aliquot of the stock solution and further dilute with sterile distilled water to the reference concentration of 0.100 microgram of doxycycline per milliliter (estimated).

(2) *Moisture.* Proceed as directed in § 436.201 of this chapter.

(3) *Dissolution.* Proceed as directed in § 436.541 of this chapter, except in lieu of paragraph (d) of that section, use the interpretation described in the United States Pharmacopeia XX dissolution test. The quantity, *Q* (the amount of doxycycline dissolved) is 55 percent at 60 minutes and 85 percent at 90 minutes.

(4) *Indentity.* Proceed as directed in § 436.308 of this chapter, except prepare the sample and standard solutions as follows: Grind tablet to a powder. Dissolve precise amount of the doxycycline tablet and of the doxycycline working standard in methanol and further dilute each solution to a concentration of 1 milligram of doxycycline per milliliter. Prepare the sample-standard mixed solution by mixing equal volumes of the final standard and sample solutions. The standard and sample must each produce a major, yellow flourescent spot with the same R_f value and the standard-sample mixed solution must show no separation of major spots.

This regulation announces standards that FDA has accepted in a request for approval of an antibiotic drug. In accordance with the conditions for certification in section 507 of the act, FDA permits the manufacturer to market this drug on a "release" status pending the regulation's becoming effective. Because this regulation is not controversial and because when effective it provides notice of accepted standards and permits earlier certification of regulated products, notice and comment procedure and delayed effective date are found to be unnecessary and not in the public interest. The amendment, therefore, is effective upon the date of publication in the **Federal Register**. However, interested persons may, on or before February 23, 1981, submit to the Dockets Management Branch (HFA–305), Food and Drug Administration, Rm. 4–62, 5600 Fishers Lane, Rockville, MD 20857, written comments on this rule. Four copies of any comments are to be submitted, except that individuals may submit one copy. Comments are to be identified with the docket number found in brackets in the heading of this document. Received comments may be seen in the Dockets Management Branch office between 9 a.m. and 4 p.m., Monday through Friday.

Any person adversely affected by this regulation may file objections to it, request a hearing, and show reasonable ground for the hearing. Any person who decides to seek a hearing must file (1) on or before February 23, 1981, a written notice of participation and request for hearing, and (2) on or before March 24, 1981, the data, information, and analyses on which the person relies to justify a hearing, as specified in 21 CFR 430.20. A request for a hearing may not rest upon mere allegations or denials, but must set forth specific facts showing that there is a genuine and substantial issue of fact that requires a hearing. If it conclusively appears from the face of the data, information, and factual analyses in the request for a hearing that no genuine and substantial issue of fact precludes the action taken by this order, or if a request for hearing is not made in the required format or with the required analyses, the Commissioner of Food and Drugs will enter summary judgment against the person(s) who request(s) the hearing, making findings and conclusions and denying a hearing.

The procedures and requirements governing this order, a notice of participation and request for hearing, a submission of data, information, and analyses to justify a hearing, other comments, and grant or denial of a hearing are contained in 21 CFR 430.20.

All submissions under this order must be filed in four copies, identified with the docket number appearing in the heading of this order and filed with the Dockets Management Branch (HFA–305), Food and Drug Administration, Rm. 4–62, 5600 Fishers Lane, Rockville, MD 20857.

All submissions under this order, except for data and information prohibited from public disclosure under 21 U.S.C 331(j) or 18 U.S.C. 1905, may be seen in the office of the Dockets Management Branch, between 9 a.m. and 4 p.m., Monday through Friday.

Effective date. This regulation shall be effective January 23, 1981.

(Sec. 507, 59 Stat. 463 as amended (21 U.S.C. 357))

Dated: January 12, 1981.

Mary A. McEniry,

Assistant Director for Regulatory Affairs, Bureau of Drugs.

[FR Doc. 81-2205 Filed 1-22-81; 8:45 am]

BILLING CODE 4110-03-M

21 CFR Part 449

[Docket No. 80N-0300]

Antifungal Antibiotic Drugs Griseofulvin (Ultramicrosize) Tablets

AGENCY: Food and Drug Administration.

ACTION: Final rule.

SUMMARY: The Food and Drug Administration (FDA) amends the antibiotic drug regulations to provide for certification of a new type (without polyethylene glycol 6,000) of griseofulvin (ultramicrosize) tablet. The manufacturer has supplied sufficient data and information to establish its safety and efficacy.

DATES: Effective January 23, 1981; comments by February 23, 1981.

ADDRESS: Written comments to the Dockets Management Branch (formerly the Hearing Clerk's office) (HFA–305), Food and Drug Administration, Rm. 4–62, 5600 Fishers Lane, Rockville, MD 20857.

FOR FURTHER INFORMATION CONTACT: Joan Eckert, Bureau of Drugs (HFD–140), Food and Drug Administration, 5600 Fishers Lane, Rockville, MD 20857, 301–443–4290.

SUPPLEMENTARY INFORMATION: FDA has evaluated data submitted in accordance with regulations promulgated under section 507 of the Federal Food, Drug, and Cosmetic Act (21 U.S.C. 357), as amended, with respect to providing for the certification of a new type (without polyethylene gylcol 6,000) of griseofulvin (ultramicrosize) tablet. The agency concludes that the data supplied by the manufacturer concerning this antibiotic drug are adequate to establish its safety and efficacy when the drug is used as directed in the labeling and that the regulations should be amended in Part 449 (21 CFR Part 449) to provide for its certification.

The agency has determined pursuant to 21 CFR 25.24(b)(22) (proposed December 11, 1979, 44 FR 71742), that this action is of a type that does not individually or cumulatively have a significant impact on the human environment. Therefore, neither an environmental assessment nor an environmental impact statement is required.

Therefore, under the Federal Food, Drug, and Cosmetic Act (sec. 507, 59 Stat. 463 as amended (21 U.S.C. 357)) and under authority delegated to the Commissioner of Food and Drugs (21 CFR 5.1), Part 449 is amended in § 449.120d by revising paragraphs (a)(1) and (a)(3)(i)(*a*), to read as follows:

§ 449.120d Griseofulvin (ultramicrosize) tablets.

(a) * * *

(1) *Standards of identity, strength, quality, and purity.* Griseofulvin (ultramicrosize) tablets are composed of ultramicrosize crystals of griseofulvin which may or may not be dispersed in polyethylene glycol 6,000. Each tablet contains 125 milligrams of griseofulvin. The griseofulvin content is satisfactory if it is not less than 90 percent and not more than 115 percent of the number of milligrams of griseofulvin that it is represented to contain. The loss on drying is not more than 5.0 percent. It passes the solubility characteristic test. If it is dispersed in polyethylene glycol 6,000, the griseofulvin used conforms to the standards prescribed by § 449.20(a)(1). If it is not dispersed in polyethylene glycol 6,000, the griseofulvin used conforms to the standards prescribed by § 449.20(a)(1), except specific surface area.

* * * * *

(3) * * *

(i) * * *

(*a*) The griseofulvin used in making the batch for potency, safety, loss on drying, melting point, specific rotation, identity, residue on ignition, heavy metals, specific surface area (if it is dispersed in polyethylene glycol 6,000), and crystallinity.

* * * * *

This regulation announces standards that FDA has accepted in a request for approval of an antibiotic drug. In accordance with the conditions for certification in section 507 of the act, FDA permits the manufacturer to market this drug on a "release" status pending the regulation's becoming effective. Because this regulation is not controversial and because when effective it provides notice of accepted standards and permits earlier certification of regulated products, notice and comment procedure and delayed effective date are found to be unnecessary and not in the public interest. The amendment, therefore, is effective upon the date of publication in the **Federal Register.** However, interested persons may, on or before February 23, 1981, submit to the Dockets Management Branch (HFA–305), Food and Drug Administration, Rm. 4–62, 5600 Fishers Lane, Rockville, MD 20857, written comments on this rule. Four copies of any comments are to be submitted, except that individuals may submit one copy. Comments are to be identified with the Docket number found in brackets in the heading of this document. Received comments may be seen in the Dockets Management Branch office between 9 a.m. and 4 p.m., Monday through Friday.

Any person who will be adversely affected by this regulation may file objections to it, request a hearing, and show reasonable grounds for the hearing. Any person who decides to seek a hearing must file (1) on or before February 23, 1981, a written notice of participation and request for hearing, and (2) on or before March 24, 1981, the data, information, and analyses on which the person relies to justify a hearing, as specified in 21 CFR 430.20. A request for a hearing may not rest upon mere allegations or denials, but must set forth specific facts showing that there is a genuine and substantial issue of fact that requires a hearing. If it conclusively appears from the face of the data, information, and factual analyses in the request for a hearing that no genuine and substantial issue of fact precludes the action taken by this order, or if a request for hearing is not made in the required format or with the required analyses, the Commissioner of Food and Drugs will enter summary judgment against the person(s) who request(s) the hearing, making findings and conclusions and denying a hearing.

The procedures and requirements governing this order, a notice of participation and request for hearing, a submission of data, information, and analyses to justify a hearing, other comments, and grant or denial of a hearing are contained in 21 CFR 430.20.

All submissions under this order must be filed in four copies, identified with the docket number appearing in the heading of this order and filed with the Dockets Management Branch (HFA–305), Food and Drug Administration, Rm. 4–62, 5600 Fishers Lane, Rockville, MD 20857.

All submissions under this order, except for data and information prohibited from public disclosure under 21 U.S.C. 331(j) or 18 U.S.C. 1905, may be seen in the office of the Dockets Management Branch, between 9 a.m. and 4 p.m., Monday through Friday.

Effective date. This regulation shall be effective January 23, 1981.

(Sec. 507, 59 Stat. 463 as amended (21 U.S.C. 357))

Dated: January 12, 1981.

Mary A. McEniry,

Assistant Director for Regulatory Affairs, Bureau of Drugs.

[FR Doc. 81–2204 Filed 1–22–81; 8:45 am]

BILLING CODE 4110–03–M

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[T.D. 7762]

Income Tax; Defined Benefit Plans for Self-Employed Individuals and Shareholder-Employees

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document provides final regulations relating to defined benefit plans for self-employed individuals and shareholder-employees. Changes to the applicable tax law were made by the Employee Retirement Income Security Act of 1974. These regulations provide necessary guidance to the public for compliance with the law and affect sole proprietorships, partnerships, and "Subchapter S" corporations which maintain tax-qualified defined benefit plans.

DATE: The regulations are generally effective for taxable years beginning after December 31, 1975, and to plan years beginning with or within such taxable years.

FOR FURTHER INFORMATION CONTACT: Richard J. Wickersham of the Employee Plans and Exempt Organizations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, D.C. 20224 (Attention: CC:LR:T) (202–566–3250) (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On May 26, 1978, the **Federal Register** published proposed amendments to the Income Tax Regulations (26 CFR Part 1) under sections 401(a)(18), 401(j), 404 and 1379 of the Internal Revenue Code of 1954 (43 FR 22734). The amendments were proposed to conform the regulations to section 2001(d) of the Employee Retirement Income Security Act of 1974 (88 Stat. 953). A public hearing was held on October 4, 1978. After consideration of all comments regarding the proposed amendments, those amendments are adopted as revised by this Treasury decision.

Organization of the Regulations

In response to criticism that the proposed regulations were unnecessarily confusing, the final regulations have been reorganized. The sections have been substantially reordered, but the substance is unchanged except as discussed below.

Defined Benefit Plans

Section 401(j) applies only to defined benefit plans benefitting self-employed individuals or shareholder-employees. Several commentators asked whether a target benefit plan would be considered a defined benefit plan for purposes of section 401(j). A target benefit plan is a money purchase pension plan which specifies a targeted benefit commencing at normal retirement age. Under such a plan contributions equal the amount necessary to fund the targeted benefit if all the actuarial assumptions are realized. However, because contributions are not adjusted to reflect experience gains and losses, a participant's actual benefit, which is provided solely from amounts allocated to the participant's account, may differ from the participant's targeted benefit. A sentence has been added to § 1.401(j)–1(a)(2) to make it clear that a target benefit plan is not a defined benefit plan even though the amount contributed is based on estimates of amounts necessary to fund specified benefits.

Adjustments for Nonbasic Benefits

Several commentators objected to adjustments to the statutory percentages for various nonbasic benefits, particularly pre-retirement death benefits and qualified joint and survivor annuities. Other commentators suggested that organizations other than insurance companies, such as banks and savings and loans, be permitted to offer benefits for a term greater than life expectancies. Benefits for longer than life expectancy are permitted, although an adjustment is required because benefits for any period other than life are nonbasic benefits. However, adjustments for nonbasic benefits are required under section 401(j)(3)(B)(ii) to provide for comparability between defined contribution and defined benefit plans for owner-employees and shareholder-employees. Therefore these adjustments cannot be eliminated. Section 1.401(j)–1(g)(2)(i) of the final regulations provides that the actuarial equivalents for nonbasic benefits must be based on the 1971 Group Annuity Mortality Table for males and an interest rate of 6% compounded annually. These are the assumptions used to determine the applicable percentages in section 401(j)(3) and § 1.401(j)–1(f)(1).

Several commentators objected to the prohibition of cost of living adjustments in proposed § 1.401(j)–1(g)(2)(ii). As a result, cost of living adjustment has been added to the list of nonbasic benefits in § 1.401(j)–1(g)(3)(i) of the final regulations. While the cost of living adjustment may be based on any index (for example, the Consumer Price Index, the performance of a particular group of stocks, or the prime rate) the plan must provide a maximum annual percentage increase. The adjustments for cost of living adjustments will be based on those maximums.

Adjustments for various nonbasic benefits were set forth in a proposed Revenue Ruling, IRS Announcement 78–96, 1978–23 I.R.B. 42 (June 5, 1978). The Service intends to finalize that Revenue Ruling in the near future.

Multiple Plans

Proposed § 1.401(j)–2(b) provided that benefits under all plans of a single employer and all plans in which an individual is a self-employed individual would be aggregated in determining whether the benefit for that individual exceeds the maximum basic benefit permitted under section 401(j). Several commentators suggested that the final regulations clarify to what extent Subchapter S plans must be aggregated, for purposes of section 401(j), with other Keogh, Subchapter S and non-Subchapter S corporate plans that are aggregated under section 414 (b) or (c).

Under § 1.401(j)–2(a) of the final regulations Subchapter S plans must be aggregated with other Subchapter S or Keogh plans only if they are part of a controlled group within the meaning of section 414 (b) or (c). If a controlled group includes both Subchapter S corporations and non-Subchapter S corporations, the plans of the non-Subchapter S corporations will be disregarded for purposes of section 401(j). All Keogh plans in which an individual is a self-employed individual must be aggregated, whether or not under common control.

Aggregating Plans

Section 1.401(j)–2(c) provides a method for determining the maximum benefit permitted on behalf of an employee subject to the limitations of section 401(j) when a defined benefit plan and defined contribution plan covering that employee are required to be aggregated. Under this method the plan first determines the 401(j) defined contribution fraction (the amount deductible for the participant under the defined contribution plan over the maximum amount deductible). The 401(j) defined benefit fraction is then determined by subtracting the 401(j) defined contribution fraction from one.

A new provision has been added to § 1.401(j)–2(c)(3) to cover situations where the 401(j) defined contribution fraction varies from year to year because of varying contributions.

Insured Plans

Section 1.401(j)–2(c) of the proposed regulations provided an adjustment to a participant's maximum benefit under a fully insured plan if the cash value exceeded the rates set forth in that paragraph of the proposed regulations. That rule has been revised in the final regulations. New § 1.401(j)–4(a) limits the cash value which may be accumulated under a fully insured level premium plan described in section 412(i). New § 1.401(j)–4(b)(1) limits the value of all other insurance or annuity contracts to the actuarial equivalent of the maximum benefit, using the same assumptions used to determine the applicable percentages (1971 Group Annuity Mortality Table (male) without projection and 6 percent interest compounded annually). For single premium participating or variable annuity contracts purchased at or near normal retirement age the value of the contract equals the premium. Limits on variable or participating contracts purchased at other times or in installments equals the premium for a comparable single premium contract.

Under § 1.401 (j)–4 (c) of the final regulations, an insured plan that does not distribute insurance or annuity contracts to its participants or otherwise provide that a participant may receive the cash surrender value or dividends under such contract will not be subject to the limitations of § 1.401 (j)–4.

Participating and Variable Annuities

Proposed § 1.401 (j)–1(g)(2)(ii) prohibited variable annuities in section 401(j) plans. Several commentators objected that variable benefits may be a desirable feature in a defined benefit plan. As a result of these comments, the final regulations permit the use of participating and variable annuity contracts in section 401(j) plans.

Transitional Rule

Section 401(j) and the regulations thereunder are effective for taxable years beginning after December 31, 1975. However, § 1.401(j)–6(b) provides a transitional period during which a plan can be amended to limit future accruals to compensate for accruals in excess of the maximum benefit permitted under section 401(j). Under the proposed regulations, the transitional rule applied only to excess benefits accrued in plan years beginning before July 25, 1978. Under the final regulations, the transitional rule applies to all plan years beginning before January 23, 1982.

The transitional rule has also been expanded to explain how a plan can limit future accruals to comply with the

transitional rule. A fully insured level premium plan described in section 412(i) will comply with the transitional rule if a new level premium is established which, when combined with the cash surrender value of the current contract, will result in a cash surrender value at or below the limits described in § 1.401(j)–4(a).

Integration

Several commentators were uncertain whether a Subchapter S plan could be integrated with Social Security. Section 401(j)(4) and § 1.401(j)–2(f) provide that a plan benefiting owner-employees will not satisfy the requirements of section 401(j) unless the plan is nondiscriminatory without taking into account contributions or benefits provided under Social Security or other state or federal law. There is no similar restriction on plans benefiting shareholder-employees. Thus, a Subchapter S plan may be integrated with Social Security.

Drafting Information

The principal author of this regulation is Ellen A. Hennessy of the Employee Plans and Exempt Organizations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulation, both on matters of substance and style.

Adoption of Amendments to the Regulations

Accordingly—

1. Paragraphs 3 and 4, as set forth in the notice of proposed rulemaking, are withdrawn.

2. The other amendments to 26 CFR Part 1 are hereby adopted as set forth below.

Paragraph 1. Section 1.401(a)–18, as set forth in paragraph 1 of the notice of proposed rulemaking, is added immediately after § 1.401(a)–17:

§ 1.401(a)–18 Special requirements for defined benefit plans providing benefits for self-employed individuals or shareholder-employees.

For special requirements which apply to a defined benefit plan which provides benefits for an employee who is either an employee within the meaning of section 401(c)(1) or a shareholder-employee within the meaning of section 1379(d), see §§ 1.401(j)–1 through 1.401(j)–6.

Par. 2. Sections 1.401(j)–1 through 1.401(j)–6, as set forth in paragraph 2 of the notice of proposed rulemaking, are revised to read as follows and added immediately after § 1.401(e)–6:

§ 1.401(j)–1 Defined benefit plans covering self-employed individuals or shareholder-employees.

