Pages 10113–10184

THE NATIONAL ARCHIVES — LITTERA SCRIPTA MANET — 1934 — OF THE UNITED STATES

FEDERAL REGISTER

VOLUME 28 NUMBER 181

Washington, Tuesday, September 17, 1963

Contents

(*Continued on next page*)

Codification Guide

The following numerical guide is a list of the parts of each title of the Code of Federal Regulations affected by documents published in today's issue. A cumulative list of parts affected, covering the current month to date, appears at the end of each issue beginning with the second issue of the month.

Monthly, quarterly, and annual cumulative guides, published separately from the daily issues, include the section numbers as well as the part numbers affected.

3 CFR

EXECUTIVE ORDERS:
5450 (revoked by PLO 3222) ... 10156
7448 (revoked by PLO 3222) ... 10156
8102 (revoked in part by PLO 3222) ... 10156

5 CFR

213 ... 10149
591 ... 10149
831 ... 10149
870 ... 10149
890 ... 10150

7 CFR

1128 ... 10151

PROPOSED RULES:
51 (2 documents) ... 10167, 10168
900—999 ... 10168
1097 ... 10169

10 CFR

2 ... 10151
30 ... 10154

PROPOSED RULES:
20 ... 10170

14 CFR

71 [New] (5 documents) ... 10155, 10156

PROPOSED RULES:
71 [New] ... 10172

21 CFR

121 ... 10150
146e ... 10151

26 CFR

1 (3 documents) ... 10115, 10132, 10146
301 ... 10146

PROPOSED RULES:
1 ... 10161

43 CFR

PUBLIC LAND ORDERS:
2564 (revoked in part by PLO 3231) ... 10159
3101 (corrected by PLO 3229) ... 10158
3128 (corrected by PLO 3229) ... 10158
3222 ... 10156
3223 ... 10156
3224 ... 10157
3225 ... 10157
3226 ... 10157
3227 ... 10157
3228 ... 10157
3229 ... 10158
3230 ... 10158
3231 ... 10159
3232 ... 10158
3233 ... 10158

50 CFR

32 (2 documents) ... 10159

FEDERAL REGISTER
Telephone WOrth 3-3261

Published daily, except Sundays, Mondays, and days following official Federal holidays, by the Office of the Federal Register, National Archives and Records Service, General Services Administration, pursuant to the authority contained in the Federal Register Act, approved July 26, 1935 (49 Stat. 500, as amended; 44 U.S.C., ch. 8B), under regulations prescribed by the Administrative Committee of the Federal Register, approved by the President. Distribution is made only by the Superintendent of Documents, Government Printing Office, Washington, D.C., 20402.

The FEDERAL REGISTER will be furnished by mail to subscribers, free of postage, for $1.50 per month or $15.00 per year, payable in advance. The charge for individual copies (minimum 15 cents) varies in proportion to the size of the issue. Remit check or money order, made payable to the Superintendent of Documents, Government Printing Office, Washington, D.C., 20402.

The regulatory material appearing herein is keyed to the CODE OF FEDERAL REGULATIONS, which is published, under 50 titles, pursuant to section 11 of the Federal Register Act, as amended August 5, 1953. The CODE OF FEDERAL REGULATIONS is sold by the Superintendent of Documents. Prices of books and pocket supplements vary.

Rules and Regulations

Title 26—INTERNAL REVENUE

Chapter I—Internal Revenue Service, Department of the Treasury

SUBCHAPTER A—INCOME TAX

[T. D. 6675]

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Qualified Pension, Profit-Sharing, and Stock Bonus and Bond Purchase Plans

On April 6, 1963, notice of proposed rule making with respect to the amendment of the Income Tax Regulations (26 CFR Part 1) under sections 401 and 405 of the Internal Revenue Code of 1954 (relating to qualified pension, profit-sharing, and stock bonus plans, and qualified bond purchase plans) to conform to sections 2 (in part) and 5 of the Self-Employed Individuals Tax Retirement Act of 1962 (76 Stat. 809, 826) was published in the FEDERAL REGISTER (28 F.R. 3401). After consideration of all such relevant matter as was presented by interested persons regarding the rules proposed, the amendment of the regulations as proposed is hereby adopted, subject to the changes set forth below:

PARAGRAPH 1. Paragraph (a)(3) of § 1.401–1, as set forth in paragraph 2 of the appendix to the notice of proposed rule making, is changed by revising subdivision (iii).

PAR. 2. Paragraph (c)(1), the portion of (2)(iii) which precedes subdivision (*a*) thereof, (4)(i), (5), and (6) of § 1.401–4, as set forth in paragraph 4 of the appendix to the notice of proposed rule making, is changed.

PAR. 3. Section 1.401–6, as set forth in paragraph 5 of the appendix to the notice of proposed rule making, is changed by adding a new subdivision (iii) to paragraph (a)(2), by revising paragraph (b)(1) and (2), and by revising paragraph (e).

PAR. 4. Section 1.401–7, as set forth in paragraph 5 of the appendix to the notice of proposed rule making, is changed by deleting example (1) of paragraph (b), by redesignating examples (2) and (3) of paragraph (b) as examples (1) and (2), respectively, and by revising paragraph (c).

PAR. 5. Section 1.401–8, as set forth in paragraph 5 of the appendix to the notice of proposed rule making, is revised by changing paragraphs (b)(1)(iii) and (e)(2).

PAR. 6. Section 1.401–9, as set forth in paragraph 5 of the appendix to the notice of proposed rule making, is changed by revising subparagraphs (1)(i) and (2) of paragraph (b) and by revising example (2) of paragraph (c).

PAR. 7. Section 1.401–10, as set forth in paragraph 5 of the appendix to the notice of proposed rule making, is changed by revising subparagraph (3)(i) of paragraph (b).

PAR. 8. Section 1.401–11, as set forth in paragraph 5 of the appendix to the notice of proposed rule making, is changed by deleting paragraph (b)(2) and redesignating paragraph (b)(3) and (4) as (b)(2) and (3), respectively, and by revising paragraph (e)(3), (4), (5), (6), and (7).

PAR. 9. Section 1.401–12, as set forth in paragraph 5 of the appendix to the notice of proposed rule making, is changed by revising so much of paragraph (c)(4)(ii) as follows subdivision (*b*) thereof, subparagraph (1) of paragraph (d), subparagraph (1)(ii) of paragraph (g), subparagraph (2)(i) of paragraph (i), subparagraphs (1) and (2) of paragraph (j), and subparagraph (1)(i) of paragraph (m).

PAR. 10. Section 1.405–3, as set forth in paragraph 6 of the appendix to the notice of proposed rule making, is revised by adding a sentence at the end of paragraph (a)(1) and by changing paragraph (b)(3), (4), and (5).

(Sec. 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805))

[SEAL] MORTIMER M. CAPLIN,
Commissioner of Internal Revenue.

Approved: September 10, 1963.

STANLEY S. SURREY,
Assistant Secretary of the Treasury.

In order to conform the Income Tax Regulations (26 CFR Part 1) to sections 2 (in part) and 5 of the Self-Employed Individuals Tax Retirement Act of 1962 (76 Stat. 809, 826), such regulations are amended as follows:

PARAGRAPH 1. Section 1.401 is amended by revising paragraph (5) of section 401(a), by adding paragraphs (7), (8), (9), and (10) to section 401(a), by redesignating subsection (c) of section 401 as subsection (h), by inserting after subsection (b) of section 401 new subsections (c), (d), (e), (f), and (g), and by adding a historical note. These amended and added provisions read as follows:

§ 1.401 Statutory provisions; qualified pension, profit-sharing, and stock bonus plans.

SEC. 401. *Qualified pension, profit-sharing, and stock bonus plans*—(a) *Requirements for qualification.* * * *

(5) A classification shall not be considered discriminatory within the meaning of paragraph (3)(B) or (4) merely because it excludes employees the whole of whose remuneration constitutes "wages" under section 3121(a)(1) (relating to the Federal Insurance Contributions Act) or merely because it is limited to salaried or clerical employees. Neither shall a plan be considered discriminatory within the meaning of such provisions merely because the contributions or benefits of or on behalf of the employees under the plan bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of such employees, or merely because the contributions or benefits based on that part of an employee's remuneration which is excluded from "wages" by section 3121(a)(1) differ from the contributions or benefits based on employee's remuneration not so excluded, or differ because of any retirement benefits created under State or Federal law. For purposes of this paragraph and paragraph (10), the total compensation of an individual who is an employee within the meaning of subsection (c)(1) means such individual's earned income (as defined in subsection (c)(2)), and the basic or regular rate of compensation of such an individual shall be determined, under regulations prescribed by the Secretary or his delegate, with respect to that portion of his earned income which bears the same ratio to his earned income as the basic or regular compensation of the employees under the plan bears to the total compensation of such employees.

* * * * *

(7) A trust shall not constitute a qualified trust under this section unless the plan of which such trust is a part provides that, upon its termination or upon complete discontinuance of contributions under the plan, the rights of all employees to benefits accrued to the date of such termination or discontinuance, to the extent then funded, or the amounts credited to the employees' accounts are nonforfeitable. This paragraph shall not apply to benefits or contributions which, under provisions of the plan adopted pursuant to regulations prescribed by the Secretary or his delegate to preclude the discrimination prohibited by paragraph (4), may not be used for designated employees in the event of early termination of the plan.

(8) A trust forming part of a pension plan shall not constitute a qualified trust under this section unless the plan provides that forfeitures must not be applied to increase the benefits any employee would otherwise receive under the plan.

(9) In the case of a plan which provides contributions or benefits for employees some or all of whom are employees within the meaning of subsection (c)(1), a trust forming part of such plan shall not constitute a qualified trust under this section unless, under the plan, the entire interest of each employee—

(A) Either will be distributed to him not later than his taxable year in which he attains the age of 70½ years, or, in the case of an employee other than an owner-employee (as defined in subsection (c)(3)), in which he retires, whichever is the later, or

(B) Will be distributed, commencing not later than such taxable year, (i) in accordance with such regulations prescribed by the Secretary or his delegate, over the life of such employee or over the lives of such employee and his spouse, or (ii) in accordance with such regulations, over a period not extending beyond the life expectancy of such employee or the life expectancy of such employee and his spouse.

A trust shall not be disqualified under this paragraph by reason of distributions under a designation, prior to the date of the enactment of this paragraph, by any employee under the plan of which such trust is a part, of a method of distribution which does not meet the terms of the preceding sentence.

(10) In the case of a plan which provides contributions or benefits for employees some or all of whom are owner-employees (as defined in subsection (c)(3))—

(A) Paragraph (3) and the first and second sentences of paragraph (5) shall not apply, but—

(i) Such plan shall not be considered discriminatory within the meaning of paragraph (4) merely because the contributions or benefits of or on behalf of employees under the plan bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of such employees, and

(ii) Such plan shall not be considered discriminatory within the meaning of paragraph (4) solely because under the plan contributions described in subsection (e)(3)(A) which are in excess of the amounts which may be deducted under section 404 (determined without regard to section 404(a)(10)) for the taxable year may be made on behalf of any owner-employee; and

(B) A trust forming a part of such plan shall constitute a qualified trust under this section only if the requirements in subsection (d) are also met.

* * * * *

(c) *Definitions and rules relating to self-employed individuals and owner-employees.* For purposes of this section—

(1) *Employee.* The term "employee" includes, for any taxable year, an individual who has earned income (as defined in paragraph (2)) for the taxable year. To the extent provided in regulations prescribed by the Secretary or his delegate, such term also includes, for any taxable year—

(A) An individual who would be an employee within the meaning of the preceding sentence but for the fact that the trade or business carried on by such individual did not have net profits for the taxable year, and

(B) An individual who has been an employee within the meaning of the preceding sentence for any prior taxable year.

(2) *Earned income*—(A) *In general.* The term "earned income" means the net earnings from self-employment (as defined in sections 1402(a)) to the extent that such net earnings constitute earned income (as defined in section 911(b) but determined with the application of subparagraph (B)), but such net earnings shall be determined—

(i) Without regard to paragraphs (4) and (5) of section 1402(c),

(ii) In the case of any individual who is treated as an employee under sections 3121(d)(3)(A), (C), or (D), without regard to paragraph (2) of section 1402(c), and

(iii) Without regard to items which are not included in gross income for purposes of this chapter, and the deductions properly allocable to or chargeable against such items.

For purposes of this subparagraph, sections 911(b) and 1402, as in effect for a taxable year ending on December 31, 1962, and subparagraph (B), as in effect for a taxable year beginning on January 1, 1963, shall be treated as having been in effect for all taxable years ending before such date.

(B) *Earned income when both personal services and capital are material income-producing factors.* In applying section 911(b) for purposes of subparagraph (A), in the case of an individual who is an employee within the meaning of paragraph (1) and who is engaged in a trade or business in which both personal services and capital are material income-producing factors and with respect to which the individual actually renders personal services on a full-time, or substantially full-time, basis, so much of his share of the net profits of such trade or business as does not exceed $2,500 shall be considered as earned income. In the case of any such individual who is engaged in more than one trade or business with respect to which he actually renders substantial personal services, if with respect to all such trades or businesses he actually renders personal services on a full-time, or substantially full-time, basis, there shall be considered as earned income with respect to the trades or businesses in which both personal services and capital are material income-producing factors—

(i) So much of his share of the net profits of such trades or businesses as does not exceed $2,500, reduced by

(ii) His share of the net profits of any trade or business in which only personal services is a material income-producing factor.

The preceding sentences shall not be construed to reduce the share of net profits of any trade or business which under the second sentence of section 911(b) would be considered as earned income of any such individual.

(3) *Owner-employee.* The term "owner-employee" means an employee who—

(A) Owns the entire interest in an unincorporated trade or business, or

(B) In the case of a partnership, is a partner who owns more than 10 percent of either the capital interest or the profits interest in such partnership.

To the extent provided in regulations prescribed by the Secretary or his delegate, such term also means an individual who has been an owner-employee within the meaning of the preceding sentence.

(4) *Employer.* An individual who owns the entire interest in an unincorporated trade or business shall be treated as his own employer. A partnership shall be treated as the employer of each partner who is an employee within the meaning of paragraph (1).

(5) *Contributions on behalf of owner-employees.* The term "contribution on behalf of an owner-employee" includes, except as the context otherwise requires, a contribution under a plan—

(A) By the employer for an owner-employee, and

(B) By an owner-employee as an employee.

(d) *Additional requirements for qualification of trusts and plans benefiting owner-employeees.* A trust forming part of a pension or profit-sharing plan which provides contributions or benefits for employees some or all of whom are owner-employees shall constitute a qualified trust under this section only if, in addition to meeting the requirements of subsection (a), the following requirements of this subsection are met by the trust and by the plan of which such trust is a part:

(1) In the case of a trust which is created on or after the date of the enactment of this subsection, or which was created before such date but is not exempt from tax under section 501(a) as an organization described in subsection (a) on the day before such date, the trustee is a bank, but a person (including the employer) other than a bank may be granted, under the trust instrument, the power to control the investment of the trust funds either by directing investments (including reinvestments, disposals, and exchanges) or by disapproving proposed investments (including reinvestments, disposals, and exchanges). This paragraph shall not apply to a trust created or organized outside the United States before the date of the enactment of this subsection if, under section 402(c), it is treated as exempt from tax under section 501(a) on the day before such date; or, to the extent provided under regulations prescribed by the Secretary or his delegate, to a trust which uses annuity, endowment, or life insurance contracts of a life insurance company exclusively to fund the benefits prescribed by the trust, if the life insurance company supplies annually such information about trust transactions affecting owner-employees as the Secretary or his delegate shall by forms or regulations prescribe. For purposes of this paragraph, the term "bank" means a bank as defined in section 581, a corporation which under the laws of the State of its incorporation is subject to supervision and examination by the comissioner of banking or other office of such State in charge of the administration of the banking laws of such State, and, in the case of a trust created or organized outside the United States, a bank or trust company, wherever incorporated, exercising fiduciary powers and subject to supervision and examination by governmental authority.

(2) Under the plan—

(A) The employees' rights to or derived from the contributions under the plan are non-forfeitable at the time the contributions are paid to or under the plan; and

(B) In the case of a profit-sharing plan, there is a definite formula for determining the contributions to be made by the employer on behalf of employees (other than owner-employees).

Subparagraph (A) shall not apply to contributions which, under provisions of the plan adopted pursuant to regulations prescribed by the Secretary or his delegate to preclude the discrimination prohibited by subsection (a)(4), may not be used to provide benefits for designated employees in the event of early termination of the plan.

(3) The plan benefits each employee having a period of employment of 3 years or more. For purposes of the preceding sentence, the term "employee" does not include any employee whose customary employment is for not more than 20 hours in any one week or is for not more than 5 months in any calendar year.

(4) Under the plan—

(A) Contributions or benefits are not provided for any owner-employee unless such owner-employee has consented to being included under the plan; and

(B) No benefits may be paid to any owner-employee, except in the case of his becoming disabled (within the meaning of section 213(g)(3)), prior to his attaining the age of 59½ years.

(5) The plan does not permit—

(A) Contributions to be made by the employer on behalf of any owner-employee in excess of the amounts which may be deducted under section 404 (determined without regard to section 404(a)(10)) for the taxable year;

(B) In the case of a plan which provides contributions or benefits only for owner-employees, contributions to be made on behalf of any owner-employee in excess of the amounts which may be deducted under section 404 (determined without regard to section 404(a)(10)) for the taxable year; and

(C) If a distribution under the plan is made to any employee and if any portion of such distribution is an amount described in section 72(m)(5)(A)(i), contributions to be made on behalf of such employee for the 5 taxable years succeeding the taxable year in which such distribution is made.

Subparagraphs (A) and (B) shall not apply to any contribution which is not considered to be an excess contribution (as defined in subsection (e)(1)) by reason of the application of subsection (e)(3).

(6) Except as provided in this paragraph, the plan meets the requirements of subsection (a)(4) without taking into account for any purpose contributions or benefits under chapter 2 (relating to tax on self-employment income), chapter 21 (relating to Federal Insurance Contributions Act), title II of the Social Security Act, as amended, or any other Federal or State law. If—

(A) Of the contributions deductible under section 404 (determined without regard to section 404(a)(10)), not more than one-third is deductible by reason of contributions by the employer on behalf of owner-employees, and

(B) Taxes paid by the owner-employees under chapter 2 (relating to tax on self-employment income), and the taxes which would be payable under such chapter 2 by the owner-employees but for paragraphs (4) and (5) of section 1402(c), are taken into account as contributions by the employer on behalf of such owner-employees,

then taxes paid under section 3111 (relating to tax on employers) with respect to an employee may, for purposes of subsection (a)(4), be taken into account as contributions by the employer for such employee under the plan.

(7) Under the plan, if an owner-employee dies before his entire interest has been distributed to him, or if distribution has been commenced in accordance with subsection (a)(9)(B) to his surviving spouse and such surviving spouse dies before his entire interest has been distributed to such surviving spouse, his entire interest (or the remaining part of such interest if distribution thereof has commenced) will, within 5 years after his death (or the death of his surviving spouse), be distributed, or applied to the purchase of an immediate annuity for his beneficiary or beneficiaries (or the beneficiary or beneficiaries of his surviving spouse) which will be payable for the life of such beneficiary or beneficiaries (or for a term certain not extending beyond the life expectancy of such beneficiary or beneficiaries) and which will be immediately distributed to such beneficiary or beneficiaries. The preceding sentence shall not apply if distribution of the interest of an owner-employee has commenced and such distribution is for a term certain over a period permitted under subsection (a)(9)(B)(ii).

(8) Under the plan—

(A) Any contribution which is an excess contribution, together with the income attributable to such excess contribution, is (unless subsection (e)(2)(E) applies) to be repaid to the owner-employee on whose behalf such excess contribution is made;

(B) If for any taxable year the plan does not, by reason of subsection (e)(2)(A), meet (for purposes of section 404) the requirements of this subsection with respect to an owner-employee, the income for the taxable year attributable to the interest of such owner-employee under the plan is to be paid to such owner-employee; and

(C) The entire interest of an owner-employee is to be repaid to him when required by the provisions of subsection (e)(2)(E).

(9) (A) If the plan provides contributions or benefits for an owner-employee who controls, or for two or more owner-employees who together control, the trade or business with respect to which the plan is established, and who also control as an owner-employee or as owner-employees one or more other trades or businesses, such plan and the plans established with respect to such other trades or businesses, when coalesced, constitute a single plan which meets the requirements of subsection (a) (including paragraph (10) thereof) and of this subsection with respect to the employees of all such trades or businesses (including the trade or business with respect to which the plan intended to qualify under this section is established).

(B) For purposes of subparagraph (A), an owner-employee, or two or more owner-employees, shall be considered to control a trade or business if such owner-employee, or such two or more owner-employees together—

(i) Own the entire interest in an unincorporated trade or business, or

(ii) In the case of a partnership, own more than 50 percent of either the capital interest or the profits interest in such partnership.

For purposes of the preceding sentence, an owner-employee, or two or more owner-employees, shall be treated as owning any interest in a partnership which is owned, directly or indirectly, by a partnership which such owner-employee, or such two or more owner-employees, are considered to control within the meaning of the preceding sentence.

(10) The plan does not provide contributions or benefits for any owner-employee who controls (within the meaning of paragraph (9)(B)), or for two or more owner-employees who together control, as an owner-employee or as owner-employees, any other trade or business, unless the employees of each trade or business which such owner-employee or such owner-employees control are included under a plan which meets the requirements of subsection (a) (including paragraph (10) thereof) and of this subsection, and provides contributions and benefits for employees which are not less favorable than contributions and benefits provided for owner-employees under the plan.

(11) Under the plan, contributions on behalf of any owner-employee may be made only with respect to the earned income of such owner-employee which is derived from the trade or business with respect to which such plan is established.

(e) *Excess contributions on behalf of owner-employees*—(1) *Excess contribution defined.* For purposes of this section, the term "excess contribution" means, except as provided in paragraph (3)—

(A) If, in the taxable year, contributions are made under the plan only on behalf of owner-employees, the amount of any contribution made on behalf of any owner-employee which (without regard to this subsection) is not deductible under section 404 (determined without regard to section 404(a)(10)) for the taxable year; or

(B) If, in the taxable year, contributions are made under the plan on behalf of employees other than owner-employees—

(i) The amount of any contribution made by the employer on behalf of any owner-employee which (without regard to this subsection) is not deductible under section 404 (determined without regard to section 404(a)(10)) for the taxable year;

(ii) The amount of any contribution made by any owner-employee (as an employee) at a rate which exceeds the rate of contributions permitted to be made by employees other than owner-employees;

(iii) The amount of any contribution made by any owner-employee (as an employee) which exceeds the lesser of $2,500 or 10 percent of the earned income for such taxable year derived by such owner-employee from the trade or business with respect to which the plan is established; and

(iv) In the case of any individual on whose behalf contributions are made under more than one plan as an owner-employee, the amount of any contribution made by such owner-employee (as an employee) under all such plans which exceeds $2,500; and

(C) The amount of any contribution made on behalf of an owner-employee in any taxable year for which, under paragraph (2)(A) or (E), the plan does not (for purposes of section 404) meet the requirements of subsection (d) with respect to such owner-employee.

For purposes of this subsection, the amount of any contribution which is allocable (determined in accordance with regulations prescribed by the Secretary or his delegate) to the purchase of life, accident, health, or other insurance shall not be taken into account.

(2) *Effect of excess contribution*—(A) *In general.* If an excess contribution (other than an excess contribution to which subparagraph (E) applies) is made on behalf of an owner-employee in any taxable year, the plan with respect to which such excess contribution is made shall, except as provided in subparagraphs (C) and (D), be considered, for purposes of section 404, as not meeting the requirements of subsection (d) with respect to such owner-employee for the taxable year and for all succeeding taxable years.

(B) *Inclusion of amounts in gross income of owner-employees.* For any taxable year for which any plan does not meet the requirements of subsection (d) with respect to an owner-employee by reason of subparagraph (A), the gross income of such owner-employee shall, for purposes of this chapter, include the amount of net income for such taxable year attributable to the interest of such owner-employee under such plan.

