INFORMATION

The principal authors of this Notice are Diane S. Bloom of the Employee Plans Division and Susan M. Lennon of the Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations); however, other personnel from the Service and Treasury contributed to its development. For further information regarding this Notice, please contact the Employee Plans Division's taxpayer assistance telephone service at (202) 622–6074/6075, between the hours of 1:30 p.m. and 4 p.m. Eastern Time, Monday through Thursday. Alternatively, please call Ms. Bloom at (202) 622–6214 or Ms. Lennon at (202) 622–4606. Questions concerning QDROs may be addressed to Susan G. Lahne of the Pension and Welfare Benefits Administration, Department of Labor, at (202) 219–7461. These telephone numbers are not toll-free.

APPENDIX

Part I of this Appendix discusses certain issues that are relevant in drafting a qualified domestic relations order (''QDRO''). Part II of this Appendix contains sample language that can be used in a QDRO. However, the discussion and sample language do not attempt to address every issue that may arise in drafting a QDRO. Also, some parts of the discussion are not relevant to all situations and some parts of the sample language are not appropriate for all QDROs. In formulating a particular QDRO, it is important that the drafters tailor the QDRO to the needs of the parties and ensure that the QDRO is consistent with the terms of the retirement plan to which the QDRO applies.

PART I. DISCUSSION OF QDRO REQUIREMENTS AND RELATED ISSUES

In order to be recognized as a QDRO, an order must first be a ''domestic relations order.'' A domestic relations order is any judgment, decree or order (including approval of a property settlement) which (i) relates to the provision of child support, alimony payments or marital property rights to a spouse, former spouse, child or other dependent of the plan participant, and (ii) is made pursuant to a State domestic relations law (including a community property law). A State authority must actually issue an order or formally approve a proposed property settlement before it can be a domestic relations order. A property settlement signed by a participant and the participant's former spouse or a draft order to which both parties consent is not a domestic relations order until the State authority has adopted it as an order or formally approved it and made it part of the domestic relations proceeding.

The sample language in Part II assumes that the QDRO applies to one qualified plan and one alternate payee. If a QDRO is intended to cover more than one qualified plan or alternate payee, the QDRO should clearly state which qualified plan and which alternate payee each provision is intended to address.

The terms of a qualified plan must be set forth in a written document. The plan must also establish written QDRO procedures to be used by the plan administrator in determining whether a domestic relations order is a QDRO and in administering QDROs. The plan administrator maintains copies of the plan document and the plan's QDRO procedures. If the plan is required under federal law to have a summary plan description, or ''SPD,'' the plan administrator will also have a copy of the SPD. The information in these documents is helpful in drafting a QDRO. The drafter of a QDRO may wish to obtain copies of these documents before drafting a QDRO.

A. IDENTIFICATION OF PARTICIPANT AND ALTERNATE PAYEE

A QDRO must clearly specify the name and last known mailing address (if any) of the participant and of each alternate payee covered by the QDRO. In the event that an alternate payee is a minor or legally incompetent, the QDRO should also include the name and address of the alternate payee's legal representative. A QDRO can have more than one alternate payee, such as a former spouse and a child.

The ''participant'' is the individual whose benefits under the plan are being divided by the QDRO. The participant's spouse (or former spouse, child, or other dependent) who receives some or all of the plan's benefits with respect to the participant under the terms of the QDRO is the ''alternate payee.''

B. IDENTIFICATION OF RETIREMENT PLAN

A QDRO must clearly identify each plan to which the QDRO applies. A QDRO can satisfy this requirement by stating the full name of the plan as provided in the plan document.

C. AMOUNT OF BENEFITS TO BE PAID TO ALTERNATE PAYEE

A QDRO must clearly specify the amount or percentage of the partici-

pant's benefits in the plan that is assigned to each alternate payee, or the manner in which the amount or percentage is to be determined. Many factors should be taken into account in determining which benefits to assign to an alternate payee and how these benefits are to be assigned. The following discussion highlights some of these factors. Because of the complexity and variety of the factors that should be considered, and the need to tailor the assignment of benefits under a QDRO to the individual circumstances of the parties, specific sample language regarding the assignment of benefits has not been provided in Part II of this Appendix.

1. Types of Benefits

In order to decide how to divide benefits under a QDRO, the drafter first should determine the types of benefits the plan provides. Most benefits provided by qualified plans can be classified as (1) retirement benefits that are paid during the participant's life and (2) survivor benefits that are paid to beneficiaries after the participant's death. Generally, a QDRO can assign all or a portion of each of these types of benefits to an alternate payee. The drafters of a QDRO should coordinate the assignment of these types of benefits. QDRO drafters should also consider how the benefits divided under the QDRO may be affected, under the plan, by the death of either the participant or the alternate payee.

2. Types of Qualified Plans

Another important factor to consider in the drafting of a QDRO is the type of plan to which the QDRO will apply. As discussed below, the type of plan may affect the types of benefits available for assignment, how the parties choose to assign the benefits, and other matters.

There are two basic types of qualified plans to which QDROs apply: defined benefit plans and defined contribution plans.

a. Defined Benefit Plans

A "defined benefit plan" promises to pay each participant a specific benefit at retirement. The basic retirement benefits are usually based on a formula that takes into account factors such as the number of years a participant has worked for the employer and the participant's salary. The basic retirement benefits are generally expressed in the form of periodic payments for the participant's life beginning at the plan's normal retirement age. This stream of periodic payments is generally known as an "annuity." There are special rules that apply if the participant is married; these rules are discussed in greater detail in section E below. A plan may also provide that these retirement benefits may be paid in other forms, such as a lump sum payment.

b. Defined Contribution Plans

A "defined contribution plan" is a retirement plan that provides for an individual account for each participant. The participant's benefits are based solely on the amount contributed to the participant's account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant's account. Examples of defined contribution plans include a profit sharing plan (including a "401(k)" plan), an employee stock ownership plan (an "ESOP") and a money purchase pension plan. Defined contribution plans commonly permit retirement benefits to be paid in the form of a lump sum payment of the participant's entire account balance.

3. Approaches to Dividing Retirement Benefits

There are two common approaches to dividing retirement benefits in a QDRO: one awards a separate interest in the retirement benefits to the alternate payee, and the other allows the alternate payee to share in the payment of the retirement benefits. In drafting a QDRO using either of these approaches, consideration should be given to factors such as whether the plan is a defined benefit plan or defined contribution plan, and the purpose of the QDRO (such as whether the QDRO is meant to provide spousal support or child support, or to divide marital property).

a. Separate Interest Approach

A QDRO that creates a "separate interest" divides the participant's benefits into two separate parts: one for the participant and one for the alternate payee. Subject to the terms of the plan and as discussed in more detail below, a QDRO may provide that the alternate payee can determine the form in which his or her benefits are paid and when benefit payments commence. If benefits are allocated under the separate interest approach, the drafters of a QDRO should take into account certain issues depending on the type of plan.

(1) Issues Relevant to Defined Benefit Plans

The treatment of subsidies provided by a plan and the treatment of future increases in benefits due to increases in the participant's compensation, additional years of service, or changes in the plan's provisions are among the matters that should be considered when drafting a QDRO that uses the separate interest approach to allocate benefits under a defined benefit plan.