(a) *Application of section 401(j)*—(1) *Qualification.* A defined benefit plan (as defined in section 414(j)) which provides benefits for a self-employed individual or shareholder-employee is not a qualified plan (and a trust forming part of such plan is not a qualified trust) unless the plan satisfies the applicable requirements of section 401(j) and §§ 1.401(j)–1 through 1.401(j)–6. "Self-employed individual" refers to an employee within the meaning of section 401(c)(1). "Shareholder-employee" refers to a shareholder-employee of an electing small business (Subchapter S) corporation within the meaning of section 1379(d).

(2) *Section 401(j) limitation.* Except in the case of a final average pay plan, section 401(j) imposes a limitation on the amount of the basic benefit, as defined in paragraph (c)(2) of this section, which may be accrued under a defined benefit plan for any plan year of participation, as defined in paragraph (c)(4)(iii) of this section, by any employee who is either a self-employed individual or a shareholder-employee. Section 401(j) and this section do not, however, limit the benefit of an employee which may be accrued under a plan for any plan year in which the employee is neither a self-employed individual nor a shareholder-employee nor do they require a plan to provide accrued benefits in the form of a basic benefit. For purposes of section 401(j), a target benefit plan is not a defined benefit plan.

(3) *Outline of regulations*—(i) *Limitations on benefits-career average plans.* This section (§ 1.401(j)–1) provides limitations on benefits under section 401(j) for plans other than final average pay plans ("career average plans").

(ii) *Aggregation of plans and other plan requirements.* Section 1.401(j)–2 provides rules under section 401(j)(1) (relating to certain plan aggregations) and under section 401(j)(4) (relating to the requirement that a plan covering owner-employees may not be integrated with social security, etc.).

(iii) *Changes in accrual rate or compensation base-career average plans.* Section 1.401(j)–3 provides rules under section 401(j)(3)(B)(iii) relating to changes in the rate of benefit accrual and compensation base under a career average plan.

(iv) *Insured plans.* Section 1.401(j)–4 provides a special rule for certain plans funded with insurance or annuity contracts.

(v) *Final average pay plan.* Section 1.401(j)–5 provides limitations on benefits under section 401(j) for final average pay plans. A final average pay plan is a defined benefit plan accruing benefits based on the employee's compensation over a period less than the total period of the employee's participation in the plan. Thus, for example, a plan which provides that an employee's accrued benefit is based on compensation earned over the last five years would be a final average pay plan.

(vi) *Effective dates.* Section 1.401(j)–6 provides the effective dates for the application of section 401(j) to a plan and special transitional rules.

(b) *Maximum benefit—career average plan*—(1) *In general.* For purposes of section 401(j), in the case of a plan other than a final average pay plan or an insured plan described in § 1.401(j)–4 (a) or (b), the maximum benefit of a self-employed individual or a shareholder employee for a plan year equals—

(i) The employee's annual compensation not in excess of the compensation base for such year, as defined in paragraph (d)(2) of this section, multiplied by

(ii) The applicable percentage as determined under paragraphs (c), (d)(1), and (e) of this section and § 1.401(j)–3 (change in compensation base or rate of accrual), if applicable.

For special rules governing final average pay plans, see § 1.401 (j)–5.

(2) *No possibility of excess accruals.* A plan to which this section applies is not a qualified plan (and a trust forming a part of such a plan is not a qualified trust) if the benefit accruing under the plan for any plan year of participation by an employee exceeds the maximum benefit. Further, the plan is not qualified unless the plan contains provisions that preclude any such benefit accrual proscribed in the preceding sentence, irrespective of whether or not there is, in fact, an excess accrual for such an employee.

(3) *Section 415 limitations.* A plan to which this section applies is also subject to the limitations on benefits set forth in section 415. Consequently, even though a plan provides benefits which are not in excess of the maximum benefit set forth in this section, the plan will not be qualified under section 401(a) if the plan benefits are in excess of the section 415 limitations.

(c) *Applicable percentage*—(1) *Table of applicable percentages.* For purposes of section 401(j) and the regulations thereunder, the applicable percentage for an employee for any plan year shall

be the percentage shown on the following table opposite the age of the employee at the time the current period of participation in the plan by the employee began, with adjustments as provided by these regulations:

Age	Applicable percentage
30 or less	6.5
31	6.3
32	6.0
33	5.8
34	5.6
35	5.4
36	5.1
37	4.9
38	4.8
39	4.6
40	4.4
41	4.2
42	4.1
43	3.9
44	3.8
45	3.6
46	3.5
47	3.4
48	3.2
49	3.1
50	3.0
51	2.9
52	2.8
53	2.7
54	2.6
55	2.5
56	2.4
57	2.3
58	2.2
59	2.1
60 or over	2.0

The applicable percentages above may be adjusted by the Commissioner from time to time to take into account changes in prevailing interest and mortality rates occurring after December 31, 1973.

(2) *Basic benefit.* The term "basic benefit" means that—

(i) The benefit is in the form of a straight life annuity,

(ii) The benefit commences at the later of age 65, or the day 5 years after the day the participant's current period of participation began,

(iii) The plan provides no ancillary benefits, and

(iv) The employee does not contribute to the plan.

(3) *Adjustments for nonbasic benefits.* (i) A plan to which section 401(j) applies may provide benefits other than the basic benefit. Other benefits which a plan may provide include, but are not limited to, pre-retirement death and disability benefits, benefits that vary with a cost of living formula (up to a maximum stated by the plan), and benefits payable in the form of either a joint and survivor annuity or an annuity certain for a specified period. The Commissioner shall provide adjustments to the applicable percentage for such nonbasic benefits, based on the 1971 Group Annuity Mortality Table (male) without projection and an assumed interest rate of 6 percent compounded annually, to assure that the total benefit, including the nonbasic benefit, does not exceed the actuarial equivalent of the maximum basic benefit.

(ii) If a plan provides a benefit in the form of life, accident, health, or other insurance protection, no adjustment is required for any such plan benefit attributable to amounts considered to be contributed by the employee under the rules of section 72(f) and paragraph (b) of § 1.72–16 if such amounts are includable in the employee's gross income.

(4) *Definitions*—(i) *Determination of ages.* For determining the applicable percentage, the age of an employee when the employee's current period of participation began is the employee's age (last birthday) on or before the beginning of the first plan year in the current period of participation.

(ii) *Current period of participation.* The term "current period of participation" means any period of consecutive plan years of participation beginning with the first day of the first plan year of participation in the period and ending with the last day of the last consecutive plan year of participation in the period. The status of an employee at the time the employee's current period of participation began (*i.e.*, as a common-law employee, self-employed individual, or shareholder-employee) is not relevant.

(iii) *Plan year of participation.* The term "plan year of participation" means a plan year for which a participant accrues a benefit under the terms of the plan (determined only with respect to benefits provided by the plan and without regard to any plan provision not in effect in that plan year). Thus, for example, benefits provided under the Social Security Act or past service benefits for prior years are not included for purposes of determining plan year of participation.

(d) *Compensation and compensation base*—(1) *Compensation.* The term "compensation" means—

(i) In the case of a self-employed individual, the earned income of the individual,

(ii) In the case of a shareholder-employee, the compensation received (or accured in the case of an individual who computes income under the accrual method) by the individual from the electing small business corporation, or

(iii) In the case of any employee not included in subdivision (i) or (ii) for any relevant year, the compensation includible in the individual's gross income derived from the sole proprietorship, partnership or electing small business corporation (see the change in status rules in paragraph (e) of this section for application of this provision).

(2) *Compensation base.* The term "compensation base" means the highest level of annual compensation of the employee which may be taken into account for a plan year under the plan for determining benefits. The compensation base must be specified in the plan and may not exceed $100,000. If a plan initially specifies a compensation base in excess of $50,000, the applicable percentage shall be adjusted by multiplying such percentage by the ratio of $50,000 to the initial compensation base of the plan. For rules applicable to plans which change compensation bases, see § 1.401(j)–3.

(e) *Change in status*—(1) *Participant becomes subject to section 401(j).* In the case of a participant who is neither a self-employed individual nor a shareholder-employee and who becomes a self-employed individual or shareholder-employee during the plan year, the applicable percentage for such year is not less than the applicable percentage determined under this section for the age of the participant when he becomes a self-employed individual or shareholder-employee. A higher applicable percentage is allowed, limited to the accrual rate established by the lesser of (A) the past accrual rate for the participant or (B) the applicable percentage determined under this section for the age when the participant's current period of participation commenced, and for the compensation base in effect when the participant becomes a self-employed individual or shareholder-employee.

(2) *Subchapter S plan.* If a defined benefit plan of a Subchapter S corporation is established prior to the first plan year to which section 401(j) applies (e.g., before the employer makes the Subchapter S election), the applicable percentage shall be determined as if the time section 401(j) applies to the plan is the time of a change in status. A plan amendment required (with respect to the first plan year) to satisfy the requirements of section 401(a) (18) and (j) shall not be treated as a change in the plan's compensation base or rate of accrual for purposes of applying the rules of § 1.401(j)–3. Thus, for example, if a plan provided for a 7.5% past accrual rate (calculated in accordance with subparagraph (3)) on $50,000 of compensation for Participant A, who commenced participation at age 30 in 1966, and the plan is amended for 1976 to meet the requirements of section 401(j), the applicable percentage for 1976

is determined under subparagraph (1) and equals 6.5% (the lesser of 7.5% (past accrual rate) or 6.5% (applicable percentage at age 30); but not less than 4.4% (the applicable percentage at age 40)).

(3) *Past accrual rate.* (i) For purposes of this paragraph, the past accrual rate equals the ratio determined by dividing (A) the employer-derived accrued benefit of the participant as of the close of the plan year immediately preceding the year in which the participant becomes a self-employed individual or a shareholder-employee, by (B) the sum of the compensation earned by the participant in each year (limited to the compensation covered by the plan for each year) for all periods of plan participation ending with the close of such immediately preceding plan year. The accrued benefit of the participant as of the close of the immediately preceding plan year shall be determined by disregarding any increase in the benefit not in effect at such time. Thus, for example, a subsequent past service benefit provided retroactively for the plan year would be disregarded.

(ii) If records are unavailable to compute the sum of the compensation earned by the participant, the compensation of the participant, referred to in subdivision (i) of this subparagraph, shall be determined by assuming that the participant earned compensation in each year of plan participation equal to the compensation earned in the plan year immediately preceding the plan year in which the participant becomes a self-employed individual or shareholder-employee. This assumption shall not apply to any plan years of participation ending after December 31, 1975.

(f) *Employee contributions*—(1) *Voluntary contributions.* The maximum benefit shall not be adjusted for voluntary contributions within the meaning of section 411. In such a case the plan can provide a benefit equal to the sum of the maximum benefit and the benefit derived from employee contributions accounted for separately. See section 411 (b) (2), (c) (2) (A), and (d) (5), and § 1.411 (c)–1 (a) for rules which require separate accounting in the case of voluntary-employee contributions.

(2) *Mandatory contributions.* Under section 411(c) and § 1.411(c)–1, the employee's total accrued benefit (determined without regard to any accrued benefit attributable to voluntary employee contributions) must be allocated between the part attributable to mandatory employee contributions and the part attributable to employer contributions according to specified rules. For purposes of determining the participant's maximum benefit in a career average pay plan under section 401(j) the following rules apply with respect to each plan year. For each plan year, the total benefit accruing derived from all contributions and the benefit accruing from mandatory employee contributions must be computed in accordance with the rules in section 411 (c) (2) (B). Then the participant's total benefit accruing for the year must be reduced by the benefit accruing derived from his mandatory contributions for the year and the remaining difference must be compared with the maximum basic benefit. The total benefit accruing for the year is determined by ascertaining the increase from the total accrued benefit (for all prior years) as of the close of the immediately preceding plan year and the benefit accruing from mandatory employee contributions is determined only with respect to those contributions made for the year. For a final average pay plan, the rules of section 411 (c) and § 1.411 (c)–1 apply.

(g) *Examples.* The provisions of this section can be illustrated by the following examples, in which, except where otherwise specified, it is assumed that the plan is a career average pay plan and that the participant is not married and has continuous service and plan years of participation:

Example (1). Maximum benefit. (i) A enters a defined benefit plan as a self-employed individual at age 30. The plan provides benefits on compensation up to $50,000 in the form of a single life annuity commencing at age 65 with no ancillary benefits. A's compensation for the first year is $20,000. The applicable percentage for A is 6.5%, determined under paragraph (c) for the age at which A's participation began (age 30). Under this section the maximum benefit that A could accrue for the plan year is $1,300 (6.5% of $20,000).

(ii) The second plan year, A's compensation is $25,000. The applicable percentage for A is still 6.5%, the applicable percentage for age 30 when A's current period of participation began, even though A is older in the second plan year. The maximum benefit A may accrue under this section for the plan year is $1,625 (6.5% of $25,000).

Example (2). Section 415 limitations. Assume the same facts as in Example 1, except that in the first plan year and all subsequent plan years, A's compensation is $50,000. A works 35 years. A's maximum benefit for each year under this section equals $3,250. Under this section, A's maximum accrued benefit at the end of 35 years would be $113,750 (35 years × $3,250). However, section 415 (b) (1) limits A's benefit to 100% of A's average compensation for A's high 3 years. A's average compensation in the high 3 years is $50,000. Therefore, under section 415 (b) (1), A's accrued benefit may not exceed $50,000.

Example (3). Multiple periods of participation. (i) A, a self-employed individual, enters a defined benefit plan at age 30. The plan provides benefits on compensation up to $50,000 in the form of a single life annuity commencing at age 65 with no ancillary benefits. A's compensation for the first year equals $20,000. The maximum benefit accruing which could be provided by the plan for A under paragraph (f) of this section equals $1,300 (6.5% of $20,000). The applicable percentage for such year is determined under paragraph (c) of this section for the age at which A's participation begins, age 30.

(ii) Assume that for the next four years, A's compensation remains at $20,000. Under this section, A's maximum benefit accruing for each of these years is still $1,300 (6.5% of $20,000). The applicable percentage is still measured by the 6.5% applicable to age 30, when A's current period of plan participation began, even though A is older.

(iii) Assume that, after five years of participation, A leaves the plan and recommences participation at age 50. In the first year after his return, A earns $30,000. Under this section, A's maximum benefit for the year cannot exceed $900 (3% of $30,000). The applicable percentage is determined for age 50, when A's next current period of plan participation began, and not at age 30. If A's compensation remains at $30,000 for four more years, A's maximum benefit for each of these four years remains at $900 (3% of $30,000).

(iv) Assume that, at age 55, A's compensation is $40,000. Under this section, A's maximum benefit for the year cannot exceed $1,200 (3% of $40,000). The percentage limit of paragraph (c)(1) of this section remains at 3% because the determination is made by reference to age 50, when A's current period of plan participation began. If A's compensation remains at $50,000 for four more years, A's maximum benefit for each of these four years remains at $1,200 (3% of $40,000).

(v) Assume that, at age 60, A's compensation is $40,000. Under this section, A's maximum benefit for the year cannot exceed $1,500 (3% of $50,000). The percentage limit of paragraph (c)(1) of this section remains at 3 percent. If A's compensation remains at or above $50,000 for four more years, A's maximum benefit for each of these four years remains at $1,500 (3% of $50,000).

(vi) Accordingly, when A retires at age 65 the maximum benefit which could be paid to A under the plan would be $24,500 per year, computed as follows:

Age	Compensation per year	Rate	Benefit earned per year	Total benefit
30 to 34	$20,000	6.5	$1,300	$6,500
50 to 54	30,000	3.0	900	4,500
55 to 59	40,000	3.0	1,200	6,000
60 to 64	50,000	3.0	1,500	7,500
Total				24,500

Example (4). Joint and survivor annuity. Assume the same facts as in *Example (3),*

except that A is married. Under section 401(a)(11), the plan is required to offer the payment of benefits in the form of a qualified joint and survivor annuity. If A receives the joint and survivor annuity, which is a nonbasic benefit, A's applicable percentage (and therefore A's maximum benefit) will be reduced to reflect the actuarial value of the nonbasic benefit. A's maximum benefit ($24,500) will be multiplied by a factor determined by the Commissioner for the age of A's beneficiary. Assuming for example that the factor were .90, A's maximum benefit after adjusting for the joint and survivor annuity would be $22,050 ($24,500×.90).

Example (5). Annual accrual in excess of maximum. A career-average defined benefit plan covers employee F who is a self-employed individual. In 1980, F's total accrued annual benefits equal $13,000. Had F accrued the maximum benefit for each year, F's total accrued benefit would have been $13,500. The plan, however, for plan year 1980 accrued an annual benefit for F equal to $1,800 when the maximum benefit equaled $1,625. The plan fails to satisfy the requirements of this section in 1980 and thus the plan is not qualified. Under § 1.401(j)-1(b)(1), the limitation on an employee's benefits must be satisfied with respect to the incremental increase in accrued benefits in each plan year, even though the employee's aggregate benefits could have been higher if the employee had accrued the maximum benefit for each year of participation.

§ 1.401(j)-2 Aggregating plans and other rules.

(a) *Plans required to be aggregated—*(1) *General rules.* In determining whether or not the requirements of section 401(j) are satisfied—

(i) All plans of an employer must be aggregated;

(ii) All plans of all trades or businesses in which the employee is a self-employed individual must be aggregated whether or not under common control under section 414(c); and

(iii) All plans in which an employee is a shareholder-employee must be aggregated with all other plans in which the employee is a self-employed individual or a shareholder-employee that are maintained by employers described in section 414 (b) or (c).

(2) *Special rule for Subchapter S plan.* In determining whether the requirements of section 401(j) are satisfied, a plan in which an employee is a shareholder-employee is not aggregated with any plan not described in subparagraph (1)(iii) of this paragraph. Thus, if an individual is a shareholder-employee in a Subchapter S corporation and an employee of a non-Subchapter S corporation, whether or not part of a controlled group under section 414(b), benefits under the non-Subchapter S corporate plan will be disregarded in determining whether the requirements of section 401(j) are satisfied. Similarly, if an individual is a shareholder-employee in a Subchapter S corporation and a self-employed individual in a partnership that are not under common control within the meaning of section 414(c), the limitations of section 401(j) will be applied separately to each plan.

(b) *Two or more defined benefit plans—*(1) *Limit on accrued benefit.* If two or more defined benefit plans are required to be aggregated under paragraph (a) of this section, then the accrued benefit under all such plans for any employee subject to the limitations of this section must be aggregated in determining whether or not the limitation on benefit accruals is exceeded.

(2) *Same plan year required.* In order to insure reasonable comparability of retirement benefits between qualified defined benefit plans and qualified defined contribution plans, or combinations thereof, as required by section 401(j)(1), this subparagraph sets forth certain conditions which must be satisfied in order for a defined benefit plan to be qualified. If one defined benefit plan ("first plan") is established and another defined benefit plan ("second plan") is established by the same employer subsequent to the establishment of the first plan, and if the second plan is required to be aggregated with the first plan under paragraph (a) of this section, then the second plan shall be deemed not to satisfy the requirements of section 401(j) unless both plans have the same plan year. Notwithstanding the preceding sentence, in the case where two or more such plans have been adopted prior to January 23, 1981 with different plan years, the second plan shall not fail to satisfy the requirements of this section solely by reason of having a different plan year if the plans are amended to adopt, for years beginning after that date, the same plan year and to adjust plan benefits as determined by the Commissioner. Such amendments must also comply with section 412(c)(5). Irrespective of any limitation on the time of amendment, the amendment required by the preceding sentence may be adopted within the 1 year period beginning January 23, 1981.