(C) *Repayment within prescribed period.* Subparagraph (A) shall not apply to an excess contribution with respect to any taxable year, if, on or before the close of the 6-month period beginning on the day on which the Secretary or his delegate sends notice (by certified or registered mail) to the person to whom such excess contribution was paid of the amount of such excess contribution, the amount of such excess contribution, and the net income attributable thereto, is repaid to the owner-employee on whose behalf such excess contribution was made. If the excess contribution is an excess contribution as defined in paragraph (1)(A) or (B)(i), or is an excess contribution as defined in paragraph (1)(C) with respect to which a deduction has been claimed under section 404, the notice required by the preceding sentence shall not be mailed prior to the time that the amount of the tax under this chapter of such owner-employee for the taxable year in which such excess contribution was made has been finally determined.

(D) *Repayment after prescribed period.* If an excess contribution, together with the net income attributable thereto, is not repaid within the 6-month period referred to in subparagraph (C), subparagraph (A) shall not apply to an excess contribution with respect to any taxable year beginning with the taxable year in which the person to whom such excess contribution was paid repays the amount of such excess contribution to the owner-employee on whose behalf such excess contribution was made, and pays to such owner-employee the amount of net income attributable to the interest of such owner-employee which, under subparagraph (B), has been included in the gross income of such owner-employee for any prior taxable year.

(E) *Special rule if excess contribution was willfully made.* If an excess contribution made on behalf of an owner-employee is determined to have been willfully made, then—

(i) Subparagraphs (A), (B), (C), and (D) shall not apply with respect to such excess contribution;

(ii) There shall be distributed to the owner-employee on whose behalf such excess contribution was willfully made his entire interest in all plans with respect to which he is an owner-employee; and

(iii) No plan shall, for purposes of section 404, be considered as meeting the requirements of subsection (d) with respect to such owner-employee for the taxable year in which it is determined that such excess contribution was willfully made and for the 5 taxable years following such taxable year.

(F) *Statute of limitations.* In any case in which subparagraph (A) applies, the period for assessing any deficiency arising by reason of—

(i) The disallowance of any deduction under section 404 on account of a plan not meeting the requirements of subsection (d) with respect to the owner-employee on whose behalf an excess contribution was made, or

(ii) The inclusion, under subparagraph (B), in gross income of such owner-em-

ployee of income attributable to the interest of such owner-employee under a plan, for the taxable year in which such excess contribution was made or for any succeeding taxable year shall not expire prior to one year after the close of the 6-month period referred to in subparagraph (C).

(3) *Contributions for premiums on annuity, etc., contracts.* A contribution by the employer on behalf of an owner-employee shall not be considered to be an excess contribution within the meaning of paragraph (1), if—

(A) Under the plan such contribution is required to be applied (directly or through a trustee) to pay premiums or other consideration for one or more annuity, endowment, or life insurance contracts on the life of such owner-employee issued under the plan,

(B) The amount of such contribution exceeds the amount deductible under section 404 (determined without regard to section 404(a)(10)) with respect to contributions made by the employer on behalf of such owner-employee under the plan, and

(C) The amount of such contribution does not exceed the average of the amounts which were deductible under section 404 (determined without regard to section 404 (a)(10)) with respect to contributions made by the employer on behalf of such owner-employee under the plan (or which would have been deductible under such section if such section had been in effect) for the first 3 taxable years (i) preceding the year in which the last such annuity, endowment, or life insurance contract was issued under the plan and (ii) in which such owner-employee derived earned income from the trade or business with respect to which the plan is established, or for so many of such taxable years as such owner-employee was engaged in such trade or business and derived earned income therefrom.

In the case of any individual on whose behalf contributions described in subparagraph (A) are made under more than one plan as an owner-employee during any taxable year, the preceding sentence shall not apply if the amount of such contributions under all such plans for such taxable year exceeds $2,500. Any contribution which is not considered to be an excess contribution by reason of the application of this paragraph shall, for purposes of subparagraphs (B) (ii), (iii), and (iv) of paragraph (1), be taken into account as a contribution made by such owner-employee as an employee to the extent that the amount of such contribution is not deductible under section 404 (determined without regard to section 404(a)(10)) for the taxable year, but only for the purpose of applying such subparagraphs to other contributions made by such owner-employee as an employee.

(f) *Certain custodial accounts*—(1) *Treatment as qualified trust.* For purposes of this title, a custodial account shall be treated as a qualified trust under this section, if—

(A) Such custodial account would, except for the fact that it is not a trust, constitute a qualified trust under this section;

(B) The custodian is a bank (as defined in subsection (d)(1));

(C) The investment of the funds in such account (including all earnings) is to be made—

(i) Solely in regulated investment company stock with respect to which an employee is the beneficial owner, or

(ii) Solely in annuity, endowment, or life insurance contracts issued by an insurance company;

(D) The shareholder of record of any such stock described in subparagraph (C)(i) is the custodian or its nominee; and

(E) The contracts described in subparagraph (C)(ii) are held by the custodian until distributed under the plan.

For purposes of this title, in the case of a custodial account treated as a qualified trust under this section by reason of the preceding sentence, the custodian of such account shall be treated as the trustee thereof.

(2) *Definition.* For purposes of paragraph (1), the term "regulated investment company" means a domestic corporation which—

(A) Is a regulated investment company within the meaning of section 851(a), and

(B) Issues only redeemable stock.

(g) *Annuity defined.* For purposes of this section and sections 402, 403, and 404, the term "annuity" includes a face-amount certificate, as defined in section 2(a)(15) of the Investment Company Act of 1940 (15 U.S.C., sec. 80a–2); but does not include any contract or certificate issued after December 31, 1962, which is transferable, if any person other than the trustee of a trust described in section 401(a) which is exempt from tax under section 501(a) is the owner of such contract or certificate.

(h) *Cross reference.* For exemption from tax of a trust qualified under this section, see section 501(a).

[Sec. 401 as amended by sec. 2, Self-Employed Individuals Tax Retirement Act 1962 (76 Stat. 809)]

PAR. 2. Section 1.401–1 is amended by revising paragraph (a)(1), by revising subdivisions (iii), (v), and (vi) of paragraph (a)(3), by adding new subdivisions (vii), (viii), and (ix) to paragraph (a)(3), by adding a new subparagraph (4) to paragraph (a), and by revising paragraph (b)(1) (i) and (2). These amended and added provisions read as follows:

§ 1.401–1 Qualified pension, profit-sharing, and stock bonus plans.

(a) *Introduction.* (1) Sections 401 through 405 relate to pension, profit-sharing, stock bonus, and annuity plans, compensation paid under a deferred-payment plan, and bond purchase plans. Section 401(a) prescribes the requirements which must be met for qualification of a trust forming part of a pension, profit-sharing, or stock bonus plan.

* * * * *

(3) * * *

(iii) It must be formed or availed of for the purpose of distributing to the employees or their beneficiaries the corpus and income of the fund accumulated by the trust in accordance with the plan, and, in the case of a plan which covers (as defined in paragraph (a)(2) of § 1.401–10) any self-employed individual, the time and method of such distribution must satisfy the requirements of section 401(a)(9) with respect to each employee covered by the plan (see paragraph (e) of § 1.401–11);

* * * * *

(v) It must be part of a plan which benefits prescribed percentages of the employees, or which benefits such employees as qualify under a classification set up by the employer and found by the Commissioner not to be discriminatory in favor of certain specified classes of employees (see § 1.401–3 and, in addition, see § 1.401–12 for special rules as to plans covering owner-employees);

(vi) It must be part of a plan under which contributions or benefits do not discriminate in favor of certain specified classes of employees (see § 1.401–4);

(vii) It must be part of a plan which provides the nonforfeitable rights described in section 401(a)(7) (see § 1.401–6);

(viii) If the trust forms part of a pension plan, the plan must provide that forfeitures must not be applied to increase the benefits any employee would receive under such plan (see § 1.401–7);

(ix) It must, if the plan benefits any self-employed individual who is an owner-employee, satisfy the additional requirements for qualification contained in section 401(a)(10) and (d).

(4) For taxable years beginning after December 31, 1962, self-employed individuals may be included in qualified plans. See §§ 1.401–10 through 1.401–13.

(b) *General rules.* (1) (i) A pension plan within the meaning of section 401(a) is a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement. Retirement benefits generally are measured by, and based on, such factors as years of service and compensation received by the employees. The determination of the amount of retirement benefits and the contributions to provide such benefits are not dependent upon profits. Benefits are not definitely determinable if funds arising from forfeitures on termination of service, or other reason, may be used to provide increased benefits for the remaining participants (see § 1.401–7, relating to the treatment of forfeitures under a qualified pension plan). A plan designed to provide benefits for employees or their beneficiaries to be paid upon retirement or over a period of years after retirement will, for the purposes of section 401(a), be considered a pension plan if the employer contributions under the plan can be determined actuarially on the basis of definitely determinable benefits, or, as in the case of money purchase pension plans, such contributions are fixed without being geared to profits. A pension plan may provide for the payment of a pension due to disability and may also provide for the payment of incidental death benefits through insurance or otherwise. However, except as provided in section 401(h) and the regulations thereunder, a pension plan may not provide for the payment of benefits not customarily included in such a plan such as layoff benefits or benefits for sickness, accident, hospitalization, or medical expenses.

* * * * *

(2) The term "plan" implies a permanent as distinguished from a temporary program. Thus, although the employer may reserve the right to change or terminate the plan, and to discontinue contributions thereunder, the abandonment of the plan for any reason other than business necessity within a few years after it has taken effect will be evidence that the plan from its inception was not a bona fide program for the exclusive benefit of employees in general. Especially will this be true if, for example, a pension plan is abandoned soon after

pensions have been fully funded for persons in favor of whom discrimination is prohibited under section 401(a). The permanency of the plan will be indicated by all of the surrounding facts and circumstances, including the likelihood of the employer's ability to continue contributions as provided under the plan. In the case of a profit-sharing plan, other than a profit-sharing plan which covers employees and owner-employees (see section 401(d)(2)(B)), it is not necessary that the employer contribute every year or that he contribute the same amount or contribute in accordance with the same ratio every year. However, merely making a single or occasional contribution out of profits for employees does not establish a plan of profit-sharing. To be a profit-sharing plan, there must be recurring and substantial contributions out of profits for the employees. In the event a plan is abandoned, the employer should promptly notify the district director, stating the circumstances which led to the discontinuance of the plan.

PAR. 3. Section 1.401–3 is amended by revising paragraph (a) and by adding a new subparagraph (5) to paragraph (e). These amended and added provisions read as follows:

§ 1.401–3 Requirements as to coverage.

(a) (1) In order to insure that stock bonus, pension, and profit-sharing plans are utilized for the welfare of employees in general, and to prevent the trust device from being used for the principal benefit of shareholders, officers, persons whose principal duties consist in supervising the work of other employees, or highly paid employees, or as a means of tax avoidance, a trust will not be qualified unless it is part of a plan which satisfies the coverage requirements of section 401(a)(3). However, if the plan covers any individual who is an owner-employee, as defined in section 401(c)(3), the requirements of section 401(a)(3) and this section are not applicable to such plan, but the plan must satisfy the requirements of section 401(d) (see § 1.401–12).

(2) The percentage requirements in section 401(a)(3)(A) refer to a percentage of all the active employees, including employees temporarily on leave, such as those in the Armed Forces of the United States, if such employees are eligible under the plan.

(3) The application of section 401(a)(3)(A) may be illustrated by the following example:

Example. A corporation adopts a plan at a time when it has 1,000 employees. The plan provides that all full-time employees who have been employed for a period of two years and have reached the age of 30 shall be eligible to participate. The plan also requires participating employees to contribute 3 percent of their monthly pay. At the time the plan is made effective 100 of the 1,000 employees had not been employed for a period of two years. Fifty of the employees were seasonal employees whose customary employment did not exceed five months in any calendar year. Twenty-five of the employees were part-time employees whose customary employment did not exceed 20 hours in any one week. One hundred and fifty of the full-time employees who had been employed for two years or more had not yet reached age 30. The requirements of section 401(a)(3)(A) will be met if 540 employees are covered by the plan, as shown by the following computation:

(i) Total employees with respect to whom the percentage requirements are applicable (1,000 minus 175 (100 plus 50 plus 25))	825
(ii) Employees not eligible to participate because of age requirements	150
(iii) Total employees eligible to participate	675
(iv) Percentage of employees in item (i) eligible to participate	81+%
(v) Minimum number of participating employees to qualify the plan (80 percent of 675)	540

If only 70 percent, or 578, of the 825 employees satisfied the age and service requirements, then 462 (80 percent of 578) participating employees would satisfy the percentage requirements.

* * * * *

(e) * * *

(5) If a plan provides contributions or benefits for a self-employed individual, the rules relating to the integration of such a plan with the contributions or benefits under the Social Security Act are set forth in paragraph (c) of § 1.401–11 and paragraph (h) of § 1.401–12.

PAR. 4. Section 1.401–4 is amended by revising paragraph (a)(1)(iii) and (2)(i) and paragraph (c) thereof. These amended provisions read as follows:

§ 1.401–4 Discrimination as to contributions or benefits.

(a) (1) * * *

(iii) Funds in a stock bonus or profit-sharing plan arising from forfeitures on termination of service, or other reason, must not be allocated to the remaining participants in such a manner as will effect the prohibited discrimination. With respect to forfeitures in a pension plan, see § 1.401–7.

(2) (i) Section 401(a)(5) sets out certain provisions which will not in and of themselves be discriminatory within the meaning of section 401(a)(3) or (4). See § 1.401–3. Thus, a plan will not be considered discriminatory merely because the contributions or benefits bear a uniform relationship to total compensation or to the basic or regular rate of compensation, or merely because the contributions or benefits based on that part of the annual compensation of employees which is subject to the Federal Insurance Contributions Act (chapter 21 of the Code) differ from the contributions or benefits based on any excess of such annual compensation over such part. With regard to the application of the rules of section 401(a)(5) in the case of a plan which benefits a self-employed individual, see paragraph (c) of § 1.401–11.

* * * * *

(c) (1) Although a qualified plan may provide for termination at will by the employer or discontinuance of contributions thereunder, this will not of itself prevent a trust from being a qualified trust. However, a qualified pension plan must expressly incorporate provisions which comply with the restrictions contained in subparagraph (2) of this paragraph at the time the plan is established, unless (i) it is reasonably certain at the inception of the plan that such restrictions would not affect the amount of contributions which may be used for the benefit of any employee, or (ii) the Commissioner determines that such provisions are not necessary to prevent the prohibited discrimination that may occur in the event of any early termination of the plan. Although these provisions are the only provisions required to be incorporated in the plan to prevent the discrimination that may arise because of an early termination of the plan, the plan may in operation result in the discrimination prohibited by section 401(a)(4), unless other provisions are later incorporated in the plan.

(2)(i) If employer contributions under a qualified pension plan may be used for the benefit of an employee who is among the 25 highest paid employees of the employer at the time the plan is established and whose anticipated annual pension under the plan exceeds $1,500, such plan must provide that upon the occurrence of the conditions described in subdivision (ii) of this subparagraph, the employer contributions which are used for the benefit of any such employee are restricted in accordance with subdivision (iii) of this subparagraph.

(ii) The restrictions described in subdivision (iii) of this subparagraph become applicable if—

(*a*) The plan is terminated within 10 years after its establishment,

(*b*) The benefits of an employee described in subdivision (i) of this subparagraph become payable within 10 years after the establishment of the plan, or

(*c*) The benefits of an employee described in subdivision (i) of this subparagraph become payable after the plan has been in effect for 10 years, and the full current costs of the plan for the first 10 years have not been funded.

In the case of an employee described in (*b*) of this subdivision, the restrictions will remain applicable until the plan has been in effect for 10 years, but if at that time the full current costs have been funded the restrictions will no longer apply to the benefits payable to such an employee. In the case of an employee described in (*b*) or (*c*) of this subdivision, if at the end of the first 10 years the full current costs are not met, the restrictions will continue to apply until the full current costs are funded for the first time.

(iii) The restrictions required under subdivision (i) of this subparagraph must provide that the employer contributions which may be used for the benefit of an employee described in such subdivision shall not exceed the greater of $20,000, or 20 percent of the first $50,000 of the annual compensation of such employee multiplied by the number of years between the date of the establishment of the plan and—

(*a*) The date of the termination of the plan,

(*b*) In the case of an employee described in subdivision (ii) (*b*) of this subparagraph, the date the benefit of the employee becomes payable, if before the date of the termination of the plan, or

(*c*) In the case of an employee described in subdivision (ii) (*c*) of this subparagraph, the date of the failure to meet the full current costs of the plan.

However, if the full current costs of the plan have not been met on the date described in (*a*) or (*b*) of this subdivision, whichever is applicable, then the date of the failure to meet such full current costs shall be substituted for the date referred to in (*a*) or (*b*) of this subdivision. For purposes of determining the contributions which may be used for the benefit of an employee when (*b*) of this subdivision applies, the number of years taken into account may be recomputed for each year if the full current costs of the plan are met for such year.

(iv) For purposes of this subparagraph, the employer contributions which, at a given time, may be used for the benefits of an employee include any unallocated funds which would be used for his benefits if the plan were then terminated or the employee were then to withdraw from the plan, as well as all contributions allocated up to that time exclusively for his benefits.

(v) The provisions of this subparagraph apply to a former or retired employee of the employer, as well as to an employee still in the employer's service.

(vi) The following terms are defined for purposes of this subparagraph—

(*a*) The term "benefits" includes any periodic income, any withdrawal values payable to a living employee, and the cost of any death benefits which may be payable after retirement on behalf of an employee, but does not include the cost of any death benefits with respect to an employee before retirement nor the amount of any death benefits actually payable after the death of an employee whether such death occurs before or after retirement.

(*b*) The term "full current costs" means the normal cost, as defined in § 1.404(a)–6, for all years since the effective date of the plan, plus interest on any unfunded liability during such period.

(*c*) The term "annual compensation" of an employee means either such employee's average regular annual compensation, or such average compensation over the last five years, or such employee's last annual compensation if such compensation is reasonably similar to his average regular annual compensation for the five preceding years.

(3) The amount of the employer contributions which can be used for the benefit of a restricted employee may be limited either by limiting the annual amount of the employer contributions for the designated employee during the period affected by the limitation, or by limiting the amount of funds under the plan which can be used for the benefit of such employee, regardless of the amount of employer contributions.

(4) The restrictions contained in subparagraph (2) of this paragraph may be exceeded for the purpose of making current retirement income benefit payments to retired employees who would otherwise be subject to such restrictions, if—

(i) The employer contributions which may be used for any such employee in accordance with the restrictions contained in subparagraph (2) of this paragraph are applied either (*a*) to provide level amounts of annuity in the basic form of benefit provided for under the plan for such employee at retirement (or, if he has already retired, beginning immediately), or (*b*) to provide level amounts of annuity in an optional form of benefit provided under the plan if the level amount of annuity under such optional form of benefit is not greater than the level amount of annuity under the basic form of benefit provided under the plan;

(ii) The annuity thus provided is supplemented, to the extent necessary to provide the full retirement income benefits in the basic form called for under the plan, by current payments to such employee as such benefits come due; and

(iii) Such supplemental payments are made at any time only if the full current costs of the plan have then been met, or the aggregate of such supplemental payments for all such employees does not exceed the aggregate employer contributions already made under the plan in the year then current.

If disability income benefits are provided under the plan, the plan may contain like provisions with respect to the current payment of such benefits.

(5) If a plan has been changed so as to increase substantially the extent of possible discrimination as to contributions and as to benefits actually payable in event of the subsequent termination of the plan or the subsequent discontinuance of contributions thereunder, then the provisions of this paragraph shall be applied to the plan as so changed as if it were a new plan established on the date of such change. However, the provision in subparagraph (2) (iii) of this paragraph that the unrestricted amount of employer contributions on behalf of any employee is at least $20,000 is applicable to the aggregate amount contributed by the employer on behalf of such employee from the date of establishment of the original plan, and, for purposes of determining if the employee's anticipated annual pension exceeds $1,500, both the employer contributions on the employee's behalf prior to the date of the change in the plan and those expected to be made on his behalf subsequent to the date of the change (based on the employee's rate of compensation on the date of the change) are to be taken into account.

(6) This paragraph shall apply to taxable years of a qualified plan commencing after September 30, 1963. In the case of an early termination of a qualified pension plan during any such taxable year, the employer contributions which may be used for the benefit of any employee must conform to the requirements of this paragraph. However, any pension plan which is qualified on September 30, 1963, will not be disqualified merely because it does not expressly include the provisions prescribed in this paragraph.

PAR. 5. There are inserted immediately after § 1.401–5, the following new sections:

§ 1.401–6 Termination of a qualified plan.

(a) *General rules.* (1) In order for a pension, profit-sharing, or stock bonus trust to satisfy the requirements of section 401, the plan of which such trust forms a part must expressly provide that, upon the termination of the plan or upon the complete discontinuance of contributions under the plan, the rights of each employee to benefits accrued to the date of such termination or discontinuance, to the extent then funded, or the rights of each employee to the amounts credited to his account at such time, are nonforfeitable. As to what constitutes nonforfeitable rights of an employee, see paragraph (a) (2) of § 1.402(b)–1.

(2) (i) A qualified plan must also provide for the allocation of any previously unallocated funds to the employees covered by the plan upon the termination of the plan or the complete discontinuance of contributions under the plan. Such provision may be incorporated in the plan at its inception or by an amendment made prior to the termination of the plan or the discontinuance of contributions thereunder.

(ii) Any provision for the allocation of unallocated funds is acceptable if it specifies the method to be used and does not conflict with the provisions of section 401(a)(4) and the regulations thereunder. The allocation of unallocated funds may be in cash or in the form of other benefits provided under the plan. However, the allocation of the funds contributed by the employer among the employees need not necessarily benefit all the employees covered by the plan. For example, an allocation may be satisfactory if priority is given to benefits for employees over the age of 50 at the time of the termination of the plan, or those who then have at least 10 years of service, if there is no possibility of discrimination in favor of employees who are officers, shareholders, employees whose principal duties consist in supervising the work of other employees, or highly compensated employees.

(iii) Subdivisions (i) and (ii) of this subparagraph do not require the allocation of amounts to the account of any employee if such amounts are not required to be used to satisfy the liabilities with respect to employees and their beneficiaries under the plan (see section 401(a)(2)).

(b) *Termination defined.* (1) Whether a plan is terminated is generally a question to be determined with regard to all the facts and circumstances in a particular case. For example, a plan is terminated when, in connection with the winding up of the employer's trade or business, the employer begins to discharge his employees. However, a plan is not terminated, for example, merely because an employer consolidates or replaces that plan with a comparable plan. Similarly, a plan is not terminated merely because the employer sells or otherwise

disposes of his trade or business if the acquiring employer continues the plan as a separate and distinct plan of its own, or consolidates or replaces that plan with a comparable plan. See paragraph (d)(4) of § 1.381(c)(11)–1 for the definition of comparable plan. In addition, the Commissioner may determine that other plans are comparable for purposes of this section.

(2) For purposes of this section, the term "termination" includes both a partial termination and a complete termination of a plan. Whether or not a partial termination of a qualified plan occurs when a group of employees who have been covered by the plan are subsequently excluded from such coverage either by reason of an amendment to the plan, or by reason of being discharged by the employer, will be determined on the basis of all the facts and circumstances. Similarly, whether or not a partial termination occurs when benefits or employer contributions are reduced, or the eligibility or vesting requirements under the plan are made less liberal, will be determined on the basis of all the facts and circumstances. However, if a partial termination of a qualified plan occurs, the provisions of section 401(a)(7) and this section apply only to the part of the plan that is terminated.

(c) *Complete discontinuance defined.* (1) For purposes of this section, a complete discontinuance of contributions under the plan is contrasted with a suspension of contributions under the plan, which is merely a temporary cessation of contributions by the employer. A complete discontinuance of contributions may occur although some amounts are contributed by the employer under the plan if such amounts are not substantial enough to reflect the intent on the part of the employer to continue to maintain the plan. The determination of whether a complete discontinuance of contributions under the plan has occurred will be made with regard to all the facts and circumstances in the particular case, and without regard to the amount of any contributions made under the plan by employees.