Subsidies. Defined benefit plans may promise to pay benefits at various times and in alternative forms. Benefits paid at certain times or in certain forms may have a greater actuarial value than the basic retirement benefits payable at normal retirement age. When one form of benefit has a greater actuarial value than another form, the difference in value is often called a subsidy. Plans usually provide that a participant must meet specific eligibility requirements, such as working for a minimum number of years for the employer that maintains the plan, in order to receive the subsidy.

For example, a defined benefit plan may offer an "early retirement subsidy" to employees who retire before the plan's normal retirement age but after having worked for a specific number of years for the employer maintaining the plan. In some cases, this subsidized benefit provides payments in the form of an annuity that pays the same annual amount as would be paid if the payments commenced instead at the normal retirement age. Because these benefits are not reduced for early commencement, they have a greater actuarial value than benefits payable at normal retirement age. This subsidy may be available only for certain forms of benefit.

A QDRO may award to the alternate payee all or part of the participant's basic retirement benefits. A QDRO can also address the disposition of any subsidy to which the participant may become entitled after the QDRO has been entered.

Future Increases in the Participant's Benefits. A participant's basic retirement benefits may increase due to circumstances that occur after a QDRO has been entered, such as increases in salary, crediting of additional years of service, or amendments to the plan's provisions, including amendments to provide cost of living adjustments. The treatment of such benefit increases should be considered when drafting a QDRO using the separate interest approach.

(2) Issues Relevant to Defined Contribution Plans

Investment of the amount assigned to the alternate payee when the account is invested in more than one investment vehicle and division of any future allocation of contributions or forfeitures to the participant's account are among the matters that should be considered when drafting a QDRO that allocates the alternate payee a separate interest under a defined contribution plan. Investment Choices. The participant's account may be invested in more than one investment fund. If the plan provides for participant-directed investment of the participant's account, consideration should be given to how the alternate payee's interest will be invested.

Future Allocations. A participant's account balance may later increase due to the allocation of contributions or forfeitures after the QDRO has been entered. A QDRO may provide that the amounts assigned to the alternate payee will include a portion of such future allocations.

b. Shared Payment Approach

A QDRO may use the ''shared payment'' approach, under which benefit payments from the plan are split between the participant and the alternate payee. The alternate payee receives payments under this approach only when the participant receives payments. A QDRO may provide that the alternate payee will commence receiving benefit payments when the participant begins receiving payments or at a later stated date, and that the alternate payee will cease to share in the benefit payments at a stated date (or upon a stated event, provided that adequate notice is given to the plan). In splitting the benefit payments, the QDRO may award the alternate payee either a percentage or a dollar amount of each of the participant's benefit payments; in either case, the amount awarded cannot exceed the amount of each payment to which the participant is entitled under the plan. If a QDRO awards a percentage of the participant's benefit payments (rather than a dollar amount), then, unless the QDRO provides otherwise, the alternate payee generally will automatically receive a share of any future subsidy or other increase in the participant's benefits.

D. FORM AND COMMENCEMENT OF PAYMENT TO ALTERNATE PAYEE

QDRO drafters should take into account certain issues that may arise in connection with the alternate payee's choice of a form of benefit payments and the date on which payment will commence.

1. Separate Interest Approach

a. Form of Alternate Payee's Benefit Payments

A QDRO either may specify a particular form in which payments are to be made to the alternate payee or may provide that the alternate payee may choose a form of benefit from among the options available to the participant. However, federal law provides that the alternate payee cannot receive payments in the form of a joint and survivor annuity with respect to the alternate payee and his or her subsequent spouse.

The choice of the form of benefits should take into account the period over which payments will be made. For example, if the alternate payee elects to receive a lump sum payment, no further payments will be made by the plan with respect to the alternate payee's interest.

Any decision concerning the form of benefit should take into account the difference, if any, in the actuarial value of different benefit forms available under the plan. For example, as discussed above, a plan might provide an early retirement subsidy that is available only for payment in certain forms.

In addition, the forms of benefit available to the alternate payee may be limited by § 401(a)(9) of the Code, which specifies the date by which benefit payments from a qualified plan must commence and limits the period over which the benefit payments may be made. Section 1.401(a)(9)–1, Q&A H–4, of the Proposed Income Tax Regulations addresses the application of the required minimum distribution rules of § 401(a)(9) to payments to an alternate payee. The proposed regulation limits the period over which benefits may be paid with respect to the alternate payee's interest. For example, the proposed regulation provides that distribution of the alternate payee's separate interest will not satisfy § 401(a)(9)(A)(ii) of the Code if the separate interest is distributed over the joint lives of the alternate payee and a designated beneficiary (other than the participant).

b. Commencement of Benefit Payments to Alternate Payee

Under the separate interest approach, the alternate payee may begin receiving benefits at a different time than the participant. A QDRO either may specify a time at which payments are to commence to the alternate payee or may provide that the alternate payee can elect a time when benefits will commence in accordance with the terms of the plan. In two circumstances, an alternate payee who is given a separate interest may begin receiving his or her separate benefit before the participant is eligible to begin receiving payments. First, federal law provides that benefit payments to the alternate payee may begin as soon as the participant attains his or her earliest retirement age. Federal law defines ''earliest retirement age'' as the earlier of (i) the date on which the participant is entitled to a distribution under the plan, or (ii) the later of (I) the date the participant attains age 50, or (II) the earliest date on which the participant could begin receiving benefits under the plan if the participant separated from service. Second, the retirement plan may (but is not required to) allow payments to begin to an alternate payee at a date before the earliest retirement date.

2. Shared Payment Approach

As indicated above, under the shared payment approach, benefit payments are split between the participant and the alternate payee. The alternate payee receives payments in the same form as the participant. Further, payments to the alternate payee do not commence before the participant has begun to receive benefits. Payments to the alternate payee can cease at any time stated in the QDRO but do not continue after payments with respect to the participant cease. As noted above, a QDRO must state the number of payments or the period to which the order applies.

E. SURVIVOR BENEFITS AND TREATMENT OF FORMER SPOUSE AS PARTICIPANT'S SPOUSE

Survivor benefits include both benefits payable to surviving spouses and other benefits that are payable after the participant's death. These benefits can be awarded to an alternate payee. In determining the assignment of survivor benefits, QDRO drafters should take into account that benefits awarded to the

alternate payee under a QDRO will not be available to a subsequent spouse of the participant or to another beneficiary. QDRO drafters may consult with the plan administrator for information on the survivor benefits provided under the plan.

A QDRO may provide for treatment of a former spouse of a participant as the participant's spouse with respect to all or a portion of the spousal survivor benefits that must be provided under federal law. The following discussion explains the spousal survivor benefits that must be offered under a plan, and identifies issues that should be considered in determining whether to treat the alternate payee as the participant's spouse.

Only a spouse or former spouse of the participant can be treated as a spouse under a QDRO. A child or other dependent who is an alternate payee under a QDRO cannot be treated as the spouse of a participant.

Retirement plans generally need not provide the special survivor benefits to the participant's surviving spouse unless the participant is married for at least one year. If the retirement plan to which the QDRO relates contains such a one-year marriage requirement, then the QDRO cannot require that the alternate payee be treated as the participant's spouse if the marriage lasted for less than one year.

1. Qualified Joint and Survivor Annuity

Federal law generally requires that defined benefit plans and certain defined contribution plans pay retirement benefits to participants who were married on the participant's annuity starting date (this is the first day of the first period for which an amount is payable to the participant) in a special form called a qualified joint and survivor annuity, or QJSA. Under a QJSA, retirement payments are made monthly (or at other regular intervals) to the participant for his or her lifetime; after the participant dies, the plan pays the participant's surviving spouse an amount each month (or other regular interval) that is at least one half of the retirement benefit that was paid to the participant. At any time that benefits are permitted to commence under the plan, a QJSA must be offered that commences at the same time and that has an actuarial value that is at least as great as any other form of benefit payable under the plan at the same time. A married participant can choose to receive retirement benefits in a form other than a QJSA if the participant's spouse agrees in writing to that choice.