(c) *Defined benefit and defined contribution plans—*(1) *Defined benefit fraction.* If a defined benefit plan and a defined contribution plan are required to be aggregated under paragraph (a) of this section, the maximum benefit with respect to the defined benefit plan for a plan year on behalf of an employee subject to the limitations of section 401(j) shall be determined by multiplying the maximum benefit otherwise determined under section 401(j) for the defined benefit plan (determined without regard to this subparagraph) by 1 minus the fraction determined under subparagraph (2) of this paragraph, for the taxable year ending with or within that plan year.

(2) *Section 401(j) defined contribution fraction.* The fraction for any taxable year in which an employee is a participant in a defined contribution plan is a fraction—

(i) The numerator of which is the amount deductible for the participant under the defined contribution plan, and

(ii) The denominator of which is the maximum amount that would be deductible (and not includable in gross income under section 1379(b)) under the defined contribution plan if the plan provided for the maximum deduction allowable for the participant under section 404 and the regulations thereunder.

(3) *Increase in 401(j) defined benefit fraction.* If a plan limits the benefit of an employee by stating the above fractional rule, any increase in the 401(j) defined benefit fraction described in subparagraph (1) of this paragraph resulting from a decrease in the 401(j) defined contribution fraction described in subparagraph (2) under the defined contribution plan will be considered an amendment to the defined benefit plan increasing the plan's rate of benefit accrual. Thus, the plan will be subject to the rules of § 1.401(j)-3, which requires that the maximum benefit be calculated by reference to the age of the participant at the time of the amendment.

(d) *No integration for plan benefiting owner-employees.* A defined benefit plan which provides contributions or benefits for owner-employees does not satisfy the requirements of section 401(j) and this section unless such plan meets the requirements of section 401(a)(4) without taking into account contributions or benefits under chapter 2 of the Code (relating to tax on self-employment income), chapter 21 of the Code (relating to Federal Insurance Contributions Act), Title II of the Social Security Act, or under any other Federal or State law. Thus, a plan covering owner-employees will not qualify if the plan integrates its benefits with benefits provided under Social Security or under similar laws.

(e) *Deductions and inclusions.* A defined benefit plan to which section 401(j) applies is not subject to the special limitations on deductions for self-employed individuals set forth in section 404(e) or the special deduction computations, for common-law employees and self-employed

individuals, set forth in section 404(a)(9). (See § 1.404(e)–1A.) Except as provided in § 1.401(j)–6(c) for Subchapter S plans in existence before January 1, 1976, the rules on taxability of shareholder-employees set forth in section 1379(d) do not apply to a defined benefit plan to which section 401(j) applies. Section 404(a)(1) sets forth the rules with respect to deductions for defined benefit plans.

(f) *Nondiscrimination.* Section 401(a)(4) requires that a defined benefit plan not discriminate in favor of employees who are members of the prohibited group. The term "prohibited group employees" means those employees in whose favor the benefits provided under a defined benefit plan may not discriminate under section 401(a)(4). For purposes of testing discrimination under a plan which provides for full and immediate vesting, the plan will not be considered to be discriminatory merely because the accrued benefit determined under the plan for any employee is limited to the maximum basic benefit as determined under section 401(j). Thus, for example, a plan which provides for full and immediate vesting and which bases benefits on percentages of compensation determined at the age when an employee's participation in the plan commences will not be considered to be discriminatory merely because the prohibited group employees are younger than other employees at such time and consequently have benefits determined at higher percentages.

(g) *Definitely determinable benefits.* A defined benefit plan to which this section applies is also subject to the requirements under section 401(a) to provide definitely determinable benefits. Thus, for example, for a final average pay plan to satisfy both the requirements of section 401(j) and the definitely determinable requirements, the plan would have to provide for a plan benefit formula under which a self-employed individual's or shareholder-employee's accrued benefit does not exceed the lesser of the final average pay formula, determined without regard to § 1.401(j)–5 but with regard to other applicable requirements (such as those set forth in section 415), or the limitation in that section.

(h) *Examples.* The provisions of this section can be illustrated by the following examples, in which, except where otherwise specified, it is assumed that the participant is not married and has continuous service and plan years of participation:

Example (1). Two defined benefit plans. Employee D is a self-employed individual in a partnership which has a defined benefit plan. D also has an unrelated sole proprietorship which has a defined benefit plan. The two plans both have the same plan years. Under paragraph (a)(1)(ii) of this section, both plans are required to be taken into account in determining whether or not the requirements of this section are satisfied.

Example (2). Defined contribution plan and defined benefit plan. Employee E is covered by both a defined benefit and a defined contribution plan required to be aggregated under paragraph (a) of this section. If, for 1980, the defined contribution plan is subject to the limitation of section 404(e) and E had $50,000 of earned income in 1980, the maximum amount deductible with respect to E equals $7,500 (15% of $50,000). If, for 1980, there is a deductible contribution for E under the defined contribution plan of $1,875, the fraction referred to in paragraph (c)(2) of this section equals $7,500÷$1,875 or ¼. If, for 1980, E's maximum benefit under the defined benefit plan, determined without regard to paragraph (d)(1) of this section, equals $2,200, E's maximum benefit is determined by multiplying $2,200 times ¾ (that is, 1 minus ¼) which equals $1,650. Consequently, if E accrues a benefit in 1980 in excess of $1,650 under the defined benefit plan, the plan fails to satisfy the requirements of section 401(j).

Example (3). Related Sub-S and non-Sub-S corporations. (i) Employee E, age 30, is a shareholder-employee in S, a Subchapter S corporation. E is also an employee of C, a non-electing corporation related to S under section 414(b). E is covered by career average, defined benefit pension plans of S and C. E accrues a basic benefit of 6.5% of compensation under the S plan and an annual benefit accrual of 10% of compensation in the C plan. The compensation base in the S plan is $50,000. E earns $30,000 from each corporation. The plans comply with all other requirements of section 401(a).

(ii) Although C is related to S, the limitations of section 401(j) do not apply to the C plan, because C is not a Subchapter S corporation. Therefore, E's benefits under the C plan need not be aggregated with the benefit E accrues under the S plan to determine whether the section 401(j) limitations are satisfied by the S plan. E's maximum benefit under the S plan is $1,950 (6.5% of $30,000). E accrues a benefit of $1,950 under the S plan, satisfying the section 401(j) limitations.

Example (4). Unrelated Partnerships. (i) Employee F, age 30, is a partner in P1 and P2, partnerships which are not under common control within the meaning of section 414(c). F is covered by career average, defined benefit pension plans of P1 and P2. F accrues a basic benefit of 6.5% of compensation under each plan. The compensation base in each plan is $50,000 and F earns $30,000 from each partnership.

(ii) F's benefit accrual under the P1 and P2 plans must be aggregated because all plans in which F is a self-employed individual, whether or not related under section 414(c), must be aggregated under paragraph (a)(ii) of this section. F's maximum benefit under the P1 and P2 plans together is $3,250 (6.5% of $50,000). However, F accrues a benefit of $3,900 ($1,950 under the P1 plan and $1,950 under the P2 plan). Because F's benefit accrual for the year exceeds F's maximum benefit, neither the P1 nor P2 plan is qualified.

Example (5). Unrelated Subchapter S Plans. (i) Assume the same facts as in Example (4) except that F is a shareholder-employee in S1 and S2, Subchapter S corporations which are not under common control within the meaning of section 414(b).

(ii) The benefit F accrues under S1 and S2 need not be aggregated because the two Subchapter S corporations are not related under section 414(b). The benefit E accrues under each plan ($1,950) equals E's maximum benefit (6.5% of $30,000) for that plan. Thus, the plans satisfy the section 401(j) limitations.

Example (6). Partnerships and Subchapter S corporation. (i) Employee G, age 30, is a partner in P1 and P2, partnerships which are not under common control within the meaning of section 414(c). G is also a shareholder-employee in S1, a Subchapter S corporation under common control with P1 within the meaning of section 414(c). G is covered by career-average, defined benefit pension plans of P1, P2, and S1. G accrues a basic benefit of 6.5% of compensation under the terms of the S1 and P2 plans. G accrues a basic benefit of 4% of compensation under the P1 plan. G earns $30,000 from each business.

(ii) Under paragraph (a)(ii) of this section, G's benefit accrual under P1 and P2 must be aggregated because both are plans in which G is a self-employed individual. Under § 1.401(j)–1(b), G's maximum benefit under the P1 and P2 plans together is $3,250 (6.5% of $50,000). G accrues a benefit of $1,200 under the P1 plan and $1,950 under the P2 plan for a total of $3,150. Because G's benefit accrual for the year ($3,150) is less than G's maximum benefit ($3,250) both the P1 and P2 plans satisfy the section 401(j) limitations for the plan year.

(iii) Separately, G's benefit accrual under the P1 and S1 plans must be aggregated because S1 and P1 are under common control within the meaning of section 414(c). G's maximum benefit under the S1 and P1 plans together is $3,250 (6.5% of $50,000). G accrues a benefit of $1,200 under the P1 plan (4% of $30,000) and $1,950 under the S1 plan (6.5% of $30,000), totaling $3,150. Because G's benefit accrual is less than G's maximum benefit under the two plans, the P1 and S1 plans satisfy the section 401(j) limitations for the plan year.

(iv) Even though the P1, P2 and S1 plans satisfy the section 401(j) limitations for the plan year the plans will not be qualified under section 401(j) unless the plan contains a provision precluding excess accruals (see § 1.401(j)–1(b)(2)).

§ 1.401(j)–3 Change in compensation base or rate of accrual.

(a) *Changes in rate of benefit accrual or compensation base*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, if a plan changes either the rate of benefit accrual or the compensation base (or both) with respect to a participant, the applicable percentage for any level of compensation is the greater of (i) the prior-benefit accrual rate with respect to

that level of compensation, or (ii) the attained-age applicable percentage with respect to that level of compensation. If a plan changes its compensation base applicable to a participant, an applicable percentage shall be determined for that participant for each level of compensation that results from such change.

(2) *Fresh start.* If with respect to any participant subject to the requirements of section 401(j) a plan is amended so that the participant is treated under the plan as commencing a new period of plan participation and the applicable percentage is determined on the basis of the participant's age at that time, then the plan shall be deemed to be a new plan with respect to that participant. Thus, such a plan amendment would not be subject to the requirements of this section.

(b) *Definitions.* For purposes of this section—

(1) *Level of compensation.* The term "level of compensation" means (i) the initial compensation base and (ii) the difference between each prior compensation base (beginning with the initial base) and the next succeeding compensation base.

(2) *Prior-benefit accural rate.* The term "prior-benefit accrual rate" means the benefit accrual rate, if any, determined under the plan for each level of compensation under the plan prior to any change in the plan's compensation base or the benefit accrual rate. If a plan decreases its benefit accrual rate, the decreased benefit accrual rate (not the rate prior to the decrease) shall, on and after the effective date of the decrease, be deemed to be the plan's prior-benefit accrual rate. In no event shall the prior-benefit accrual rate exceed the entry-age applicable percentage.

(3) *Attained-age applicable percentage.* The term "attained-age applicable percentage" means the otherwise determined applicable percentage for the age of the participant when the plan amendment to either the compensation base or the rate of accrual is effective. The attained-age applicable percentage is determined for each different level of compensation by using the compensation base in effect after the plan amendment, including any adjustment for excess compensation base referred to in paragraph (c)(5) of this section.

(4) *Entry-age applicable percentage.* The term "entry-age applicable percentage" means, with respect to a level of compensation, the otherwise applicable percentage determined under section 401(j) for the age of the participant at which a benefit could first accrue under the plan for that level of compensation or, if later, at which that participant's current period of participation began. The entry-age applicable percentage is determined for each different level of compensation by using the compensation base in effect prior to any change in the plan's compensation base and by including any adjustment (in effect prior to such change) for excess compensation base referred to in paragraph (c)(5) of this section.

(c) *Other rules*—(1) *Amendment not applicable to self-employed individual or shareholder-employee.* If a plan never amends its compensation base or rate of benefit accrual (or amends, but makes the changes applicable only to participants who are neither self-employed individuals nor shareholder-employees), the requirements of this section will not apply.

(2) *Adopted and scheduled amendments.* For purposes of section 401(j) and the regulations thereunder, amendments to the compensation base or rate of accrual include both adopted plan amendments and scheduled amendments (that is, amendments which are effective at a later time). Whether a particular amendment results in a change in base or rate shall be determined by the effect of the amendment upon plan benefit accruals and not by either the particular form of the amendment or the specific plan provision amended. For example, any plan amendment which changes the definition of compensation from less than total compensation to increase that amount upon which benefit accruals are based (for example, to add overtime hours to the compensation taken into account) would constitute a change in compensation base. Additionally, an increase in a survivor annuity from 50 percent to 75 percent of the employee benefit without any actuarial reduction would constitute a change in rate of benefit accrual.

(3) *No possibility of excess accruals.* If the rate of benefit accrual for any level of compensation exceeds the applicable percentage for that level determined under this section, the plan does not satisfy section 401(j). Also, the general rule set forth in § 1.401(j)–1(b)(2) that a plan is not qualified unless the plan contains provisions that preclude benefit accruals in excess of permissible section 401(j) amounts is equally applicable to changes in a plan's rate of accrual or compensation base. Thus, even though there is not in fact an excess accrual for a self-employed individual or shareholder-employee by reason of such an amendment, the plan is not qualified if there could be such an excess under the plan amendment.

(4) *Amendments effective at same time.* All plan amendments which effect a change in the plan's rate of benefit accrual or compensation base, and which are effective at the same time, shall be deemed to be a single amendment for purposes of applying the rules of this section.

(5) *Compensation bases in excess of $50,000.* (i) In the case of a plan which initially specifies a compensation base in excess of $50,000, the applicable percentage must be adjusted under § 1.401(j)–1)(d)(2) by multiplying such percentage by the ratio of $50,000 to the initial compensation base of the plan.

(ii) In the case of a plan which amends its compensation base to increase such base in excess of $50,000, the percentage applicable to the compensation between the prior compensation base and the new compensation base shall be adjusted by multiplying that percentage by a fraction, the numerator of which equals the excess of $50,000, if any, over the prior compensation base, and the denominator of which equals the new compensation base minus the prior compensation base. However, no adjustment is required to the percentage applicable to a participant's compensation up to the prior compensation base.

(iii) In the case of a plan which has a compensation base in excess of $50,000 and which subsequently amends its compensation base to decrease such base to another base in excess of $50,000, either the adjustment specified in subdivision (ii) or (i) of this subparagraph shall be made, depending on whether there is, or is not, respectively, a prior compensation base less than $50,000.

(d) *Other changes.* If a plan's rate of benefit accrual or compensation base is changed in a manner not dealt with in this section, the applicable percentages for the plan shall be adjusted, as determined by the Commissioner, in a manner consistent with the regulations under section 401(j).

(e) *Examples.* The provisions of this section can be illustrated by the examples set forth below. In each of the examples (except where otherwise specified) the following assumptions have been made: (1) Each plan is a career average defined benefit plan; (2) each plan provides a basic benefit as defined in § 1.401(j)–1(c)(2); (3) each participant has continuous service and one current period of participation; (4) each plan provides no non-basic benefit except an actuarially equivalent joint and survivor annuity required by section

401(a)(11); and (5) each plan is not a fully insured plan subject to § 1.401(j)–4.

Example (1). Change in accrual rate. Participant A, a self-employed individual, begins participation at age 30 in Plan X, which provides a basic benefit accruing at the annual rate of 3.25%. Plan X's compensation base is $50,000. The applicable percentage for A at age 30 is 6.5%. When A is 40 Plan X is amended to increase its rate of benefit accrual to the maximum applicable percentage, and to provide the maximum benefit. A's applicable percentage and maximum benefit are determined as follows:

(i) Under paragraph (a), A's applicable percentage after the plan is amended is the greater of (1) 3.25% (Plan X's prior-benefit accrual rate for A) or (2) 4.4% (the attained-age applicable percentage for a participant age 40). Accordingly, the rate of benefit accrual for A in Plan X after the amendment cannot exceed 4.4%.

(ii) Under § 1.401(j)–1(b), the maximum benefit which could accrue annually for A under Plan X equals the product of A's compensation (up to the compensation base) times 4.4% (the applicable percentage). Accordingly, A's maximum benefit per year equals $2,200, if A's compensation equals or exceeds $50,000.

Example (2). Change in compensation base. B, a self-employed individual, begins participation at age 30 in Plan Y, which provides a basic benefit accruing at the annual rate of 5.0% of compensation up to $20,000. The applicable percentage for B is 6.5%. When B is 40, Plan Y is amended to increase the specified compensation base to $50,000 and to provide the maximum basic benefit. B's compensation equals or exceeds the plan's compensation base at all times. The applicable percentages for each level of compensation and maximum benefit after the plan is amended are determined as follows:

(i) Under paragraph (a), B's applicable percentage after the plan is amended cannot exceed the limitation applicable to each level of compensation. For the initial compensation base of $20,000, the applicable percentage is the greater of (1) 5.0% (Plan Y's prior-benefit accrual rate for B) or (2) 4.4% (Plan Y's attained-age applicable percentage for B). Therefore, B's applicable percentage for the first $20,000 of compensation is 5.0%.

(ii) B's applicable percentage for the level of compensation in excess of $20,000 up to the new $50,000 compensation base, or the next $30,000 of compensation, is 4.4% (Plan Y's attained-age applicable percentage for B). There is no prior-benefit accrual rate for this level of compensation.

(iii) Under § 1.401 (j)–1(b), the maximum benefit which could accrue annually for B under Plan Y after the plan is amended equals the sum of $1,000 (the initial compensation base of $20,000 times the 5.0% applicable percentage) and $1,320 (the $30,000 next level of compensation times the 4.4% applicable percentage). Accordingly, B's maximum benefit equals $2,320.

Example (3). Change to compensation base over $50,000. Assume the same facts as in *Example (2)* for participant C at age 30 in Plan Y except that the annual rate is 6.5%. When C is 40, Plan Y is amended to increase the specified compensation base to $75,000 and to provide the maximum benefit. The applicable percentages for each level of compensation and maximum benefit after the plan is amended are determined as follows:

(i) Under paragraph (a), C's applicable percentage after the amendment cannot exceed a limitation applicable to each level of compensation. For the initial compensation base of $20,000, the applicable percentage is the greater of (*1*) 6.5% (Plan Y's prior-benefit accrual rate for C) or (*2*) 4.4% (Plan Y's attained-age applicable percentage for C). Therefore, C's applicable percentage for the first $20,000 of compensation is 6.5%.