(2) In the case of a pension plan, a suspension of contributions will not constitute a discontinuance if—

(i) The benefits to be paid or made available under the plan are not affected at any time by the suspension, and

(ii) The unfunded past service cost at any time (which includes the unfunded prior normal cost and unfunded interest on any unfunded cost) does not exceed the unfunded past service cost as of the date of establishment of the plan, plus any additional past service or supplemental costs added by amendment.

(3) In any case in which a suspension of a profit-sharing plan is considered a discontinuance, the discontinuance becomes effective not later than the last day of the taxable year of the employer following the last taxable year of such employer for which a substantial contribution was made under the profit-sharing plan.

(d) *Contributions or benefits which remain forfeitable.* The provisions of this section do not apply to amounts which are reallocated to prevent the discrimination prohibited by section 401(a)(4) (see paragraph (c) of § 1.401–4).

(e) *Effective date.* This section shall apply to taxable years of a qualified plan commencing after September 30, 1963. In the case of the termination or complete discontinuance (as defined in this section) of any qualified plan during any such taxable year, the rights accorded to each employee covered under the plan must conform to the requirements of this section. However, a plan which is qualified on September 30, 1963, will not be disqualified merely because it does not expressly include the provisions prescribed by this section.

§ 1.401–7 Forfeitures under a qualified pension plan.

(a) *General rules.* In the case of a trust forming a part of a qualified pension plan, the plan must expressly provide that forfeitures arising from severance of employment, death, or for any other reason, must not be applied to increase the benefits any employee would otherwise receive under the plan at any time prior to the termination of the plan or the complete discontinuance of employer contributions thereunder. The amounts so forfeited must be used as soon as possible to reduce the employer's contributions under the plan. However, a qualified pension plan may anticipate the effect of forfeitures in determining the costs under the plan. Furthermore, a qualified plan will not be disqualified merely because a determination of the amount of forfeitures under the plan is made only once during each taxable year of the employer.

(b) *Examples.* The rules of paragraph (a) of this section may be illustrated by the following examples:

Example (1). The B Company Pension Trust forms a part of a pension plan which is funded by individual level annual premium annuity contracts. The plan requires ten years of service prior to obtaining a vested right to benefits under the plan. One of the company's employees resigns his position after two years of service. The insurance company paid to the trustees the cash surrender value of the contract—$750. The B Company must reduce its next contribution to the pension trust by this amount.

Example (2). The C Corporation's trusteed pension plan has been in existence for 20 years. It is funded by individual contracts issued by an insurance company, and the premiums thereunder are paid annually. Under such plan, the annual premium accrued for the year 1966 is due and is paid on January 2, 1966, and on July 1 of the same year the plan is terminated due to the liquidation of the employer. Some forfeitures were incurred and collected by the trustee with respect to those participants whose employment terminated between January 2 and July 1. The plan provides that the amount of such forfeitures is to be applied to provide additional annuity benefits for the remaining employees covered by the plan. The pension plan of the C Corporation satisfies the provisions of section 401(a)(8). Although forfeitures are used to increase benefits in this case, this use of forfeitures is permissible since no further contributions will be made under the plan.

(c) *Effective date.* This section applies to taxable years of a qualified plan commencing after September 30, 1963. However, a plan which is qualified on September 30, 1963, will not be disqualified merely because it does not expressly include the provisions prescribed by this section.

§ 1.401–8 Custodial accounts.

(a) *Treatment of a custodial account as a qualified trust.* For taxable years of a plan beginning after December 31, 1962, a custodial account may be used, in lieu of a trust, under any pension, profit-sharing, or stock bonus plan, described in section 401 if the requirements of paragraph (b) of this section are met. A custodial account may be used under such a plan, whether the plan covers common-law employees, self-employed individuals who are treated as employees by reason of section 401(c), or both. The use of a custodial account as part of a plan does not preclude the use of a trust or another custodial account as part of the same plan. A plan under which a custodial account is used may be considered in connection with other plans of the employer in determining whether the requirements of section 401 are satisfied.

(b) *Rules applicable to custodial accounts.* (1) A custodial account shall be treated for taxable years beginning after December 31, 1962, as a qualified trust under section 401 if such account meets the following requirements described in subdivisions (i) through (iii) of this subparagraph:

(i) The custodial account must satisfy all the requirements of section 401 that are applicable to qualified trusts. See subparagraph (2) of this paragraph.

(ii) The custodian of the custodial account must be a bank.

(iii) The custodial agreement provides that the investment of the funds in the account is to be made—

(*a*) Solely in stock of one or more regulated investment companies which is registered in the name of the custodian or its nominee and with respect to which an employee who is covered by the plan is the beneficial owner, or

(*b*) Solely in annuity, endowment, or life insurance contracts, issued by an insurance company and held by the custodian until distributed pursuant to the terms of the plan. For purposes of the preceding sentence, a face-amount certificate described in section 401(g) and § 1.401–9 is treated as an annuity issued by an insurance company.

See subparagraphs (3) and (4) of this paragraph.

(2) As a result of the requirement described in subparagraph (1)(i) of this paragraph (relating to the requirements applicable to qualified trusts), the custodial account must, for example, be created pursuant to a written agreement which constitutes a valid contract under local law. In addition, the terms of the contract must make it impossible, prior to the satisfaction of all liabilities with respect to the employees and their beneficiaries covered by the plan, for any part of the funds of the custodial account to be used for, or diverted to, purposes other than for the exclusive benefit of the employees or their beneficiaries

as provided for in the plan (see paragraph (a) of § 1.401–2).

(3) The requirement described in subparagraph (1)(iii) of this paragraph, relating to the investment of the funds of the plan, applies, for example, to the employer contributions under the plan, any employee contributions under the plan, and any earnings on such contributions. Such requirement also applies to capital gains realized upon the sale of stock described in (*a*) of such subdivision, to any capital gain dividends received in connection with such stock, and to any refunds described in section 852(b)(3)(D)(ii) (relating to undistributed capital gains of a regulated investment company) which is received in connection with such stock. However, since such requirement relates only to the investment of the funds of the plan, the custodian may deposit funds with a bank, in either a checking or savings account, while accumulating sufficient funds to make additional investments or while awaiting an appropriate time to make additional investments.

(4) The requirement in subparagraph (1)(iii)(*a*) of this paragraph that an employee covered by the plan be the beneficial owner of the stock does not mean that the employee who is the beneficial owner must have a nonforfeitable interest in the stock. Thus, a plan may provide for forfeitures of an employee's interest in such stock in the same manner as plans which use a trust. In the event of a forfeiture of an employee's beneficial ownership in the stock of a regulated investment company, the beneficial ownership of such stock must pass to another employee covered by the plan.

(c) *Effects of qualification.* (1) Any custodial account which satisfies the requirements of section 401(f) shall be treated as a qualified trust for all purposes of the Internal Revenue Code of 1954. Accordingly, such a custodial account shall be treated as a separate legal person which is exempt from the income tax by section 501(a). On the other hand, such a custodial account is required to file the returns described in sections 6033 and 6047 and to supply any other information which a qualified trust is required to furnish.

(2) In determining whether the funds of a custodial account are distributed or made available to an employee or his beneficiary, the rules which under section 402(a) are applicable to trusts will also apply to the custodial account as though it were a separate legal person and not an agent of the employee.

(d) *Effect of loss of qualification.* If a custodial account which has qualified under section 401 fails to qualify under such section for any taxable year, such custodial account will not thereafter be treated as a separate legal person, and the funds in such account shall be treated as made available within the meaning of section 402(a)(1) to the employees for whom they are held.

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

(1) The term "bank" means a bank as defined in section 401(d)(1).

(2) The term "regulated investment company" means any domestic corporation which issues only redeemable stock and is a regulated investment company within the meaning of section 851(a) (but without regard to whether such corporation meets the limitations of section 851(b)).

§ 1.401–9 Face-amount certificates—nontransferable annuity contracts.

(a) *Face-amount certificates treated as annuity contracts.* Section 401(g) provides that a face-amount certificate (as defined in section 2(a)(15) of the Investment Company Act of 1940 (15 U.S.C. sec. 80a–2)) which is not transferable within the meaning of paragraph (b)(3) of this section shall be treated as an annuity contract for purposes of sections 401 through 404 for any taxable year of a plan subject to such sections beginning after December 31, 1962. Accordingly, there may be established for any such taxable year a qualified plan under which such face-amount certificates are purchased for the participating employees without the creation of a trust or custodial account. However, for such a plan to qualify, the plan must satisfy all the requirements applicable to a qualified annuity plan (see section 403(a) and the regulations thereunder).

(b) *Nontransferability of face-amount certificates and annuity contracts.* (1)(i) Section 401(g) provides that, in order for any face-amount certificate, or any other contract issued after December 31, 1962, to be subject to any provision under sections 401 through 404 which is applicable to annuity contracts, as compared to other forms of investment, such certificate or contract must be nontransferable at any time when it is held by any person other than the trustee of a trust described in section 401(a) and exempt under section 501(a). Thus, for example, in order for a group or individual retirement income contract to be treated as an annuity contract, if such contract is not held by the trustee of an exempt employees' trust, it must satisfy the requirements of this section. Furthermore, a face-amount certificate or an annuity contract will be subject to the tax treatment under section 403(b) only if it satisfies the requirements of section 401(g) and this section. Any certificate or contract in order to satisfy the provisions of this section must expressly contain the provisions that are necessary to make such certificate or contract not transferable within the meaning of this paragraph.

(ii) In the case of any group contract purchased by an employer under a plan to which sections 401 through 404 apply, the restriction on transferability required by section 401(g) and this section applies to the interest of the employee participants under such group contract but not to the interest of the employer under such contract.

(2) If a trust described in section 401(a) which is exempt from tax under section 501(a) distributes any annuity, endowment, retirement income, or life insurance contract, then the rules relating to the taxability of the distributee of any such contract are set forth in paragraph (a)(2) of § 1.402(a)–1.

(3) A face-amount certificate or an annuity contract is transferable if the owner can transfer any portion of his interest in the certificate or contract to any person other than the issuer thereof. Accordingly, such a certificate or contract is transferable if the owner can sell, assign, discount, or pledge as collateral for a loan or as security for the performance of an obligation or for any other purpose his interest in the certificate or contract to any person other than the issuer thereof. On the other hand, for purposes of section 401(g), a face-amount certificate or annuity contract is not considered to be transferable merely because such certificate or contract, or the plan of which it is a part, contains a provision permitting the employee to designate a beneficiary to receive the proceeds of the certificate or contract in the event of his death, or contains a provision permitting the employee to elect to receive a joint and survivor annuity, or contains other similar provisions.

(4) A material modification in the terms of an annuity contract constitutes the issuance of a new contract regardless of the manner in which it is made.

(c) *Examples.* The rules of this section may be illustrated by the following examples:

Example (1). The P Employees' Annuity Plan is a nontrusteed plan which is funded by individual annuity contracts issued by the Y Insurance Company. Each annuity contract issued by such company after December 31, 1962, provides, on its face, that it is "NOT TRANSFERABLE". The terms of each such contract further provide that, "This contract may not be sold, assigned, discounted, or pledged as collateral for a loan or as security for the performance of an obligation or for any other purpose, to any person other than this company." The annuity contracts of the P Employees' Annuity Plan satisfy the requirements of section 401(g) and this section.

Example (2). The R Company Pension Trust forms a part of a pension plan which is funded by individual level premium annuity contracts. Such contracts are purchased by the trustee of the R Company Pension Trust from the Y Insurance Company. The trustee of the R Company Pension Trust is the legal owner of each such contract at all times prior to the distribution of such contract to a qualifying annuitant. The trustee purchases such a contract on January 3, 1963, in the name of an employee who qualifies on that date for coverage under the plan. At the time such contract is purchased, and while the contract is held by the trustee of the R Company Pension Trust, the contract does not contain any restrictions with respect to its transferability. The annuity contract purchased by the trustee of the R Company Pension Trust satisfies the requirements of section 401(g) and this section while it is held by the trustee.

Example (3). A is the trustee of the X Corporation's Employees' Pension Trust. The trust forms a part of a pension plan which is funded by individual level premium annuity contracts. The trustee is the legal owner of such contracts, but the employees covered under the plan obtain beneficial interests in such contracts after ten years of service with the X Corporation. On January 15, 1980, A distributes to D an annuity contract issued to A in D's name on June 25, 1959, and distributes to E an annuity contract issued to A in E's name on September 30, 1963. The contract issued to D need

not be nontransferable, but the contract issued to E must be nontransferable in order to satisfy the requirements of section 401(g) and this section.

Example (4). The corpus of the Y Corporation's Employees' Pension Plan consists of individual insurance contracts in the names of the covered employees and an auxiliary fund which is used to convert such policies to annuity contracts at the time a beneficiary of such trust retires. F retires on June 15, 1963, and the trustee converts the individual insurance contract on F's life to a life annuity which is distributed to him. The life annuity issued on F's life must be nontransferable in order to satisfy the requirements of section 401(g) and this section.

§ 1.401–10 Definitions relating to plans covering self-employed individuals.

(a) *In general.* (1) Certain self-employed individuals may be covered by a qualified pension, annuity, or profit-sharing plan for taxable years beginning after December 31, 1962. This section contains definitions relating to plans covering self-employed individuals. The provisions of §§ 1.401–1 through 1.401–9, relating to requirements which are applicable to all qualified plans, are also generally applicable to any plan covering a self-employed individual. However, in addition to such requirements, any plan covering a self-employed individual is subject to the rules contained in §§ 1.401–11 through 1.401–13. Section 1.401–11 contains general rules which are applicable to any plan covering a self-employed individual who is an employee within the meaning of paragraph (b) of this section. Section 1.401–12 contains special rules which are applicable to plans covering self-employed individuals when one or more of such individuals is an owner-employee within the meaning of paragraph (d) of this section. Section 1.401–13 contains rules relating to excess contributions by, or for, an owner-employee. The provisions of this section and of §§ 1.401–11 through 1.401–13 are applicable to taxable years beginning after December 31, 1962.

(2) A self-employed individual is covered under a qualified plan during the period beginning with the date a contribution is first made by, or for, him under the qualified plan and ending when there are no longer funds under the plan which can be used to provide him or his beneficiaries with benefits.

(b) *Treatment of a self-employed individual as an employee.* (1) For purposes of section 401, a self-employed individual who receives earned income from an employer during a taxable year of such employer beginning after December 31, 1962, shall be considered an employee of such employer for such taxable year. Moreover, such an individual will be considered an employee for a taxable year if he would otherwise be treated as an employee but for the fact that the employer did not have net profits for that taxable year. Accordingly, the employer may cover such an individual under a qualified plan during years of the plan beginning with or within a taxable year of the employer beginning after December 31, 1962.

(2) If a self-employed individual is engaged in more than one trade or business, each such trade or business shall be considered a separate employer for purposes of applying the provisions of sections 401 through 404 to such individual. Thus, if a qualified plan is established for one trade or business but not the others, the individual will be considered an employee only if he received earned income with respect to such trade or business and only the amount of such earned income derived from that trade or business shall be taken into account for purposes of the qualified plan.

(3) (i) The term "employee", for purposes of section 401, does not include a self-employed individual when the term "common-law" employee is used or when the context otherwise requires that the term "employee" does not include a self-employed individual. The term "common-law" employee also includes an individual who is treated as an employee for purposes of section 401 by reason of the provisions of section 7701(a)(20), relating to the treatment of certain full-time life insurance salesmen as employees. Furthermore, an individual who is a common-law employee is not a self-employed individual with respect to income attributable to such employment, even though such income constitutes net earnings from self-employment as defined in section 1402(a). Thus, for example, a minister who is a common-law employee is not a self-employed individual with respect to income attributable to such employment, even though such income constitutes net earnings from self-employment as defined in section 1402(a).

(ii) An individual may be treated as an employee within the meaning of section 401(c)(1) of one employer even though such individual is also a common-law employee of another employer. For example, an attorney who is a common-law employee of a corporation and who, in the evenings maintains an office in which he practices law as a self-employed individual is an employee within the meaning of section 401(c)(1) with respect to the law practice. This example would not be altered by the fact that the corporation maintained a qualified plan under which the attorney is benefited as a common-law employee.

(4) For the purpose of determining whether an employee within the meaning of section 401(c)(1) satisfies the requirements for eligibility under a qualified plan established by an employer, such an employer may take into account past services rendered by such an employee both as a self-employed individual and as a common-law employee if past services rendered by other employees, including common-law employees, are similarly taken into account. However, an employer cannot take into account only past services rendered by employees within the meaning of section 401(c)(1) if past services rendered to such employer by individuals who are, or were, common-law employees are not taken into account. Past service as described in this subparagraph may be taken into account for the purpose of determining whether an individual who is, or was, an employee within the meaning of section 401(c)(1) satisfies the requirements for eligibility even if such service was rendered prior to January 1, 1963. On the other hand, past service cannot be taken into account for purposes of determining the contributions which may be made on such an individual's behalf under a qualified plan.

(c) *Definition of earned income.*—(1) *General rule.* For purposes of section 401 and the regulations thereunder, "earned income" means, in general, net earnings from self-employment (as defined in section 1402(a)) to the extent such net earnings constitute compensation for personal services actually rendered within the meaning of section 911(b).

(2) *Net earnings from self-employment.* (i) The computation of the net earnings from self-employment shall be made in accordance with the provisions of section 1402(a) and the regulations thereunder, with the modifications and exceptions described in subdivisions (ii) through (iv) of this subparagraph. Thus, an individual may have net earnings from self-employment, as defined in section 1402(a), even though such individual does not have self-employment income, as defined in section 1402(b), and, therefore, is not subject to the tax on self-employment income imposed by section 1401.

(ii) Items which are not included in gross income for purposes of chapter 1 of the Code and the deductions properly attributable to such items must be excluded from the computation of net earnings from self-employment even though the provisions of section 1402(a) specifically require the inclusion of such items. For example, if an individual is a resident of Puerto Rico, so much of his net earnings from self-employment as are excluded from gross income under section 933 must not be taken into account in computing his net earnings from self-employment which are earned income for purposes of section 401.

(iii) In computing net earnings from self-employment for the purpose of determining earned income, a self-employed individual may disregard only deductions for contributions made on his own behalf under a qualified plan. However, such computation must take into account the deduction allowed by section 404 or 405 for contributions under a qualified plan on behalf of the common-law employees of the trade or business.

(iv) For purposes of determining whether an individual has net earnings from self-employment and, thus, whether he is an employee within the meaning of section 401(c)(1), the exceptions in section 1402(c)(4) and (5) shall not apply. Thus, certain ministers, certain members of religious orders, doctors of medicine, and Christian Science practitioners are treated for purposes of section 401 as being engaged in a trade or business from which net earnings from self-employment are derived. In addition, the exceptions in section 1402(c)(2) shall not apply in the case of any individual who is treated as an employee under section 3121(d)(3)(A), (C), or (D). Therefore, such individuals are treated, for purposes of section 401, as being engaged in a trade or

business from which net earnings from self-employment may be derived.

(3) *Compensation for personal services actually rendered.* (i) For purposes of section 401, the term "earned income" includes only that portion of an individual's net earnings from self-employment which constitutes earned income as defined in section 911(b) and the regulations thereunder. Thus, such term includes only professional fees and other amounts received as compensation for personal services actually rendered by the individual. There is excluded from "earned income" the amount of any item of income, and any deduction properly attributable to such item, if such amount is not received as compensation for personal services actually rendered. Therefore, an individual who renders no personal services has no "earned income" even though such an individual may have net earnings from self-employment from a trade or business.

(ii) If a self-employed individual is engaged in a trade or business in which capital is a material income-producing factor, then, under section 911(b), his earned income is only that portion of the net profits from the trade or business which constitutes a reasonable allowance as compensation for personal services actually rendered. However, such individual's earned income cannot exceed 30 percent of the net profits of such trade or business. The net profits of the trade or business is not necessarily the same as the net earnings from self-employment derived from such trade or business.

(4) *Minimum earned income when both personal services and capital are material income-producing factors.* (i) If a self-employed individual renders personal services on a full-time, or substantially full-time, basis to only one trade or business, and if with respect to such trade or business capital is a material income-producing factor, then the amount of such individual's earned income from the trade or business is considered to be not less than so much of his share in the net profits of such trade or business as does not exceed $2,500.

(ii) If a self-employed individual renders substantial personal services to more than one trade or business, and if with respect to all such trades or businesses such self-employed individual actually renders personal services on a full-time, or substantially full-time, basis, then the earned income of the self-employed individual from trades or businesses for which he renders substantial personal services and in which both personal services and capital are material income-producing factors is considered to be not less than—

(*a*) So much of such individual's share of the net profits from all trades or businesses in which he renders substantial personal services as does not exceed $2,500, reduced by

(*b*) Such individual's share of the net profits of any trade or business in which only personal services is a material income-producing factor.

However, in no event shall the share of the net profits of any trade or business in which capital is a material income-producing factor be reduced below the amount which would, without regard to the provisions of this subdivision, be treated as the earned income derived from such trade or business under section 911(b). In making the computation required by this subdivision, any trade or business with respect to which the individual renders substantial personal services shall be taken into account irrespective of whether a qualified plan has been established by such trade or business.

(iii) If the provisions of subdivision (ii) of this subparagraph apply in determining the earned income of a self-employed individual, and such individual is engaged in two or more trades or businesses in which capital and personal services are material income-producing factors, then the total amount treated as the earned income shall be allocated to each such trade or business for which he performs substantial personal services in the same proportion as his share of net profits from each such trade or business bears to his share of the total net profits from all such trades or businesses. Thus, in such case, the amount of earned income attributable to any such trade or business is computed by multiplying the total earned income as determined under subdivision (ii) of this subparagraph by the individual's net profits from such trade or business and dividing that product by the individual's total net profits from all such trades or businesses.

(iv) For purposes of this subparagraph, the determination of whether an individual renders personal services on a full-time, or substantially full-time, basis is to be made with regard to the aggregate of the trades and businesses with respect to which the employee renders substantial personal services as a common-law employee or as a self-employed individual. However, for all other purposes in applying the rules of this subparagraph, a trade or business with respect to which an individual is a common-law employee shall be disregarded.

(d) *Definition of owner-employee.* For purposes of section 401 and the regulations thereunder, the term "owner-employee" means a proprietor of a proprietorship, or, in the case of a partnership, a partner who owns either more than 10 percent of the capital interest, or more than 10 percent of the profits interest, of the partnership. Thus, an individual who owns only 2 percent of the profits interest but 11 percent of the capital interest of a partnership is an owner-employee. A partner's interest in the profits and the capital of the partnership shall be determined by the partnership agreement. In the absence of any provision regarding the sharing of profits, the interest in profits of the partners will be determined in the same manner as their distributive shares of partnership taxable income. However, a guaranteed payment (as described in section 707(c)) is not considered a distributive share of partnership income for such purpose. See section 704(b), relating to the determination of the distributive share by the income or loss ratio, and the regulations thereunder. In the absence of a provision in the partnership agreement, a partner's capital interest in a partnership shall be determined on the basis of his interest in the assets of the partnership which would be distributable to such partner upon his withdrawal from the partnership, or upon liquidation of the partnership, whichever is the greater.

(e) *Definition of employer.* (1) For purposes of section 401, a sole proprietor is considered to be his own employer, and the partnership is considered to be the employer of each of the partners. Thus, an individual partner is not an employer who may establish a qualified plan with respect to his services to the partnership.

(2) Regardless of the provision of local law, a partnership is deemed, for purposes of section 401, to be continuing until such time as it is terminated within the meaning of section 708, relating to the continuation of a partnership.

§ 1.401–11 General rules relating to plans covering self-employed individuals.

(a) *Introduction.* This section provides certain rules which supplement, and modify, the rules of §§ 1.401–1 through 1.401–9 in the case of a qualified pension, annuity, or profit-sharing plan which covers a self-employed individual who is an employee within the meaning of section 401(c)(1). The provisions of this section apply to taxable years beginning after December 31, 1962.