2. Qualified Preretirement Survivor Annuity

Federal law generally requires that defined benefit plans and certain defined contribution plans pay a monthly survivor benefit to a surviving spouse for the spouse's life when a married participant dies prior to the participant's annuity starting date, to the extent the participant's benefit is nonforfeitable under the terms of the plan at the time of his or her death. This benefit is called a qualified preretirement survivor annuity, or QPSA. As a general rule, an individual loses the right to the QPSA survivor benefits when he or she is divorced from the participant. However, if a former spouse is treated as the participant's surviving spouse under a QDRO, the former spouse is eligible to receive the QPSA unless the former spouse consents to the waiver of the QPSA. If the spouse does not waive the QPSA, the plan may allow the spouse to receive the value of the QPSA in a form other than an annuity.

3. Defined Contribution Plans Not Subject to the QJSA or QPSA Requirements

Those defined contribution plans that are not required to pay benefits to married participants in the form of a QJSA or a QPSA are required by federal law to pay the balance remaining in the participant's account after the participant dies to the participant's surviving spouse. If the spouse gives written consent, the participant can direct that upon his or her death the account will be paid to a beneficiary other than the spouse, for example, the couple's children.

4. Alternate Payee Treated as Spouse

A QDRO may provide that an alternate payee who is a former spouse of the participant will be treated as the participant's spouse for some or all of the benefits payable upon the participant's death, so that the alternate payee will receive benefits provided to a spouse under the plan. To the extent that a former spouse is to be treated under the plan as the participant's spouse pursuant to a QDRO, any subsequent spouse of the participant cannot be treated as the participant's surviving spouse. Thus, QDRO drafters should consider the potential impact of designating a former spouse as the participant's spouse on the disposition of survivor benefits among the former spouse and any subsequent spouse of the participant, as well as the impact on children or any other beneficiaries designated by the participant in accordance with the terms of the plan.

In determining the portion of the participant's benefits for which the alternate payee is treated as the spouse, the drafters should take into account the manner in which benefits are otherwise divided under the QDRO. In particular, consideration should be given to whether the formula for dividing the participant's benefits for this purpose should be coordinated with the formula otherwise used for dividing the benefits.

Under a defined benefit plan, or a defined contribution plan that is subject to the QJSA and QPSA requirements, to the extent the former spouse is treated as the current spouse, the former spouse must consent to payment of retirement benefits in a form other than a QJSA or to the participant's waiver of the QPSA. For example, in a defined benefit plan, the participant would not be able to elect to receive a lump sum payment of the retirement benefits for which the alternate payee is treated as the participant's spouse unless the alternate payee consents. Similarly, the former spouse's consent might be required for any loan to the participant from the plan that is secured by his or her retirement benefits. In a defined contribution plan that is not subject to the QJSA and QPSA requirements, to the extent the QDRO treats the former spouse as the participant's spouse under the plan, the survivor benefits under the plan must be paid to the former spouse unless he or she consents to have those benefits paid to someone else.

F. TAX TREATMENT OF BENEFIT PAYMENTS MADE PURSUANT TO A QDRO

The federal income tax treatment of retirement benefits is governed by federal law, and a QDRO cannot designate who will be liable for the taxes owed when retirement benefits are paid. For a description of the tax consequences of payments to an alternate payee pursuant to a QDRO, see Internal Revenue Service Publication 575, "Pension and Annuity Income." A local IRS office can provide this publication, or it may be obtained by calling 1–800–TAX–FORM.

PART II. SAMPLE LANGUAGE FOR INCLUSION IN QDRO

A. SAMPLE LANGUAGE FOR IDENTIFICATION OF PARTICIPANT AND ALTERNATE PAYEE

The "Participant" is **[insert name of Participant]**. The Participant's address is **[insert Participant's address]**. The Participant's social security number is **[insert Participant's social security number]**.

The "Alternate Payee" is **[insert name of Alternate Payee]**. The Alternate Payee's address is **[insert Alternate Payee's address]**. The Alternate Payee's social security number is **[insert Alternate Payee's social security number]**. The Alternate Payee is the **[describe the Alternate Payee's relationship to Participant]** of the Participant.

B. SAMPLE LANGUAGE FOR IDENTIFICATION OF RETIREMENT PLAN

This order applies to benefits under the **[insert formal name of retirement plan]** ("Plan").

C. AMOUNT OF BENEFITS TO BE PAID TO ALTERNATE PAYEE

Instruction: *The QDRO should clearly specify the amount or percentage of benefits assigned to the Alternate Payee or the manner in which the amount or percentage is to be determined, and the number of payments or period to which the Order applies. There are many different forms in which benefits may be paid from a qualified plan. Because of the diversity of factors that should be considered, and the need to tailor the assignment of benefits under a QDRO to meet the needs of the parties involved, specific sample language regarding the assignment of benefits has not been provided. See the discussion in Part I for further information.*

D. SAMPLE LANGUAGE FOR FORM AND COMMENCEMENT OF PAYMENT TO ALTERNATE PAYEE

Instruction: *Drafters using the separate interest approach may use paragraph 1. Drafters using the shared payment approach may use paragraph 2. Drafters using the separate interest approach for a portion of the benefits allocated to the alternate payee and the shared payment approach for the remainder should modify the sample language to specify the benefits to which each paragraph provided below applies.*

1. Separate Interest Approach

The Alternate Payee may elect to receive payment from the Plan of the benefits assigned to the Alternate Payee under this Order in any form in which such benefits may be paid under the Plan to the Participant (other than in the form of a joint and survivor annuity with respect to the Alternate Payee and his or her subsequent spouse), but only if the form elected complies with the minimum distribution requirements of § 401(a)(9) of the Internal Revenue Code. Payments to the Alternate Payee pursuant to this Order shall commence on any date elected by the Alternate Payee (and such election shall be made in accordance with the terms of the Plan), but not earlier than the Participant's earliest retirement age (or such earlier date as allowed under the terms of the Plan), and not later than the earlier of (A) the date the Participant would be required to commence benefits under the terms of the Plan or (B) the latest date permitted by § 401(a)(9) of the Internal Revenue Code. For purposes of this Order, the Participant's earliest retirement age shall be the earlier of (i) the date on which the participant is entitled to a distribution under the Plan, or (ii) the later of (I) the date the Participant attains age 50, or (II) the earliest date on which the Participant could begin receiving benefits under the plan if the Participant separated from service.

2. Shared Payment Approach

The Alternate Payee shall receive payments from the Plan of the benefits assigned to the Alternate Payee under this Order (including payments attributable to the period in which the issue of whether this Order is a qualified domestic relations order is being determined) commencing as soon as practicable after this Order has been determined to be a qualified domestic relations order or, if later, on the date the Participant commences receiving benefit payments from the Plan. Payment to the Alternate Payee shall cease on the earlier of: **[insert date or future event, such as the Alternate Payee's remarriage]**, or the date that payments from the Plan with respect to the Participant cease.