(ii) C's applicable percentage for the level of compensation in excess of $20,000 up to the new $75,000 compensation base, or the next $55,000 of compensation, is the attained-age applicable percentage (there is no prior-benefit accrual rate for this level of compensation). Under paragraph (b)(3), the attained-age applicable percentage for C is determined by making the adjustment for the excess compensation base specified in paragraph (c)(5). Accordingly, the applicable percentage is 2.4% (4.4% times ($50,000 − $20,000)/($75,000 − $20,000)).

(iii) Under § 1.401(j)–1(b), the maximum benefit which could accrue annually for C under Plan Y after the plan is amended equals the sum of $1,300 (the initial compensation base of $20,000 times the 6.5% applicable percentage) and $1,320 ($55,000, the next level of compensation, times the 2.4% applicable percentage). Accordingly, C's maximum benefit per year equals $2,620.

Example (4). Decrease in compensation base to $50,000. D begins participation as a shareholder employee at age 30 in Plan Z, which provides a basic benefit accruing at the annual rate of 3.25% of compensation up to $100,000. D's compensation equals or exceeds the compensation base at all times. In order to determine the applicable percentage, 6.5% must be adjusted for the excess compensation base, as specified in paragraph (c)(5)(i), to obtain an applicable percentage of 3.25% (6.5% times $50,000/$100,000). When D is 40, Plan Z is amended to decrease its specified compensation base to $50,000 and to provide the maximum basic benefit. The applicable percentage for the new compensation base and the maximum benefit after the plan is amended are determined as follows:

(i) Under paragraph (a), the applicable percentage for the new $50,000 compensation base is the greater of 3.25% (Plan Z's prior-benefit accrual rate for D) or 4.4% (Plan Z's attained-age applicable percentage for D). Therefore, D's applicable percentage is 4.4%.

(ii) Under § 1.401(j)–1(b), the maximum benefit which could accrue annually for C under Plan Z after the amendment equals the product of $50,000 (the new compensation base) times 4.4% (the applicable percentage). Accordingly, D's maximum benefit equals $2,200.

Example (5). Change in both accrual rate and compensation base. E, a self-employed individual, begins participation at age 30 in Plan W, which provides a basic benefit accruing at the annual rate of 3% of compensation up to $30,000. The applicable percentage for E at age 30 is 6.5%. When E is age 40, Plan W is amended to increase the compensation base to $50,000, to increase the rate of benefit accrual and to provide the maximum basic benefit. E's compensation equals or exceeds the plan's compensation base at all times. The applicable percentages for each level of compensation, the accrual rates and maximum benefit after the plan is amended are determined as follows:

(i) Under paragraph (a), an applicable percentage is determined for each level of compensation. For the initial compensation base of $30,000, the limitation determined under paragraph (a) is 4.4% (the greater of 3%, Plan W's prior-benefit accrual rate for E, or 4.4%, Plan W's attained-age applicable percentage for E). In this instance, Plan W can raise its benefit accrual rate to 4.4% applicable to the initial compensation base of $30,000.

(ii) The limitation on the applicable percentage for the next level of compensation in excess of $30,000 up to the new $50,000 compensation base (the next $20,000 of compensation) is 4.4%, the attained-age applicable percentage (there is no prior-benefit accrual rate for this level of compensation). In this instance, Plan W can raise its benefit accrual rate to 4.4% applicable to this next $20,000 level of compensation.

(iii) Under § 1.401(j)–1(b), the maximum benefit which could accrue annually for E under Plan W after the plan is amended equals the sum of $1,320 (the initial compensation base of $30,000 times the 4.4% applicable percentage) and $880 (the $20,000 next level of compensation times the 4.4% applicable percentage). Accordingly, E's maximum benefit equals $2,200.

§ 1.401(j)–4 Special rules for certain insured plans.

(a) *Insurance contract plans described in section 412(i)*—(1) *Targeted cash surrender value.* If a plan is described in section 412(i), the cash surrender value of insurance or annuity contracts at normal retirement age (the targeted cash surrender value) may not exceed the product of—

(i) The total annual life annuity benefit commencing at that normal retirement age that would be permitted under section 401(j) for the participant for all years of participation, adjusted to reflect all pre-retirement ancillary benefits provided by the plan, and

(ii) The amount shown in Table A (if the insurance or annuity contracts are based on mortality assumptions determined by the sex of the participant) or Table B (if the contracts are not based on different assumptions by sex) for the normal retirement age.

Table A.—*Sex Based Table*

Normal retirement age	Amount	
	Male	Female
55	$11.78	$13.20
56	11.55	13.00
57	11.32	12.80
58	11.09	12.58
59	10.84	12.36

Table A.—*Sex Based Table*—Continued

Normal retirement age	Amount	
	Male	Female
60	10.59	12.13
61	10.34	11.90
62	10.08	11.65
63	9.81	11.40
64	9.54	11.14
65	9.27	10.88
66	8.99	10.60
67	8.72	10.32
68	8.44	10.03
69	8.17	9.73
70	7.90	9.43

Table B.—*Unisex Table*

Normal retirement age	Amount
55	$12.06
56	11.84
57	11.62
58	11.39
59	11.14
60	10.90
61	10.65
62	10.39
63	10.13
64	9.86
65	9.59
66	9.32
67	9.03
68	8.76
69	8.48
70	8.21

(2) *Benefits before normal retirement age.* A plan described in section 412(i) shall not fail to satisfy section 401(j) because it provides a benefit before a participant's normal retirement age equal to the cash surrender value under the insurance or annuity contracts so long as the targeted cash surrender value does not exceed the limitations of subparagraph (1).

(b) *Other plans involving insurance*—(1) *In general.* If a plan other than a plan described in section 412(i) distributes insurance or annuity contracts (including participating and variable annuities) to provide plan benefits, the value of such contracts together with the value of any other distribution may not exceed the actuarial equivalent of the maximum benefit that could be provided to that participant. The actuarial equivalent will be determined by the Commissioner based on the 1971 Group Annuity Mortality Table (male) without projection and an assumed interest rate of 6 percent compounded annually.

(2) *Participating and variable annuities*—(i) *Single premium contracts.* If a plan purchases a single-premium insurance or annuity contract at or about the time that the participant attains normal retirement age and the participant's benefits may vary because of mortality, interest, or expense experience, the value of the contract will equal the premium paid for the contract.

(ii) *Other contracts.* If a plan purchases an insurance or annuity contract under which a self-employed individual or shareholder-employee may receive a benefit that varies in accordance with mortality, interest, or expense experience in circumstances other than those described in subdivision (i) of this subparagraph, the value of the contract will be the single premium purchase price (at the date of distribution) of an equivalent contract.

(3) *Cash surrender value.* For purposes of this paragraph, the value of any insurance or annuity contract shall not be less than its cash surrender value.

(c) *Nonparticipating contracts with no cash surrender value.* The rules of paragraph (b) shall not apply to any contract which provides for level benefits during the life of the participant, which pays no dividends to the participant or a beneficiary, and which cannot be exchanged by the participant or beneficiary for cash or a contract with cash surrender value.

§ 1.401(j)-5 Benefit limitations applicable to final average pay plans.

(a) *General rule.* A final average pay plan as defined in § 1.401(j)-1(a)(3)(v) is not qualified unless the plan precludes the accrual (or the potential of accurual) of benefits by a self-employed individual or shareholder-employee in excess of the limitation determined under this section. Except as provided in this section, the provisions of § 1.401(j)-1 through 1.401(j)-4, inclusive, and § 1.401(j)-6 apply to a final average pay plan.

(b) *Maximum benefit. Final average pay plan*—(1) *General rule.* If a participant has been subject to the section 401(j) limitations during all plan years for which that participant has accrued benefits under the plan, the participant's accrued benefit is limited to the sum of the products of:

(i) The applicable percentage rate, determined under § 1.401(j)-1, for each period of plan participation, multiplied by

(ii) The sum of the participant's compensation covered under the plan for that period of plan participation including the plan year for which the limitation is being determined.

If the plan changes the participant's rate of accrual, the compensation base with respect to the participant, or both, the Amended Limitation determined under paragraph (c)(2) applies to the participant.

(2) *Change in status.* If a participant has not been subject to section 401(j) during all plan years in which the participant accrued benefits under the plan, the participant's accrued basic benefit is limited to the sum of (i) the participant's pre-401(j) benefit and (ii) the maximum benefit determined under subparagraph (1) of this paragraph for the participant's post-401(j) periods of participation. If the plan changes the participant's rate of accrual, the compensation base with respect to the participant or both, the Amended Limitation determined under paragraph (c)(2) applies to the participant. However, if a plan is amended effective as of the date section 401(j) first applies to the plan to conform the plan to the requirements of section 401(j) the limitations of this subparagraph apply to the plan: *Provided,* That the plan is not subsequently amended.

(3) *Pre-401(j) benefit.* In a final average pay plan, a participant's pre-401(j) benefit equals the greater of—

(i) The accrued benefit of the participant under the plan as of the close of the plan year immediately preceding the first plan year in which section 401(j) applies to the participant (*i.e.*, the later of (A) the plan year in which the participant becomes a self-employed individual or a shareholder-employee or (B) the first plan year for which section 401(j) applies to the plan) determined as if the participant separates at such time; or

(ii) The benefit of the participant obtained by totaling the products of (A) the applicable percentage rate, determined under § 1.401(j)-1, for each period of plan participation by (B) the sum of the compensation earned by the participant for each year during that period of plan participation (ending the current period of participation with the close of the immediately preceding plan year referred to in subdivision (i) of this subparagraph).

The pre-401(j) benefit of the participant determined under subdivisions (i) and (ii) of this subparagraph shall be determined in a manner consistent with the determination of the accrued benefit under § 1.401(j)-1(e)(3) (relating to past accrual rates in the case of an employee's change in status). Notwithstanding § 1.401(j)-1(e)(3) any plan amendment affecting the compensation base or rate of accrual occurring prior to or within the immediately preceding plan year referred to in subdivision (i) of this subparagraph shall be disregarded for purposes of determining the accrued benefit under subdivision (ii) of this subparagraph. Further, the applicable percentage in subdivision (ii)(A) and the compensation for each year described in subdivision (ii)(B) shall be determined with respect to the plan's compensation base in effect for the first plan year in which section 401(j) applies to the participant.

(c) *Change in compensation base or rate of accrual*—(1) *Application.* If a final average pay plan changes either the compensation base or the rate of accrual with respect to a participant who is either a self-employed individual or shareholder-employee, the plan does not satisfy section 401(j) in any plan year for which the plan provides for (or permits) an accrual of benefits for the participant which exceeds the Amended Limitation.

(2) *Amended Limitation.* The Amended Limitation, with respect to a participant, for any level of compensation (see § 1.401(j)–3(b)(1)), equals the sum of—

(i) The accrued benefit of the participant with respect to that level of compensation under the plan as established and

(ii) The accrued benefit of the participant under the plan on account of each subsequent amendment with respect to that level of compensation.

For purposes of this subparagraph and the succeeding rules in this section, the term "under the plan as established" means, with respect to a participant's level of compensation, under the plan at the time the participant first accrues a benefit for a particular level of compensation (or could have so accrued but for his compensation being less than such level). Thus, for example, if a plan is established in year 1 and a designated employee commences participation in year 10, then the plan as established means the plan in year 10.

(3) *Accrued benefit under plan as established.* The accrued basic benefit of the participant under the plan as established equals the lesser of—

(i) The accrued benefit of the participant as determined for each level of compensation based on the plan in effect on the date that the participant is first subject to section 401(j) and based on that participant's service and compensation taken into account under the plan for the participant's period of plan participation, or

(ii) The participant's maximum benefit determined under paragraph (b) of this section for each level of compensation.

(4) *Limitation on increases.* If the accrued benefit of the participant on account of the plan as established with respect to a level of compensation equals the participant's maximum benefit determined under paragraph (b) of this section, then the accrued benefit of the participant on account of each subsequent amendment with respect to such level of compensation is zero.

(5) *Permitted increases.* If the accrued benefit of the participant on account of the plan as established with respect to a level of compensation is less than the participant's maximum benefit determined under paragraph (b) of this section, then the accrued benefit of the participant on account of each subsequent amendment with respect to such level of compensation at any relevant time affected by such amendment equals the lesser of—

(i) The increase in the accrued benefit of the participant determined under subparagraph (6) or

(ii) The Averaged Cap with respect to that participant determined under subparagraph (7).

(6) *Increase in accrued benefit.* The increase in the participant's accrued benefit under the plan formula described in subparagraph (5)(i) of this paragraph equals the difference between—

(i) The participant's accrued benefit determined under the plan in effect prior to the plan amendment and

(ii) The participant's accrued benefit determined under the plan in effect after the plan amendment. Both such accrued benefits are determined with respect to the participant's service and compensation taken into account under the plan as of the plan year for which the limitation is being determined.

(7) *Averaged Cap.* The Averaged Cap with respect to the participant equals the product of—

(i) The difference, if any, between (A) the applicable percentage rate of the participant after the amendment and (B) the prior-benefit accrual rate of the participant before the amendment, as defined in § 1.401(j)–3(b)(2), and

(ii) The sum of the compensation earned by the participant after the amendment (and taken into account under the plan's level of compensation) for each plan year within the participant's current period of plan participation including the plan year for which the limitation is being determined.

The percentage rates of the participant referred to in subdivision (i) (A) and (B) of this subparagraph are the otherwise determined percentages under section 401(j), including the required adjustments under § 1.401(j)–3, relating to changes in compensation base and rate of accrual. Thus, for example, the participant's applicable percentage rate before the amendment for a particular level of compensation must be determined in a manner consistent with the rules in § 1.401(j)–3(d), relating to requirements for changes in compensation bases.

(8) *Limitation on increases.* (i) If the accrued benefit of the participant on account of the plan as first amended with respect to a level of compensation equals the participant's Averaged Cap (determined under subparagraph (7) of this paragraph), then the accrued benefit of the participant on account of each succeeding amendment, after the first such amendment, with respect to such level of compensation is zero.

(ii) If the accrued benefit of the participant on account of the plan's first amendment with respect to a level of compensation is less than the participant's Averaged Cap (determined under subparagraph (7) of this paragraph, then the participant's accrued benefit on account of each succeeding amendment, after the first such amendment, is determined by applying the rules of subparagraphs (6) and (7) of this paragraph to each succeeding amendment as if the plan as established and first amended with respect to a level of compensation constituted the established plan. In that application of the rules under subparagraphs (6) and (7) of this paragraph, the participant's maximum benefit determined under paragraph (b) of this section shall be deemed to be the participant's Averaged Cap (determined under subparagraph (7) of this paragraph).

(d) *Other adjustments.* The Commissioner shall, in the case of a final average pay plan, determine if any other adjustments to plan accruals are required to be made in a manner consistent with section 401(j) including this section and § 1.401(j)–3.

(e) *Examples.* The provisions of this section can be illustrated by the examples set forth below. In each of the examples (except where otherwise specified) the following assumptions have been made: (1) Each participant is a single self-employed individual or shareholder-employee in a final average pay plan; (2) the plan year and employer taxable year coincide; and (3) each plan provides a basic benefit for each participant.

Example (1). Maximum benefit. Participant A begins participation in Plan M at age 50. Plan M provides for an annual benefit accrual of 1% of final year's compensation, not to exceed $50,000, for each year of participation. (A plan would not be qualified if benefits were based on only the last year, but for illustrative purposes assume that such a formula is permissible.) Plan M also limits benefit accruals to satisfy the limitations of this section. A's compensation for each of the first 10 years equals $10,000 per year. At age 60, A's compensation is increased and equals $40,000. A's maximum benefit and benefit accrual for the 11th year is determined as follows:

(A) Because A is always subject to section 401(j) under Plan M, A's maximum benefit is determined under paragraph (b)(1) and equals the product of 3% (the applicable

percentage at age 50) times $140,000 ((10 years times $10,000, or $100,000) plus (1 year times $40,000, or $40,000)), or $4,200.

(B) Under Plan M's benefit formula, without regard to the plan provision required to satisfy this section, A's accrued benefit would equal 1% times $40,000 times 11 years, or $4,400.

(C) Accordingly, Plan M would satisfy section 401(j) if it provided a deferred normal retirement benefit for A of $4,200, if A left the plan at the end of the 11th year of participation.

(D) If Plan M is never amended and A continues plan participation (instead of ending plan participation as in (C), above) for 4 more years at the same compensation of $40,000, then A's accrued normal retirement benefit under the plan equals $6,000 (1% times $40,000 times 15 years). A's maximum benefit in this instance, equals $9,000 (3% times $300,000 ($140,000 over 11 years plus $160,000 over 4 years)). Thus, Plan M would satisfy section 401(j) by providing A with a $6,000 normal retirement benefit.

Example (2). Amended limitation. Participant B begins participation in Plan N at age 50. Plan N provides for an annual benefit accrual of 1% of final year's compensation, not to exceed $50,000 for each year of participation. Plan N is amended to provide for an annual benefit accrual of 2% of last year's compensation, not to exceed $50,000, when B is age 55 (6th year of B's plan participation). Plan N also limits benefit accruals to satisfy the limitation of this section. B's compensation for each of the first 10 years (age 50 to 59) equals $25,000 per year. When B is age 60, B's compensation is increased and equals $40,000 for each of the next 5 years (age 60 to age 64). Assume the Plan N's benefit formula has satisfied this section prior to the plan amendment. B's Amended Limitation and benefit accrual are determined as follows:

(A) B's Amended Limitation under Plan N is determined under paragraph (c). B's Amended Limitation for the plan's $50,000 level of compensation equals the sum of (1) B's accrued benefit under Plan N as established and (2) B's accrued benefit on account of the amendment to Plan N.

(B) B's accrued benefit under Plan N as established equals the lesser of (1) B's accrued benefit under Plan N as in effect when section 401(j) applies to B or (2) B's maximum benefit. In this case these amounts, respectively, equal $6,000 (1% times $40,000 times 15 years) and $13,500 (3%, age 50, times $450,000 (10 years times $25,000, or $250,000) plus (5 years times $40,000, or $200,000)). Accordingly, B's accrued benefit under Plan N, as established, equals $6,000. Because B's maximum benefit exceeds B's accrued benefit under the plan as established, Plan N can amend its plan benefit accrual formula to provide B a greater accrued benefit.

(C) B's accrued benefit on account of the amendment to Plan N equals the lesser of (1) B's increased accrued benefit as a result of the amendment or (2) B's Averaged Cap. B's accrued benefit under the new plan benefit formula equals $12,000 (2% times $40,000 times 15 years). Therefore, B's increased accrued benefit equals $6,000 ($12,000 new minus $6,000 old). B's Averaged Cap equals (under paragraph (c)(7)) the product of a percentage and a career compensation dollar amount. B's compensation for his 10 years of plan participation since the plan amendment equals $325,000 (5 times $25,000 plus 5 times $40,000). The percentage equals the difference between the *post*-amendment applicable percentage and the prior-benefit accrual rate, both determined consistently with the plan amendment rules in § 1.401(j)-3. In this case, B's *post*-amendment percentage equals the attained-age applicable percentage of 2.5% for age 55. B's prior-benefit accrual rate is determined by dividing B's accrued benefit of $6,000 under the original plan by B's $450,000 compensation for his 15 years of plan participation and equals 1.33%. The difference between the two percentages equals 1.17%. Accordingly, B's Averaged Cap under Plan N, as amended, equals $3,803 ($325,000 times 1.17%). B's accrued benefit on account of the amendment equals $3,803 (the lesser of $6,000 or $3,803).