(b) *General rules.* (1) If the amount of employer contributions for common-law employees covered under a qualified plan is related to the earned income (as defined in section 401(c)(2)) of a self-employed individual, or group of self-employed individuals, such a plan is a profit-sharing plan (as described in paragraph (b)(1)(ii) of § 1.401–1) since earned income is dependent upon the profits of the trade or business with respect to which the plan is established. Thus, for example, a plan, which provides that the employer will contribute 10 percent of the earned income of a self-employed individual but no more than $2,500, and that the employer contribution on behalf of common-law employees shall be the same percentage of their salaries as the contribution on behalf of the self-employed individual bears to his earned income, is a profit-sharing plan, since the amount of the employer's contribution for common-law employees covered under the plan is related to the earned income of a self-employed individual and thereby to the profits of the trade or business. On the other hand, for example, a plan which defines the compensation of any self-employed individual as his earned income and which provides that the employer will contribute 10 percent of the compensation of each employee covered under the plan is a pension plan since the contribution on behalf of common-law employees is fixed without regard to whether the self-employed individual has earned income or the amount thereof.

(2) The Self-Employed Individuals Tax Retirement Act of 1962 (76 Stat. 809) permits self-employed individuals to be treated as employees and therefore

included in qualified plans, but it is clear that such law requires such self-employed individuals to provide benefits for their employees on a nondiscriminatory basis. Self-employed individuals will not be considered as providing contributions or benefits for an employee to the extent that the wages or salary of the employee covered under the plan are reduced at or about the time the plan is adopted.

(3) In addition to permitting self-employed individuals to participate in qualified plans, the Self-Employed Individuals Tax Retirement Act of 1962 extends to such individuals some of the tax benefits allowed common-law employee-participants in such plans. However, the tax benefits allowed a self-employed individual are restricted by the limits which are placed on the deductions allowed for contributions on such an individual's behalf. In view of these restrictions on the tax benefits extended to any self-employed individual, a self-employed individual participating in a qualified plan may not participate in any forfeitures. Therefore, in the case of a qualified plan which covers any self-employed individual, a separate account must be established for each self-employed individual to which no forfeitures can be allocated.

(c) *Requirements as to coverage.* (1) In general, section 401(a)(3) and the regulations thereunder prescribe the coverage requirements which a quailfied plan must satisfy. However, if such a plan covers self-employed individuals who are not owner-employees, it must, in addition to satisfying such requirements, satisfy the requirements of this paragraph. If any owner-employee is covered under a qualified plan, the provisions of this paragraph do not apply, but the provisions of section 401(d), including section 401(d)(3), do apply (see § 1.401–12).

(2)(i) Section 401(a)(3)(B) provides that a plan may satisfy the coverage requirements for qualification if it covers such employees as qualify under a classification which is found not to discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees. Section 401(a)(5) sets forth certain classifications that will not in themselves be considered discriminatory. Under such section, a classification which excludes all employees whose entire remuneration constitutes "wages" under section 3121(a)(1), will not be considered discriminatory merely because of such exclusion. Similarly, a plan which includes all employees will not be considered discriminatory solely because the contributions or benefits based on that part of their remuneration which is excluded from "wages" under section 3121(a)(1) differ from the contributions or benefits based on that part of their remuneration which is not so excluded. However, in determining if a classification is discriminatory under section 401(a)(3)(B), consideration will be given to whether the total benefits resulting to each employee under the plan and under the Social Security Act, or under the Social Security Act only, establish an integrated and correlated retirement system satisfying the tests of section 401(a). A plan which covers self-employed individuals none of whom is an owner-employee may also be integrated with the contributions or benefits under the Social Security Act. In such a case, the portion of the earned income (as defined in section 401(c)(2)) of such an individual which does not exceed $4,800 and which is derived from the trade or business with respect to which the plan is established shall be treated as "wages" under section 3121(a)(1) subject to the tax imposed by section 3111 (relating to the tax on employers) for purposes of applying the rules of paragraph (e)(2) of § 1.401–3, relating to the determination of whether a plan is properly integrated. However, if the plan covers an owner-employee, the rules relating to the integration contained in paragraph (h) of § 1.401–12 apply.

(ii) Certain of the classifications enumerated in section 401(a)(5) do not apply to plans which provide contributions or benefits for any self-employed individual. Since self-employed individuals are not salaried or clerical employees, the provision in section 401(a)(5) permitting a plan, in certain cases, to cover only this type of employee is inapplicable to plans which cover any self-employed individual.

(iii) The classifications enumerated in section 401(a)(5) are not exclusive, and it is not necessary that a qualified plan cover all employees or all full-time employees. Plans may qualify even though coverage is limited in accordance with a particular classification incorporated in the plan, provided the effect of covering only such employees as satisfy such eligibility requirement does not result in the prohibited discrimination.

(d) *Discrimination as to contributions or benefits*—(1) *In general.* In order for a plan to be qualified, there must be no discrimination in contributions or benefits in favor of employees who are officers, shareholders, supervisors, or highly compensated, as against other employees whether within or without the plan. A self-employed individual, by reason of the contingent nature of his compensation, is considered to be a highly-compensated employee, and thus is a member of the group in whose favor discrimination is prohibited. In determining whether the prohibited discrimination exists, the total employer contribution on behalf of a self-employed individual shall be taken into account regardless of the fact that only a portion of such contribution is allowed as a deduction. For additional rules relating to discrimination as to contributions or benefits with regard to plans covering any owner-employee, see § 1.401–12.

(2) *Base for computing contributions or benefits.* (i) A plan which is otherwise qualified is not considered discriminatory merely because the contributions or benefits provided under the plan bear a uniform relationship to the total compensation, basic compensation, or regular rate of compensation of the employees, including self-employed individuals, covered under the plan.

(ii) In the case of a self-employed individual who is covered under a qualified plan, the total compensation of such individual is the earned income (as defined in section 401(c)(2)) which such individual derives from the employer's trade or business, or trades or businesses, with respect to which the qualified plan is established. Thus, for example, in the case of a partner, his total compensation includes both his distributive share of partnership income, whether or not distributed, and guaranteed payments described in section 707(c) made to him by the partnership establishing the plan, to the extent that such income constitutes earned income as defined in section 401(c)(2).

(iii)(*a*) The basic or regular rate of compensation of any self-employed individual is that portion of his earned income which bears the same ratio to his total earned income derived from the trade or business, or trades or businesses, with respect to which the qualified plan is established as the aggregate basic or regular compensation of all common-law employees covered under the plan bears to the aggregate total compensation of such employees derived from such trade or business, or trades or businesses.

(*b*) If an employer establishes two or more plans which satisfy the requirements of section 401(a) separately, and only one such plan covers a self-employed individual, the determination of the basic or regular rate of compensation of such self-employed individual is made with regard to the compensation of common-law employees covered under the plan which provides contributions or benefits for such self-employed individual. On the other hand, if two or more plans must be considered together in order to satisfy the requirements of section 401(a), the computation of the basic or regular rate of compensation of a self-employed individual must be made with regard to the compensation of the common-law employees covered by so many of such plans as are required to be taken together in order to satisfy the qualification requirements of section 401(a).

(3) *Discriminatory contributions.* If a discriminatory contribution is made by, or for, a self-employed individual who is an employee within the meaning of section 401(c)(1) because of an erroneous assumption as to the earned income of such individual, the plan will not be considered discriminatory if adequate adjustment is made to remove such discrimination. In the case of any self-employed individual who is an owner-employee, the amount of any excess contribution to be returned and the manner in which it is to be repaid are determined by the provisions of section 401(d)(8) and (e). However, if any self-employed individual, including any owner-employee, has not made the full contribution permitted to be made on his behalf as an employee, then, if the plan expressly provides, so much of any excess contribution by such self-employed individual's employer as may, under the provisions of the plan, be

treated as a contribution made by such individual as an employee can be so treated.

(e) *Distribution of entire interest.* (1) If a trust forms part of a plan which covers a self-employed individual, such trust shall constitute a qualified trust under section 401 only if the plan of which such trust is a part expressly provides that the entire interest of each employee, including any common-law employee, will be distributed in accordance with the provisions of subparagraph (2) or (3) of this paragraph.

(2) Unless the provisions of subparagraph (3) of this paragraph apply, the entire interest of each employee (including contributions he has made on his own behalf, contributions made on his behalf by his employer, and interest thereon) must be actually distributed to such employee—

(i) In the case of an employee, other than an individual who is, or has been, an owner-employee under the plan, not later than the last day of the taxable year of such employee in which he attains the age of 70½, or not later than the last day of the taxable year in which such employee retires, whichever is later, and

(ii) In the case of an employee who is, or has been, an owner-employee under the plan, not later than the last day of the taxable year in which he attains the age of 70½.

(3) In lieu of distributing an employee's entire interest in a qualified plan as provided in subparagraph (2) of this paragraph, such interest may be distributed commencing no later than the last taxable year described in such subparagraph (2). In such case, the plan must expressly provide that the entire interest of such an employee shall be distributed to him and his beneficiaries, in a manner which satisfies the requirements of subparagraph (5) of this paragraph, over any of the following periods (or any combination thereof)—

(i) The life of the employee, or

(ii) The lives of the employee and his spouse, or

(iii) A period certain not longer than the life expectancy of the employee, or

(iv) A period certain not longer than the joint life and last survivor expectancy of the employee and his spouse.

(4) For purposes of subparagraphs (3) and (5) of this paragraph, the determination of the life expectancy of the employee or the joint life and last survivor expectancy of the employee and his spouse is to be made either (i) only once, at the time the employee receives the first distribution of his entire interest under the plan, or (ii) periodically, in a consistent manner. Such life expectancy or joint life and last survivor expectancy cannot exceed the period computed by the use of the expected return multiples in § 1.72–9, or, in the case of payments under a contract issued by an insurance company, the period computed by use of the life expectancy tables of such company.

(5) If an employee's entire interest is to be distributed over a period described in subparagraph (3) of this paragraph, then the amount to be distributed each year must be at least an amount equal to the quotient obtained by dividing the entire interest of the employee under the plan at the time the distribution is made (expressed in either dollars or units) by the life expectancy of the employee, or joint life and last survivor expectancy of the employee and his spouse (whichever is applicable), determined in accordance with the provisions of subparagraph (4) of this paragraph. However, no distribution need be made in any year, or a lesser amount may be distributed, if the aggregate amounts distributed by the end of that year are at least equal to the aggregate of the minimum amounts required by this subparagraph to have been distributed by the end of such year.

(6) If an employee's entire interest is distributed in the form of an annuity contract, then the requirements of section 401(a)(9) are satisfied if the distribution of such contract takes place before the end of the latest taxable year described in subparagraph (2) of this paragraph, and if the employee's interest will be paid over a period described in subparagraph (3) of this paragraph and at a rate which satisfies the requirements of subparagraph (5) of this paragraph.

(7) The requirements of section 401(a)(9) do not preclude contributions from being made on behalf of an owner-employee under a qualified plan subsequent to the taxable year in which the distribution of his entire interest is required to commence. Thus, if all other requirements for qualification are satisfied, a qualified plan may provide contributions for an owner-employee who has already attained age 70½. However, a distribution of benefits attributable to contributions made on behalf of an owner-employee in a taxable year beginning after the taxable year in which he attains the age of 70½ must satisfy the requirements of subparagraph (3) of this paragraph. Thus, if an owner-employee has already attained the age of 70½ at the time the first contribution is made on his behalf, the distribution of his entire interest must commence in the year in which such contribution is first made on his behalf.

(8) This paragraph shall not apply and an otherwise qualified trust will not be disqualified if the method of distribution under the plan is one which was designated by a common-law employee prior to October 10, 1962, and such method of distribution is not in accordance with the provisions of section 401(a)(9). Such exception applies regardless of whether the actual distribution of of the entire interest of an employee making such a designation, or any portion of such interest, has commenced prior to October 10, 1962.

§ 1.401–12 Requirements for qualification of trusts and plans benefiting owner-employees.

(a) *Introduction.* This section prescribes the additional requirements which must be met for qualification of a trust forming part of a pension or profit-sharing plan, or of an annuity plan, which covers any self-employed individual who is an owner-employee as defined in section 401(c)(3). However, to the extent that the provisions of § 1.401–11 are not modified by the provisions of this section, such provisions are also applicable to a plan which covers an owner-employee. The provisions of this section apply to taxable years beginning after December 31, 1962.

(b) *General rules.* (1) The qualified plan and trust of an unincorporated trade or business does not have to satisfy the additional requirements for qualification merely because an owner-employee derives earned income (as defined in section 401(c)(2)) from the trade or business with respect to which the plan is established. Such additional requirements need be satisfied only if an owner-employee is actually covered under the plan of the employer. An owner-employee may only be covered under a plan of an employer if such owner-employee has so consented. However, the consent of the owner-employee may be either expressed or implied. Thus, for example, if contributions are, in fact, made on behalf of an owner-employee, such owner-employee is considered to have impliedly consented to being covered under the plan.

(2) A qualified plan covering an owner-employee must be a definite written program and arrangement setting forth all provisions essential for qualification at the time such plan is established. Therefore, for example, even though the owner-employee is the only employee covered under the plan at the time the plan is established, the plan must incorporate all the provisions relating to the eligibility and benefits of future employees.

(c) *Bank trustee.* (1)(i) If a trust created after October 9, 1962, is to form a part of a qualified pension or profit-sharing plan covering an owner-employee, or if a trust created before October 10, 1962, but not exempt from tax on October 9, 1962, is to form part of such a plan, the trustee of such trust must be a bank as defined in subparagraph (2) of this paragraph, unless an exception contained in subparagraph (4) of this paragraph applies.

(ii) The provisions of this paragraph do not apply to an employees' trust created prior to October 10, 1962, if such trust was exempt from tax on October 9, 1962, even though the plan of which such trust forms a part is amended after December 31, 1962, to cover any owner-employee. Although the trustee of a trust described in the preceding sentence need not be a bank, all other requirements for the qualification of such a trust must be satisfied at the time an owner-employee is first covered under such plan.

(2) The term "bank" as used in this paragraph means—

(i) A bank as defined in section 581;

(ii) A corporation which, under the laws of the State of its incorporation or under the laws of the District of Columbia, is subject to both the supervision of, and examination by, the authority in such jurisdiction in charge of the administration of the banking laws;

(iii) In the case of a trust created or organized outside of the United States,

that is, outside the States and the District of Columbia, a bank or trust company, wherever incorporated, exercising fiduciary powers and subject to both supervision and examination by governmental authority.

(3) Although a bank is required to be the trustee of a qualified trust, another person, including the employer, may be granted the power in the trust instrument to control the investment of the trust funds either by directing investments, including reinvestments, disposals, and exchanges, or by disapproving proposed investments, including reinvestments, disposals, or exchanges.

(4) (i) This paragraph does not apply to a trust created or organized outside the States and the District of Columbia before October 10, 1962, if, on October 9, 1962, such trust is described in section 402(c) as an organization treated as if it was a trust exempt from tax under section 501(a).

(ii) In addition, the requirement that the trustee must be a bank does not apply to a qualified trust forming a part of a pension or profit-sharing plan if—

(*a*) The investments of all the funds in such trust are in annuity, endowment, or life insurance contracts, issued by a company which is a life insurance company as defined in section 801(a) during the taxable year immediately preceding the year that such contracts are originally purchased;

(*b*) All the proceeds which are, or may become, payable under the contract are payable directly to the employee or his beneficiary;

(*c*) The plan contains a provision to the effect that the employer is to substitute a bank as a trustee or custodian of the contracts if the employer is notified by the district director that such substitution is required because the trustee is not keeping such records, or making such returns, or rendering such statements, as are required by forms or regulations.

However, a qualified trust may only purchase insurance protection to the extent permitted under a qualified plan (see paragraph (b)(1) (i) and (ii) of § 1.401–1).

(5) An employer may designate several trusts (or custodial accounts) or a trust or trusts and an annuity plan or plans as constituting parts of a single plan which is intended to satisfy the requirements for qualification. However, each trust (or custodial account) so designated which is part of a plan covering an owner-employee must satisfy the requirements of this paragraph. Thus, for example, if all other requirements for qualification are satisfied by the plan, a qualified profit-sharing plan may provide that a portion of the contributions under the plan will be paid to a custodial account, the custodian of which is a bank, for investment in stock of a regulated investment company, and the remainder of such contributions will be paid to a trust, the trustee of which is not a bank, for investment in annuity contracts.

(d) *Profit-sharing plan.* (1) A profit-sharing plan, as defined in paragraph (b)(1)(ii) of § 1.401–1, which covers any owner-employee must contain a definite formula for determining the contributions to be made by the employer on behalf of employees, other than owner-employees. A formula to be definite must specify the portion of profits to be contributed to the trust and must also define profits for plan purposes. A definite formula may contain a variable factor, if the value of such factor may not vary at the discretion of the employer. For example, the percentage of profits to be contributed each year may differ depending on the amount of profits. On the other hand, a formula which, for example, specifies that profits for plan purposes are not to exceed the cash on hand at the time the employer contribution is made is not a definite formula. The requirement that the plan formula be definite is satisfied if such formula limits the amount to be contributed on behalf of all employees covered under the plan to the amount which permits self-employed individuals to obtain the maximum deduction under section 404(a). However, even though the plan formula is definite, the plan must satisfy all the other requirements for qualification, including the requirement that the contributions under the plan not discriminate in favor of any self-employed individual, and the requirement that the plan be for the exclusive benefit of the employees in general.

(2) A definite contribution formula constitutes an integral part of a qualified profit-sharing plan and may not be amended except for a valid business reason.

(3) The requirement that a profit-sharing plan contain a definite formula for determining the amount of contributions to be made on behalf of employees does not apply to contributions which are made on behalf of owner-employees. However, such contributions are subject to the requirement that they be nondiscriminatory with respect to other employees and must not exceed the limitations on allowable and deductible contributions which may be made by owner-employees.

(e) *Requirements as to coverage*—(1) *Coverage of all employees.* The coverage requirements contained in section 401(a)(3) do not apply to a plan which covers any owner-employee. However, such a plan must satisfy the coverage requirements of section 401(d), including section 401(d)(3). Accordingly, a plan which covers an owner-employee must benefit each employee of the trade or business (other than any owner-employee who does not consent to be covered under the plan) whose customary period of employment has been for more than 20 hours a week for more than five months during each of three consecutive periods of twelve calendar months. Therefore, a plan may not provide, for example, that an employee, other than an owner-employee, is ineligible to participate because he does not consent to be a participant or because he does not consent to make reasonable contributions under the plan.

(2) *Period of service.* (i) In determining whether an employee renders service to the same employer, and, therefore, must be covered under the plan of such employer, a partnership is considered to be one employer during the entire period prior to the time it is terminated within the meaning of section 708 (see paragraph (e)(2) of § 1.401–10).

(ii) In the case of a common-law employee who becomes an employee within the meaning of section 401(c)(1) with respect to the same trade or business, his period of employment is the aggregate of his service as a common-law employee and an employee within the meaning of section 401(c)(1).

(iii) In determining whether any employee, including any owner-employee, has three years of service, past service of any such employee may be taken into account as provided in paragraph (b) of § 1.401–10. Thus, if an employer takes into account past service for any owner-employee, he must take into account the past service of all his other employees to the same extent. However, a plan may provide for coverage after a period of service which is shorter than three years, but in no case may the plan require a waiting period for employees which is longer than that required for the owner-employees.

(f) *Discrimination in contributions or benefits.* (1) Variations in contributions or benefits may be provided under the plan so long as the plan does not discriminate, either as to contributions or benefits, in favor of officers, employees whose principal duties consist in supervising the work of other employees, or highly compensated employees, as against other employees (see § 1.401–4). For the purpose of determining whether the provisions of a plan which provide contributions or benefits for an owner-employee result in the prohibited discrimination, an owner-employee, like other self-employed individuals, is considered a highly compensated employee (see paragraph (d) of § 1.401–11). Whether or not a plan is discriminatory is determined by the actual operation of the plan as well as by its formal provisions.

(2) The provisions of section 401(a)(5), relating to certain plan provisions which will not in and of themselves be considered discriminatory, are not applicable to any plan which covers any owner-employee. Such a plan must, instead, satisfy the requirements of section 401(a)(10) and section 401(d)(6). Accordingly, a plan is not discriminatory within the meaning of section 401(a)(4) merely because the contributions or benefits provided for the employees covered under the plan bear a uniform relationship to the total compensation, or to the basic or regular rate of compensation, of such employees. The total compensation or the basic or regular rate of compensation of an owner-employee is computed in accordance with the provisions of paragraph (d)(2) of § 1.401–11.

(3) Even though the contributions under the plan do not bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of the employees covered thereunder and the plan would otherwise be considered discriminatory within the

meaning of section 401(a)(4), the plan shall not be considered discriminatory if such variation is due to employer contributions on behalf of any owner-employee which are required, under the plan, to be applied to pay premiums or other consideration on one or more level premium contracts described in section 401(e)(3)(A). In a taxable year to which the foregoing exception applies and, therefore, one in which the contributions under the plan would otherwise be discriminatory, the employer contributions to pay such premiums or other consideration must be the only employer contributions made for the owner-employee, and the contributions for such taxable year under such plan must not be in excess of the amount permitted to be paid toward the purchase of such a contract under the provisions of section 401(e)(3). Furthermore, the exception described in this subparagraph only applies to contributions made under a plan which otherwise satisfies the requirements of section 401(a)(4) and the regulations thereunder. Thus, if a plan provides for the purchase, in accordance with section 401(e)(3), of a level premium contract for an owner-employee, then such plan must provide either that the benefits for all employees are nondiscriminatory or, in the case of a money-purchase type of plan, that the contributions for all employees are based on compensation determined in a nondiscriminatory manner. For example, since the contributions on behalf of the owner-employee are based on his earned income during the period preceding the purchase of the contract, the contributions for other employees must be based on their compensation during the same period if this will result in larger contributions on their behalf.

(4) In the case of a plan which covers any owner-employee, the contributions or benefits provided under the plan cannot vary with respect to years of service except as provided in subparagraph (5) of this paragraph.

(5) The provisions of section 401(d)(3) do not preclude the coverage of employees with less than three years of service if such coverage is provided on a nondiscriminatory basis. However, a plan will not be disqualified merely because the contributions or benefits for employees who have less than three years of service are not as favorable as the contributions or benefits for employees having more than three years of service.

(g) *Nonforfeitable rights.* (1)(i) Except as provided in subparagraph (2) of this paragraph, if an owner-employee is covered under the plan of his employer, each employee's rights to the contributions, or to the benefits derived from the contributions, of such employer must be nonforfeitable at the time such contributions are paid to, or under, the plan. The employees who must obtain such nonforfeitable rights include the self-employed individuals who are covered under the plan. As to what constitutes nonforfeitable rights of an employee, see paragraph (a)(2) of § 1.402(b)-1.

(ii) Under section 401(d)(2), it is necessary that each employee obtain nonforfeitable rights to the employer contributions under the plan on his behalf from the time such contributions are paid. Thus, each employee must have a nonforfeitable interest to the portion of the funds under the plan which is allocable to the employer contributions made under the plan on his behalf.

(2) The provisions of subparagraph (1) of this paragraph do not apply to the extent that employer contributions on behalf of any employee must remain forfeitable in order to satisfy the requirements of paragraph (c) of § 1.401-4. However, employer contributions on behalf of employees whose rights are required to remain forfeitable to satisfy such requirements must be nonforfeitable except for such contingency.

(h) *Integration with social security.* (1) If a qualified plan covers any owner-employee, then the rules relating to the integration of such plan with the contributions or benefits under the Social Security Act are provided in this paragraph. Accordingly, the provisions of paragraph (e) of § 1.401-3 and paragraph (c) of § 1.401-11 do not apply to such a plan. In the case of a plan which provides contributions or benefits for any owner-employee, integration of the plan with the Social Security Act for any taxable year of the employer can take place only if not more than one-third of the employer contributions under the plan which are deductible under section 404 for that year are made on behalf of the owner-employees. If such requirement is satisfied, then the plan may be integrated with the contributions or benefits under the Social Security Act in accordance with the rules of subparagraph (3) of this paragraph.