E. SAMPLE LANGUAGE FOR TREATMENT OF FORMER SPOUSE AS PARTICIPANT'S SPOUSE

Instruction: *The Alternate Payee may be treated as the Participant's spouse only if the Alternate Payee is the Participant's spouse or former spouse, and not if the Alternate Payee is a child or other dependent of the Participant. If the Alternate Payee is the Participant's spouse or former spouse, drafters may select sample paragraph 1, sample paragraph 2, or sample paragraph 3. Sample paragraph 1 applies if the Alternate Payee is treated as the Participant's spouse for all of the spousal survivor benefits payable with respect to the Participant's benefits under the Plan. Sample paragraph 2 applies if the Alternate Payee is treated as the Participant's spouse for a portion of the spousal survivor benefits payable with respect to the Participant's benefits under the Plan. Sample paragraph 3 applies if the Alternate Payee is not treated as the Participant's spouse for any of the spousal survivor benefits payable with respect to the Participant's benefits under the Plan.*

1. Alternate Payee Treated as Spouse For All Spousal Survivor Benefits

The Alternate Payee shall be treated as the Participant's spouse under the Plan for purposes of §§ 401(a)(11) and 417 of the Code.

2. Alternate Payee Treated as Spouse For a Portion of the Spousal Survivor Benefits

The Alternate Payee shall be treated as the Participant's spouse under the Plan for purposes of §§ 401(a)(11) and 417 of the Code with respect to **[insert percentage of benefit or a formula, such as a formula describing the benefit earned under the plan during marriage]**.

3. Alternate Payee not Treated as Spouse

The Alternate Payee shall not be treated as the Participant's spouse under the Plan.

Rev. Proc. 97–9

SECTION 1. PURPOSE

.01 This revenue procedure provides a model amendment that may be used to assist employers in adopting a plan that contains 401(k) SIMPLE provisions.

The model amendment gives plan sponsors a way to incorporate 401(k) SIMPLE provisions in plans containing cash or deferred arrangements (''CODAs'') and matching contributions. The model amendment incorporates the alternative method of satisfying the nondiscrimination tests applicable to these plans as contained in §§ 401(k)(11) and 401(m)(10) of the Internal Revenue Code. Sections 401(k)(11) and 401(m)(10) were added to the Code by § 1422 of the Small Business Job Protection Act of 1996, Pub. L. No. 104–188 (''SBJPA''). This revenue procedure does not apply to § 408(p) SIMPLE plans, as described in § 1421 of the SBJPA, under which contributions are made to employees' SIMPLE IRAs.

.02 The model amendment may be used by organizations or practitioners with approved master and prototype (''M&P'') plans, regional prototype plans, or volume submitter specimen plans to modify the existing plans they sponsor so that employers can establish new plans containing 401(k) SIMPLE provisions. Employers that currently maintain an M&P plan, a regional prototype plan or a volume submitter specimen plan may modify existing 401(k) plans to incorporate 401(k) SIMPLE provisions. The model amendment may also be used by sponsors of individually designed plans to modify existing 401(k) plans to incorporate 401(k) SIMPLE provisions. The model amendment is available only for sponsors of plans containing provisions required to satisfy §§ 401(k), 401(m) and 401(a)(30) that have received favorable opinion, notification, advisory, or determination letters that take into account the requirements of the Tax Reform Act of 1986, Pub. L. No. 99–514 (''TRA '86'').

SECTION 2. BACKGROUND AND GENERAL INFORMATION

.01 New sections 401(k)(11) and 401(m)(10) of the Code (''401(k) SIMPLE provisions''), provide an alternative method of satisfying the nondiscrimination tests contained in §§ 401(k)(3)(A)(ii) and 401(m)(2), applicable to CODAs. These 401(k) SIMPLE provisions may only be adopted by employers that employed 100 or fewer employees earning at least $5,000 in compensation for the preceding year. The 401(k) SIMPLE provisions may not be adopted by an employer who maintains another employer-sponsored plan covering employees who are eligible to participate in the cash or deferred arrangement using the 401(k) SIMPLE provisions. Generally, no contributions may be made during a year to a plan using the 401(k) SIMPLE provisions, other than those contributions described in section 2.03 below.

.02 A 401(k) plan that includes 401(k) SIMPLE provisions does not have to satisfy the actual deferral percentage and actual contribution percentage tests otherwise applicable to plans containing CODAs and matching contributions and is not treated as top-heavy under § 416 of the Code.

.03 Under a plan containing the 401(k) SIMPLE provisions, each employee may elect to make salary reduction contributions for a year of up to $6,000. The employer must make either a matching contribution equal to the employee's salary reduction contributions, limited to 3% of the employee's compensation for the year, or a nonelective contribution for all eligible employees equal to 2% of the employee's compensation for the year. All amounts contributed under 401(k) SIMPLE provisions must be nonforfeitable at all times.

.04 The plan year of a plan containing the 401(k) SIMPLE provisions must be the calendar year. An employer maintaining a 401(k) plan on a fiscal year basis must convert the plan to a calendar year in order to adopt the 401(k) SIMPLE provisions.

.05 Several additional requirements apply to plans adopting the model amendment and include the following:

(1) a special definition of compensation for purposes of the 3% matching and 2% nonelective contributions described in section 2.03;
(2) notification and election period requirements; and
(3) transitional rules for growing employers.

.06 Except as provided in section 2.02, all other qualification requirements of the Code continue to apply to a plan that contains 401(k) SIMPLE provisions including the contribution limitations of § 415; the compensation limitations of § 401(a)(17); and the requirement that the plan as amended continue to be operated in accordance with its terms. In addition, all other requirements applicable to 401(k) plans continue to apply, including, the distribution restrictions of § 401(k)(2)(B) and the general prohibition set forth in § 401(k)(4)(B) on State and local governments maintaining a 401(k) plan. Contributions under a plan containing 401(k) SIMPLE provisions are deductible subject to the limits of § 404(a).

.07 The model amendment supersedes any plan provision that is inconsistent with the provisions of the model amendment. For example, if the plan contains a provision that limits any employee's salary reduction contributions for a year to a percentage that results in an amount less than $6,000, the salary reduction contribution provision of the model amendment permitting yearly contributions of up to $6,000 will govern.

.08 Employers adopting a new 401(k) plan containing the model amendment may make it effective as of any date on or after January 1, 1997, but in no event later than October 1 of the year in which adopted. Employers amending an existing 401(k) plan to incorporate the model amendment must make the model amendment effective as of the following January 1 unless they are using the 1997 Transition Rule described in section 3.

SECTION 3. 1997 TRANSITION RULE

.01 Employers that have maintained a 401(k) plan in 1997 may adopt the model amendment for 1997 if the following conditions are satisfied:

(1) the employer adopts the 401(k) SIMPLE provisions by July 1, 1997, effective as of January 1, 1997;

(2) the salary reduction contributions for the year made prior to adoption of the model amendment do not total more than $6,000 for each employee;

(3) the matching or nonelective contributions described in section 2.03 are of inherently equal or greater value than the contributions required under the plan prior to the amendment; and

(4) all eligible employees are provided with an election period described in section 3.3(b)(iv) of the model amendment.

.02 If an employer adopts 401(k) SIMPLE provisions under this transition rule, the model amendment applies to the plan for the 1997 year. For example, the cumulative salary reduction contributions for the year, including those made prior to and those made following the adoption of the model amendment, must not total more than $6,000 for any employee.