(D) B's Amended Limitation under Plan N equals $9,803 ($6,000 plus $3,803). Because B's accrued benefit on account of the plan amendment is determined by reference to B's Averaged Cap, Plan N could not provide for additional benefit accruals for B, assuming B leaves the plan after his 15 years of participation.

Example (3). Worksheet. Using the facts of Example (2), B's Amended Limitation and benefit accrual can be computed under the following worksheet:

FINAL AVERAGE PAY WORKSHEET

(For one level of compensation and only one period of current participation)

Step No., Operation, and Answer

1. Determine accrued benefit under plan as established, using plan formula and final average pay—$6,000 (1%×15×$40,000)
2. Determine maximum benefit by following steps:
   (a) Limitation on pre-401(j) benefit:
   (i) accrued benefit of participant as of close of last pre-401(j) plan year determined as of that time—0
   (ii) applicable percentage based on age as of beginning of current participation—3%
   (iii) sum of compensations within this level for years prior to 401(j)—0
   (iv) product of (ii) and (iii)—0
   (v) greater of (i) or (iv)—0
   (b) Limitation on post-401(j) benefit:
   (i) applicable percentage in (a)(ii)—3%
   (ii) sum of compensations within this level for years since 401(j)—$450,000 (10×$25,000+5×$40,000)
   (iii) product of (i) and (ii)—$13,500
   (c) Maximum benefit equals the sum of (a)(v) plus (b)(iii)—$13,500

If Step 1 is not less than Step 2(c), or if there are no further plan amendments, enter zero in Step 6 and proceed to Step 7. Otherwise proceed to Step 3.

Amendment: 1, 2, and 3.

3. Determine the accrued benefit on account of each subsequent amendment, using plan formula, and final average pay as follows:
   (a) Accrued benefit based on plan in effect after the amendment—$12,000 (2%×15×$40,000)
   (b) Accrued benefit based on plan in effect prior to the amendment—$6,000
   (c) Increase [(a)-(b)]—$6,000
4. Determine Averaged Cap steps:
   (a) Prior benefit accrual rate:
   (i) accrual rate for plan as established [Step 1÷(Step 2(a)(iii)+Step 2(b)(ii))]—1.33% $6,000 0+$450,000
   (ii) greater of Step 4(a)(i) in this column or Step 4(a)(iv) in prior column—1.33%
   (iii) from prior column [Step 5÷Step 4(d)]—0
   (iv) sum of Step 4(a)(iii) and Step 4 (a)(ii)—1.33%
   (b) Attained age applicable percentage at time of amendment—2.5%
   (c) Excess, if any [(b)-(a)(iv)]—1.17%
   (d) Sum of compensations within this level for years since amendment—$325,000 (5×$40,000+5×$25,000)
   (e) Product of (c) and (d)—$3,803
5. Maximum accrued benefit attributable to this amendment (Lesser of Step 3(c) or Step 4(e))—$3,803

If, for this amendment, Step 3(c) is not less than Step 4(e) or, if there are no subsequent amendments, proceed to Step 6. Otherwise, do Steps 3–5 for the next amendment.

6. Maximum accrued benefit due to all amendments (sum columns of Step 5)—$3,803
7. Maximum accrued benefit under plan as established (lesser of Steps 1 or 2(c))—$6,000
8. Maximum accrued benefit—Total (Sum of Step 6 and Step 7)—$9,803

Example (4). Multiple periods of participation. (i) Assume the same facts as in *Example (3)* of § 1.401(j)-1(g), except that the plan is a final average pay plan instead of a career average plan. The final average pay plan provides for an annual benefit accrual of 2.5% of the participant's average compensation for the high three years. The plan also limits benefit accruals to satisfy the limitation of this section and section 415. In each of the high three years, A earned $50,000. Therefore, A's accrued basic benefit under the plan (without regard to this section) equals $25,000 (2.5% of $50,000×20 years).

(ii) A's maximum benefit is determined by multiplying A's applicable percentage for each period of participation by the sum of A's compensation (not in excess of the contribution base) in that period of participation. As summarized in *Example (3)(vi)* of § 1.401(j)-1(g), A's compensation, applicable percentages and maximum benefits for each period of participation are as follows:

Age	Compensation per year	Rate	Benefit earned per year	Total benefit
30 to 31	$20,000	6.5	$1,300	$6,500
50 to 54	30,000	3.0	900	4,500
55 to 59	40,000	3.0	1,200	6,000
60 to 64	50,000	3.0	1,500	7,500
Total				24,500

(iii) Accordingly, A's maximum benefit under the final average pay plan would be $24,500 (the same as A's maximum benefit under the career average plan described in

Example (3) of § 1.401 (j)–1 (g)). Thus, the plan would satisfy section 401(j) if it provided A with a $24,500 normal retirement benefit instead of the $25,000 benefit determined under the plan formula without regard to this section.

§ 1.401(j)–6 Effective dates and transitional rules.

(a) *Effective dates.* Section 401(j) and the regulations thereunder apply to taxable years of an employer beginning after December 31, 1975, and to any plan year beginning with or within such taxable years.

(b) *Transitional rule.* (1) A plan will be treated as satisfying the requirements of section 401(j) for plan years beginning prior to January 23, 1982 if, for such years, any excess of the benefit accruing under the plan over the maximum benefit permitted for a participant under section 401(j) for such years is used, to the extent reasonably possible, to reduce the maximum benefit permitted under section 401(j) for plan years beginning on or after such date. This subparagraph will apply to a plan only if it is amended to satisfy the requirements of this subparagraph by the beginning of the first plan year beginning on or after January 23, 1982.

(2) A plan other than a plan described in section 412(i) will satisfy subparagraph (1) of this paragraph only if it is amended to provide that a participant who has accrued an excess benefit will reduce the accruals in each subsequent year by the remaining amount of such excess, until the excess is completely eliminated. An amendment required by this subparagraph shall not be considered a change in benefit accruals requiring the adjustments described in §§ 1.401(j)–3 or 1.401(j)–5(c).

(3) A plan described in section 412 (i) will satisfy subparagraph (1) if a new level premium is established based on a targeted cash surrender value at or below the limits described in § 1.401(j)–4(a).

(4) The rules of this paragraph may be illustrated by the following examples:

Example (1). (i) A, a partner in the X partnership, becomes a participant in the X Plan, a career average defined benefit plan, in 1977 at age 32. A accrues a basic benefit of 6.5% of compensation up to $50,000 for each year of service. A earns $20,000 in 1977, $30,000 in 1978, $40,000 in 1979, and $50,000 or more in 1980 and all subsequent years. In 1977, A accrues a basic benefit of $1,300 (6.5% of $20,000); in 1978, $1,950 (6.5% of $30,000); in 1979, $2,600 (6.5% of $40,000); and in 1980, $3,250 (6.5% of $50,000), for a total of $9,100. The plan otherwise complies with the requirements of section 401 and is not a plan described in section 412(i).

(ii) Under § 1.401(j)–1(c)(1) A's applicable percentage is 6.0% and A's maximum benefit accrual is $1,200 (6% of $20,000) for 1977; $1,800 (6% of $30,000) for 1978; $2,400 (6% of $40,000) for 1979; and $3,000 (6% of $50,000) for 1980, for a total maximum benefit of $8,400. Thus, A accrued an excess benefit of $700 in 1977–80. In 1980, the plan is amended effective January 1, 1981, the beginning of the plan year, to provide A with a benefit accrual in 1981 of $2,300 (6% of $50,000, or $3,000, minus $700) and 6% of compensation up to $50,000 thereafter.

(iii) Under subparagraphs (1) and (2), the plan will continue to be qualified because the amendment to reduce future accruals to the extent of past excess accruals was adopted before [one year after publication of this Treasury decision in the **Federal Register**]. A's applicable percentage remains 6.0% because the amendment required by this section does not begin a new period of participation.

Example (2). (i) A, a self-employed individual, begins participation in Plan X, a career average defined benefit plan, in 1976 at age 32. The plan is not a plan described in section 412(i). Each year A accrues a basic benefit of 6.5% of compensation up to $50,000. On May 1, 1980, A ceases to be covered by the plan.

(ii) Under § 1.401(j)–1(b) (1) A's maximum benefit for each plan year is 6.0% (the applicable percentage for age 32) of compensation up to $50,000. Therefore A has accrued a benefit in excess of the maximum benefit permitted under section 401(j). The plan will satisfy the requirements of section 401(j) if it is amended to provide that A's future benefit accruals will be reduced to zero until A's accrued benefit equals the sum of A's maximum benefits for all plan years in which A is or was subject to the section 401(j) limitations. The plan, so amended, will satisfy the requirements of this section even though A never again participates in the plan.

Example (3). (i) Employee A, a shareholder-employee, became a participant in a defined benefit plan in 1976 at age 45. The plan is a plan described in section 412(i) and the insurance company uses sex base tables to determine its premiums. A is male. A's compensation each year from 1976 through 1980 was $20,000. The plan year begins on January 1. In 1981, A's compensation was again $20,000. Under the terms of the plan in effect through 1980 and the terms of the insurance contract purchased to fund A's benefit, A's targeted cash surrender value was $150,000. However, under § 1.401(j)–4(a) the maximum targeted cash surrender value for A at age 65 is $133,488 (3.6% (A's applicable percentage) times 20 (A's years of possible participation to retirement) times $20,000 (A's compensation for each year) times 9.27 (Table A)).

(ii) The plan is amended in December 1980, effective January 1, 1981, to conform to these regulations. A lower annual premium is established to reflect the new targeted cash surrender value of $133,488. Under subparagraph (3), the plan will continue to be qualified because the plan has been amended to conform to these regulations prior to January 23, 1982.

Example (4). (i) Employee B, a shareholder-employee, became a participant in a defined benefit plan in 1979 at age 50. The plan is a plan described in section 412(i) and the insurance company uses sex-based tables to determine the premiums. B is female. B's compensation was $30,000 in 1979 and 1980 and increased to $40,000 in 1981. The plan year begins January 1. Under the terms of the plan in effect through 1980 and the terms of the insurance contract purchased to fund B's benefit, B's targeted cash surrender value was $185,000. However, under § 1.401(j)–4(a) the maximum targeted cash surrender value for B at age 65 was $146,880 (3% (B's applicable percentage) times 15 (B's years of possible participation to retirement) times $30,000 (B's compensation for each year) times 10.88 (Table A)).

(ii) The plan is amended in December 1980, effective January 1, 1981, to conform to these regulations. Because B's compensation increased and because the plan was amended, B's targeted cash surrender value at age 65 under the terms of the plan and insurance contracts purchased to fund B's benefits is $188,000. Under § 1.401(j)–4(a) the maximum targeted cash surrender value for B at age 65 is $189,312 (3% times $30,000 times 10.88 for each of the first two plan years plus 3% times 13 (B's years of possible plan participation from age 52 to retirement) times $40,000 (B's compensation) times 10.88). No adjustment in B's targeted cash surrender value need be made, even though B's targeted cash surrender value under the plan exceeded the maximum targeted cash surrender value for years prior to 1981.

(c) *Subchapter S plan in existence before December 31, 1975.* If a defined benefit plan covered a shareholder-employee in a plan year beginning before December 31, 1975, the pre-401(j) part of the plan is subject to the rules on taxability of shareholder-employees set forth in section 1379(b). The pre-401(j) part of the plan is the part attributable to benefits accrued for plan years beginning prior to December 31, 1975, in which the plan covered a shareholder-employee.

(Secs. 401(j), 7805, Internal Revenue Code of 1954 (88 Stat. 953, 68A Stat. 917 (26 U.S.C. 401(j), 7805)))

Jerome Kurtz,

Commissioner of Internal Revenue.

Approved: January 12, 1981.

Donald C. Lubick,

Assistant Secretary of the Treasury.

[FR Doc. 81–2337 Filed 1–19–81; 11:00 am]

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26 CFR Part 1

[T.D. 7765]

Investment Credit for Energy Property

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the business

investment credit for energy property. Changes in the applicable tax law were made by the Energy Tax Act of 1978. These regulations will provide the public with the guidance needed to comply with the law.

DATES: These regulations are effective, in general, for the period beginning on October 1, 1978, and ending December 31, 1982.

FOR FURTHER INFORMATION CONTACT: Mary Frances Pearson of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, D.C. 20224, Attention: CC:LR:T (202-566-3458, not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR Part 1) under section 48 of the Internal Revenue Code of 1954. These amendments were proposed in the **Federal Register** for September 19, 1980 (45 FR 62496). A public hearing concerning the proposed amendments was held on December 4, 1980. These amendments conform the regulations to certain changes made by section 301(b) of the Energy Tax Act of 1978 (Pub. L. 95-618, 92 Stat. 3174) and are issued under the authority contained in Code sections 7805 (68A Stat. 917, 26 U.S.C. 7805) and 38(b) (76 Stat. 962, 26 U.S.C. 38).

After careful consideration of the comments submitted in response to the notice of proposed rulemaking, and after consultation with the Department of Energy, the proposed rules are adopted, as revised by this Treasury Decision.

Windfall Profit Tax Legislation

This regulation does not reflect any amendments under sections 221-223 of the Crude Oil Windfall Profit Tax Act of 1980 (Pub. L. 96-223, 94 Stat. 229). Under that Act, certain categories of energy property have been expanded and effective dates for certain energy property have been extended. A subsequent notice of proposed rulemaking will cover those amendments.

In General

In general, a taxpayer may claim a 10-percent investment credit (regular credit) for certain tangible business property. The taxpayer may apply the regular credit against a portion of its tax liability. Unused credits may be carried forward or carried back. If property for which the regular credit was claimed is disposed of before the end of its estimated useful life, the credit must be recomputed on the basis of its actual life.

For the period beginning October 1, 1978, and ending December 31, 1982, section 301(b) of the Energy Tax Act of 1978 adds a 10 percent credit for energy property (energy credit). The rules for the regular credit apply, in general, to the energy credit. However, the energy credit may offset 100 percent of the tax liability remaining after applying the regular credit.

Energy property is defined as alternative energy property, solar or wind energy property, specially defined energy property, recycling equipment, shale oil equipment, and equipment used to produce natural gas from geopressured brine. Energy property must be new section 38 property. For the energy credit only, building and structural components of buildings and property used in lodging facilities (to the extent qualified, *e.g.*, solar or geothermal equipment) are treated as section 38 property. However, since this type of property, in general, is not otherwise section 38 property, the property does not qualify for the regular credit. Public utility property generally does not qualify as energy property. To be eligible, the original use of acquired property must begin after September 30, 1978, and before January 1, 1983. Property constructed by the taxpayer is eligible only to the extent of basis attributable to construction for the period beginning on October 1, 1978, and ending on December 31, 1982.

Recapture

If energy property is sold or otherwise disposed of, the recapture rules of section 47 apply to both the regular credit and energy credit. In response to public comments, the application of the section 47 recapture rules to the energy credit was clarified to emphasize that the recapture determination is based upon the estimated useful life of the property which was taken into account in computing qualified investment. Thus, the principles of recapture for the energy credit are the same as for the regular credit.

Alternative Energy Property

Alternative energy property includes (1) equipment which uses an alternate substance as a fuel, and (2) equipment which produces a snythetic fuel from an alternate substance. An alternate substance is a substance other than oil or natural gas or any product of oil or natural gas. Various comments suggested that the definition of alternate substance in the proposed regulations should be expanded to include the synthetic fuels produced from an alternate substance, oil shale, and tar sands. These suggestions were not adopted.

Congress provided a subsidy for direct use of alternate substances as a fuel as well as for producing synthetic fuels from the alternate substance. The commentators would disregard the word "synthetic" and would treat it as the equivalent of alternate substance, the very product from which the synthetic fuel is produced. Congress did not intend, however, to subsidize the use of synthetic fuel. Such a subsidy is unnecessary because synthetic fuel in most cases is a close substitute for conventional fuel and does not require specialized equipment. For example, a credit is provided for equipment used to produce methane from landfill, but, since such methane is a close substitute for pipeline quality natural gas, no credit is provided for equipment which uses such methane as a fuel and which is indistinguishable from equipment using natural gas.

The suggestion that shale oil and tar sands be considered alternate substances was not adopted because those are oil substances although in a form which makes their recovery more difficult. Of course, in the case of oil shale property, Congress provided a credit for such equipment in section 48(l)(7). The Senate had adopted a $3 per barrel credit for production of oil from tar sands. See H.R. 5263, section 1044, as passed by the Senate on October 31, 1977. However, that provision was rejected in Conference. Such a credit was adopted as section 44D of the Code by Congress in the Crude Oil Windfall Profit Tax Act of 1980. (Pub. L. 96-223 94 Stat. 268)

There were some suggestions that synthetic fuel production equipment be expanded to include an oxygen plant. Under section 48(l)(3)(iii), synthetic fuel equipment is "equipment for *converting* and alternate substance into a synthetic liquid, gaseous, or solid fuel. An oxygen plant does not convert the alternate substance into a synthetic fuel but merely supplies the catalyst use in the conversions process. If the statutory language meant to incorporate equipment not directly involved in the conversion process, language such as "used in connection with the conversion" would have been used instead. For this reason, oxygen plants are not synthetic fuel equipment under the regulations.

In response to comments, the definition of synthetic fuel has been changed to state that fuel derived from biomass which undergoes the process of defiberization is a synthetic fuel. This

change is consistent with the "chemical change" requirement since biomass is changed into a refuse derived fuel through a series of chemical and heat treatments which break down the structural fibers of the substance.

Pollution Control Equipment

Under the proposed regulations, pollution control equipment was eligible for the energy credit only if installed on or in connection with eligible alternative energy property. Pollution control equipment required by Federal, State, or local government regulation in effect on October 1, 1978, with respect to property burning coal on that date was excluded. Any order permitting delayed compliance was to be disregarded in determining whether property was required to be installed on October 1, 1978.

Several comments took issue with the requirement in § 1.48–9(c)(8)(iii) that in order for pollution control equipment to qualify as alternative energy property, it must be installed in connection with eligible alternative energy property. These comments were not adopted. The inclusion of certain pollution control equipment under the energy credit was not intended to provide a general subsidy for pollution control equipment, but rather was intended to provide an incentive for the installation of new property using alternate substances. A credit was provided for pollution control equipment only to the extent that such equipment was required for the installation of the alternative energy property. Therefore, this limitation remains in the final rules.

Comments also suggested that orders which permit delayed compliance should be considered in determining what pollution control equipment was required on October 1, 1978. The statutory language in section 48(l)(3)(C) indicates an intention to determine what equipment was required by reference to rules of general application. The law clearly denies the credit to taxpayers who installed such equipment prior to October 1, 1978. Taxpayers, required to install pollution control equipment on that date, who arranged to delay compliance should not be given preferential treatment.