(2)(i) For purposes of subparagraph (1) of this paragraph, in determining the total amount of employer contributions which are deductible under section 404, the provisions of section 404(a), including the provisions of section 404(a)(9) (relating to plans benefiting self-employed individuals), and section 404(e) (relating to the special limitations for self-employed individuals) are taken into account, but the provisions of section 404(a)(10) (relating to the special limitation on the amount allowed as a deduction for self-employed individuals) are not taken into account.

(ii) The amount of deductible employer contributions which are made on behalf of all owner-employees for the year is compared with the amount of deductible employer contributions for the year made on behalf of all employees covered under the plan (including self-employed individuals who are not owner-employees and owner-employees) for the purpose of determining whether the deductible contributions by the employer on behalf of owner-employees are not more than one-third of the total deductible contributions.

(3) If a plan covering an owner-employee satisfies the requirement of subparagraph (1) of this paragraph, and if the employer wishes to integrate such plan with the contributions or benefits under the Social Security Act, then—

(i) The employer contributions under the plan on behalf of any owner-employee shall be reduced by an amount determined by multiplying the earned income of such owner-employee which is derived from the trade or business with respect to which the plan is established and which does not exceed $4,800 by the rate of tax imposed under section 1401; and

(ii) The employer contributions under the plan on behalf of any employee other than an owner-employee may be reduced by an amount not in excess of the amount determined by multiplying the employee's wages under section 3121(a)(1) by the rate of tax imposed under section 3111. For purposes of this subdivision, the earned income of a self-employed individual which is derived from the trade or business with respect to which the plan is established and which does not exceed $4,800 shall be treated as "wages" under section 3121(a)(1).

(4) A money purchase pension plan or a profit-sharing plan may provide that such plan will be integrated with the Social Security Act only for such taxable years of the employer in which the requirements for integration are satisfied. However, a qualified plan cannot provide that employer contributions are only to be made for taxable years in which the integration requirements are satisfied.

(i) *Limit on contributions on behalf of an owner-employee.* (1) Section 401(d)(5) requires that a plan which covers any owner-employee must contain provisions which restrict the employer contributions that may be made on behalf of any owner-employee for each taxable year to an amount no greater than that which is deductible under section 404. In computing the amount deductible under section 404 for purposes of section 401(d)(5) and this paragraph, the limitations contained in section 404(a)(9) and (e), relating to special limitations for self-employed individuals, are taken into account, but such amount is determined without regard to section 404(a)(10), relating to the special limitation on the amount allowed as a deduction for self-employed individuals. Accordingly, a qualified plan which covers any owner-employee cannot permit employer contributions to be made on behalf of such owner-employee in excess of 10 percent of the earned income which is derived by such owner-employee from the trade or business with respect to which the plan is established, or permit the employer to contribute more than $2,500 on behalf of any such owner-employee for any taxable year.

(2) (i) In determining whether the plan permits contributions to be made in excess of the limitations of subparagraph (1) of this paragraph, employer contributions under the plan which are allocable to the purchase of life, accident, health, or other insurance are not to be taken into account. To determine the amount of employer contributions under the plan which are allocable to the purchase of life, accident, health, or other insurance, see paragraph (f) of § 1.404(e)-1 and paragraph (b) of § 1.72-16. However, contributions for such insurance can be made only to the

extent otherwise permitted under sections 401 through 404 and the regulations thereunder.

(ii) A further exception to the limit on the amount of contributions which an employer may make under the plan on behalf of an owner-employee is made in the case of contributions which are required, under the plan, to be applied to pay premiums or other consideration for one or more annuity, endowment, or life insurance contracts described in section 401(e)(3) (see section 401(e)(3) and the regulations thereunder).

(j) *Excess contributions.* The provisions of section 401(e) define the term "excess contribution" and indicate the consequences of making such a contribution (see § 1.401–13). However, section 401(d)(8) provides that a qualified plan which provides contributions or benefits for any owner-employee must contain certain provisions which complement the rules contained in section 401(e). Under section 401(d)(8), a qualified plan must provide that—

(1) The net amount of any excess contribution (determined in accordance with the provisions of § 1.401–13) must be returned to the owner-employee on whose behalf it is made, together with the net income earned on such excess contribution;

(2) For each taxable year for which the trust is considered to be a nonqualified trust with respect to an owner-employee under section 401(e)(2) because the net amount of an excess contribution and the earnings thereon have not been returned to such owner-employee, the income of the trust for that taxable year attributable to the interest of such owner-employee is to be paid to him.

(3) If an excess contribution is determined to be willfully made (within the meaning of section 401(e)(2)(E)), the entire interest of the owner-employee on whose behalf such contribution was made is required to be distributed to such owner-employee. Furthermore, the plan must require the distribution of an owner-employee's entire interest under the plan if a willful excess contribution is determined to have been made under any other plan in which the owner-employee is covered as an owner-employee.

(k) *Contributions of property under a qualified plan.* (1) The contribution of property, other than money, by the person who is the employer (within the meaning of section 401(c)(4)) to a qualified trust forming a part of a plan which covers employees some or all of whom are owner-employees who control (within the meaning of section 410(d)(9)(B) and the regulations thereunder) the trade or business with respect to which the plan is established is a prohibited transaction between such trust and the employer-grantor of such trust (see section 503(j)(1)(D) and the regulations thereunder).

(2) A contribution of property, other than money, to a qualified trust by an owner-employee who controls, or a member of a group of owner-employees who together control, the trade or business with respect to which the plan is established, or a contribution of property, other than money, to a qualified trust by a member of such an owner-employee's family (as defined in section 267(c)(4)), is a prohibited transaction. If the plan does not cover an owner-employee, or group of owner-employees, who control the trade or business, see the rules relating to prohibited transactions contained in section 503, other than the provisions of section 503(j).

(l) *Controlled trades or businesses—*(1) *Plans covering an owner-employee who controls another trade or business.* (i) A plan must not cover any owner-employee, or group of two or more owner-employees, if such owner-employee, or group of owner-employees, control (within the meaning of subparagraph (3) of this paragraph) any other trade or business, unless the employees of such other trade or business controlled by such owner-employee, or such group of owner-employees, are included in a plan which satisfies the requirements of section 401(a), including the qualification requirements of section 401(d). The employees who must be covered under the plan of the trade or business which is controlled include the self-employed individuals who are not owner-employees and the owner-employees who consent to be covered by such plan. Accordingly, the employer must determine whether any owner-employee, or group of owner-employees, who may participate in the plan which is established by such employer controls any other trade or business, and whether the requirements of this subparagraph are satisfied with respect to the plan established in such other trade or business. The plan of an employer may exclude an owner-employee who controls another trade or business from coverage under the plan even though such owner-employee consents to be covered, if a plan which satisfies the requirements of subdivision (ii) of this subparagraph has not been established in the trade or business which such owner-employee controls.

(ii) The qualified plan which the owner-employee, or owner-employees, are required to provide for the employees of the trade or business which they control must provide contributions and benefits which are not less favorable than the contributions and benefits provided for the owner-employee, or owner-employees, under the plan of any trade or business which they do not control. Thus, for example, if the contributions or benefits for the owner-employee under the plan of the trade or business which he does not control are computed on the basis of his total (as compared to basic or regular rate) of compensation, then the contributions or benefits for employees covered under the plan of the trade or business which the owner controls must be computed on the basis of their total compensation. However, the requirements of this subdivision cannot be satisfied if the benefits and contributions provided under the plan for the employees of the trade or business which is controlled are not comparable to those provided under the plan covering the owner-employee, or group of owner-employees, in the trade or business which they do not control. Thus, for example, if the owner-employee is covered by a pension plan in the trade or business which he does not control, he may not satisfy the requirements of this subdivision by establishing a profit-sharing plan in the trade or business which he does control.

(iii) If an individual is covered as an owner-employee under the plans of two or more trades or businesses which he does not control and such individual controls a trade or business, then the contributions or benefits of the employees under the plan of the trade or business which he does control must be as favorable as those provided for him under the most favorable plan of the trade or business which he does not control.

(2) *Owner-employees who control more than one trade or business.* If the plan provides contributions or benefits for an owner-employee who controls, or group of owner-employees who together control, the trade or business with respect to which the plan is established, and such owner-employee, or group of owner-employees, also control as owner-employees one or more other trades or businesses, plans must be established with respect to such controlled trades or businesses so that when taken together they form a single plan which satisfies the requirements of section 401 (a) and (d) with respect to the employees of all the controlled trades or businesses.

(3) *Control defined.* (i) For purposes of this paragraph, an owner-employee, or a group of two or more owner-employees, shall be considered to control a trade or business if such owner-employee, or such group of two or more owner-employees together—

(*a*) Own the entire interest in an unincorporated trade or business, or

(*b*) In the case of a partnership, own more than 50 percent of either the capital interest or the profits interest in such partnership.

In determining whether an owner-employee, or group of owner-employees, control a trade or business within the meaning of the preceding sentence, it is immaterial whether or not such individuals could be covered under a plan established with respect to the trade or business. For example, if an individual who is an owner-employee has a 60-percent capital interest in another trade or business, such individual controls such trade or business and the provisions of this paragraph apply even though the individual derives no earned income, as defined in section 401(c)(2), from the controlled trade or business. For purposes of determining the ownership interest of an owner-employee, or group of owner-employees, an owner-employee, or group of owner-employees, is treated as owning any interest in a partnership which is owned, directly or indirectly, by a partnership controlled by such owner-employee, or group of owner-employees.

(ii) The provisions of subparagraphs (1) and (2) of this paragraph apply only if the owner-employee who controls, or the group of owner-employees who control, a trade or business, or trades or businesses, within the meaning of sub-

division (i) of this subparagraph is the same owner-employee, or group of owner-employees, covered under the plan intended to satisfy the requirements for qualification. Thus, for example, if A is a 50-percent partner in both the AB and AC partnership, and if the AB partnership wishes to establish a plan covering A and B, the provisions of subparagraphs (1) and (2) of this paragraph do not apply, since A does not control either partnership, and since B has no interest in the AC partnership.

(m) *Distribution of benefits.* (1) (i) Section 401(d)(4)(B) requires that a qualified plan which provides contributions or benefits for any owner-employee must not provide for the payment of benefits to such owner-employee at any time before he has attained age 59½. An exception to the foregoing rule permits a qualified plan to provide for the distribution of benefits to an owner-employee prior to the time he attains age 59½ if he is disabled within the meaning of section 213(g)(3) and the regulations thereunder. In general, section 213(g)(3) provides that an individual is considered disabled if he is unable to engage in any substantial gainful activity because of a medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration. In addition, section 401(d)(4)(B) does not preclude the distribution of benefits to the estate or other beneficiary of a deceased owner-employee prior to the time the owner-employee would have attained age 59½ if he had lived.

(ii) A qualified plan must provide that if, despite the restrictions in the plan to the contrary, an amount is prematurely distributed, or made available, to a participant in such plan who is, or has been, an owner-employee, then no contribution shall be made under the plan by, or for, such individual during any of the 5 taxable years of the plan beginning after the distribution is made.

(2) (i) The provisions of subparagraph (1) of this paragraph preclude an owner-employee who is a participant in a qualified pension or profit-sharing plan of his employer from withdrawing any part of the funds accumulated on his behalf except as provided in such subparagraph (1). However, the distribution of an owner-employee's interest, or any portion of such interest, after he attains age 59½ is determined by the provisions of the plan. Thus, for example, if a qualified pension plan provides that the normal retirement age under the plan is age 65, an owner-employee would not be entitled to a distribution of an amount under the plan merely because he attained age 59½.

(ii) The provisions of subparagraph (1) of this paragraph do not preclude the establishment of a profit-sharing plan which provides for the distribution of all, or part, of participants' accounts after a fixed number of years. However, such a plan must not permit a distribution of any amount to any owner-employee prior to the time the owner-employee has attained age 59½ or becomes disabled within the meaning of section 213(g)(3). On the other hand, if a distribution would have been made under the plan to an owner-employee but for the fact that he had not attained age 59½, then the amount of such distribution (including any increment earned on such amount) must be distributed to such owner-employee at such time as he attains age 59½.

(3) A qualified pension, annuity, or profit-sharing plan which covers an owner-employee must provide that the distribution of an owner-employee's entire interest under the plan must begin prior to the end of the taxable year in which he attains the age of 70½, and such distribution must satisfy the requirements of section 401(a)(9) and paragraph (e) of § 1.401–11. Furthermore, section 401(d)(7) provides that, if an owner-employee dies prior to the time his entire interest has been distributed to him, such owner-employee's entire remaining interest under the plan must, in general, either be distributed to his beneficiary, or beneficiaries, within 5 years, or be used within that period to purchase an immediate annuity for his beneficiary, or beneficiaries. However, a distribution within 5 years of the death of the owner-employee is not required if the distribution of his interest has commenced and such distribution is for a term certain over a period not extending beyond the joint life and survivor expectancy of the owner-employee and his spouse. Thus, for example, an annuity for the joint life and survivor expectancy of an owner-employee and his spouse which guarantees payments for 10 years is a distribution which is payable over a period which does not exceed the joint life and survivor expectancy of the owner-employee and his spouse if such expectancy is at least 10 years at the time the distribution first commences.

§ 1.401–13 Excess contributions on behalf of owner-employees. [Reserved]

PAR. 6. There are inserted immediately after § 1.404(d)–1, the following new sections:

§ 1.405 Statutory provisions; qualified bond purchase plans.

SEC. 405. *Qualified bond purchase plans*—(a) *Requirements for qualification.* A plan of an employer for the purchase for and distribution to his employees or their beneficiaries of United States bonds described in subsection (b) shall constitute a qualified bond purchase plan under this section if—

(1) The plan meets the requirements of section 401(a)(3), (4), (5), (6), (7), and (8) and, if applicable, the requirements of section 401(a)(9) and (10) and of section 401(d) (other than paragraphs (1), (5)(B), and (8)); and

(2) Contributions under the plan are used solely to purchase for employees or their beneficiaries United States bonds described in subsection (b).

(b) *Bonds to which applicable*—(1) *Characteristics of bonds.* This section shall apply only to a bond issued under the Second Liberty Bond Act, as amended, which by its terms, or by regulations prescribed by the Secretary under such Act—

(A) Provides for payment of interest, or investment yield, only upon redemption;

(B) May be purchased only in the name of an individual;

(C) Ceases to bear interest, or provide investment yield, not later than 5 years after the death of the individual in whose name it is purchased;

(D) May be redeemed before the death of the individual in whose name it is purchased only if such individual—

(i) Has attained the age of 59½ years, or

(ii) Has become disabled (within the meaning of section 213(g)(3)); and

(E) Is nontransferable.

(2) *Must be purchased in name of employee.* This section shall apply to a bond described in paragraph (1) only if it is purchased in the name of the employee.

(c) *Deduction for contributions to bond purchase plans.* Contributions paid by an employer to or under a qualified bond purchase plan shall be allowed as a deduction in an amount determined under section 404 in the same manner and to the same extent as if such contributions were made to a trust described in section 401(a) which is exempt from tax under section 501(a).

(d) *Taxability of beneficiary of qualified bond purchase plan*—(1) *Gross income not to include bonds at time of distribution.* For purposes of this chapter, in the case of a distributee of a bond described in subsection (b) under a qualified bond purchase plan, or from a trust described in section 401(a) which is exempt from tax under section 501(a), gross income does not include any amount attributable to the receipt of such bond. Upon redemption of such bond, the proceeds shall be subject to taxation under this chapter, but the provisions of section 72 (relating to annuities, etc.) and section 1232 (relating to bonds and other evidences of indebtedness) shall not apply.

(2) *Basis.* The basis of any bond received by a distributee under a qualified bond purchase plan—

(A) If such bond is distributed to an employee, or with respect to an employee, who at the time of purchase of the bond, was an employee other than an employee within the meaning of section 401(c)(1), shall be the amount of the contributions by the employee which were used to purchase the bond, and

(B) If such bond is distributed to an employee, or with respect to an employee, who, at the time of purchase of the bond, was an employee within the meaning of section 401(c)(1), shall be the amount of the contributions used to purchase the bond which were made on behalf of such employee and were not allowed as a deduction under subsection (c).

The basis of any bond described in subsection (b) received by a distributee from a trust described in section 401(a) which is exempt from tax under section 501(a) shall be determined under regulations prescribed by the Secretary or his delegate.

(e) *Capital gains treatment not to apply to bonds distributed by trusts.* Section 402(a)(2) shall not apply to any bond described in subsection (b) distributed to any distributee and, for purposes of applying such section, any such bond distributed to any distributee and any such bond to the credit of any employee shall not be taken into account.

(f) *Employee defined.* For purposes of this section, the term "employee" includes an individual who is an employee within the meaning of section 401(c)(1), and the employer of such individual shall be the person treated as his employer under section 401(c)(4).

(g) *Proof of purchase.* At the time of purchase of any bond to which this section applies, proof of such purchase shall be furnished in such form as will enable the purchaser, and the employee in whose name such bond is purchased, to comply with the provisions of this section.

(h) *Regulations.* The Secretary or his delegate shall prescribe such regulations as may be necessary to carry out the provisions of this section.

[Sec. 405 as added by sec. 5, Self-Employed Individuals Tax Retirement Act of 1962 (76 Stat. 826)]

§ 1.405–1 Qualified bond purchase plans.

(a) *Introduction.* Section 405 relates to the requirements for qualification of, and the tax treatment of funds contributed to, retirement plans of an employer for the benefit of his employees which are funded through the purchase of United States retirement plan bonds. Such bonds may be purchased under a qualified bond purchase plan described in section 405(a) and paragraph (b) of this section. The qualified bond purchase plan is an alternative method of providing some of the deferred compensation benefits provided by plans described in section 401. In addition, retirement bonds may be purchased under a qualified pension or profit-sharing plan described in section 401. A qualified bond purchase plan or a qualified pension or profit-sharing plan under which retirement bonds are purchased may cover only common-law employees, self-employed individuals, or both. A qualified bond purchase plan may be established after December 31, 1962, and retirement bonds may be purchased by a qualified pension or profit-sharing plan after December 31, 1962. For the terms and conditions of the retirement bonds, see section 405(b) and Treasury Department Circular, Public Debt Series—No. 1–63.

(b) *Qualified bond purchase plans.* (1) A qualified bond purchase plan is a definite written program and arrangement which is communicated to the employees and established and maintained by an employer solely to purchase for and distribute to his employees or their beneficiaries retirement bonds. These bonds must be purchased in the name of the employee on whose behalf the contributions are made. The plan must be a permanent plan which meets the requirements of section 401(a) (3), (4), (5), (6), (7), and (8) and, if applicable, the requirements of section 401(a) (9) and (10) and of section 401(d) (other than paragraphs (1), (5)(B), and (8)). The rules set forth in the regulations relating to those provisions shall be applicable to qualified bond purchase plans.

(2) A qualified bond purchase plan must provide that an employee's right to the proceeds of a bond purchased in his name are nonforfeitable and will in no event inure to the benefit of the employer or be reallocated in any manner.

(c) *Benefits under a qualified bond purchase plan.* (1) Except as provided in subparagraph (2) of this paragraph, a qualified bond purchase plan must conform to the definition of a pension plan in paragraph (b)(1)(i) of § 1.401–1, or the definition of a profit-sharing plan in paragraph (b)(1)(ii) of § 1.401–1. For example, if the qualified bond purchase plan is a profit-sharing plan, the plan must include the definite allocation formula described in paragraph (b)(1)(ii) of § 1.401–1. In addition, if such a profit-sharing plan covers any owner-employee, the plan must also include the definite contribution formula described in section 401(d)(2)(B).

(2)(i) Under a qualified bond purchase plan, the bonds may be distributed to the employees at any time, and the plan need not prohibit the distribution or redemption of the bonds until the retirement of the employee. Accordingly, even though a qualified bond purchase plan is designed as a pension plan, it need not provide systematically for the payment of definitely determinable benefits. However, provisions for distribution must apply in a nondiscriminatory manner.

(ii) A qualified bond purchase plan which is designed as a pension plan may not contain a formula for contributions or benefits which might require the reallocation of amounts to an employee's credit or which might provide for the reversion of any amounts to the employer.

(d) *Contributions under a qualified bond purchase plan.* (1) The retirement bonds will be issued in the denominations of $50, $100, $500, and $1,000. Therefore, the contribution otherwise called for under the plan may not coincide with an amount that can be invested in retirement bonds. Accordingly, the plan must provide that the contributions on behalf of an individual employee for any year shall be rounded to the nearest multiple of $50.

(2) Since the employee's rights to any bonds purchased for him under a qualified bond purchase plan must be nonforfeitable, a qualified bond purchase plan must, in order to conform to the requirements of section 401(a)(4) with respect to the early termination of the plan, restrict the contributions on behalf of any employee to the amount which could be allocated to him under paragraph (c) of § 1.401–4.

(e) *Definitions.* For purposes of this section and §§ 1.405–2 and 1.405–3—

(1) The term "employee" includes an employee as defined in section 401(c)(1) and paragraph (b) of § 1.401–10, and the term "employer" means the person treated as the employer of such individual under section 401(c)(4);

(2) The term "owner-employee" means an owner-employee as defined in section 401(c)(3) and paragraph (d) of § 1.401–10;

(3) The term "earned income" means earned income as defined in section 401(c)(2) and paragraph (c) of § 1.401–10; and

(4) The term "retirement bond" means a United States Retirement Plan Bond, as described in section 405(b) and Treasury Department Circular, Public Debt Series—No. 1–63.

§ 1.405–2 Deduction of contributions to qualified bond purchase plans.

(a) *In general.* An employer shall be allowed a deduction for contributions paid to or under a qualified bond purchase plan in the same manner and to the same extent as if such contributions were made to a trust described in section 401(a) which is exempt from tax under section 501(a). A deduction will be allowed only for the taxable year in which the contributions are paid, or treated as paid, except as provided by section 404(a) (1), (3), and (7). For purposes of the deduction, a contribution is paid at the time the application for the bond is made and the full purchase price paid.

(b) *Rules for applying section 404.* If a qualified bond purchase plan is designed as a pension plan as defined in paragraph (b)(1)(i) of § 1.401–1, the limitations of section 404 applicable to qualified pension trusts shall apply. See §§ 1.404(a)–3 through 1.404(a)–7. Similarly, if a qualified bond purchase plan is designed as a profit-sharing plan as defined in paragraph (b)(1)(ii) of § 1.401–1, the limitations of section 404 applicable to qualified profit-sharing trusts shall apply. See §§ 1.404(a)–9 and 1.404(a)–10. In addition, if a qualified bond purchase plan designed as a pension plan covers some or all of the employees who are covered by a qualified profit-sharing plan established and maintained by the same employer, or if a qualified bond purchase plan which is designed as a profit-sharing plan covers some or all the employees who are also covered by a qualified pension or annuity plan established and maintained by the same employer, section 404(a)(7) is applicable. See § 1.404(a)–(13). Furthermore, if a qualified bond purchase plan covers employees some or all of whom are employees within the meaning of section 401(c)(1), the provisions of section 404 (a) (8), (9), and (10) and 404(e) shall also apply.

(c) *Accrual method taxpayers.* In the case of a taxpayer using the accrual method of accounting, a contribution to a qualified bond purchase plan will be deemed paid on the last day of the year of accrual if—

(1) During the taxable year of accrual the taxpayer incurs a liability to make the contribution, the amount of which is accruable under section 461 for such taxable year, and

(2) Payment is in fact made no later than the time prescribed by the law for filing the return for the taxable year of accrual (including extensions thereof).

§ 1.405–3 Taxation of retirement bonds.

(a) *In general.* (1) As in the case of employer contributions under a qualified pension, annuity, profit-sharing, or stock bonus plan, employer contributions on behalf of his common-law employees under a qualified bond purchase plan are not includible in the gross income of the employees when made, and employer contributions on behalf of self-employed individuals are deductible as provided in section 405(c) and § 1.405–2. Further, an employee or his beneficiary does not realize gross income upon the receipt of a retirement bond pursuant to a qualified bond purchase plan or from a trust described in section 401(a) which is exempt from tax under section 501(a). Upon redemption of such a bond, ordinary income will be realized to the extent the proceeds thereof exceed the basis (determined in accordance with paragraph (b) of this section) of the bond. The proceeds of a retirement bond are

not entitled to the special tax treatment of section 72(n) and § 1.72–18.