SECTION 4. USE OF THE MODEL AMENDMENT

.01 Sponsors described in section 4.02 may amend their plans by adopting, word-for-word, the model amendment in the appendix in accordance with the instructions in this revenue procedure. If a sponsor to whom the model amendment is available pursuant to section 4.02 adopts the model amendment, neither application to the Service nor a user fee is required. The Service will not issue new opinion, notification, advisory, or determination letters for plans that are amended solely to add the model amendment.

.02 The only sponsors to whom the model amendment is available are sponsors of M&P, regional prototype, volume submitter specimen, and individually designed plans that contain CODA provisions and that have received favorable opinion, notification, advisory, or determination letters that take into account the requirements of TRA '86 under Rev. Proc. 89–9, 1989–1 C.B. 780, as modified; Rev. Proc. 89–13, 1989–1 C.B. 801, as modified; Rev. Proc. 90–20, 1990–1 C.B. 495; Rev. Proc. 91–41, 1991–2 C.B. 697; Rev. Proc. 91–66, 1991–2 C.B. 870; Rev. Proc. 93–39, 1993–2 C.B. 513; or Rev. Proc. 96–6, 1996–1 I.R.B. 151.

.03 Organizations and practitioners that have approved M&P and regional prototype plans and volume submitter specimen plan sponsors that use the model language must file Form 8837, Notice of Adoption of Revenue Procedure Model Amendments.

SECTION 5. REVOCATION OF MODEL AMENDMENT

The model amendment contains a model revocation clause which permits employers to revoke the 401(k) SIMPLE provisions without terminating the plan. The revocation clause should be executed only if the employer wants to revert to the plan provisions that apply in the absence of 401(k) SIMPLE provisions. The revocation may be adopted on any date, but may only become effective on the first day of the calendar year following the date of adoption.

SECTION 6. RELIANCE

Plans that are amended in accordance with sections 4 and 5 will not lose their otherwise applicable extended reliance period under Rev. Procs. 89–9 and 89–13, as modified by Rev. Proc. 93–9, 1993–1 C.B. 474, or section 13 of Rev. Proc. 93–39. Employers entitled to rely on an opinion, notification, advisory, or determination letter will not lose reliance on the letter merely because of these amendments.

DRAFTING INFORMATION

The principal authors of this revenue procedure are Maxine Terry and Roger Kuehnle of the Employee Plans Division. For further information regarding this revenue procedure, contact the Employee Plans Division's taxpayer assistance telephone service between 1:30 and 4:00 p.m., Eastern Time, Monday through Thursday at (202) 622–6074/6075. (These telephone numbers are not toll-free numbers.)

APPENDIX

MODEL AMENDMENT UNDER SECTIONS 401(k)(11) AND 401(m)(10)

MODEL AMENDMENT TO ADOPT SIMPLE 401(k) PROVISIONS

SECTION I. SIMPLE 401(K) PROVISIONS

1.1 This amendment adds to the plan SIMPLE 401(k) provisions that are intended to satisfy the requirements of §§ 401(k)(11) and 401(m)(10) of the Internal Revenue Code.

1.2 The provisions of sections 3.3, IV, VI, and VII of this amendment apply for a year only if the following conditions are met:

(a) The employer adopting this amendment is an eligible employer. An eligible employer means, with respect to any year, an employer that had no more than 100 employees who received at least $5,000 of compensation from the employer for the preceding year. In applying the preceding sentence, all employees of controlled groups of corporations under § 414(b), all employees of trades or businesses (whether incorporated or not) under common control under § 414(c), all employees of affiliated service groups under § 414(m), and leased employees required to be treated as the employer's employees under § 414(n), are taken into account.

An eligible employer that adopts this amendment and that fails to be an eligible employer for any subsequent year, is treated as an eligible employer for the 2 years following the last year the employer was an eligible employer. If the failure is due to any acquisition, disposition, or similar transaction involving an eligible employer, the preceding sentence applies only if the provisions of § 410(b)(6)(C)(i) are satisfied.

(b) No contributions are made, or benefits accrued for services during the year, on behalf of any eligible employee under any other plan, contract, pension, or trust described in § 219(g)(5)(A) or (B), maintained by the employer.

1.3 To the extent that any other provision of the plan is inconsistent with the provisions of this amendment, the provisions of this amendment govern.

SECTION II. DEFINITIONS

2.1 "Compensation" means, for purposes of sections 1.2(a), 3.1 and 3.2, the sum of the wages, tips, and other compensation from the employer subject to federal income tax withholding (as described in § 6051(a)(3)) and the employee's salary reduction contributions made under this or any other 401(k) plan, and, if applicable, elective deferrals under a § 408(p) SIMPLE plan, a SARSEP, or a § 403(b) annuity contract and compensation deferred under a § 457 plan, required to be reported by the employer on Form W–2 (as described in § 6051(a)(8)). For self-employed individuals, compensation means net earnings from

self-employment determined under § 1402(a) prior to subtracting any contributions made under this plan on behalf of the individual. The provisions of the plan implementing the limit on compensation under § 401(a)(17) apply to the compensation under Section III.

2.2 ''Eligible employee'' means, for purposes of this amendment, any employee who is entitled to make elective deferrals described in § 402(g) under the terms of the plan.

2.3 ''Year'' means the calendar year.

SECTION III. CONTRIBUTIONS

3.1 Salary Reduction Contributions

(a) Each eligible employee may make a salary reduction election to have his or her compensation reduced for the year in any amount selected by the employee subject to the limitation in section 3.1(b). The employer will make a salary reduction contribution to the plan, as an elective deferral, in the amount by which the employee's compensation has been reduced.

(b) The total salary reduction contribution for the year cannot exceed $6,000 for any employee. To the extent permitted by law, this amount will be adjusted to reflect any annual cost-of-living increases announced by the IRS.

3.2 Other Contributions

(a) Matching Contributions—Each year, the employer will contribute a matching contribution to the plan on behalf of each employee who makes a salary reduction election under section 3.1. The amount of the matching contribution will be equal to the employee's salary reduction contribution up to a limit of 3% of the employee's compensation for the full calendar year.

(b) Nonelective Contribution—For any year, instead of a matching contribution, the employer may elect to contribute a nonelective contribution of 2% of compensation for the full calendar year for each eligible employee who received at least $5,000 of compensation from the employer for the year. By inserting a number less than $5,000 here __________, the employer agrees to substitute this lesser amount for the $5,000 amount in the preceding sentence.

3.3 Limitation on Other Contributions

(a) General rule—No employer or employee contributions may be made to this plan for the year other than salary reduction contributions described in section 3.1, matching or nonelective contributions described in section 3.2 and rollover contributions described in § 1.402(c)–2, Q&A–1(a) of the Income Tax Regulations.

(b) 1997 Transition Rule—If the employer has maintained this plan during 1997 prior to adopting this amendment, then contributions made prior to the amendment are treated as made under sections 3.1 and 3.2 provided that: (i) the employer adopts the 401(k) SIMPLE provisions by July 1, 1997, effective as of January 1, 1997; (ii) the salary reduction contributions for the year made prior to adoption of the amendment do not total more than $6,000 for any employee; (iii) the other contributions set forth in section 3.2 are of inherently equal or greater value than the contributions required under the plan prior to the amendment; and (iv) for 1997, the 60-day election period requirement described in sections 4.1(a) and (b) is deemed satisfied if the employee may make or modify a salary reduction election during a 60-day election period that begins no later than 30 days after the amendment is adopted but in no event later than July 1, 1997.

3.4 The provisions of the plan implementing the limitations of § 415 apply to contributions made pursuant to sections 3.1 and 3.2.