Geothermal Equipment

Under section 48(l)(3)(A)(viii), alternative energy property includes "equipment used to produce, distribute, or use energy derived from a geothermal deposit (within the meaning of section 613(e)(3)). . . ." The proposed regulations defined geothermal deposit by cross-reference to section 1.44C–2(h), which requires a wellhead temperature exceeding 50°C. The proposed regulations also provided that, to qualify, geothermal equipment (1) must be specially adapted to use geothermal energy and (2) must be used exclusively with energy derived from a geothermal deposit. Under the statute, production and distribution equipment qualifies while exploration and development equipment does not.

Comments suggested elimination of the "dual function rule." The dual function rule prevents unnecessary administrative burdens and reflects Congressional intent to limit the subsidy to equipment exclusively used for geothermal energy. Without such a rule, it frequently would be impossible to determine when energy from a geothermal deposit is being used. Further, property which uses energy from a conventional source in addition to geothermal energy is indistinguishable from property that performs the same function without the use of geothermal energy. Congress did not intend to provide a credit for property that would be purchased for conventional heating or cooling uses. However, as noted below, the rule is clarified to indicate that dual use is determined by reference to the particular application, and not by reference to any uses for any equipment.

In response to comments, the final regulations do not contain the specially adapted equipment rule. The comments noted that, in general, geothermal equipment is not specially designed for geothermal use. Consequently, adoption of this rule would have disqualified most geothermal equipment. In response to requests by commentators, the regulations also make it clear that "downhole" equipment necessary to produce geothermal energy (*e.g.*, screening or slotted liners, tubing and downhole pumps), and reinjection well property are production equipment.

Finally, comments have criticized the § 1.44C–2(h) requirement adopted by cross reference that the wellhead temperature exceed 50°C for an energy source to be considered to be a geothermal deposit. The statutory language "energy derived from a geothermal *deposit* (within the meaning of section 613(e)(3)) (emphasis added)" indicates a clear Congressional intent to limit the credit to property utilizing geothermal energy contained in a distinct, specific, and identifiable reservoir. Reference to the depletion provisions contemplates a depletable energy source, and not an aquifer whose water is being constantly replenished.

The intent to thus restrict the term geothermal is also reflected in the description of geothermal energy in the Ways and Means committee print, Energy Program, Number 11, "Geothermal Tax Provisions and Minimum Tax Treatment of Intangible Drilling Costs for Oil and Gas," prepared by the staff of the Joint Committee on Taxation, June 11, 1977. In the committee print, which provided the technical background material for the legislation which ultimately became the Energy Tax Act of 1978, geothermal energy is described by reference as definable deposits of steam, hot water and hot, dry rocks. The lowest temperature mentioned is 60°C, the highest, 1500°C. The technology described involved direct use of the heat from such resources.

Recognizing the difficulty taxpayers would otherwise face in demonstrating that energy was derived from a sufficiently identifiable and depletable deposit, the proposed regulations provide a 50°C rule as a safe-harbor rule. The final regulations retain this liberal rule.

Solar Energy Property

In response to comments, the definition of solar energy property was expanded to make it clear that it includes storage devices, power conditioning equipment, transfer equipment, and property solely related to the functioning of those items. However, such equipment does not include transmission equipment.

Wind Energy Property

A number of comments cited specific legislative history to the effect that wind energy property includes "transfer equipment." *See*, H. Rep. No. 95–496, Part III, 95th Cong., 1st Sess., p. 121; S. Rep. No. 95–1324, 95th Cong., 2d Sess., p. 62). Accordingly, transfer equipment is specifically added to the definition of wind energy property. Transfer equipment includes equipment which permits the aggregation of electricity generated by several windmills and equipment which alters voltage in order to permit transfer to a transmission line. However, transfer equipment does not include transmission lines, a distinction based upon the technical definition of the terms transfer and transmission, and on specific references to transmission in the Act (both including and excluding such equipment) indicating Congressional cognizance of the differences between the two functions.

Specially Defined Energy Property

Section 48(l)(5) lists items of specially defined energy property, which qualify for the energy credit if installed in an existing industrial or commercial process. The proposed regulations

provided descriptions of the items listed. The proposed regulations also excluded equipment used in connection with general office, retail, and similar activities as not involving industrial or commercial processes.

A large number of comments suggested that the term "industrial or commercial process" should include office, retail, and similar activities. Specifically, many commentators argued that automatic energy control systems even when installed in retail stores, office buildings, or multi-family dwellings should qualify for the energy credit as specially defined energy property. The commentators relied primarily on the fact that the administration had proposed a business energy conservation credit which applied to all business buildings and on the appearance of the term "automatic energy control systems" in the statute. These comments were rejected as being inconsistent with the statute and the legislative history of the provision.

The Administration 1977 energy tax proposals contained a general business energy conservation credit which combined both industrial and commercial conservation property under one category. See the Treasury Department's Technical Explanation A-7, published May 16, 1977. Thus, automatic energy control systems, recuperators, and heart wheels (presently eligible for a credit as specially defined energy property) were on a list with insulation, double glazing, and other business insulation property. The House generally adopted the Administration proposal with respect to the business energy credits. However, the House distinguished between those items that were specially designed to achieve conservation in existing industrial processes and items for general business conservation uses.

Property identified as qualifying for the conservation credit, in addition to insulation, included items to be designated by the Secretary as being designed to reduce the heat loss or gain of an existing commercial or industrial building or facility. In contrast to "specifically" defined energy property the class of property described in the conservation credit was not limited by reference to recovery of waste heat or gas nor was it required that it be installed in connection with an existing process. (See, section 2061 (b) & (c) of H.R. 8444 as passed by the House on August 5, 1977; The Ways and Means Committee report (H. Rep. No. 95-496, Part III, 95th Cong. 1st Sess., p. 121).

The Senate bill expanded the definition of specially defined energy property, and retained the House conservation provision. Under the Senate bill, the requirement of use with an existing process was eliminated because the Senate has expanded the qualifying category of items to include non-process items. Thus, under the Senate bill the result called for in these comments would have been correct. (See section 1031 of H.R. 5263 as passed by the Senate October 31, 1977).

However, in Conference, the conferees adopted the House specially defined energy tax credit provision, reinserting the existing industrial or commercial process limitation which the Senate had deleted. The position taken in the comments would require interpreting "in connection with an existing industrial or commercial process," which Congress specifically reinserted, in a way which would cause it to have no meaning. The insulation and conservation credit was not adopted because of budgetary constraints. (See, S. Rep. No. 95-1324) (Conference Report), 95th Cong., 2d Sess., p. 64-67.)

In response to a number of comments, several technical changes were made in the definition of the listed items.

Recycling Equipment

Under section 48(1)(6), recycling equipment is equipment that sorts or prepares solid waste for recycling or that recycles solid waste, as well as equipment that converts solid waste into useful energy. The proposed regulations defined solid waste by reference to the definition in the regulations under section 103(b)(4)(E), which permits tax-exempt financing of "solid waste disposal facilities." Under the proposed rules, the recycling process for recovering raw materials from solid waste is limited to one in which raw materials are recovered which may be used in fabricating an end product in the same way as materials from a virgin substance.

A number of comments suggested including "reconstituted products for commercial purposes" in the definition of recycling. Thus, equipment used to remanufacture used industrial and automotive parts, such as valves, gaskets, carburetors, and distributors or to retread tires would be eligible for the credit. These suggestions were not adopted. Permitting equipment used in these processes to qualify would be inconsistent with the Senate Report which requires that recycling equipment (other than conversion equipment) be designed to recover raw materials. (See, S. Rep. 95-529, 95th Cong., 1st Sess., at 82.) Thus, no change is made in the proposed rules in response to these comments.

In response to a request for clarification, the final rules specify that equipment that processes animal waste is not recycling equipment.

Some comments suggested that the regulations incorporate by reference the definition of solid waste under 42 U.S.C. § 6903, the Solid Waste Disposal Act, as amended, (which treats *e.g.*, liquid and gaseous wastes as "solid waste") rather than the definition of solid waste in the regulations under section 103(b)(4). It is not appropriate to adopt this suggestion.

There is no indication that Congress intended to alter the tax definition of solid waste (except to the extent described below). The legislative history of section 103(b)(4)(E) incorporates by reference, and specifically cites, the definition of solid waste in the Solid Waste Disposal Act in effect at that time. (See, H. Rep. No. 1533, 90 Cong., 2d Sess., p. 38). When that definition in that Act was subsequently amended, Congress did not conform the tax law to the new definition. Furthermore, the legislative history of the Energy Tax Act of 1978 contains no cross-reference to the Solid Waste Disposal Act, as amended, thereby impliedly accepting the existing tax definition.

As a general rule, Congress is presumed to intend terms to have the same meaning for tax purposes when used in more than one Code section. Therefore, under the final rules, the term continues to have the same meaning for purposes of the energy credit as under the regulations under section 103(b)(4)(E).

However, Congress clearly intended certain changes be made in the tax definition of solid waste for purposes of the energy credit. The section 103 regulation excludes from the definition of solid waste any substance that may be sold (*i.e.*, for value) to an unrelated third party. Under this rule, virtually none of the items identified in the Senate Report, such as scrap metal, newsprint, and fibers would be considered solid waste, since all of these items have a market value at least equal to the price a recycler would pay for the material. See, Senate Report, at 83.

Therefore, the proposed regulation defined solid waste by beginning with the section 103 definition but has modified it by deleting an irrelevant reference to the date of issue of obligations, by adding a provision which indicates that if the market value of material is attributable only to its recycling use the material is not considered to have a market value, and by permitting the recycled material to include not more than 10 percent virgin material during a taxable year.

Shale Oil Equipment

In response to comments, the distinction in the proposed regulations between surface mining equipment and equipment used in *in situ* technology is eliminated in the final rules. The distinction appeared in the Senate Report at page 83, although it was not made in the Conference Report. It was decided that, consistent with the legislative intent to encourage shale oil development, the final rules should not favor any particular shale oil recovery technology. In addition, the rules are clarified to indicate that retorting includes direct cooling and condensing and that water supply and treatment equipment and handling equipment for spent shale qualifies. However, under the statute equipment which is used for hydrogenation, refining, or other process subsequent to retorting does not qualify. Consequently, gas cleanup equipment has not been included within the qualified category of equipment.

Several comments took issue with the incremental cost rule in the proposed regulations. Incremental cost is the excess of the total cost of equipment over the amount that would have been expended for the equipment if the equipment were not used for a qualifying purpose.

One item of property in many instances can be used in part for a qualifying energy purpose and in part for non-qualifying functions. The approach in this situation is to give no energy credit for the property, partial credit or full credit. Denying the credit entirely would discourage energy property investments. On the other hand, property which incidently serves an energy function should not receive the subsidy of a full energy credit. The fairer approach adopted in this regulation is the incremental cost rule.

Drafting Information

The principal author of these regulations is Mary Frances Pearson of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations, both on matters of substance and style.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR Part 1 is amended as follows:

Paragraph 1. Section 1.47–1 is amended as follows:

1. Paragraph (a)(1)(i) is amended by adding at the end thereof "For rules applicable to energy property, see paragraph (h) of this section."

2. A new paragraph (h) is added to read as set forth below:

§ 1.47–1 Recomputation of credit allowed by section 38.

* * * * *

(h) *Special rules for energy property*—(1) *In general.* A recapture determination is required for the investment credit attributable to the energy percentage (energy credit) if property is (i) disposed of or (ii) otherwise ceases to be energy property (as defined in section 48(l)) with regard to the taxpayer before the close of the estimated useful life (as determined under paragraph (a)(2)(i) of this section) which was taken into account in computing qualified investment.

(2) *Dispositions.* The term "disposition" is described in § 1.47–2(a)(1). A transfer of energy property that is a "disposition" requiring a recapture determination for the investment credit attributable to the regular percentage (regular credit) and the ESOP percentage (ESOP credit) will also be a "disposition" requiring a recapture determination for the energy credit.

(3) *Cessation.* The term "cessation" is described in § 1.47–2(a)(2). For energy property, a cessation occurs during a taxable year if, by reason of a change in use or otherwise, the property would not have qualified for an energy credit if placed in service during that year. A change in use will not require a recapture determination for the regular or ESOP credit unless, by reason of the change, the property would not have qualified for the regular or ESOP credit if placed in service during that year.

(4) *Recordkeeping requirement.* For recordkeeping requirements with respect to dispositions or cessations, the rules of paragraph (e)(1) of this section apply. For example, the taxpayer must maintain records for each recycling facility indicating the percentage of virgin materials used each year. See, § 1.48–9(g)(5)(ii).

(5) *Examples.* The following examples illustrate this paragraph (h).

Example (1). (a) In 1980, corporation X, a calendar year taxpayer, acquires and places in service a computer that will perform solely energy conserving functions in connection with an existing industrial process. Assume the computer has a 10 year useful life and qualifies for both the regular and energy credits. In 1981, a change is made in the industrial process (within the meaning of § 1.48–9(l)(2)). However, for 1981 the computer continues to perform solely energy conserving functions. In 1982, the computer ceases to perform energy conserving functions and begins to perform a production related function.

(b) For 1981, a recapture determination is not required. For 1982, the entire energy credit must be recaptured, although none of the regular credit is recaptured. If in 1989 the computer first ceased to perform an energy conserving function, no part of the energy credit would be recaptured.

Example (2). Assume the same facts and conclusion as in example (1). Assume further that X sells the computer in 1985. A recapture determination is required for the regular credit.

Example (3). In 1981, corporation Y, a calendar year taxpayer, acquires and places in service recycling equipment. Assume the equipment has a 7-year useful life and qualifies for both the regular credit and energy credit. During the course of 1982, more than 10 percent of the material recycled is virgin material. The energy credit is recaptured in its entirety, although none of the regular credit is recaptured. See § 1.48–9(g)(5)(B)(ii).

Example (4). In 1980, corporation Z, a calendar year taxpayer, acquires and places in service a boiler the primary fuel for which is an alternate substance. The boiler has a 7-year useful life. Assume the boiler is a structural component of a building within the meaning of § 1.48–1(e)(2). Assume further that the boiler is not a part of a qualified rehabilitated building (as defined in section 48(g)(1)) or a single purpose agricultural or horticultural structure (as defined in section 48(p)). Z is allowed only an energy credit since the boiler is a structural component of a building. In 1984, Z modifies the boiler to use oil as the primary fuel. A recapture determination is required for the energy credit. See § 1.48–9(c)(3).

Par. 2. A new § 1.48–9 is added to read as set forth below:

§ 1.48–9 Definition of energy property.

(a) *General rule*—(1) *In general.* Under section 48(l)(2), energy property means property that is described in at least one of 6 categories of energy property and that meets the other requirements of this section. If property is described in more than one of these categories, or is described more than once in a single category, only a single energy investment credit is allowed. In that case, the energy investment credit will be allowed under the category the taxpayer chooses by indicating the chosen category on Form 3468, Schedule B. The 6 categories of energy property are:

(i) alternative energy property,
(ii) solar or wind energy property,
(iii) specially defined energy property,
(iv) recycling equipment,
(v) shale oil equipment, and
(vi) equipment for producing natural gas from geopressured brine.

(2) *Depreciable property with 3-year useful life.* Property is not energy property unless depreciation (or amortization in lieu of depreciation) is

allowable and the property has an estimated useful life (determined at the time when the property is placed in service) of 3 years or more.

(3) *Effective date rules.* To be energy property—

(i) If property is constructed, reconstructed or erected by the taxpayer, the construction, reconstruction, or erection must be completed after September 30, 1978, or

(ii) If the property is acquired, the original use of the property must (A) commence with the taxpayer and (B) commence after September 30, 1978, and before January 1, 1983.

For transitional rules, see section 48(m).

(4) *Cross references.* (i) To determined if depreciation (or amortization in lieu of depreciation) is allowable for property, see § 1.48–1(b).

(ii) For the meaning of "estimated useful life", see § 1.46–3(e)(7).

(iii) The meaning of "acquired", "original use", "construction", "reconstruction", and "erection" is determined under the principles of § 1.48–2(b).

(iv) For the definition of energy investment credit (energy credit), see section 48(o)(2).

(v) For special rules relating to public utility property, see paragraph (n) of this section.

(b) *Relationship to section 38 property*—(1) *In general.* (i) Energy property is treated under section 48(l)(1) as meeting the general requirements for section 38 property set forth in section 48(a)(1). For example, structural components of a building may qualify for the energy credit. In addition, the exclusion from section 38 property under section 48(a)(3) (lodging limitation) does not apply to energy property. For purposes of the energy credit, energy property is treated as section 38 property solely by reason of section 48(l)(1). For example, if property ceases to be energy property, it ceases to be section 38 property for all purposes relating to the energy credit and, thus, if subject to recapture under section 47. See § 1.47–1(h).

(ii) See the effective date rules under paragraph (a)(3) of this section for limitations on the eligibility of property as energy property.

(iii) Section 48(l)(1) does not affect the character of property under sections of the Code outside the investment credit provisions. For example, structural components of a building that are treated as section 38 property under section 48(l)(1) remain section 1250 property and are not section 1245 property.

(2) *Other section 48 rules apply.* (i) In general, section 48(a) otherwise applies in determining if energy property is section 38 property. Thus, energy property excluded from the definition of section 38 property under section 48(a) (except by reason of section 48(a)(1) or (a)(3)) is not eligible for the energy credit. For example, energy property used predominantly outside the United States (section 48(a)(2)) or used by tax exempt organizations (section 48(a)(4)), in general, is not treated as section 38 property for any purpose and thus, is not eligible for the energy credit.

(ii) Other rules of section 48, such as those for leased property under section 48(d), also apply to energy property.

(3) *Regular credit denied for certain energy property.* In computing the amount of credit under section 46(a)(2), the regular percentage does not apply to any energy property which, but for section 48(l)(1), would not be section 38 property. See section 46(a)(2)(D). For example, energy property used for lodging (section 48(a)(3)) and, in general, structural components of a building (section 48(a)(1)(B)) re not eligible for the regular credit even though they may be eligible for the energy credit. However, a structural component of a qualified rehabilitated building (as defined in section 48(g)(1)) or a single purpose agricultural or horticultural structure (as defined in section 48(p)) may qualify for the regular credit without regard to section 48(l)(1).

(c) *Alternative energy property*—(1) *In general.* Alternative energy property means property described in paragraph (c)(3) through (10) of this section. In general alternative energy property includes certain property that uses an alternate substance as a fuel or feedstock or converts an alternate substance to a synthetic fuel and certain associated equipment.

(2) *Alternate substance.* (i) An alternate substance is any substance or combination of substances other than an oil or gas substance. Alternate substances include coal, wood, and agricultural, industrial, and municipal wastes or by-products. Alternate substances do not include synthetic fuels or other products that are produced from an alternate substance and that have undergone a chemical change as described in paragraph (c)(5)(ii) of this section. For example, methane produced from landfills is not an alternate substance; rather it is a synthetic fuel produced from an alternate substance. However, preparing an alternate substance for use as a fuel or feedstock or for conversion into a fuel does not create a new product if no chemical change occurs. For example, pelletizing, drying, compacting, and liquefying do not result in a new product if no chemical change occurs.