(2) In the event a retirement bond is surrendered for partial redemption and reissuance of the remainder, the person surrendering the bond shall be taxable on the proceeds received to the extent such proceeds exceed the basis in the portion redeemed. In such case, the basis shall be determined (in accordance with paragraph (b) of this section) as if the portion redeemed and the portion reissued had been issued as separate bonds.

(3) In the event a retirement bond is redeemed after the death of the registered owner, the amount taxable (as determined in accordance with subparagraph (1) of this paragraph) is income in respect of a decedent under section 691.

(4) The provisions of section 402(a)(2) are not applicable to a retirement bond. In general, section 402(a)(2) provides for capital gains treatment of certain distributions from a qualified trust which constitute the total distributions payable with respect to any employee. The proceeds of a retirement bond received upon redemption will not be entitled to such capital gain treatment even though the bond is received as a part of, or as the whole of, such a total distribution. Nor will such a bond be taken into consideration in determining whether the distribution represents the total amount payable by the trust with respect to an employee. Thus, a distribution by a qualified trust may constitute a total distribution payable with respect to an employee for purposes of section 402(a)(2) even though the trust retains retirement bonds registered in the name of such employee.

(b) *Basis.* (1) This paragraph is applicable in determining the basis of any retirement bond distributed pursuant to a qualified bond purchase plan or distributed by a trust qualifying under section 401. In the case of such a bond purchased for an individual at the time he is a common-law employee, the basis is that portion of the purchase price attributable to employee contributions. In the case of such a bond purchased for an individual at the time he is a self-employed individual, the basis shall be determined under subparagraph (3) of this paragraph.

(2) At the time a retirement bond is purchased, there shall be indicated on the application for the retirement bond whether the individual for whom the retirement bond is purchased is a common-law employee or a self-employed individual, and in the case of common-law employees the amount of the purchase price, if any, attributable to the employee's contribution. The answers to these questions will appear on the retirement bond, and when the retirement bond is purchased for a common-law employee, the basis for the retirement bond is presumed to be the amount of the purchase price which the retirement bond indicates was contributed by the employee.

(3)(i) Except as provided in subdivision (ii) of this subparagraph, for purposes of determining the basis of retirement bonds purchased for an individual while he was a self-employed individual, all such bonds redeemed during a taxable year shall be considered in the aggregate as a single retirement bond. The basis of such retirement bonds shall be the difference between the aggregate of their face amounts and the lesser of:

(*a*) One-half the aggregate of their face amounts, or

(*b*) The aggregate of the unused amounts allowed as a deduction at the end of the taxable year (as determined in subparagraph (4) of this paragraph).

(ii) The basis of a retirement bond purchased for a self-employed individual which is redeemed after his death is the amount determined by multiplying the face amount of such retirement bond by a fraction—

(*a*) The numerator of which is the aggregate of the face amounts of all the bonds registered in the individual's name at his death which were purchased while he was a self-employed individual reduced by the aggregate of the unused amounts allowed as a deduction at his death (as determined in subparagraph (4) of this paragraph), and

(*b*) The denominator of which is the aggregate of the face amounts of all such bonds.

(4)(i) In the case of retirement bonds purchased under a qualified bond purchase plan, the aggregate of the unused amounts allowed as a deduction at the end of any taxable year shall be an amount equal to the total of the amounts allowable for such taxable year, and the amounts allowed in all prior taxable years, as a deduction under section 405(c) for contributions used to purchase retirement bonds for the registered owner while he was a self-employed individual, reduced by an amount equal to the portion of the face amounts of such retirement bonds redeemed in prior taxable years which were included in the registered owner's gross income.

(ii) In the case of retirement bonds purchased by a trust described in section 401(a) and exempt under section 501(a), there shall be allocated to the retirement bond the deduction under section 404 attributable to the contributions used to purchase the retirement bond. The amount so allocated shall be treated in the same manner as the deduction allowed under section 405(c) for purposes of computing the unused amounts allowed as a deduction under subdivision (i) of this subparagraph. Further, the amount so allocated shall not be included in the investment in the contract for purposes of section 72 in determining the portion of the other assets distributed by the trust included in gross income.

(5) The application of the rule of subparagraphs (3) and (4) of this paragraph may be illustrated by the following examples:

Example (1). B, a self-employed individual, adopts a qualified bond purchase plan in 1963. During 1963 the plan purchased $2,000 worth of retirement bonds in his name. As a result of overestimating his income for 1963, only $400 was allowed B as a deduction pursuant to section 405(c). In 1964, prior to B's retirement in June of that year, the plan purchased a $500 retirement bond in B's name for which a deduction was allowable pursuant to section 405(c) in the amount of $250. B redeemed a retirement bond with a face amount of $500 in September of 1964 and another with a face amount of $500 in October of 1964. Of the proceeds received in 1964 from the redemption of the bonds, $1,000 plus interest, B shall exclude from his gross income $500 (face amount of the retirement bonds, $1,000, less $500, one-half of the face amount, the latter being less than the aggregate of the unused amounts allowed as a deduction, $250 allowable for the taxable year in which the bonds were redeemed plus $400, the unused amounts allowed in prior taxable years, or $650). The aggregate of the unused amounts allowed as a deduction shall be reduced by the amount so excluded ($650−$500=$150). During the following year, B redeems another retirement bond with a face amount of $500. Of the proceeds received from the redemption of such retirement bond, $500 plus interest, B shall exclude from his gross income $350 (face amount of the retirement bonds, $500, less $150, the aggregate of the unused amounts allowed as a deduction, the latter being less than one-half of the face amount of the bond, $250). The aggregate of the unused amounts allowed as a deduction is reduced to zero ($150−$150=0). Upon redemption of the remaining retirement bonds registered in B's name, B shall exclude from his gross income with respect to such proceeds an amount equal to the face amounts of the bonds redeemed.

Example (2). C, a self-employed individual, participated in a qualified bond purchase plan during the years 1963 through 1966. The plan purchased in his name retirement bonds in the aggregate of $10,000. C deducted $4,000 from his gross income for the four years ($1,000 for each year) with respect to the purchase of such retirement bonds. C retired in December of 1966 and during the following year redeemed one retirement bond with a face amout of $1,000. C excluded from his gross income $500 of of the proceeds of the bond. C died without redeeming any of the remaining retirement bonds registered in his name. The basis of each remaining retirement bond shall be determined by multiplying the face amount of each retirement bond by $\frac{\$5,500}{\$9,000}$. The numerator is the aggregate of the face amounts registered in C's name (as a self-employed individual) at his death, $9,000, reduced by the aggregate of the unused amounts allowed as a deduction at his death, $3,500 (amounts allowed as a deduction under section 405(c), $4,000, reduced by the portion of the face amount of the retirement bond redeemed by C which was included in C's gross income, $500), or $5,500. The denominator is the face amount of the retirement bonds registered in his name as a self-employed individual at his death, $9,000.

[F.R. Doc. 63–9921; Filed, Sept. 16, 1963; 8:48 a.m.]

[T.D. 6676]

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Self-Employed Individuals

On June 18, 1963, notice of proposed rule making with respect to the amendment of the Income Tax Regulations (26 CFR Part 1) to reflect the changes made by sections 2 (in part), 3, and 4 of the Self-Employed Individuals Tax Retirement Act of 1962 (76 Stat. 815, 819, 821) was published in the FEDERAL REGISTER (28 F.R. 6215). After consideration of

all such relevant matter as was presented by interested persons regarding the rules proposed, the amendment of the regulations as proposed is hereby adopted, subject to the changes set forth below:

PARAGRAPH 1. Paragraph (a)(2) of § 1.72–11, as set forth in paragraph 4 of the appendix to the notice of proposed rule making, is revised.

PAR. 2. Paragraph (g) of § 1.72–15, as set forth in paragraph 6 of the appendix to the notice of proposed rule making, is revised.

PAR. 3. Section 1.72–16, as set forth in paragraph 6 of the appendix to the notice of proposed rule making, is revised.

PAR. 4. Section 1.72–18, as set forth in paragraph 6 of the appendix to the notice of proposed rule making, is revised by changing paragraph (a).

PAR. 5. Section 1.401–13, as set forth in paragraph 7 of the appendix to the notice of proposed rule making, is changed by revising subparagraphs (2)(i), (3), and (4)(i) of paragraph (c), and subparagraph (2)(i) of paragraph (d).

PAR. 6. Section 1.402(a)–1, as set forth in paragraph 9 of the appendix to the notice of proposed rule making, is revised by changing paragraph (a)(2).

PAR. 7. Section 1.403(a)–1, as set forth in paragraph 11 of the appendix to the notice of proposed rule making, is revised by changing paragraph (d).

PAR. 8. Paragraph 12 of the appendix to the notice of proposed rule making is changed by eliminating the proposed amendment of that portion of paragraph (a) of § 1.403(a)–2 which precedes subparagraph (1).

PAR. 9. Section 1.404(a)–8, as set forth in paragraph 16 of the appendix to the notice of proposed rule making, is revised by changing paragraph (a)(2).

(Sec. 7805 of the Internal Revenue Code of 1954 (69A Stat. 917; 26 U.S.C. 7805))

[SEAL] MORTIMER M. CAPLIN,
Commissioner of Internal Revenue.

Approved: September 10, 1963.

STANLEY S. SURREY,
Assistant Secretary of the Treasury.

In order to conform the Income Tax Regulations (26 CFR Part 1) to sections 2 (in part), 3, and 4 of the Self-Employed Individuals Tax Retirement Act of 1962 (76 Stat. 815, 819, 821), such regulations are amended as follows:

PARAGRAPH 1. Section 1.72 is amended by revising section 72(d)(2), by redesignating subsection (m) of section 72 as subsection (o) and inserting after subsection (l) new subsections (m) and (n), and by adding a historical note. These amended and added provisions read as follows:

§ 1.72 Statutory provisions; annuities; certain proceeds of endowment and life insurance contracts.

SEC. 72. *Annuities; certain proceeds of endowment and life insurance contracts.* * * *

(d) *Employees' annuities.* * * *

(2) *Special rules for application of paragraph (1).* For purposes of paragraph (1)—

(A) If the employee died before any amount was received as an annuity under the contract, the words "receivable by the employee" shall be read as "receivable by a beneficiary of the employee"; and

(B) Any contribution made with respect to the contract while the employee is an employee within the meaning of section 401(c)(1) which is not allowed as a deduction under section 404 shall be treated as consideration for the contract contributed by the employee.

* * * * *

(m) *Special rules applicable to employee annuities and distributions under employee plans*—(1) *Certain amounts received before annuity starting date.* Any amounts received under an annuity, endowment, or life insurance contract before the annuity starting date which are not received as an annuity (within the meaning of subsection (e)(2)) shall be included in the recipient's gross income for the taxable year in which received to the extent that—

(A) Such amounts, plus all amounts theretofore received under the contract and includible in gross income under this paragraph, do not exceed

(B) The aggregate premiums or other consideration paid for the contract while the employee was an owner-employee which were allowed as deductions under section 404 for the taxable year and all prior taxable years.

Any such amounts so received which are not includible in gross income under this paragraph shall be subject to the provisions of subsection (e).

(2) *Computation of consideration paid by the employee.* In computing—

(A) The aggregate amount of premiums or other consideration paid for the contract for purposes of subsection (c)(1)(A) (relating to the investment in the contract),

(B) The consideration for the contract contributed by the employee for purposes of subsection (d)(1) (relating to employee's contributions recoverable in 3 years), and

(C) The aggregate premiums or other consideration paid for purposes of subsection (e)(1)(B) (relating to certain amounts not received as an annuity),

any amount allowed as a deduction with respect to the contract under section 404 which was paid while the employee was an employee within the meaning of section 401(c)(1) shall be treated as consideration contributed by the employer, and there shall not be taken into account any portion of the premiums or other consideration for the contract paid while the employee was an owner-employee which is properly allocable (as determined under regulations prescribed by the Secretary or his delegate) to the cost of life, accident, health, or other insurance.

(3) *Life insurance contracts.* (A) This paragraph shall apply to any life insurance contract—

(i) Purchased as a part of a plan described in section 403(a), or

(ii) Purchased by a trust described in section 401(a) which is exempt from tax under section 501(a) if the proceeds of such contract are payable directly or indirectly to a participant in such trust or to a beneficiary of such participant.

(B) Any contribution to a plan described in subparagraph (A)(i) or a trust described in subparagraph (A)(ii) which is allowed as a deduction under section 404, and any income of a trust described in subparagraph (A)(ii), which is determined in accordance with regulations prescribed by the Secretary or his delegate to have been applied to purchase the life insurance protection under a contract described in subparagraph (A), is includible in the gross income of the participant for the taxable year when so applied.

(C) In the case of the death of an individual insured under a contract described in subparagraph (A), an amount equal to the cash surrender value of the contract immediately before the death of the insured shall be treated as a payment under such plan or a distribution by such trust, and the excess of the amount payable by reason of the death of the insured over such cash surrender value shall not be includible in gross income under this section and shall be treated as provided in section 101.

(4) *Amounts constructively received*—(A) *Assignments or pledges.* If during any taxable year an owner-employee assigns (or agrees to assign) or pledges (or agrees to pledge) any portion of his interest in a trust described in section 401(a) which is exempt from tax under section 501(a) or any portion of the value of a contract purchased as part of a plan described in section 403(a), such portion shall be treated as having been received by such owner-employee as a distribution from such trust or as an amount received under the contract.

(B) *Loans on contracts.* If during any taxable year, an owner-employee receives, directly or indirectly, any amount from any insurance company as a loan under a contract purchased by a trust described in section 401(a) which is exempt from tax under section 501(a) or purchased as part of a plan described in section 403(a), and issued by such insurance company, such amount shall be treated as an amount received under the contract.

(5) *Penalties applicable to certain amounts received by owner-employees.* (A) *This* paragraph shall apply—

(i) To amounts (other than any amount received by an individual in his capacity as a policyholder of an annuity, endowment, or life insurance contract which is in the nature of a dividend or similar distribution) which are received from a qualified trust described in section 401(a) or under a plan described in section 403(a) and which are received by an individual, who is, or has been, an owner-employee, before such individual attains the age of 59½ years, for any reason other than the individual's becoming disabled (within the meaning of section 213(g)(3)), but only to the extent that such amounts are attributable to contributions paid on behalf of such individual (whether or not paid by him) while he was an owner-employee,

(ii) To amounts which are received from a qualified trust described in section 401(a) or under a plan described in section 403(a) at any time by an individual who is, or has been, an owner-employee, or by the successor of such individual, but only to the extent that such amounts are determined, under regulations prescribed by the Secretary or his delegate, to exceed the benefits provided for such individual under the plan formula, and

(iii) To amounts which are received, by an individual who is, or has been, an owner-employee, by reason of the distribution under the provisions of section 401(e)(2)(E) of his entire interest in all qualified trusts described in section 401(a) and in all plans described in section 403(a).

(B)(1) If the aggregate of the amounts to which this paragraph applies received by any person in his taxable year equals or exceeds $2,500, the increase in his tax for the taxable year in which such amounts are received and attributable to such amounts shall not be less than 110 percent of the aggregate increase in taxes, for the taxable year and the 4 immediately preceding taxable years, which would have resulted if such amounts had been included in such person's gross income ratably over such taxable years.

(ii) If deductions have been allowed under section 404 for contributions paid on behalf of the individual while he is an owner-employee for a number of prior taxable years less than 4, clause (i) shall be applied by taking into account a number of taxable years immediately preceding the taxable year in which the amount was so received equal to such lesser number.

(C) If subparagraph (B) does not apply to a person for the taxable year, the increase in tax of such person for the taxable year attributable to the amounts to which this paragraph applies shall be 110 percent of such increase (computed without regard to this subparagraph).

(D) Subpargraph (A)(ii) of this paragraph shall not apply to any amount to which section 402(a)(2) or 403(a)(2) applies.

(E) For special rules for computation of taxable income for taxable years to which this paragraph applies, see subsection (n)(3).

(6) *Owner-employee defined.* For purposes of this subsection, the term "owner-employee" has the meaning assigned to it by section 401(c)(3).

(n) *Treatment of certain distributions with respect to contributions by self-employed individuals*—(1) *Application of subsection*—(A) *Distributions by employees' trust.* Subject to the provisions of subparagraph (C), this subsection shall apply to amounts distributed to a distributee, in the case of an employees' trust described in section 401(a) which is exempt from tax under section 501(a), if the total distributions payable to the distributee with respect to an employee are paid to the distributee within one taxable year of the distributee—

(i) On account of the employee's death,

(ii) After the employee has attained the age of 59½ years, or

(iii) After the employee has become disabled (within the meaning of section 213(g)(3)).

(B) *Annuity plans.* Subject to the provisions of subparagraph (C), this subsection shall apply to amounts paid to a payee, in the case of an annuity plan described in section 403(a), if the total amounts payable to the payee with respect to an employee are paid to the payee within one taxable year of the payee—

(i) On account of the employee's death,

(ii) After the employee has attained the age of 59½ years, or

(iii) After the employee has become disabled (within the meaning of section 213(g)(3)).

(C) *Limitations and exceptions.* This subsection shall apply—

(i) Only with respect to so much of any distribution or payment to which (without regard to this subparagraph) subparagraph (A) or (B) applies as is attributable to contributions made on behalf of an employee while he was an employee within the meaning of section 401(c)(1), and

(ii) If the recipient is the employee on whose behalf such contributions were made, only if contributions which were allowed as a deduction under section 404 have been made on behalf of such employee while he was an employee within the meaning of section 401(c)(1) for 5 or more taxable years prior to the taxable year in which the total distributions payable or total amounts payable, as the case may be, are paid.

This subsection shall not apply to amounts described in clauses (ii) and (iii) of subparagraph (A) of subsection (m)(5) (but, in the case of amounts described in clause (ii) of such subparagraph, only to the extent that subsection (m)(5) applies to such amounts).

(2) *Limitation of tax.* In any case to which this subsection applies, the tax attributable to the amounts to which this subsection applies for the taxable year in which such amounts are received shall not exceed whichever of the following is the greater:

(A) 5 times the increase in tax which would result from the inclusion in gross income of the recipient of 20 percent of so much of the amount so received as is includible in gross income, or

(B) 5 times the increase in tax which would result if the taxable income of the recipient for such taxable year equaled 20 percent of the amount of the taxable income of the recipient for such taxable year determined under paragraph (3)(A).

(3) *Determination of taxable income.* Notwithstanding section 63 (relating to definition of taxable income), for purposes only of computing the tax under this chapter attributable to amounts to which this subsection or subsection (m)(5) applies and which are includible in gross income—

(A) The taxable income of the recipient for the taxable year of receipt shall be treated as being not less than the amount by which (i) the aggregate of such amounts so includible in gross income exceeds (ii) the amount of the deductions allowed for such taxable year under section 151 (relating to deductions for personal exemptions); and

(B) In making ratable inclusion computations under paragraph (5)(B) of subsection (m), the taxable income of the recipient for each taxable year involved in such ratable inclusion shall be treated as being not less than the amount required by such paragraph (5)(B) to be treated as includible in gross income for such taxable year.

In any case in which the preceding sentence results in an increase in taxable income for any taxable year, the resulting increase in the taxes imposed by section 1 or 3 for such taxable year shall not be reduced by any credit under part IV of subchapter A (other than section 31 thereof) which, but for this sentence, would be allowable.

(o) *Cross reference.* For limitation on adjustments to basis of annuity contracts sold, see section 1021.

[Sec. 72 as amended by sec. 4 (a), (b), Self-Employed Individuals Tax Retirement Act 1962 (76 Stat. 821)]

PAR. 2. Paragraph (d) of § 1.72–1 is amended to read as follows:

§ 1.72–1 Introduction.

* * * * *

(d) *"Amounts not received as an annuity".* In the case of "amounts not received as an annuity", if such amounts are received after an annuity has begun and during its continuance, amounts so received are generally includible in the gross income of the recipient. Amounts not received as an annuity which are received at any other time are generally includible in the gross income of the recipient only to the extent that such amounts, when added to all amounts previously received under the contract which were excludable from the gross income of the recipient under the income tax law applicable at the time of receipt, exceed the premiums or other consideration paid (see § 1.72–11). However, if the aggregate of premiums or other consideration paid for the contract includes amounts for which a deduction was allowed under section 404 as contributions on behalf of an owner-employee, the amounts received under the circumstances of the preceding sentence shall be includible in gross income until the amount so included equals the amount for which the deduction was so allowed. See paragraph (b) of § 1.72–17.

PAR. 3. Paragraphs (a)(1) and (c)(2) of § 1.72–6 are amended to read as follows:

§ 1.72–6 Investment in the contract.

(a) *General rule.* (1) For the purpose of computing the "investment in the contract", it is first necessary to determine the "aggregate amount of premiums or other consideration paid" for such contract. See section 72(c)(1). This determination is made as of the later of the annuity starting date of the contract or the date on which an amount is first received thereunder as an annuity. The amount so found is then reduced by the sum of the following amounts in order to find the investment in the contract:

(i) The total amount of any return of premiums or dividends received (including unrepaid loans or dividends applied against the principal or interest on such loans) on or before the date on which the foregoing determination is made, and

(ii) The total of any other amounts received with respect to the contract on or before such date which were excludable from the gross income of the recipient under the income tax law applicable at the time of receipt.

Amounts to which subdivision (ii) of this subparagraph applies shall include, for example, amounts considered to be return of premiums or other consideration paid under section 22(b)(2) of the Internal Revenue Code of 1939 and amounts considered to be an employer-provided death benefit under section 22(b)(1)(B) of such Code. For rules relating to the extent to which an employee or his beneficiary may include employer contributions in the aggregate amount of premiums or other consideration paid, see § 1.72–8. If the aggregate amount of premiums or other consideration paid for the contract includes amounts for which deductions were allowed under section 404 as contributions on behalf of a self-employed individual, such amounts shall not be included in the investment in the contract.

* * * * *

(c) *Special rules.* * * *

(2) For special rules relating to the determination of the investment in the contract where employer contributions are involved, see § 1.72–8. See also paragraph (b) of § 1.72–16 for a special rule relating to the determination of the premiums or other consideration paid for a contract where an employee is taxable on the premiums paid for life insurance protection that is purchased by and considered to be a distribution from an exempt employees' trust.

PAR. 4. Paragraph (a)(2) of § 1.72–11 is amended to read as follows:

§ 1.72–11 Amounts not received as annuity payments.

(a) *Introductory.* * * *

(2) The principles of this section apply, to the extent appropriate thereto, to amounts paid which are taxable under section 72 (except section 72(e)(3)) in accordance with sections 402 and 403 and the regulations thereunder. However, if contributions used to purchase the contract include amounts for which a deduction was allowed under section 404 as contributions on behalf of an owner-employee, the rules of this section are modified by the rules of paragraph (b) of § 1.72–17. Further, in applying the provisions of this section, the aggregate premiums or other consideration

paid shall not include contributions on behalf of self-employed individuals to the extent that deductions were allowed under section 404 for such contributions. Nor, shall the aggregate of premiums or other consideration paid include amounts used to purchase life, accident, health, or other insurance protection for an owner-employee. See paragraph (b)(4) of § 1.72–16 and paragraph (c) of § 1.72–17. The principles of this section also apply to payments made in the manner described in paragraph (b)(3)(i) of § 1.72–2.

PAR. 5. Paragraph (a) of § 1.72–13 is amended by adding at the end thereof the following new subparagraph:

§ 1.72–13 Special rule for employee contributions recoverable in three years.

(a) *Amounts received as an annuity.*

* * *

(5) For purposes of section 72(d), contributions which are made with respect to a self-employed individual and which are allowed as a deduction under section 404(a) are not considered contributions by the employee, but such contributions are considered contributions by the employer. A contribution which is deemed paid in a prior taxable year under the provisions of section 404(a)(6) shall be considered made with respect to a self-employed individual if the individual on whose behalf the contribution is made was self-employed for the taxable year in which the contribution is deemed paid, whether or not such individual is self-employed at the time the contribution is actually paid. Contributions with respect to a self-employed individual who is an owner-employee used to purchase life, accident, health, or other insurance protection for such owner-employee shall not be treated as consideration for the contract contributed by the employee in computing the employee contributions for purposes of section 72(d).