SECTION IV. ELECTION AND NOTICE REQUIREMENTS

4.1 Election Period

(a) In addition to any other election periods provided under the plan, each eligible employee may make or modify a salary reduction election during the 60-day period immediately preceding each January 1.

(b) For the year an employee becomes eligible to make salary reduction contributions under this amendment, the 60-day election period requirement of section 4.1(a) is deemed satisfied if the employee may make or modify a salary reduction election during a 60-day period that includes either the date the employee becomes eligible or the day before.

(c) Each employee may terminate a salary reduction election at any time during the year.

4.2 Notice Requirements

(a) The employer will notify each eligible employee prior to the 60-day election period described in section 4.1 or 3.3(b)(iv) that he or she can make a salary reduction election or to modify a prior election during that period.

(b) The notification described in section 4.2(a) will indicate whether the employer will provide a 3% matching contribution described in section 3.2(a) or a 2% nonelective contribution described in section 3.2(b).

SECTION V. VESTING REQUIREMENTS

All benefits attributable to contributions made pursuant to this amendment are nonforfeitable at all times.

SECTION VI. TOP-HEAVY RULES

The plan is not treated as a top-heavy plan under § 416 for any year for which the provisions of this amendment are effective and satisfied.

SECTION VII. NONDISCRIMINATION TESTS

The plan is treated as meeting the requirements of §§ 401(k)(3)(A)(ii) and 401(m)(2) for any year for which the provisions of this amendment are effective and satisfied.

SECTION VIII. EFFECTIVE DATE

This amendment is effective on ______________________________.

______________________________	______________________________
Employer Name	By: Signature
	______________________________
	Name and Title
	______________________________
	Date

MODEL REVOCATION CLAUSE

This amendment is revoked effective as of the first day of the calendar year following______________________________ (enter the date the revocation is adopted).

______________________________	______________________________
Employer Name	By: Signature
	______________________________
	Name and Title
	______________________________
	Date

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26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part I, §§ 56, 168, 446, 481; 1.446–1.)

Rev. Proc. 97–10

SECTION 1. PURPOSE

This revenue procedure provides the exclusive procedure for making the election under § 1120 of the Small Business Job Protection Act of 1996 (the Act) to treat a retail motor fuels outlet placed in service before August 20, 1996, as 15-year property under § 168 of the Internal Revenue Code. The election set forth in this revenue procedure is available only for the taxpayer's taxable year that includes August 20, 1996, the date of enactment of the Act.

SECTION 2. BACKGROUND

.01 Section 1120 of the Act amended § 168(e)(3)(E) to provide that 15-year property includes any § 1250 property that is a retail motor fuels outlet whether or not food or other convenience items are sold at the outlet. The legislative history of the Act provides that property will qualify as a retail motor fuels outlet if 50 percent or more of the gross revenues generated from the property are derived from petroleum sales, or 50 percent or more of the floor space in the property is devoted to petroleum marketing sales. A motor fuels outlet of 1400 square feet or less qualifies as a retail motor fuels outlet under the Act without application of either 50 percent test. If the property initially meets (or fails to meet) the 50-percent test but subsequently fails to meet (or meets) the test for more than a temporary period, such failure (or qualification) is treated as a change in the use of property to which § 168(i)(5) applies. S. Rep. No. 281, 104th Cong., 2nd Sess. 14–16 (1996).

Section 1120 of the Act also amended § 168(g)(3)(B) to provide that the recovery period for a retail motor fuels outlet is 20 years under the alternative depreciation system of § 168(g).

.02 Section 1120 of the Act applies to property depreciable under § 168 that is placed in service on or after August 20, 1996. Section 1120 of the Act also provides that a taxpayer may elect, in the form and manner prescribed by the Secretary of the Treasury, to apply § 1120 to property depreciable under § 168 that was placed in service before August 20, 1996. The legislative history of the Act provides that the Secretary may treat the election as a change in the taxpayer's method of accounting for the property and provide rules similar to those provided in Rev. Proc. 96–31, 1996–1 C.B. 714. The legislative history further provides that if a taxpayer has already treated the property as 15-year property the taxpayer will be deemed to have made the election for that property.

.03 For certain changes in methods of accounting for depreciation, Rev. Proc. 96–31 provides an automatic, prospective method change under which the § 481(a) adjustment is taken into account in computing the taxable income in the year of change.

.04 Except as otherwise expressly provided, a taxpayer must obtain the consent of the Commissioner of Internal Revenue to change a method of accounting for federal income tax purposes. To obtain this consent, a Form 3115, Application for Change in Accounting Method, generally must be filed within 180 days after the beginning of the taxable year in which the proposed change is to be made. Section 446(e) and § 1.446–1(e)(2)(i) and (3)(i) of the Income Tax Regulations.

.05 The Commissioner is authorized to prescribe administrative procedures setting forth the limitations, terms, and conditions the Commissioner deems necessary to obtain consent for effecting a change in method of accounting and to prevent amounts from being duplicated or omitted, including the taxable year or years in which the § 481(a) adjustment is to be taken into account. Section 1.446–1(e)(3)(ii).

.06 In computing taxable income, § 481(a) requires a taxpayer to take into account those adjustments necessary to prevent amounts from being duplicated or omitted when the taxpayer's taxable income is computed under a method of accounting different from the method used to compute taxable income for the preceding taxable year.

SECTION 3. SCOPE

.01 Except as otherwise provided in section 3.02 of this revenue procedure, this revenue procedure applies to § 1250 property that: (1) qualifies as a retail motor fuels outlet as described in

section 2.01 of this revenue procedure; (2) is depreciable under § 168; (3) was placed in service before August 20, 1996; and (4) was not treated as 15-year property under § 168 in all taxable years since the property was placed in service or, if the property changed its use from or to a retail motor fuels outlet, in all taxable years in which the property was a retail motor fuels outlet.

.02 This revenue procedure does not apply to: (1) any property depreciable under § 168 prior to its amendment by the Tax Reform Act of 1986; or (2) any property for which the taxpayer will be deemed to have made the retail motor fuels outlet election. A taxpayer will be deemed to have made this election for: (i) property placed in service before the year of change (as defined in section 5.02 of this revenue procedure) that was treated as 15-year property under § 168 in all taxable years since the property was placed in service or, if the property changed its use from or to a retail motor fuels outlet, in all taxable years in which the property was a retail motor fuels outlet; and (ii) property placed in service during the year of change (or the immediately preceding taxable year) but before August 20, 1996, that was or will be treated as 15-year property under § 168 on the taxpayer's original tax return for the year of change (or the immediately preceding taxable year).

SECTION 4. RETAIL MOTOR FUELS OUTLET ELECTION

.01 *In general.* A taxpayer may elect to treat § 1250 property within the scope of this revenue procedure as 15-year property for § 168 purposes. This election may be made separately for each property and, once made, is irrevocable.

.02 *Effect of election.* If a taxpayer makes the retail motor fuels outlet election, the taxpayer must change to a permissible depreciation method, recovery period, and convention under § 168 for the property. Under the general depreciation system of § 168(a), 15-year property generally is depreciated by using the 150-percent declining balance method of depreciation and a 15-year recovery period. Under the alternative depreciation system of § 168(g), a retail motor fuels outlet is depreciated by using the straight-line method of depreciation and a 20-year recovery period. Under both depreciation systems, the convention is the half-year convention unless the mid-quarter convention applies. The retail motor fuels outlet election does not revoke any elections previously made by the taxpayer under § 168 or enable the taxpayer to make a late election to use the straight-line method or the alternative depreciation system. However, if the taxpayer has no other 15-year property (as defined under §§ 168(e)(1) and 168(e)(3)(E)(i) and (ii)) that was placed in service during the same taxable year as the retail motor fuels outlet, the taxpayer may elect to use the straight-line method or the alternative depreciation system for the retail motor fuels outlet.