(ii) The term "oil or gas substance" means—

(A) oil or gas and

(B) any primary product of oil or gas.

(iii) For the definition of primary product of oil or gas, see § 1.993–3(g)(3)(i), (ii), and (vi). Thus, petrochemicals are not primary products of oil or gas.

(3) *Boiler.* (i) A boiler that uses an alternate substance as its primary fuel is alternative energy property.

(ii) A boiler is a device for producing vapor from a liquid. Boilers, in general, have a burner in which fuel is burned. A boiler includes a fire box, boiler tubes, the containment shell, pumps, pressure and operating controls, and safety equipment, but not pollution control equipment (as defined in paragraph (c)(8) of this section).

(iii) A "primary fuel" is a fuel comprising more than 50 percent of the fuel requirement of an item of equipment, measured in terms of Btu's for the remainder of the taxable year from the date the equipment is placed in service and for each taxable year thereafter. Electricity and waste heat are not fuels. For example, electric boilers do not qualify as alternative energy property even if the electricity is derived from an alternate substance.

(4) *Burners.* (i) A burner for a combustor other than a burner described in paragraph (c)(3)(ii) of this section is alternative energy property if the burner uses an alternate substance as its primary fuel (as defined in paragraph (c)(3)(iii) of this section).

(ii) A burner is the part of a combustor that produces a flame. A combustor is a process heater which includes ovens, kilns, and furnaces.

(iii) A burner includes equipment (such as conveyors, flame control devices, and safety monitoring devices) located at the site of the burner and necessary to bring the alternate substance to the burner.

(5) *Synthetic fuel production equipment.* (i) Equipment (synthetic fuel equipment) that converts an alternate substance into a synthetic solid, liquid, or gaseous fuel (other than coke or coke gas) is alternative energy property. Synthetic fuel production equipment does not include equipment, such as an oxygen plant, that is not directly involved in the treatment of an alternate substance, but produces a substance that is, like the alternate substance, a basic feedstock or catalyst used in the conversion process. Equipment is not eligible if it is used beyond the point at which a substance usable as a fuel has been produced. Equipment is eligible

only to the extent of the equipment's cost or basis allocable to the annual production of substances used as a fuel or used in the production of a fuel. For example, assume for the taxable year that 50 percent of the output of equipment is used to produce alcohol for production of whiskey and 50 percent is used to produce alcohol for use in a fuel mixture, such as gasohol. The alcohol production equipment qualifies as synthetic fuel equipment but only to the extent of one-half of its cost or basis. If, in a later taxable year, the equipment is used exclusively to produce whiskey, all of the equipment ceases to be synthetic fuel equipment.

(ii) A fuel is a material that produces usable heat upon combustion. To be "synthetic", the fuel either must differ significantly in chemical composition, as opposed to physical composition, from the alternate substance used to produce it or, in the case of solid fuel produced from biomass, the chemical change must consist of defiberization. Examples of synthetic fuels include alcohol derived from coal, peat, and vegetative matter, such as wood and corn, and methane from landfills.

(iii) Synthetic fuel equipment includes coal gasification equipment, coal liquefaction equipment, equipment for recovering methane from landfill, and equipment that converts biomass to a synthetic fuel.

(iv) Synthetic fuel equipment does not include equipment that merely mixes an alternate substance with another substance. For example, synthetic fuel equipment includes neither equipment that mixes coal and water to produce a slurry nor equipment that mixes alcohol and gasoline to produce gasohol. Equipment used to produce coke or coke gas, such as coke ovens, is also ineligible.

(6) *Modification equipment.* (i) Alternative energy property includes equipment (modification equipment) designed to modify existing equipment. For the definition of "existing," see paragraph (l)(1)(i) of this section. To be eligible, the modification must result in a substitution for the remainder of the taxable year from the date the equipment is placed in service and for each taxable year thereafter of the items in paragraph (c)(6)(ii)(A) or (B) of this section for all or a portion of the oil or gas substance used as a fuel or feedstock. As a result of the modification, the substituted alternate substance must comprise at least 25 percent of the fuel or feedstock (determined on the basis of Btu equivalency). If the modification also increases the capacity of the equipment, only the incremental cost (as defined in paragraph (k) of this section) of the equipment qualifies.

(ii) The substitutes for an oil or gas substance are—

(A) An alternate substance or

(B) A mixture of oil and an alternate substance.

(iii) Modification equipment does not include replacements or a boiler of burner. If the boiler or burner is replaced, the items must be described in paragraph (c) (3) or (4) of this section to qualify as alternative energy property. Modification may include, however, replacements of components of a boiler or burner, such as a heat exchanger.

(iv) The following examples illustrate this paragraph (c)(6).

Example (1). On January 1, 1980, corporation X is using oil to fuel its boiler. On June 1, 1980, X modifies the boiler to permit substitution of a coal and oil mixture for 40 percent of X's oil fuel needs. The mixture consists 75 percent of oil and 25 percent of coal. The equipment modifying the boiler does not qualify as modification equipment because the alternate substance comprises only 10 percent of the fuel.

Example (2). Assume the same facts as in example (1) except 75 percent of the mixture is coal. The equipment modifying the boiler qualifies.

Example (3). Assume the same facts as in example (2) except, instead of substituting an oil and coal mixture for 40 percent of X's oil fuel needs, X uses the modification to expand the boiler's fuel capacity by 40 percent using the mixture as additional fuel. The additional fuel mixture comprises only 28 percent of X's total fuel needs. Thus, even though 75 percent of the additional fuel mixture is an alternate substance, the boiler does not qualify as modification equipment because the alternate substance comprises only 21 percent of the total fuel.

(7) *Equipment using coal as feedstock.* Equipment that uses coal (including lignite) to produce a feedstock for the manufacture of chemicals, such as petrochemicals, or other products is alternative energy property. Equipment is not eligible if it is not directly involved in the treatment of coal or a coal product, but produces a substance that is, like coal, a basic feedstock or catalyst used in the coal conversion process. Equipment is not eligible if it is used beyond the point at which the first product marketable as a feedstock has been produced. Equipment used to produce coke or coke gas, such as coke ovens, is ineligible.

(8) *Pollution control equipment.* (i) Pollution control equipment is alternative energy property. Eligible equipment is limited to property or equipment to the extent it qualifies as a pollution control facility under section 103(b)(4)(F) and the regulations thereunder except that, if control of pollution is not the only significant purpose (within the meaning of those regulations), only the incremental cost (as defined in paragraph (k) of this section) of the equipment qualifies. However, if a Treasury decision changes the regulations under section 103(b)(4)(F) and, thus, the rules reflected in this subdivision (i), the rules as changed will apply as of the effective date of the Treasury decision.

(ii) To be eligible, the equipment must be required by a Federal, State, or local government regulation to be installed on, or used in connection with, eligible alternative energy property (as defined in paragraph (c)(8)(v) of this section).

(iii) Under section 48(l)(3)(D) equipment is not eligible if required by a Federal, State, or local government regulation in effect on October 1, 1978, to be installed on, or in connection with, property using coal (including lignite) as of October 1, 1978.

(iv) Under this subparagraph (8), pollution control equipment is required by regulation if it would be necessary to install the equipment to satisfy the requirements of any applicable law, including nuisance law. The pollution control equipment need not be specifically identified in the applicable law. If several different types of equipment may be used to comply with the applicable law, each type of equipment is considered necessary to satisfy the requirements of the law. An order permitting a taxpayer to delay compliance with any applicable law is disregarded.

(v) Under this subparagraph (8) "eligible alternative energy property" is energy property (as defined in section 48 (l)(2)) described in paragraph (c) (3) through (7) of this section. If equipment otherwise qualifying as pollution control equipment is installed on, or used in connection with, both eligible alternative energy property and property other than eligible alternative energy property, only the incremental cost (as defined in paragraph (k) of this section) of the equipment qualifies.

(vi) *Examples.* The following examples illustrate this subparagraph (8). Assume that the property or equipment in the examples are described in § 1.103–8(g)(2)(ii) and that their only purpose is control of pollution.

Example (1). On October 1, 1978, corporation X acquires and places in service in State A a paper mill. The facility includes a boiler the primary fuel for which is wood chips. The facility includes equipment necessary to comply with pollution control standards in effect on October 1, 1978 in State A. This equipment qualifies as pollution control equipment.

Example (2). On October 1, 1978, corporation Y was burning coal at its facility

in State B. The emissions from the facility exceeded State air pollution control requirements in effect on October 1, 1978. On January 1, 1979, X installed cyclone separators to comply with the State pollution control requirements. The cyclone separators do not qualify as pollution control equipment.

Example (3). Assume the same facts as in example (2) except that Y installs a baghouse instead of cyclone separators to meet more stringent standards that take effect on December 31, 1978. The baghouse qualifies as pollution control equipment because the baghouse was not necessary to meet the standards in effect on October 1, 1978.

Example (4). On October 1, 1978, corporation Z is burning coal at its facility in State C. The emissions from that facility exceed State air pollution control standards in effect on October 1, 1978. C orders Z to install cyclone separators before January 1, 1979. However, C allows Z to operate its facility until January 1, 1979, under less stringent interim standards applicable only to Z. The separators do not qualify as pollution control equipment. The delayed compliance order is disregarded.

(9) *Handling and preparation equipment.* (i) Alternative energy property includes equipment (handling and preparation equipment) used for unloading, transfer, storage, reclaiming from storage, or preparation of an alternate substance for use in eligible alternative energy property (as defined in paragraph (c)(9)(ii) of this section). Handling and preparation equipment must be located at the site the alternate substance is used as a fuel or feedstock. For example, equipment used to screen and prepare coal for use at a power plant qualifies if located at the plant. However, similar equipment located at the coal mine would not qualify.

(ii) Under this subparagraph (9), "eligible alternative energy property" is energy property (as defined in section 48(l)(2)) described in paragraph (c) (3) through (8) of this section. If equipment otherwise qualifying as handling and preparation equipment is installed on, or used in connection with, property other than eligible alternative energy property, only the incremental cost (as defined in paragraph (k) of this section) of the equipment qualifies.

(iii) The term "preparation" includes washing, crushing, drying, compacting, and weighing of an alternate substance. Handling and preparation equipment also includes equipment for shredding, chopping, pulverizing, or screening agricultural or forestry byproducts at the site of use.

(iv) Handling and preparation equipment does not include equipment, such as coal slurry pipelines and railroad cars, that transports a fuel or a feedstock to the site of its use.

(10) *Geothermal equipment.* (i) Alternative energy property includes equipment (geothermal equipment) that produces, distributes, or uses energy derived from a geothermal deposit (as defined in § 1.44C–2(h)).

(ii) In general, production equipment includes equipment necessary to bring geothermal energy from the subterranean deposit to the surface, including well-head and downhole equipment (such as screening or slotted liners, tubing, downhole pumps, and associated equipment). Reinjection wells required for production also may qualify. Production does not include exploration and development.

(iii) Distribution equipment includes equipment that transports geothermal steam or hot water from a geothermal deposit to the site of ultimate use. If geothermal energy is used to generate electricity, distribution equipment includes equipment that transports hot water from the geothermal deposit to a power plant. Distribution equipment also includes components of a heating system, such as pipes and ductwork that distribute within a building the energy derived from the geothermal deposit.

(iv) Equipment that uses energy derived from a geothermal deposit is eligible only if it uses geothermal energy exclusively. Thus, geothermal equipment does not include equipment that uses energy derived both from a geothermal deposit and from sources other than a geothermal deposit. However, the existence of a backup system designed for use only in the event of a failure in the system providing energy derived from a geothermal deposit will not disqualify any other equipment. For example, radiators, fan-coil units, and baseboard heaters are not eligible if they are used in a particular application with hot water from sources other than a geothermal deposit. If geothermal energy is used to generate electricity, equipment using geothermal energy includes the electrical generating equipment, such as turbines and generators. However, geothermal equipment does not include any electrical transmission equipment, such as transmission lines and towers, or any equipment beyond the electrical transmission stage, such as transformers and distribution lines.

(v) *Examples.* The following examples illustrate this subparagraph (10):

Example (1). In 1979, corporation X installs a system which heats its office building by circulating hot water heated by energy derived from a geothermal deposit through the building. Geothermal equipment includes the circulation system, including the pumps and pipes which circulate the hot water through the building.

Example (2). The facts are the same as in example (1), except that corporation X also installs a boiler to produce hot water for heating the building exclusively in the event of a failure of the geothermal equipment. Such a boiler is not geothermal equipment, but the existence of such a backup system does not serve to disqualify property eligible in example (1).

Example (3). The facts are the same as in example (1), except that the water heated by energy derived from a geothermal deposit is not hot enough to provide sufficient heat for the building. Therefore, X installs a system in which the water is heated by an electric boiler before being circulated in the heating system. In this case, neither the boiler nor the circulating system is considered to be geothermal equipment.

Example (4). Corporation Y acquires a commercial vegetable dehydration system in 1981. The system operates by placing fresh vegetables on a conveyor belt and moving them through a dryer. The conveyor belt is powered by electricity. The dryer uses solely energy derived from a geothermal deposit. The dryer is geothermal equipment while the equipment powered by electricity does not qualify.

(d) *Solar energy property*—(1) *In general.* Energy property includes solar energy property. The term "solar energy property" includes equipment and materials (and parts solely related to the functioning of such equipment) that use solar energy directly to (i) generate electricity, (ii) heat or cool a building or structure, or (iii) provide hot water for use within a building or structure. Generally, these functions are accomplished through the use of equipment such as collectors (to absorb sunlight and create hot liquids or air), storage tanks (to store hot liquids), rockbeds (to store hot air), thermostats (to activate pumps or fans which circulate the hot liquids or air), and heat exchangers (to utilize hot liquids or air to create hot air or water). Property that uses, as an energy source, fuel or energy derived indirectly from solar energy, such as ocean thermal energy, fossil fuel, or wood, is not considered solar energy property.

(2) *Passive solar excluded* (i) Solar energy property excludes the materials and components of "passive solar systems," even if combined with "active solar systems."

(ii) An active solar system is based on the use of mechanically forced energy transfer, such as the use of fans or pumps to circulate solar generated energy.

(iii) A passive system is based on the use of conductive, convective, or radiant energy transfer. Passive solar property includes greenhouses, solariums, roof ponds, glazing, and mass or water trombe walls.

(3) *Electric generation equipment.* Solar energy property includes equipment that uses solar energy to

generate electricity, and includes storage devices, power conditioning equipment, transfer equipment, and parts solely related to the functioning of those items. In general, this process involves the transformation of sunlight into electricity through the use of such devices as solar cells or other collectors. However, solar energy property used to generate electricity includes only equipment up to (but not including) the stage that transmits or uses electricity.

(4) *Pipes and ducts.* Pipes and ducts are solar energy property if used exclusively to carry energy derived from solar energy.

(5) *Specially adopted equipment.* Equipment that uses solar energy beyond the distribution stage is eligible only if specially adopted to use solar energy.

(6) *Auxiliary equipment.* Solar energy property does not include equipment (auxiliary equipment), such as furnaces and hot water heaters, that use a source of power other than solar or wind energy to provide usable energy. Solar energy property also does not include equipment, such as ducts and hot water tanks, whether utilized solely by auxiliary equipment or by both auxiliary equipment and solar energy equipment.

(7) *Solar process heat equipment.* Solar energy property does not include equipment that uses solar energy to generate steam at high temperatures for use in industrial or commercial processess (solar process heat).

(8) *Example.* The following example illustrates this paragraph (d).

Example. (a) In 1979, corporation X constructs an apartment building and purchases equipment to convert solar energy into heat for the building. Corporation X also installs an oil-fired water heater and other equipment to provide a backup source of heat when the solar energy equipment cannot meet the energy needs of the building.

(b) The items purchased in addition to the water heater include a roof solar collector, a heat exchanger, a hot water tank, a control component, pumps, pipes, fan-coil units, and valves. Assume the fan-coil units could be used with energy derived from an oil or gas substance without significant modification. All items are depreciable and have a useful life of three years or more. The use of the equipment to heat the building is the first use to which the equipment has been put.

(c) Water is pumped from the basement through pipes to the roof solar collector. Heated water returns through pipes to a heat exchanger which transfers heat to the water in the hot water tank.

(d) The hot water tank and the oil-fired water heater utilize the same distribution pipe. Pumps and valves at the points of connection between the hot water tank, the oil-fired water heater, and the distribution pipe regulate the auxiliary energy supply use. They also prevent the oil-fired water heater from heating water in the hot water tank.

(e) An integrated control component determines whether hot water from the hot water tank or from the oil-fired water heater is distributed to fan-coil units located throughout the building.

(f) The roof solar collector is solar energy property. The pump that moves the water to the roof collector and the pipes between the roof collector and the hot water tank qualify because they are solely related to transporting solar heated water. The hot water tank qualifies because it stores water heated solely by solar radiation. The heat exchanger also qualifies.

(g) The oil-fired water heater does not qualify as solar energy property because it is auxiliary equipment.

(h) The distribution pipe, the control component, and the pumps and valves do not qualify because they serve the oil-fired water heater as well as the solar energy equipment. All of these items would qualify if used solely in connection with solar energy equipment. The fan-coil units do not qualify because they are not specially adapted to use energy derived from solar energy.

(e) *Wind energy property*—(1) *In general.* Energy property includes wind energy property. Wind energy property is equipment (and parts solely related to the functioning of that equipment) that performs a function described in paragraph (e)(2) of this section. In general, wind energy property consists of a windmill, wind-driven generator, storage devices, power conditioning equipment, transfer equipment, and parts solely related to the functioning of those items. Wind energy property does not include equipment that transmits or uses electricity derived from wind energy. In addition, limitations apply similar to those set forth in paragraph (d)(5) and (6) of this section.

(2) *Eligible functions.* Wind energy property is limited to equipment (and parts related solely to the functioning of that equipment) that—

(i) Uses wind energy to heat or cool, or provide hot water for use in, a building or structure, or

(ii) Uses wind energy to generate electricity (but not mechanical forms of energy).

(f) *Specially defined energy property*—(1) *In general.* Specially defined energy property means only those items described in paragraph (f)(4) through (14) of this section that meet the requirements of paragraph (f)(2) of this section. The items described in paragraph (f)(4) through (14) of this section also consist of related equipment, such as fans, pumps, ductwork, piping, and controls, the installation of which is necessary for the specified item to reduce the energy consumed or heat wasted by the process.

(2) *General requirements.* To be eligible, each item described in paragraph (f)(4) through (14) of this section must be installed in connection with an existing industrial or commercial facility. In addition, the principal purpose of each of those items must be reduction of energy consumed or heat wasted in any existing industrial or commercial process. See section 48(l)(10) and paragraph (l) of this section. If an item performs more than one function, only the incremental cost (as defined in paragraph (k) of this section) of the equipment qualifies.

(3) *Industrial or commercial process.* (i) A process is a means or method of producing a desired result by chemical, physical, or mechanical action. For example, equipment installed in connection with retail sales, general office use, and residential use are not used in a process within the meaning of this paragraph (f)(3).