PAR. 6. There are inserted immediately after paragraph (f) of § 1.72–15 a new paragraph (g) and new §§ 1.72–16 through 1.72–18. These added provisions read as follows:

§ 1.72–15 Applicability of section 72 to accident or health plans.

* * * * *

(g) *Payments to or on behalf of a self-employed individual.* A self-employed individual is not considered an employee for purposes of section 105, relating to amounts received by employees under accident and health plans, nor for purposes of excluding under section 104(a)(3) amounts received by him under an accident and health plan as referred to in section 105(e). See section 105(g) and paragraph (a) of § 1.105–1. Therefore, the other paragraphs of this section are not applicable to amounts received by or on behalf of a self-employed individual. Except where accident or health benefits are provided through an insurance contract or an arrangement having the effect of insurance, all amounts received by or on behalf of a self-employed individual from a plan described in section 401(a) and exempt under section 501(a) or a plan described in section 403(a) shall be taxed as otherwise provided in section 72, 402, or 403. If the accident or health benefits are paid under an insurance contract or under an arrangement having the effect of insurance, section 104(a)(3) shall apply. Section 72 shall not apply to any amounts received under such circumstances. For the treatment of the amounts paid for such accident or health benefits, see section 404(e)(3) and paragraph (f) of § 1.404(e)–1.

§ 1.72–16 Life insurance contracts purchased under qualified employee plans.

(a) *Applicability of section.* This section provides rules for the tax treatment of premiums paid under qualified pension, annuity, or profit-sharing plans for the purchase of life insurance contracts and rules for the tax treatment of the proceeds of such a life insurance contract and of annuity contracts purchased under such plans. For purposes of this section, the term "life insurance contract" means a retirement income, an endowment, or other contract providing life insurance protection. The rules of this section apply to plans covering only common-law employees as well as to plans covering self-employed individuals.

(b) *Treatment of cost of life insurance protection.* (1) The rules of this paragraph are applicable to any life insurance contract—

(i) Purchased as a part of a plan described in section 403(a), or

(ii) Purchased by a trust described in section 401(a) which is exempt from tax under section 501(a) if the proceeds of such contract are payable directly or indirectly to a participant in such trust or to a beneficiary of such participant.

The proceeds of a contract described in subdivision (ii) of this subparagraph will be considered payable indirectly to a participant or beneficiary of such participant where they are payable to the trustee but under the terms of the plan the trustee is required to pay over all of such proceeds to the beneficiary.

(2) If under a plan or trust described in subparagraph (1) of this paragraph, amounts which were allowed as a deduction under section 404, or earnings of the trust, are applied toward the purchase of a life insurance contract described in subparagraph (1) of this paragraph, the cost of the life insurance protection under such contract shall be included in the gross income of the participant for the taxable year or years in which such contributions or earnings are so applied.

(3) If the amount payable upon death at any time during the year exceeds the cash value of the insurance policy at the end of the year, the entire amount of such excess is considered current life insurance protection. The cost of such insurance will be considered to be a reasonable net premium cost, as determined by the Commissioner, for such amount of insurance for the appropriate period.

(4) The amount includible in the gross income of the employee under this paragraph shall be considered as premiums or other consideration paid or contributed by the employee only with respect to any benefits attributable to the contract (within the meaning of paragraph (a)(3) of § 1.72–2) providing the life insurance protection. However, if under the rules of this paragraph an owner-employee is required to include any amounts in his gross income, such amounts shall not in any case be treated as part of his investment in the contract.

(5) The determination of the cost of life insurance protection may be illustrated by the following example:

Example. An annual premium policy purchased by a qualified trust for a common-law employee provides an annuity of $100 per month upon retirement at age 65, with a minimum death benefit of $10,000. The insurance payable if death occurred in the first year would be $10,000. The cash value at the end of the first year is 0. The net insurance is therefore $10,000 minus 0, or $10,000. Assuming that the Commissioner has determined that a reasonable net premium cost for the employee's age is $5.85 per $1,000, the premium for $10,000 of life insurance is therefore $58.50, and this is the amount to be reported as income by the employee for his taxable year in which the premium is paid. The balance of the premium is the amount contributed for the annuity, which is not taxable to the employee under a plan meeting the requirements of section 401(a), except as provided under section 402(a). Assuming that the cash value at the end of the second year is $500, the net insurance would then be $9,500 for the second year. With a net 1-year term rate of $6.30 for the employee's age in the second year, the amount to be reported as income to the employee would be $59.85.

(6) This paragraph shall not apply if the trust has a right under any circumstances to retain any part of the proceeds of the life insurance contract. But see paragraph (c)(4) of this section relating to the taxability of the distribution of such proceeds to a beneficiary.

(c) *Treatment of proceeds of life insurance and annuity contracts.* (1) If under a qualified pension, annuity, or profit-sharing plan, there is purchased either—

(i) A life insurance contract described in paragraph (b)(1) of this section, and the employee either paid the cost of the insurance or was taxable on the cost of the insurance under paragraph (b) of this section, or

(ii) An annuity contract,

the amounts payable under any such contract by reason of the death of the employee are taxable under the rules of subparagraph (2) of this paragraph, except in the case of a joint and survivor annuity.

(2)(i) In the case of an annuity contract, the death benefit is the accumulation of the premiums (plus earnings thereon) which is intended to fund pension or other deferred benefits under a pension, annuity, or profit-sharing plan. Such death benefits are not in the nature of life insurance and are not excludable from gross income under section 101(a).

(ii) In the case of a life insurance contract under which there is a reserve accumulation which is intended to fund pension or other deferred benefits under a pension, annuity, or profit-sharing

plan, such reserve accumulation constitutes the source of the cash value of the contract and approximates the amount of such cash value. The portion of the proceeds paid upon the death of the insured employee which is equal to the cash value immediately before death is not excludable from gross income under section 101(a). The remaining portion, if any, of the proceeds paid to the beneficiary by reason of the death of the insured employee—that is, the amount in excess of the cash value—constitutes current insurance protection and is excludable under section 101(a).

(iii) The death benefit under an annuity contract, or the portion of the death proceeds under a life insurance contract which is equal to the cash value of the contract immediately before death, constitutes a distribution under the plan consisting in whole or in part of deferred compensation and is taxable to the beneficiary in accordance with section 72(m)(3) and the provisions of this paragraph, except to the extent that the limited exclusion from income provided in section 101(b) is applicable.

(iv) In the case of a life insurance contract under which the benefits are paid at a date or dates later than the death of the employee, section 101(d) is applicable only to the portion of the benefits which is attributable to the amount excludable under section 101(a). The portion of such benefits which is attributable to the cash value of the contract immediately before death is taxable under section 72, and in such case, any amount excludable under section 101(b) is treated as additional consideration paid by the employee in accordance with section 101(b)(2)(D).

(3) The application of the rules under subparagraph (2) of this paragraph with respect to the taxability of proceeds of a life insurance contract paid by reason of the death of an insured common-law employee who has paid no contributions under the plan is illustrated by the following examples:

Example (1).

Total face amount of the contract payable in a lump sum at time of death	$25,000
Cash value of the contract immediately before death	11,000
Excess over cash value, excludable under section 101(a)	$14,000
Cash value subject to limited exclusion under section 101(b)	11,000
Excludable under section 101(b) (assuming that there is no other death benefit paid by or on behalf of any employer with respect to the employee)	5,000
Balance taxable in accordance with section 402(a)(2) or 403(a)(2) (assuming a total distribution in one taxable year of the distributee)	6,000
Portion of premiums taxed to employee under the provisions of paragraph (b) of this section and considered as contributions of the employee	940
Balance taxable as long-term capital gain	$5,060

Example (2). The facts are the same as in example (1), except that the contract provides that the beneficiary may elect within 60 days after the death of the employee either to take the $25,000 or to receive 10 annual installments of $3,000 each, and the beneficiary elects to receive the 10 installments. In addition, the employee's rights to the cash value immediately before his death were forfeitable at least to the extent of $5,000. Section 101(d) is applicable to the amount excludable under section 101(a), that is, $14,000. The portion of each annual installment of $3,000 which is attributable to this $14,000 is determined by allocating each installment in accordance with the ratio which this $14,000 bears to the total amount which was payable at death ($25,000). Accordingly, the portion of each annual installment which is subject to section 101(d) is $1,680 ($^{14}/_{25}$ of $3,000), of which $1,400 ($^{1}/_{10}$ of $14,000) is excludable under section 101(a), and the remaining $280 is includible in the gross income of the beneficiary. However, if the beneficiary is a surviving spouse as defined in section 101(d)(3), the exclusion provided by section 101(d)(1)(B) is applicable to such $280. The remaining portion of each annual $3,000 installment, $1,320, is attributable to the cash value of the contract and is treated under section 72, as follows:

Amount actually contributed by the employee	$0
Amount considered contributed by employee by reason of section 101(b)	$5,000
Portion of premiums taxed to employee under the provisions of paragraph (b) of this section and considered as contributions of the employee	$940
Investment in the contract	$5,940
Expected return, 10×$1,320	$13,200
Exclusion ratio, $5,940÷$13,200	0.45
Annual exclusion, 0.45×$1,320	$594

Accordingly, $594 of the $1,320 portion of each annual installment is excludable each year under section 72, and the remaining $726 is includible. Thus, if the beneficiary is not a surviving spouse, a total of $1,006 ($280 plus $726) of each annual $3,000 installment is includible in income each year. If the beneficiary is a surviving spouse, and can exclude all of the $280 under section 101(d)(1)(B), the amount includible in gross income each year is $726 of each annual $3,000 installment.

(4) If an employee neither paid the total cost of the life insurance protection provided under a life insurance contract, nor was taxable under paragraph (b) of this section with respect thereto, no part of the proceeds of such a contract which are paid to the beneficiaries of the employee as a death benefit is excludable under section 101(a). The entire distribution is taxable to the beneficiaries under section 402(a) or 403(a) except to the extent that a limited exclusion may be allowable under section 101(b).

§ 1.72–17 Special rules applicable to owner-employees.

(a) *In general.* Under section 401(c) and section 403(a), certain self-employed individuals may participate in qualified pension, annuity, and profit-sharing plans, and the amounts received by such individuals from such plans are taxable under section 72. Section 72(m) and this section contain special rules for the taxation of amounts received from qualified pension, profit-sharing, or annuity plans covering an owner-employee. For purposes of section 72 and the regulations thereunder, the term "employee" shall include the self-employed individual who is treated as an employee by section 401(c)(1) (see paragraph (b) of § 1.401–10), and the term "owner-employee" has the meaning assigned to it in section 401(c)(3) (see paragraph (d) of § 1.401–10). See also paragraph (a)(2) of § 1.401–10 for the rule for determining when a plan covers an owner-employee. For purposes of this section, a self-employed individual may not treat as consideration for the contract contributed by the employee any contributions under the plan for which deductions were allowed under section 404 and which, consequently, are considered employer contributions.

(b) *Certain amounts received before annuity starting date.* (1) The rules of this paragraph are applicable to amounts received from a qualified pension, profit-sharing, or annuity plan by an employee (or his beneficiary) who is or was an owner-employee with respect to such plan when such amounts—

(i) Are received before the annuity starting date; and

(ii) Are not received as an annuity.

For the definition of annuity starting date, see paragraph (b) of § 1.72–4 and subparagraph (4) of this paragraph. As to what constitutes amounts not received as an annuity, see paragraphs (c) and (d) of § 1.72.11.

(2) Amounts to which this paragraph applies shall be included in the recipient's gross income for the taxable year in which received. However, the sum of the amounts so included under this subparagraph in all taxable years shall not exceed the aggregate deductions allowed under section 404 for premiums or other consideration paid under the plan on behalf of the employee while he was an owner-employee, including any such deductions taken in the taxable year of receipt.

(3) Any amounts to which this paragraph applies and which are not included in gross income under the rules of subparagraph (2) of this paragraph shall be subject to the provisions of section 72(e) (except paragraph (3) thereof) and § 1.72–11.

(4) Under section 401(d)(4), a qualified pension, profit-sharing, or annuity plan may not provide for distributions to an owner-employee before he reaches age 59½ years, except in the case of his earlier disability (within the meaning of section 213(g)(3)). Therefore, in the case of a distribution from a qualified plan to an individual for whom contributions have been made to the plan as an owner-employee, the annuity starting date cannot be prior to the time such individual attains the age 59½ years unless he is entitled to benefits before reaching such age because of his disability (within the meaning of section 213(g)(3)).

(5) The rules of this paragraph are not applicable to amounts credited to an individual in his capacity as a policyholder of an annuity, endowment, or life insurance contract which are in the nature of a dividend or refund of premium, and which are applied in accordance with

paragraph (a)(4) of § 1.404(a)–8 towards the purchase of benefits under the policy.

(6) The rules of this paragraph may be illustrated by the following example:

Example. B, a self-employed individual, received $8,000 as a distribution under a qualified pension plan before the annuity starting date. At the time of such distribution, $10,000 had been contributed (the whole amount being allowed as a deduction) under the plan on behalf of such individual while he was a common-law employee and $5,000 had been contributed under the plan on his behalf while he was an owner-employee, of which $2,500 was allowed as a deduction. In addition, B had contributed $1,000 on his own behalf as an employee under the plan. Of the $8,000, $2,500 (the amount allowed as a deduction with respect to contributions on behalf of the individual while he was an owner-employee) is includible in gross income under subparagraph (2) of this paragraph. With respect to the remaining $5,500, B has a basis of $3,500, consisting of the $2,500 contributed on his behalf while he was an owner-employee which was not allowed as a deduction and the $1,000 which B contributed as an employee. The difference between the $5,500 and B's basis of $3,500, or $2,000, is includible in gross income under section 72(e).

(c) *Amounts paid for life, accident, health, or other insurance.* Amounts used to purchase life, accident, health, or other insurance protection for an owner-employee shall not be taken into account in computing the following:

(1) The aggregate amount of premiums or other consideration paid for the contract for purposes of determining the investment in the contract under section 72(c)(1)(A) and § 1.72–6;

(2) The consideration for the contract contributed by the employee for purposes of section 72(d)(1) and § 1.72–13, which provide the method of taxing employees' annuities where the employee's contributions will be recoverable within 3 years; and

(3) The aggregate premiums or other consideration paid for purposes of section 72(e)(1)(B) and § 1.72–11, which provide the rules for taxing amounts not received as annuities prior to the annuity starting date.

The cost of such insurance protection will be considered to be a reasonable net premium cost, as determined by the Commissioner, for the appropriate period.

(d) *Amounts constructively received.* (1) If during any taxable year an owner-employee assigns or pledges (or agrees to assign or pledge) any portion of his interest in a trust described in section 401(a) which is exempt from tax under section 501(a), or any portion of the value of a contract purchased as part of a plan described in section 403(a), such portion shall be treated as having been received by such owner-employee as a distribution from the trust or as an amount received under the contract during such taxable year.

(2) If during any taxable year an owner-employee receives, either directly or indirectly, any amount from any insurance company as a loan under a contract purchased by a trust described in section 401(a) which is exempt from tax under section 501(a) or purchased as part of a plan described in section 403(a), and issued by such insurance company, such amount shall be treated as an amount received under the contract during such taxable year. An owner-employee will be considered to have received an amount under a contract if a premium, which is otherwise in default, is paid by the insurance company in the form of a loan against the cash surrender value of the contract. Further, an owner-employee will be considered to have received an amount to which this subparagraph applies if an amount is received from the issuer of a face-amount certificate as a loan under such a certificate purchased as part of a qualified trust or plan.

(e) *Penalties applicable to certain amounts received by owner-employees.* (1)(i) The rules of this paragraph are applicable to amounts, to the extent includible in gross income, received from a trust described in section 401(a) or under a plan described in section 403(a) by or on behalf of an individual who is or has been an owner-employee with respect to such plan or trust—

(*a*) Which are received before the owner-employee reaches the age 59½ years and which are attributable to contributions paid on behalf of such owner-employee (whether or not paid by him) while he was an owner-employee (see subdivision (ii) of this subparagraph),

(*b*) Which are in excess of the benefits provided for such owner-employee under the plan formula (see subdivision (iii) of this subparagraph), or

(*c*) Which are received by reason of a distribution of the owner-employee's entire interest under the provisions of section 401(e)(2)(E), relating to excess contributions on behalf of an owner-employee which are willfully made.

(ii) The amounts referred to in subdivision (i)(*a*) of this subparagraph do not include—

(*a*) Amounts received by reason of the owner-employee becoming disabled within the meaning of section 213(g)(3), or

(*b*) Amounts received by the owner-employee in his capacity as a policyholder of an annuity, endowment, or life insurance contract which are in the nature of a dividend or similar distribution.

Amounts attributable to contributions paid on behalf of an owner-employee and which are paid to a person other than the owner-employee before the owner-employee dies or reaches the age 59½ shall be considered received by the owner-employee for purposes of this paragraph.

(iii) This paragraph applies to amounts described in subdivision (i)(*b*) of this subparagraph (relating to excess benefits) even though a portion of such amounts may be attributable to contributions made on behalf of an individual while he was not an owner-employee and even though the amounts are received by his successor. However, these amounts do not include the portion of a distribution to which section 402(a)(2) or 403(a)(2) (relating to certain total distributions in one taxable year) applies.

(iv) (*a*) For purposes of subdivision (i)(*a*) of this subparagraph, the portion of any distribution or payment attributable to contributions on behalf of an employee-participant while he was an owner-employee includes the contributions made on his behalf while he was an owner-employee and the increments in value attributable to such contributions.

(*b*) The increments in value of an individual's account may be allocated to contributions on his behalf while he was an owner-employee either by maintaining a separate account, or an accounting, which reflects the actual increment attributable to such contributions, or by the method described in (*c*) of this subdivision.

(*c*) Where an individual is covered under the same plan both as an owner-employee and as a nonowner-employee, the portion of the increment in value of his interest attributable to contributions made on his behalf while he was an owner-employee may be determined by multiplying the total increment in value in his account by a fraction. The numerator of the fraction is the total contributions made on behalf of the individual as an owner-employee, weighted for the number of years that each contribution was in the plan. The denominator is the total contributions made on behalf of the individual, whether or not an owner-employee, weighted for the number of years each contribution was in the plan. The contributions are weighted for the number of years in the plan by multiplying each contribution by the number of years it was in the plan. For purposes of this computation, any forfeiture allocated to the account of the individual is treated as a contribution to the account made at the time so allocated.

(*d*) The method described in (*c*) of this subdivision may be illustrated by the following example:

Example. B was a member of the XYZ Partnership and a participant in the partnership's profit-sharing plan which was created in 1963. Until the end of 1967, B's interest in the partnership was less than 10 percent. On January 1, 1968, B obtained an interest in excess of 10 percent in the partnership and continued to participate in the profit-sharing plan until 1972. During 1972, prior to the time he attained the age of 59½ years and during a time when he was not disabled, B withdrew his entire interest in the profit-sharing plan. At that time his interest was $15,000, $9,600 contributions and $5,400 increment attributable to the contributions. The portion of the increment attributable to contributions while B was an owner-employee is $667.80, determined as follows:

	A Contribution	B Number of years contribution was in trust—	C Contribution weighted for years in trust (A×B)
1972	$1,000	0	0
1971	800	1	800
1970	1,200	2	2,400
1969	600	3	1,800
1968	200	4	800
1967	400	5	2,000
1966	2,000	6	12,000
1965	1,000	7	7,000
1964	1,500	8	12,000
1963	900	9	8,100
	$9,600		46,900

Total weighted contributions as owner-employee (1968–1972)—5,800.
Total weighted contributions—46,900.

$$\$5,400 \times \frac{5,800}{46,900} = \$667.80$$

(2) (i) If the aggregate of the amounts to which this paragraph applies received by any person in his taxable year equals or exceeds $2,500, the tax with respect to such amount shall be the greater of—

(*a*) The increase in tax attributable to the inclusion of the amounts so received in his gross income for the taxable year in which received, or

(*b*) 110 percent of the aggregate increase in taxes, for such taxable year and the four immediately preceding taxable years, which would have resulted if such amounts had been included in such person's gross income ratably over such taxable years. However, if deductions were allowed under section 404 for contributions to the plan on behalf of the individual as an owner-employee for less than four prior taxable years (whether or not consecutive), the number of immediately preceding taxable years taken into account shall be the number of prior taxable years in which such deductions were allowed.

(ii) If the aggregate of the amounts to which this paragraph applies received by any person in his taxable year is less than $2,500, the tax with respect to such amounts shall be 110 percent of the increase in tax which results from including such amounts in the person's gross income for the taxable year in which received.

(3) (i) For purposes of making the ratable inclusion computations of subparagraph (2) (i) of this paragraph, the taxable income of the recipient for each taxable year involved (notwithstanding section 63, relating to definition of taxable income) shall be treated as being not less than the amount required to be treated as includible in the taxable year pursuant to the ratable inclusion.

(ii) For purposes of subparagraph (2) (i) (*a*) and (ii) of this paragraph, the recipient's taxable income (notwithstanding section 63, relating to definition of taxable income) shall be treated as being not less than the aggregate of the amounts to which this paragraph applies reduced by the deductions allowed the recipient for such taxable year under section 151 (relating to deductions for personal exemptions).

(iii) In any case in which the application of subdivision (i) or (ii) of this subparagraph results in an increase in taxable income for any taxable year, the resulting increase in taxes imposed by section 1 or 3 for such taxable year shall be reduced by the credit against tax provided by section 31 (tax withheld on wages), but shall not be reduced by any other credits against tax.

(4) The application of the rules of subparagraphs (2) (i) and (3) of this paragraph may be illustrated by the following example:

Example. B, a sole proprietor, established a qualified pension trust to which he made annual contributions for 10 years of 10 percent of his earned income. B withdrew his entire interest in the trust during a taxable year when he was 55 years old and not disabled and for which, without regard to the distribution, he had a net operating loss and for which he is allowed under section 151 a deduction for one personal exemption. The portion of the distribution includible in B's gross income is $25,600. In addition, B had a net operating loss for the taxable year immediately preceding the taxable year in which he received the distribution from the trust. The other three taxable years involved in the computation under subparagraph (2) (i) of this paragraph were years of substantial income. For purposes of determining B's increase in tax attributable to the receipt of the $25,600 (before the application of the provisions of subparagraph (2) (i) (*b*) of this paragraph), B's taxable income for the year he received the $25,600 is treated, under subparagraph (3) (ii) of this paragraph, as being $25,000 ($25,600 minus $600). For purposes of determining whether 110 percent of the aggregate increase in taxes which would have resulted if 20 percent of the amount of the withdrawal had been included in B's gross income for the year of receipt and for each of the four preceding taxable years is greater (and thus is the amount of his increase in tax attributable to the receipt of the $25,600), B's taxable income for the taxable year of receipt, and for the immediately preceding taxable year, is treated, under subparagraph (3) (i) of this paragraph, as being $5,120 ($25,600 divided by 5).

§ 1.72–18 Treatment of certain total distributions with respect to self-employed individuals.

(a) *In general.* The Self-Employed Individuals Tax Retirement Act of 1962 permits self-employed individuals to be treated as employees for purposes of participation in pension, profit-sharing, and annuity plans described in sections 401(a) and 403(a). In general, amounts received by a distributee or payee which are attributable to contributions made on behalf of a participant while he was self-employed are taxed in the same manner as amounts which are attributable to contributions made on behalf of a common-law employee. However, such amounts which are paid in one taxable year representing the total distributions payable to a distributee or payee with respect to an employee are not eligible for the capital gains treatment of section 402(a) (2) or 403(a) (2). This section sets forth the treatment of such distributions, except where such a distribution is subject to the penalties of section 72(m) (5) and paragraph (e) of § 1.72–17.

(b) *Distributions to which this section applies.* (1) (i) Except as provided in subparagraphs (2) and (3) of this paragraph, this section applies to amounts distributed to a distributee in one taxable year of the distributee in the case of an employees' trust described in section 401 (a) which is exempt under section 501(a), or to amounts paid to a payee in one taxable year of the payee in the case of an annuity plan described in section 403 (a), which constitute the total distributions payable, or the total amounts payable, to the distributee or payee with respect to an employee.