The retail motor fuels outlet election also requires the taxpayer to use a 20-year recovery period and the straight-line method for the property for alternative minimum tax purposes. *See* § 168(g)(3)(B).

SECTION 5. CHANGE IN METHOD OF ACCOUNTING

.01 *Consent.* The retail motor fuels outlet election for any property within the scope of this revenue procedure is a change in method of accounting. Under § 1.446–1(e)(2)(i), the consent of the Commissioner is hereby granted to taxpayers to make this method change for § 1250 property within the scope of this revenue procedure. This consent is granted for the taxpayer's year of change. The consent is conditioned, however, on the taxpayer's complying with this section and section 4 of this revenue procedure. If the taxpayer does not comply with these sections, the taxpayer will be deemed to have initiated a change in method of accounting without obtaining the consent of the Commissioner required under § 446(e).

.02 *Year of change.* The year of change is the taxpayer's taxable year that includes August 20, 1996, the date of enactment of the Act.

.03 *Section 481(a) adjustment.*

(1) *Amount of § 481(a) adjustment.* The § 481(a) adjustment may be a positive § 481(a) adjustment (increase in taxable income) or negative § 481(a) adjustment (decrease in taxable income). The adjustment equals the difference between the total amount of depreciation taken into account in computing taxable income for the property under the taxpayer's present method of accounting, and the total amount of depreciation allowable for the property under the taxpayer's proposed method of accounting, for any taxable year prior to the year of change. However, if the taxpayer's property underwent a change in use as described in section 2.01 of this revenue procedure, the § 481(a) adjustment must only take into account those taxable years the property qualified as a retail motor fuels outlet.

(2) *Section 481(a) adjustment period.* In computing taxable income, a taxpayer must take into account (a) the entire net negative § 481(a) adjustment in the year of change, or (b) any net positive § 481(a) adjustment ratably over 3 years, beginning with the year of change.

(3) *Alternative minimum tax.* The amounts of the § 481(a) adjustments for regular tax and alternative minimum tax purposes may differ. The § 481(a) adjustment relating to the alternative minimum taxable income will be included in the computation of the alternative minimum taxable income over the same § 481(a) adjustment period applicable under section 5.03(2) of this revenue procedure. The difference between the two § 481(a) adjustments will require an adjustment to taxable income in order to arrive at alternative minimum taxable income. See Form 6251 (Alternative Minimum Tax—Individuals) and Form 4626 (Alternative Minimum Tax—Corporations).

.04 *Manner of making method change.*

(1) *Complete and file a current Form 3115.* The retail motor fuels outlet election is made on the taxpayer's timely filed (including extensions) original federal income tax return for the year of change or on an amended return for the year of change filed no later than ____*____. The election is made by attaching a completed, current Form 3115 to the taxpayer's original or amended return for the year of change. The requirement to file a Form 3115 within 180 days after the beginning of the year of change is waived in accordance with § 1.446–1(e)(3)(ii). In addition, a copy of the Form 3115 must be filed with the national office no later than when the original Form 3115 is filed with the federal income tax return or the amended return. The copy should be sent to the Commissioner of Internal Revenue, Attention: Office of Assistant Chief Counsel (Passthroughs and Special Industries) CC:DOM:P&SI, P.O. Box 7604, Benjamin Franklin Station, Washington, D.C. 20024.

* Insert the date that is 180 days after the publication of this revenue procedure.

If more than one member of a consolidated group is making the retail motor fuels outlet election, the parent corporation may file a single Form 3115 on behalf of the members of the consolidated group making the election in accordance with Rev. Proc. 92–90, 1992–2 C.B. 501 (or any successor). See section 5.02 of Rev. Proc. 92–90 for the information required to be submitted with the Form 3115.

In completing the current Form 3115 (Rev. February 1996), the taxpayer must complete Schedule D, Part II, Change in Depreciation or Amortization (page 7 of the Form 3115), and any other applicable schedule. With respect to Parts I through III on pages 1 and 2 of the Form 3115 the taxpayer must provide only the information requested on the following lines:

(a) Part I, Eligibility To Request Change (page 1)-lines 1, 2a, 2b, 3a, 4a, 5a, and 6;

(b) Part II, Description of Change (page 2)-lines 7, 8, and 10; and

(c) Part III, Section 481(a) Adjustment (page 2)-lines 20, 22, 23, and 25. Include on line 20 the amounts of the § 481(a) adjustments for regular tax and alternative minimum tax purposes. The taxpayer does not have to complete Part IV, Additional Information (page 3).

(2) *No user fee.* No user fee is required for a Form 3115 filed under this revenue procedure.

.05 *Basis adjustment.* As of the beginning of the year of change, the basis of the property for which the retail motor fuels outlet election is made must reflect the reductions required by § 1016(a)(2) for the depreciation allowable for the property (as determined under the taxpayer's proposed method of accounting) for all open and closed years prior to the year of change.

.06 *Protection from examination changes.*

(1) *In general.* If a taxpayer timely files a completed Form 3115 to change its method of accounting in the manner described in this revenue procedure and otherwise complies with the provisions of this revenue procedure, the district director may not propose that the taxpayer change the same method of accounting as that changed by the taxpayer under this revenue procedure for a year prior to the year of change prescribed in this revenue procedure. The district director, however, may verify the facts underlying the method change, including whether the property qualifies as a retail motor fuels outlet, the amounts of the regular tax and alternative minimum tax § 481(a) adjustments, the § 481(a) adjustment period, and the § 1016(a)(2) adjustment to the basis of the property.

(2) *Taxpayer under examination, before an appeals office, or before a federal court.* If a change in method of accounting under this revenue procedure results in a positive § 481(a) adjustment for an item of property, a taxpayer does not receive the protection from examination changes described in section 5.06(1) of this revenue procedure for that property if, on ___**___, the method of accounting is an issue:

(a) under consideration with respect to an examination of the taxpayer's federal income tax return for any taxable year. The issue is under consideration if the taxpayer has received written notification from the examining agent(s) (*e.g.*, by examination plan, information document request, notification of proposed adjustments or income tax examination changes) specifically citing the method of accounting as an issue under consideration for the taxable year(s) under examination;

(b) before an appeals office of the Internal Revenue Service with respect to an examination of the taxpayer's federal income tax return for any taxable year; or

(c) before a federal court.

** Insert the date of publication of this revenue procedure.

SECTION 6. EFFECTIVE DATE

.01 *In general*. This revenue procedure is effective for a taxpayer's taxable year that includes August 20, 1996, the date of enactment of the Act.

.02 *Form 3115 pending with the Service.* Because this revenue procedure provides the exclusive procedure for making the retail motor fuels outlet election, the national office will return any Form 3115 filed with the national office under Rev. Proc. 92–20, 1992–1 C.B. 685, or Rev. Proc. 96–31 for a change in method of accounting within the scope of this revenue procedure. A taxpayer that has timely filed a Form 3115 with the national office prior to the publication date of this revenue procedure must use this revenue procedure and will be so notified to this effect by the national office. If all of the property subject to the Form 3115 appears to be within the scope of this revenue procedure, any user fee submitted with the Form 3115 will be returned to the taxpayer.