(ii) An industrial process includes agricultural processes and thermal processes relating to production or manufacture, such as those involving boilers and furnaces.

(iii) A commercial process includes laundering and food preparation.

(iv) More than one process may be conducted in a single facility. The fact that several processes involved in the production of a product are integrated does not cause such integrated processes to be treated as one process. For example, in a food canning facility, producing prepared food from fresh vegetables is not one process but rather an integration of several processes including washing, cooking and canning.

(v) The following example illustrates this paragraph (f)(3).

Example. Corporation X, an advertising agency, acquires an automatic energy control system designed to reduce energy consumed by heating and cooling its office building. Although the use of an office for X's business is a commercial activity, heating or cooling an office is not an industrial or commercial process. The automatic energy control system does not qualify because it does not reduce energy consumed in an industrial or commercial process.

(4) *Recuperators.* Recuperators recover energy, usually in the form of waste heat from combustion exhaust gases, hot exiting product, or product cooling air, that is used to heat incoming combustion air, raw materials, or fuel. Recuperators are configurations of equipment consisting in part of fixed heat transfer surfaces between two gas flows, and include related baffles, dividers, entrance flanges, transition sections, and shells or cases enclosing the other components of the recuperator. In general, a fixed heat transfer surface absorbs heat from a gas or liquid flow or dissipates heat to the gas or liquid flow.

(5) *Heat wheels.* Heat wheels recover energy, usually in the form of waste heat, from exhaust gases to preheat incoming gases. Heat wheels are items of equipment consisting in part of regenerators (which rotate between two gas flows) and related drive components, wiper seals, entrance flanges, and transition sections.

(6) *Regenerators.* Regenerators are devices, such as clinker columns or chains, that recover energy by efficiently storing heat while exposed to high temperature gases and releasing heat while exposed to low temperature gases, fluids, or solids.

(7) *Heat exchangers.* Heat exchangers recover energy, usually in the form of waste heat, from high temperature gases, liquids, or solids for transfer to low temperature gases, liquids, or solids. Heat exchangers consist in part of fixed heat transfer surfaces (described in paragraph (f)(4) of this section) separating two media. Heat exchange equipment does not include fluidized bed combustion equipment.

(8) *Waste heat boilers.* Waste heat boilers use waste heat, usually in the form of combustion exhaust gases, as a substantial source of energy. A substantial source of energy is one that comprises more than 20 percent of the energy requirement on the basis of Btu's during the course of each taxable year (including the start-up year).

(9) *Heat pipes.* Heat pipes recover energy, usually in the form of waste heat, from high temperature fluids to heat low temperature fluids. A heat pipe consists in part of sealed heat transfer chambers and a capillary structure. In general, the heat transfer chambers alternatively vaporize and condense a working fluid as it passes from one end of the chamber to the other.

(10) *Automatic energy control systems.* Automatic energy control systems automatically reduce energy consumed in an industrial or commercial process for such purposes as environmental space conditioning (*i.e.*, lighting, heating, cooling or ventilating, etc.). Automatic energy control systems include, for example, automatic equipment settings controls, load shedding devices, and relay devices used as part of such system. Property such as computer hardware installed as a part of the energy control system also qualifies, but only to the extent of its incremental cost (as defined in paragraph (k) of this section).

(11) *Turbulators.* Turbulators increase the rate of transfer of heat from combustion gases to heat exchange surfaces by increasing the turbulence in the gases. A turbulator is a baffle placed in a boiler firetube or in a heat exchange tube in industrial process equipment to deflect gases to the heat transfer surface.

(12) *Preheaters.* Preheaters recover energy, usually in the form of waste heat, from either combustion exhaust gases or steam, to preheat incoming combustion air or boiler feedwater. A preheater consists in part of fixed heat transfer surfaces (described in paragraph (f)(4) of this section) separating two fluids.

(13) *Combustible gas recovery systems.* Combustible gas recovery systems are items of equipment used to recover unburned fuel from combustion exhaust gases.

(14) *Economizers.* Economizers are configurations of equipment used to reduce energy demand or recover energy from combustion exhaust gases and other high temperature sources to preheat boiler feedwater.

(15) *Other property added by the Secretary.* [Reserved]

(g) *Recycling equipment*—(1) *In general.* Recycling equipment is equipment used exclusively to sort and prepare, or recycle, solid waste (other than animal waste) to recover usable raw materials ("recovery equipment"), or to convert solid waste (including animal waste) into fuel or other useful forms of energy ("conversion equipment"). Recycling equipment may include certain other onsite related equipment.

(2) *Recovery equipment.* Recovery equipment includes equipment that—

(i) Separates solid waste from a mixture of waste,

(ii) Applies a thermal, mechanical, or chemical treatment to solid waste to ensure the waste will properly respond to recycling, or

(iii) Recycles solid waste to recover usable raw materials, but not beyond occurrence of the first of the following:

(A) The point at which a material has been created that can be used in beginning the fabrication of an end-product in the same way as materials from a virgin substance. Examples are the fiber stage in textile recycling, the newsprint or paperboard stage in paper recycling, and the ingot stage for other metals (other than iron and steel). In the case of recycling iron or steel, recycling equipment does not include any equipment used to reduce solid waste to a molten state or any process thereafter.

(B) The point at which the material is a marketable product (*i.e.*, has a value other than for recycling) even if the material is not marketed by the taxpayer at that point.

(3) *Conversion equipment.* Conversion equipment includes equipment that converts solid waste into a fuel or other usable energy, but not beyond the point at which a fuel, steam, electricity, hot water, or other useful form of energy has been created. Thus, combustors, boilers, and similar equipment may be eligible if used for a conversion process, but steam and heat distribution systems between the combustor or boiler and the point of use are not eligible.

(4) *On-site related equipment.* Recycling equipment also includes onsite loading and transportation equipment, such as conveyors, integrally related to other recycling equipment. This equipment may include equipment to load solid waste into a sorting or preparation machine and also a conveyor belt system that transports solid waste from preparation equipment to other equipment in the recycling process.

(5) *Solid waste.* (i) The term "solid waste" has the same meaning as in § 1.103–8(f)(2)(ii)(*b*), subject to the following exceptions and the other rules of this subparagraph (5):

(A) The date the equipment is placed in service is substituted in the first sentence of § 1.103–8(f)(2)(ii)(*b*) for the date of issue of the obligations, and

(B) Material that has a market value at the place it is located only by reason of its value for recycling is not considered to have a market value.

(ii) Solid waste may include a nominal amount of virgin materials, liquids, or gases, not to exceed 10 percent. If more than 10 percent of the material recycled during the course of any taxable year (including the "start up" year) consists of virgin material, liquids, or gases, the equipment ceases to be energy property and is subject to recapture under section 47. The determination of the portion of virgin material, liquids, or gases used is based on volume, weight, or Btu's whichever is appropriate.

(6) *Ineligible equipment.* Transportation equipment, such as trucks, that transfer solid waste between geographically separated sites (*e.g.*, the collection point and the recycling point) is not eligible. Steam and heat distribution systems are also ineligible.

(7) *Increased recycling capacity.* If the equipment both replaces recycling capacity and increases that capacity at a particualr site, only the incremental cost (as defined in paragraph (k) of this section) of increasing the capacity qualifies. Recycling capacity is determined by the ability to produce a product not previously produced by the taxpayer, or more of an existing product, in a way that does not lower overall production.

(8) *Examples.* The following examples illustrate this paragraph (g).

Example (1) Corporation W recycles aluminum scrap metal. W owns a junk yard where it collects and crushes the metal into compact units. W's trucks bring the scrap metal from the junk yard to its main plant located 3 miles away. W's furnace equipment at the main plant reduces the scrap to the molten state and W's rolling equipment rolls the aluminum into sheets. The furnace qualifies, but for two separate reasons the rolling equipment does not qualify. First, the molten aluminum would be a marketable product if reduced to ingots prior to rolling. It is not necessary that W actually reduce the molten aluminum to ingots. Second, the molten aluminum could be used in the same way as virgin material.

Example (2) Corporation X manufactures newsprint using wood chips discarded during X's lumber operations. Assume X could sell the wood chips to other companies located a short distance from X's mill for use as a fuel. None of the equipment used to manufacture the newsprint qualifies.

Example (3) Assume the same facts as in example (2) except X uses old newspapers which have no value except for recycling in the area where X's mill is located. The equipment qualifies.

Example (4) Corporation Y recycles municipal waste. Assume the municipal waste is "solid waste" under paragraph (g)(5) of this section. During the first taxable year Y operates the equipment, Y uses 8,500 pounds of municipal waste and 1,500 pounds of virgin material and liquids. No energy credit is allowed for the equipment.

Example (5) Corporation Z owns a waste recovery facility. The corrugated paper portion of the waste stream is picked off a conveyor as it enters the facility. The corrugated paper is baled and sold as a secondary paper product. Z acquires shredding and air-classification equipment. Corrugated paper that is not removed from the conveyor belt enters the new equipment for production as a fuel. Z increases the input of corrugated paper so that the same amount of corrugated paper is removed from the conveyor to be baled. The excess paper that is not removed for baling enters the shredding and air-classification equipment. The new equipment qualifies.

(h) *Shale oil equipment*—(1) *In general.* Shale oil equipment used in mining or either surface or *in situ* processing qualifies as energy property. Shale oil equipment means equipment used exclusively to mine, or produce or extract oil from, shale rock.

(2) *Eligible processes.* In general, processing equipment qualifies if used in or after the mining stage and up through the retorting process. Thus, eligible processes include crushing, loading into the retort, and retorting, but not hydrogenation, refining, or any process subsequent to retorting. However, with respect to *in situ* processing, eligible processes include creating the underground cavity.

(3) *Eligible equipment.* Shale oil equipment includes—

(i) Heading jumbos, bulldozers, and scaling and bolting rigs used to create an underground cavity for *in situ* processing,

(ii) On-site water supply and treatment equipment and handling equipment for spent shale,

(iii) Crushing and screening plant equipment, such as hoppers, feeders, vibrating screens, and conveyors,

(iv) Briquetting plant equipment, such as hammer mills and vibratory pan feeders, and

(v) Retort equipment, including direct cooling and condensing equipment.

(i) [Reserved]

(j) *Natural gas from geopressured brine.* Equipment used exclusively to extract natural gas from geopressured brine described in section 613A(b)(3)(C)(i) is energy property. Eligible equipment includes equipment used to separate the gas from saline water and remove other impurities from the gas. Equipment is eligible only up to the point the gas may be introduced into a pipeline.

(k) *Incremental cost.* The term "incremental cost" means the excess of the total cost of equipment over the amount that would have been expended for the equipment if the equipment were not used for a qualifying purpose. For example, assume equipment costing $100 performs a pollution control function and another function. Assuming it would cost $60 solely to perform the nonqualifying function, the incremental cost would be $40.

(l) *Existing*—(1) *In general.* for purposes of section 48(l), the term "existing" means—

(i) When used in connection with a facility or equipment, 50 percent or more of the basis of that facility or equipment is attributable to construction, reconstruction, or erection before October 1, 1978, or

(ii) When used in connection with an industrial or commercial process, that process was carried on in the facility as of October 1, 1978.

(2) *Industrial or commercial process.* (i) A process will be considered the same as the process carried on in the facility as of October 1, 1978, unless and until capitalizable expenditures are paid or incurred for modification of the process. The expenditures need not be capitalized in fact; it is sufficient if the taxpayer has an option or may elect to capitalize. In general, the date of change will be the date the expenditures are properly chargeable to capital account. If the taxpayer properly elects to expense a capitalizable expenditure, the date of change will be the date the expenditure could have been properly chargeable to capital account if the expenditure had been capitalized. Recapture will not occur by reason of a change in a process unless the process change also changes the use of the equipment. See example (1) of § 1.47-1(h)(5).

(m) *Quality and performance standards*—(1) *In general.* Energy property must meet quality and performance standards, if any, that have been prescribed by the Secretary (after consultation with the Secretary of Energy) and are in effect at the time of acquisition.

(2) *Time of acquisition.* Under this paragraph (m) the time of acquisition is—

(i) The date the taxpayer enters into a binding contract to acquire the property or

(ii) For property constructed, reconstructed, or erected by the traxpayer, (A) the earlier of the date it begins construction, reconstruction, or erection of the property, or (B) the date the taxpayer and another person enter into a binding contract requiring each to construct, reconstruct, or erect property and place the property in service for an agreed upon use. See example under paragraph (m)(4) of this section.

(3) *Binding contract.* Under this paragraph (m), a binding contract to construct, reconstruct, or erect property, or to acquire property, is a contract that is binding at all times on the taxpayer under applicable State or local law. A binding contract to construct, reconstruct, or erect property or to acquire property, does not include a contract for preparation of architect's sketches, blueprints, or performance of any other activity not involving the beginning of physical work.

(4) *Example.* The following example illustrates this paragraph (m).

Example. Corporation X owns a junk yard. Corporation Y manufactures recycling equipment and operates several recycling facilities. On January 1, 1979, X and Y enter into a written contract that is binding on both parties on that date and at all times thereafter. Under the contract's terms X will supply scrap metals to Y and Y agrees in return to build a recycling facility on land adjacent to the junk yard. Y will own and operate the facility using the scrap metal supplied by X. Y may treat the agreement as a binding contract under paragraph (m) (2) and (3) of this section.

(n) *Public utility property*—(1) *Inclusions.* Public utility property is included in both of the following categories of energy property:

(i) Shale oil equipment and

(ii) Equipment for producing natural gas from geopressured brine.

(2) *Exclusions.* Public utility property is excluded from each of the following categories of energy property:

(i) Alternative energy property,

(ii) Specially defined energy property,

(iii) Solar or wind energy property, and

(iv) Recycling equipment.

(3) *Public utility property.* The term "public utility property" has the meaning given in section 46(f)(5).

(Sec. 7805 (68A Stat. 917, 26 U.S.C. 7805) and 38 (b) (76 Stat. 962, 26 U.S.C. 38) of the Internal Revenue Code of 1954)

William E. Williams,

Acting Commissioner of Internal Revenue.

Approved: January 19, 1981.

Emil M. Sunley,

Acting Assistant Secretary of the Treasury.

[FR Doc. 81-2467 Filed 1-19-81; 5:10 pm]

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26 CFR Parts 20 and 25

[T.D. 7761]

Employee Retirement Benefits Excluded From Gross Estate and Taxable Gifts

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document provides final regulations relating to the estate and gift tax treatment of amounts payable under qualified employee pension, profit-sharing, stock bonus and annuity plans and under individual retirement plans. Changes to the applicable tax law were made by the Tax Reform Act of 1976, the Revenue Act of 1978 and the Technical Corrections Act of 1979. The regulations provide necessary guidance to the public for compliance with the law, and primarily affect the estates of decedents with respect to whom amounts are payable under such plans.

DATE: The regulations are generally effective for decedents dying and transfers made after December 31, 1976.

FOR FURTHER INFORMATION CONTACT: Richard L. Johnson of the Employee Plans and Exempt Organizations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, D.C. 20224, Attention: CC:LR:T:EE-25-78, 202-566-3544 (Not a toll-free number).

SUPPLEMENTARY INFORMATION

Background

On March 2, 1979, the **Federal Register** published at 44 FR 11791 proposed amendments to the Estate Tax Regulations (26 CFR Part 20) and the Gift Tax Regulations (26 CFR Part 25) under sections 2039 and 2517 of the Internal Revenue Code of 1954. The amendments were proposed to conform the regulations to section 2009(c) of the Tax Reform Act of 1976 (90 Stat. 1894) and section 142 of the Revenue Act of 1978 (92 Stat. 2796). No public hearing was requested. After consideration of all comments regarding the proposed amendments, those amendments are adopted as revised by this Treasury decision.

Code section 2039(f) was also amended by section 101(a)(8)(B) of the Technical Corrections Act of 1979 (94 Stat. 201). The regulations adopted by this Treasury decision reflect that amendment.

Rollovers by a Surviving Spouse

The proposed regulations took no position with regard to the consequences to an employee's gross estate if the employee's surviving spouse rolls over to an individual retirement plan all or a portion of a lump sum distribution paid on account of the death of the employee. The final regulations provide that in the case of such a rollover, the lump sum distribution is excluded from the employee's gross estate. The final regulations further provide that, with respect to the gross estate of a spouse who has made such a rollover, amounts payable under an individual retirement plan are not eligible for the estate tax exclusion to the extent that they are attributable to the rollover.

Taxpayer's Election

Under the proposed regulations, no amount paid or payable as a lump sum distribution under a qualified plan is excludable from a deceased employee's gross estate unless the recipient makes the required "section 402(a)/403(a) taxation election." The proposed regulations provided that the election is made by the recipient's filing an income tax return for the taxable year of the distribution that is consistent with the election.

Some comments requested that the regulations be revised to provide that the recipient make the election on the estate tax return. Although the election is provided for under the estate tax law, for the electing taxpayer the election is primarily an income tax election. Accordingly, the final regulations follow the proposed regulations. However, the proposed regulations have been revised to provide that when the estate tax return is filed before the recipient's income tax return, the return for the estate may reflect the exclusion of a lump sum distribution from the gross estate, even though the recipient has not yet made the required election.

The regulations have also been clarified to emphasize that once a recipient files an income tax return or makes a rollover contribution that constitutes the election described in the regulations, the election cannot be revoked. Thus, the filing of an amended income tax return reflecting either the long-term capital gain or 10-year averaging treatment otherwise afforded lump sum distributions will not be given effect for income tax and estate tax purposes. This is true even if the amended return is accompanied by the payment of any estate tax that would be due if the distribution were included in the gross estate.

IRA Provisions Added

The final regulations also contain two additional clarifying rules governing the estate tax exclusion for amounts payable under individual retirement plans. The first of these rules reflects § 1.408-2(b)(7)(ii) of the Income Tax Regulations. That section permits a beneficiary under an individual retirement plan to elect, for purposes of the income tax rules, to treat the plan as one established on the beneficiary's behalf, rather than as a plan under which amounts are payable to the beneficiary as a beneficiary. Under § 20.2039-5(c)(5), the amount with respect to which the decedent, as a beneficiary, made the election is not an amount with respect to which the exclusion described in section 2039(e) will apply.

The final regulations also contain, in § 20.2039-5(c)(6), rules relating to individual retirement plan rollovers. Under section 408(d)(3)(A)(i) or 409(b)(3)(C), amounts paid under an individual retirement plan may, subject to certain conditions, be paid ("rolled over") to another such plan. Under the income tax rules, the rolled over amounts are not included in gross income. The final regulations clarify that the rules under section 2039(e) are applied to the plan that is the recipient of the rollover (the "transferee plan") by taking into account the source of the contributions made to the transferor plan. Under the regulations the exclusion described in 2039(e) does not apply with respect to any portion of the rollover contribution to the transferee plan that is determined to be attributable to a contribution to the transferor plan with respect to which the exclusion is denied.

Examples (3) and (4) have been added to § 20.2039-5(d) to illustrate these added clarifying rules.