.03 *Claim for refund pending with the Service.* Because this revenue procedure provides the exclusive procedure for making the retail motor fuels outlet election provided by § 1120 of the Act, the Service will deny any claim for refund that is filed to make this election, except for any amended return filed under section 5.04(1) of this revenue procedure.

SECTION 7. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 92–20, 1992–1 C.B. 685, is modified.

DRAFTING INFORMATION

The principal author of this revenue procedure is Mark Pitzer of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue procedure, contact Mark Pitzer at (202) 622–3110 (not a toll-free call).

Part IV. Items of General Interest

Extension of Test of Mediation Procedure for Appeals

Announcement 97–1

SUMMARY: This document extends the test of the mediation procedure set forth in Announcement 95–86, 1995–44 I.R.B. 27, for an additional one-year period beginning on January 13, 1997.

FOR FURTHER INFORMATION CONTACT: Thomas Carter Louthan, Director, Office of Dispute Resolution and Specialty Programs, National Office Appeals, (202) 401–4098 (not a toll-free number).

EXTENSION OF TEST OF MEDIATION PROCEDURE FOR APPEALS

Summary: This procedure allows taxpayers, in certain cases that are already in the Appeals administrative process and that are not docketed in any court, to request mediation of one or more issues as a dispute resolution technique. Under the procedure, the taxpayer and Appeals attempt to negotiate a settlement, assisted by an objective and neutral third party who has no authority to impose a decision. This document extends the test of the mediation procedure set forth in Announcement 95–86 for an additional one-year period.

Background: Announcement 95–86, which contains the procedures that taxpayers may use to request mediation, applies to issues in Coordinated Examination Program cases assigned to Appeals Team Chiefs. A one-year test of the mediation procedure concluded on October 30, 1996. During this period, nine requests for mediation were made, in which four were approved. The mediation program is consistent with IRS' efforts to improve tax administration, provide customer service and reduce taxpayer burden. During the additional one-year test period, Appeals will try mediation in more cases so that the program can be further evaluated.

Effective Date: This Announcement extends the test of the mediation procedure set forth in Announcement 95–86 for an additional one-year period beginning on January 13, 1997.

For further information contact: Thomas Carter Louthan, Director, Office of Dispute Resolution and Specialty Programs, National Office Appeals, (202) 401–4098 (not a toll-free number).

Change to Schedule Q

Announcement 97–2

This announcement modifies Schedule Q (January 1996) of the Form 5300 series applications to reflect amendments to § 401(a)(26) of the Internal Revenue Code made by § 1432 of the Small Business Job Protection Act of 1996 (SBJPA), effective for plan years beginning after December 31, 1996.

Beginning with the 1997 plan year, the minimum participation requirements of § 401(a)(26) apply only to defined benefit plans. Therefore, until the application form is revised, applicants requesting a determination letter for a defined contribution plan for plan years beginning after December 31, 1996, may answer "Yes" to questions 2a and 2i of Part II of Schedule Q (January 1996). The additional information described in the instruction to line 2(a) (Demo 2) need not be submitted for defined contribution plans.

Applicants should note that § 401(a)(26)(A)(ii) was amended by SBJPA to require a plan to benefit at least 2 employees (or 1 employee if there is only 1 employee) for plan years after December 31, 1996. Schedule Q does not reflect this modification to § 401(a)(26)(A)(ii).

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

Announcement 97–3

The name of an organization that no longer qualifies as an organization described in section 170(c)(2) of the Internal Revenue Code of 1986 is listed below.

Generally, the Service will not disallow deductions for contributions made to a listed organization on or before the date of announcement in the Internal Revenue Bulletin that an organization no longer qualifies. However, the Service is not precluded from disallowing a deduction for any contributions made after an organization ceases to qualify under section 170(c)(2) if the organization has not timely filed a suit for declaratory judgment under section 7428 and if the contributor (1) had knowledge of the revocation of the ruling or determination letter, (2) was aware that such revocation was imminent, or (3) was in part responsible for or was aware of the activities or omissions of the organization that brought about this revocation.

If on the other hand a suit for declaratory judgment has been timely filed, contributions from individuals and organizations described in section 170(c)(2) that are otherwise allowable will continue to be deductible. Protection under section 7428(c) would begin on (DATE) 1997, and would end on the date the court first determines that the organization is not described in section 170(c)(2) as more particularly set forth in section 7428(c)(1). For individual contributors, the maximum deduction protected is $1,000, with a husband and wife treated as one contributor. This benefit is not extended to any individual who was responsible, in whole or in part, for the acts or omissions of the organization that were the basis for revocation.

H & M Home for Alternative Living
Detroit, MI

Definition of Terms

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

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

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

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

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

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

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

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

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

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

Abbreviations

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

A—Individual.

Acq.—Acquiescence.

B—Individual.

BE—Beneficiary.

BK—Bank.

B.T.A.—Board of Tax Appeals.

C.—Individual.

C.B.—Cumulative Bulletin.

CFR—Code of Federal Regulations.

CI—City.

COOP—Cooperative.

Ct.D.—Court Decision.

CY—County.

D—Decedent.

DC—Dummy Corporation.

DE—Donee.

Del. Order—Delegation Order.

DISC—Domestic International Sales Corporation.

DR—Donor.

E—Estate.

EE—Employee.

E.O.—Executive Order.

ER—Employer.

ERISA—Employee Retirement Income Security Act.

EX—Executor.

F—Fiduciary.

FC—Foreign Country.

FICA—Federal Insurance Contribution Act.

FISC—Foreign International Sales Company.

FPH—Foreign Personal Holding Company.

F.R.—Federal Register.

FUTA—Federal Unemployment Tax Act.

FX—Foreign Corporation.

G.C.M.—Chief Counsel's Memorandum.

GE—Grantee.

GP—General Partner.

GR—Grantor.

IC—Insurance Company.

I.R.B.—Internal Revenue Bulletin.

LE—Lessee.

LP—Limited Partner.

LR—Lessor.

M—Minor.

Nonacq.—Nonacquiescence.

O—Organization.

P—Parent Corporation.

PHC—Personal Holding Company.

PO—Possession of the U.S.

PR—Partner.

PRS—Partnership.

PTE—Prohibited Transaction Exemption.

Pub. L.—Public Law.

REIT—Real Estate Investment Trust.

Rev. Proc.—Revenue Procedure.

Rev. Rul.—Revenue Ruling.

S—Subsidiary.

S.P.R.—Statements of Procedural Rules.

Stat.—Statutes at Large.

T—Target Corporation.

T.C.—Tax Court.

T.D.—Treasury Decision.

TFE—Transferee.

TFR—Transferor.

T.I.R.—Technical Information Release.

TP—Taxpayer.

TR—Trust.

TT—Trustee.

U.S.C.—United States Code.

X—Corporation.

Y—Corporation.

Z—Corporation.

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[1]A cumulative list of all Revenue Rulings, Revenue Procedures, Treasury Decisions, etc., published in Internal Revenue Bulletins 1996–1 through 1996–26 will be found in Internal Revenue Bulletin 1996–27, dated July 1, 1996.

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[1]A cumulative finding list for previously published items mentioned in Internal Revenue Bulletins 1996–27 through 1996–53 will be found in Internal Revenue Bulletin 1996–27, dated January 6, 1997.