(ii) For the total distributions or amounts payable to a distributee or payee to be considered paid within one taxable year of the distributee or payee for purposes of this section, all amounts to the credit of the employee-participant through the end of such taxable year which are payable to the distributee or payee must be distributed or paid within such taxable year. Thus, the provisions of this section are not applicable to a distribution or payment to a distributee or payee if the trust or plan retains any amounts after the close of such taxable year which are payable to the same distributee or payee even though the amounts retained may be attributable to contributions on behalf of the employee-participant while he was a common-law employee in the business with respect to which the plan was established.

(iii) For purposes of this section, the total amounts payable to a distributee or the amounts to the credit of the employee do not include United States Retirement Plan Bonds held by a trust to the credit of the employee. Thus, a distribution to a distributee by a qualified trust may constitute a distribution to which this section applies even though the trust retains retirement plan bonds registered in the name of the employee on whose behalf the distribution is made which are to be distributed to the same distributee. Moreover, the proceeds of a retirement bond received as part of a distribution which constitutes the total distributions payable to the distributee are not entitled to the special tax treatment of this section. See section 405 (d) and paragraph (a) (1) of § 1.405–3.

(iv) If the amounts payable to a distributee from a qualified trust with respect to an employee-participant includes an annuity contract, such contract must be distributed along with all other amounts payable to the distributee in order to have a distribution to which this section applies. However, the proceeds of an annuity contract received in a total distribution will not be entitled to the tax treatment of this section unless the contract is surrendered in the taxable year of the distributee in which the total distribution was received.

(v) In the case of a qualified annuity plan, the term "total amounts" means all annuities payable to a payee. If more than one annuity contract is received under the plan by a distributee, this section shall not apply to an amount received on surrender of any such contracts unless all contracts under the plan payable to the payee are surrendered within one taxable year of the payee.

(vi) (*a*) The provisions of this section are applicable where the total amounts payable to a distributee or payee are paid within one taxable year of the distributee or payee whether or not a portion of the employee-participant's interest which is payable to another distributee or payee is paid within the same taxable year. However, a distributee or payee who, in prior taxable years received amounts (except amounts described in (*b*) of this subdivision) after the employee-participant ceases to be eligible for additional contributions to be made on his behalf, does not receive a distribution or payment to which this section applies, even though the total amount remaining to be paid to such distributee or payee with respect to such employee is paid within one taxable year. On the other hand, a distribution to a distributee or payee prior to the time

that the employee-participant ceases to be eligible for additional contributions on his behalf does not preclude the application of this section to a later distribution to the same distributee or payee.

(b) The receipt of an amount which constitutes—

(1) A payment in the nature of a dividend or similar distribution to an individual in his capacity as a policyholder of an annuity, endowment, or life insurance contract, or

(2) A return of excess contributions which were not willfully made,

does not prevent the application of this section to a total distribution even though the amount is received after the employee-participant ceases to be eligible for additional contributions and in a taxable year other than the taxable year in which the total amount is received.

(2) This section shall apply—

(i) Only if the distribution or payment is made—

(a) On account of the employee's death at any time,

(b) After the employee has attained the age 59½ years, or

(c) After the employee has become disabled (within the meaning of section 213(g)(3)); and

(ii) Only to so much of the distribution or payment as is attributable to contributions made on behalf of an employee while he was a self-employed individual in the business with respect to which the plan was established. Any distribution or payment, or any portion thereof, which is not so attributable shall be subject to the rules of taxation which apply to any distribution or payment that is attributable to contributions on behalf of common-law employees.

(3) This section shall not apply to—

(i) Distributions or payments to which the penalty provisions of section 72(m)(5) and paragraph (e) of § 1.72–17 apply,

(ii) Distributions or payments from a trust or plan made to or on behalf of an individual prior to the time such individual ceases to be eligible for additional contributions (except the contribution attributable to the last year of service) to be made to the trust or plan on his behalf as a self-employed individual, and

(iii) Distributions or payments made to the employee from a plan or trust unless contributions which were allowed as a deduction under section 404 have been made on behalf of such employee as a self-employed individual under such trust or plan for 5 or more taxable years (whether or not consecutive) prior to the taxable year in which such distributions or payments are made. Distributions or payments to which this section does not apply by reason of this subdivision are taxed as otherwise provided in section 72 (except that section 72(e)(3) is not applicable).

(4) The portion of any distribution or payment attributable to contributions on behalf of an employee-participant while he was self-employed includes the contributions made on his behalf while he was self-employed and the increments in value attributable to such contributions. Where the amounts to the credit of an employee-participant include amounts attributable to contributions on his behalf while he was a self-employed individual and amounts attributable to contributions on his behalf while he was a common-law employee, the increment in value attributable to the employee-participant's interest shall be allocated to the contributions on his behalf while he was self-employed either by maintaining a separate account, or an accounting, which reflects the actual increment attributable to such contributions, or by the method described in paragraph (e)(1)(iv)(c) of § 1.72–17. However, if the latter method is used, the numerator of the fraction is the total contributions made on behalf of the individual as a self-employed individual, weighted for the number of years that each contribution was in the plan.

(c) *Amounts includible in gross income.* (1) Where a total distribution or payment to which this section applies is made to one distributee or payee and includes the total amount remaining to the credit of the employee-participant on whose behalf the distribution or payment was made, the distributee or payee shall include in gross income an amount equal to the portion of the distribution or payment which exceeds the employee-participant's investment in the contract. For purposes of this paragraph, the investment in the contract shall be reduced by any amounts previously received from the plan or trust by or on behalf of the employee-participant which were excludable from gross income as a return of the investment in the contract.

(2) In the case of a distribution to which this section applies and which is made to more than one distributee or payee, each element of the amounts to the credit of an employee-participant shall be allocated among the several distributees or payees on the basis of the ratio of the value of the distributee's or payee's distribution or payment to the total amount to the credit of the employee-participant. The elements to be so allocated include the investment in the contract, the increments in value, and the portion of the amounts to the credit of the employee-participant which is attributable to the contributions on behalf of the employee-participant while he was a self-employed individual.

(d) *Computation of tax.* (1) The tax attributable to the amounts to which this section applies for the taxable year in which such amounts are received is the greater of—

(i) 5 times the increase in tax which would result from the inclusion in gross income of the recipient of 20 percent of so much of the amount so received as is includible in gross income, or

(ii) 5 times the increase which would result if the taxable income of the recipient for such taxable year equaled 20 percent of the excess of the aggregate of the amounts so received and includible in gross income over the amount of the deductions allowed the recipient for such taxable year under section 151 (relating to deduction for personal exemptions).

In any case in which the application of subdivision (ii) of this subparagraph results in an increase in taxable income for any taxable year, the resulting increase in taxes imposed by section 1 or 3 for such taxable year shall be reduced by the credit against tax provided by section 31 (tax withheld on wages), but shall not be reduced by any other credits against tax.

(2) The application of the rules of this paragraph may be illustrated by the following example:

Example. B, a sole proprietor, established a qualified pension trust to which he made annual contributions for 10 years of 10 percent of his earned income. B withdrew his entire interest in the trust during a taxable year for which, without regard to the distribution, he had a net operating loss and for which he is allowed under section 151 a deduction for one personal exemption. At the time of the withdrawal, B was 64 years old. The amount of the distribution that is includible in his gross income is $25,600. Because of B's net operating loss, the tax attributable to the distribution is determined under the rule of subparagraph (1)(ii) of this paragraph. For purposes of determining the tax attributable to the $25,600, B's taxable income for the taxable year in which he received such amount is treated, under subparagraph (1)(ii) of this paragraph, as being 20 percent of $25,000 ($25,600 minus $600 (the deduction allowed for his personal exemptions)). Thus, under subparagraph (1) of this paragraph, the tax attributable to the $25,600 would be 5 times the increase which would result if the taxable income of B for the taxable year he received such amount equaled $5,000. B has had no amounts withheld from wages and thus is not entitled to reduce the increase in taxes by the credit against tax provided in section 31 and may not reduce the increase in taxes by any other credits against tax.

PAR. 7. There is inserted immediately before § 1.402(a) the following new section:

§ 1.401–13 Excess contributions on behalf of owner-employees.

(a) *Introduction.* (1) The provisions of this section prescribe the rules relating to the treatment of excess contributions made under a qualified pension, annuity, or profit-sharing plan on behalf of a self-employed individual who is an owner-employee (as defined in paragraph (d) of § 1.401–10). Paragraph (b) of this section defines the term "excess contribution". Paragraph (c) of this section describes an exception to the definition of an excess contribution in the case of contributions which are applied to pay premiums on certain annuity, endowment, or life insurance contracts. Paragraph (d) of this section describes the effect of making an excess contribution which is not determined to have been willfully made, and paragraph (e) of this section describes the effect of making an excess contribution which is determined to have been willfully made.

(2) Under section 401(c)(1), certain self-employed individuals are treated as employees for purposes of section 401. In addition, under section 401(c)(4), a proprietor is treated as his own employer, and the partnership is treated as the employer of the partners. Under section 404, certain contributions on behalf of a self-employed individual are treated as deductible and taken into consideration in determining the amount

allowed as a deduction under section 404(a). Such contributions are treated under section 401 and the regulations thereunder as employer contributions on behalf of the self-employed individual. However, in some cases, additional contributions may be made on behalf of a self-employed individual. Such contributions are not taken into consideration in determining the amount deductible under section 404 and are not taken into consideration in computing the amount allowed as a deduction under section 404(a). For purposes of section 401 and the regulations thereunder, such contributions are treated as employee contributions by the self-employed individual. If a self-employed individual is an owner-employee within the meaning of section 401(c)(3) and paragraph (d) of § 1.401–10, then this section prescribes the rules applicable if contributions are made in excess of those permitted to be made under section 401.

(b) *Excess contributions defined.* (1) (i) Except as provided in paragraph (c) relating to contributions which are applied to pay premiums on certain annuity, endowment, or life insurance contracts, an excess contribution is any amount described in subparagraphs (2) through (4) of this paragraph.

(ii) For purposes of determining if the amount of any contribution made under the plan on behalf of an owner-employee is an excess contribution, the amount of any contribution made under the plan which is allocable to the purchase of life, accident, health, or other insurance is not taken into account. The amount of any contribution which is allocable to the cost of insurance protection is determined in accordance with the provisions of paragraph (f) of § 1.404(e)–1 and paragraph (b) of § 1.72–16.

(2) (i) In the case of a taxable year of the plan for which employer contributions are made on behalf of only owner-employees, an excess contribution is the amount of any contribution for such taxable year on behalf of such owner-employee which is not deductible under section 404 (determined without regard to section 404(a)(10)). This rule applies irrespective of whether the plan provides for contributions on behalf of common-law employees, or self-employed individuals who are not owner-employees, when such employees or individuals become eligible for coverage under the plan, and irrespective of whether contributions are in fact made for such employees or such individuals for other taxable years of the plan.

(ii) In the case of a taxable year of the plan for which employer contributions are made on behalf of both owner-employees and either common-law employees or self-employed individuals who are not owner-employees, an excess contribution is the amount of any employer contribution on behalf of any owner-employee for such taxable year which exceeds the amount deductible under section 404 (determined without regard to section 404(a)(10)) unless such amount may be treated as an employee contribution under the plan in accordance with the rules of paragraph (d)(3) of § 1.401–11 and is a permissible employee contribution under subparagraph (3) of this paragraph.

(3) (i) In the case of a taxable year of the plan for which employer contributions are made on behalf of both an owner-employee and either common-law employees or self-employed individuals who are not owner-employees, employee contributions on behalf of an owner-employee may be made for such taxable year of the plan. However, the amount of such contributions, if any, which is described in subdivisions (ii), (iii), or (iv) of this subparagraph is an excess contribution.

(ii) An excess contribution is the amount of any employee contribution made on behalf of any owner-employee during a taxable year of the plan at a rate in excess of the rate of contributions which may be made as employee contributions by common-law employees, or by self-employed individuals who are not owner-employees, during such taxable year of the plan.

(iii) An excess contribution is the amount of any employee contribution made on behalf of an owner-employee which exceeds the lesser of $2,500 or 10 percent of the earned income (as defined in paragraph (c) of § 1.401–10) of such owner-employee for his taxable year in which such contributions are made.

(iv) In the case of a taxable year of an owner-employee in which contributions are made on behalf of such owner-employee under more than one plan, an excess contribution is the amount of any employee contribution made on behalf of such owner-employee under all such plans during such taxable year which exceeds $2,500. If such an excess contribution is made, the amount of the excess contribution made on behalf of the owner-employee with respect to any one of such plans is the amount by which the employee contribution on his behalf under such plan for the year exceeds an amount which bears the same ratio to $2,500 as the earned income of the owner-employee derived from the trade or business with respect to which the plan is established bears to his earned income derived from the trades or businesses with respect to which all such plans are established.

(4) An excess contribution is the amount of any contribution on behalf of an owner-employee for any taxable year of the plan with respect to which the plan is treated, under section 401(e)(2), as not meeting the requirements of section 401(d) with respect to such owner-employee.

(c) *Contributions for premiums on certain annuity, endowment, or life insurance contracts.* (1) The term "excess contribution" does not include the amount of any employer contributions on behalf of an owner-employee which, under the provisions of the plan, is expressly required to be applied (either directly or through a trustee) to pay the premiums or other consideration for one or more annuity, endowment, or life insurance contracts, if—

(i) The employer contributions so applied meet the requirements of subparagraphs (2) through (4) of this paragraph, and

(ii) The total employer contributions required to be applied annually to pay premiums on behalf of any owner-employee for contracts described in this paragraph do not exceed $2,500. For purposes of computing such $2,500 limit, the total employer contributions includes amounts which are allocable to the purchase of life, accident, health, or other insurance.

(2) (i) The employer contributions must be paid under a plan which satisfies all the requirements for qualification. Accordingly, for example, contributions can be paid under the plan for life insurance protection only to the extent otherwise permitted under sections 401 through 404 and the regulations thereunder. However, certain of the requirements for qualification are modified with respect to a plan described in this paragraph (see section 401(a)(10)(A)(ii) and (d)(5)).

(ii) A plan described in this paragraph is not disqualified merely because a contribution is made on behalf of an owner-employee by his employer during a taxable year of the employer for which the owner-employee has no earned income. On the other hand, a plan will fail to qualify if a contribution is made on behalf of an owner-employee which results in the discrimination prohibited by section 401(a)(4) as modified by section 401(a)(10)(A)(ii) (see paragraph (f)(3) of § 1.401–12).

(3) The employer contributions must be applied to pay premiums or other consideration for a contract issued on the life of the owner-employee. For purposes of this subparagraph, a contract is not issued on the life of an owner-employee unless all the proceeds which are, or may become, payable under the contract are payable directly, or through a trustee of a trust described in section 401(a) and exempt from tax under section 501(a), to the owner-employee or to the beneficiary named in the contract or under the plan. Accordingly, for example, a nontransferable face-amount certificate (as defined in section 401(g) and the regulations thereunder) is considered an annuity on the life of the owner-employee if the proceeds of such contract are payable only to the owner-employee or his beneficiary.

(4) (i) For any taxable year of the employer, the amount of contributions by the employer on behalf of the owner-employee which is applied to pay premiums under the contracts described in this paragraph must not exceed the average of the amounts deductible under section 404 (determined without regard to section 404(a)(10)) by such employer on behalf of such owner-employee for the most recent three taxable years of the employer (ending prior to the date the latest contract was entered into or modified to provide additional benefits), in which the owner-employee derived earned income from the trade or business with respect to which the plan is established. However, if such owner-employee has not derived earned income for at least three taxable years preceding such date, then, in determining the "average of the amounts deductible", only so many of such taxable years as

such owner-employee was engaged in such trade or business and derived earned income therefrom are taken into account.

(ii) For the purpose of making the computation described in subdivision (i) of this subparagraph, the taxable years taken into account include those years in which the individual derived earned income from the trade or business but was not an owner-employee with respect to such trade or business. Furthermore, taxable years of the employer preceding the taxable year in which a qualified plan is established are taken into account. If such taxable years began prior to January 1, 1963, the amount deductible is determined as if section 404 included section 404 (a) (8), (9), (10), and (e).

(5) The amount of any employer contribution which is not deductible but which is not treated as an excess contribution because of the provisions of this paragraph shall be taken into account as an employee contribution made on behalf of the owner-employee during the owner-employee's taxable year with, or within which, the taxable year of the person treated as his employer under section 401(c)(4) ends. However, such contribution is only treated as an employee contribution made on behalf of the owner-employee for the purpose of determining whether any other employee contribution made on behalf of the owner-employee during such period is an excess contribution described in paragraph (b)(3) of this section.

(d) *Effect of an excess contribution which is not willfully made.* (1) If an excess contribution (as defined in paragraph (b) of this section) is made on behalf of an owner-employee, and if such contribution is not willfully made, then the provisions of this paragraph describe the effect of such an excess contribution. However, if the excess contribution made on behalf of an owner-employee is determined to have been willfully made, then the provisions of paragraph (e) of this section are applicable to such contribution.

(2)(i) This paragraph does not apply to an excess contribution if the net amount of such excess contribution (as defined in subparagraph (4) of this paragraph) and the net income attributable to such amount are repaid to the owner-employee on whose behalf the excess contribution was made at any time before the end of six months beginning on the day on which the district director sends notice (by certified or registered mail) of the amount of the excess contribution to the trust, insurance company, or other person to whom such excess contribution was paid. The net income attributable to the net amount of the excess contribution is the aggregate of the amounts of net income attributable to the net amount of the excess contribution for each year of the plan beginning with the taxable year of the plan within which the excess contribution is made and ending with the close of the taxable year of the plan immediately preceding the taxable year of the plan in which the net amount of the excess contribution is repaid. The amount of net income attributable to the net amount of the excess contribution for each year is the amount of net income earned under the plan during the year which is allocated in a reasonable manner to the net amount of the excess contribution. For example, the amount of net income earned under the plan for the year which is attributable to the net amount of an excess contribution can be computed as the amount which bears the same ratio to the amount of the "net income attributable to the interest of the owner-employee under the plan" for such taxable year (determined in accordance with the provisions of subparagraph (5)(ii) of this paragraph) as the net amount of the excess contribution bears to the aggregate amount standing to the account of the owner-employee at the end of that year (including the net amount of any excess contribution).

(ii) The notice described in subdivision (i) of this subparagraph shall not be mailed prior to the time that the amount of the tax under chapter 1 of the Code of the owner-employee to whom the excess contribution is to be repaid has been finally determined for his taxable year in which such excess contribution was made. For purposes of this subdivision, a final determination of the amount of tax liability of the owner-employee includes—

(*a*) A decision by the Tax Court of the United States, or a judgment, decree, or other order by any court of competent jurisdiction, which has become final;

(*b*) A closing agreement authorized by section 7121; or

(*c*) The expiration of the period of limitation on suits by the taxpayer for refund, unless suit is instituted prior to the expiration of such period.

(iii) For purposes of this subparagraph, an amount is treated as repaid to an owner-employee if an adequate adjustment is made to the account of the owner-employee. An adequate adjustment is made to the account of an owner-employee, for example, if the amount of the excess contribution (without any reduction for any loading or other administrative charge) and the net income attributable to such amount is taken into account as a contribution under the plan for the current year. In such a case, the gross income of the owner-employee for his taxable year in which such adjustment is made includes the amount of the net income attributable to the excess contribution.

(iv) If the net amount of the excess contribution and the net income attributable thereto is repaid, within the period described in subdivision (i) of this subparagraph, to the owner-employee on whose behalf such contribution was made, then the net income attributable to the excess contribution is, pursuant to section 61(a), includible in the gross income of the owner-employee for his taxable year in which such amount is distributed, or made available, to him. However, such amount is not a distribution to which section 402 or 403 and section 72 apply (see subparagraph (6) of this paragraph).

(3)(i) If the net amount of any excess contribution (as defined in subparagraph (4) of this paragraph) and the net income attributable to that excess contribution are not repaid to the owner-employee on whose behalf the excess contribution was made before the end of the six-month period described in subparagraph (2)(i) of this paragraph, the plan under which the excess contribution has been made is considered, for purposes of section 404, as not satisfying the requirements for qualification with respect to such owner-employee for all taxable years of the plan described in subdivision (ii) of this subparagraph. However, such disqualification only applies to the interest of the owner-employee on whose behalf an excess contribution has been made and does not disqualify the plan with respect to the other participants thereunder.

(ii) The taxable years referred to in subdivision (i) of this subparagraph include the taxable year of the plan within which the excess contribution is made and each succeeding taxable year of the plan until the beginning of the taxable year of the plan in which the trust, insurance company, or other person to whom such excess contribution was paid repays to such owner-employee—

(*a*) The net amount of the excess contribution, and

(*b*) The amount of income attributable to his interest under the plan which is includible in his gross income for any taxable year by reason of the provisions of subparagraph (5) of this paragraph.

(4) For purposes of this paragraph, the net amount of an excess contribution is the amount of such excess contribution, as defined in paragraph (b) of this section, reduced by the amount of any loading charge or other administrative charge ratably allocable to such excess contribution.

(5)(i) If a plan is considered as not meeting the requirements for qualification with respect to an owner-employee by reason of the provisions of subparagraph (3) of this paragraph for any taxable year of the plan, such owner-employee's gross income for any of his taxable years with or within which such taxable year of the plan ends shall, for purposes of chapter 1 of the Code, include the portion of the net income earned under the plan for such taxable year of the plan which is attributable to the interest of the owner-employee under the plan.

(ii) For purposes of this subparagraph, the term "net income" means the net income earned under the plan determined in accordance with generally accepted accounting principles consistently applied, and the "net income attributable to the interest of the owner-employee under the plan" is the amount which bears the same ratio to the aggregate amount of net income earned under the plan for the taxable year of the plan as the amount standing to the account of the owner-employee at the end of that year (including the amount of any excess contribution which is credited to his account) bears to the aggregate amount of all funds under the plan for all employees at the end of that year (including the aggregate amount of excess contributions credited to the ac-

counts of all owner-employees for that year).

(iii) The provisions of this subparagraph may be illustrated by the following example:

Example. A is an owner-employee covered under the X Employees' Pension Trust who files his return on the basis of a calendar year. An excess contribution was made on behalf of A during the plan year beginning on January 1, 1966. The net amount of the excess contribution and the net income attributable thereto was not repaid to A before the end of the six-month period described in subparagraph (2)(i) of this paragraph. Accordingly, the net income earned under the plan during 1966 which is attributable to A's interest is to be included in his gross income for 1966. Assume that the trust which forms a part of the pension plan of the X Company also files its returns on a calendar year basis, and that during 1966 the trust had a gross income of $4,000 (including a long-term capital gain of $2,500) and expenses of $500. Assume, further, that the amount standing to A's account on December 31, 1966 (including the amount of the excess contribution), was $20,000, and that on that date the amount funded under the plan for all employees (including A) is $140,000. Then the net income of the trust for 1966 is $3,500 ($4,000—$500). The net income attributable to the interest of A under the plan is $500 (the amount which bears the same ratio to $3,500 as $20,000 bears to $140,000). Accordingly, $500 is included in A's gross income in accordance with the provisions of section 401(e)(2)(B) as the "net income attributable to the interest of the owner-employee under the plan".

(6) The provisions of section 402 or 403 and section 72 do not apply to any amount distributed, or made available, to an owner-employee which is described in this paragraph. Accordingly, for example, the provisions of section 72(m)(5)(A)(i), relating to amounts subject to the penalty tax imposed by section 72(m), do not apply to the amount of the net income attributable to the interest of an owner-employee (as defined in subparagraph (5)(ii) of this paragraph) which is includible in his gross income. Furthermore, in such a case, the provisions of section 401(d)(5)(C) do not apply to such amount.

(7) Certain adjustments will be required with respect to the interest of an owner-employee after any amount previously allocated to his account has been returned to him pursuant to the provisions of this paragraph. For example, if the determination of whether life insurance benefits provided under the plan are incidental is made, in part, with regard to the contributions allocated to the accounts of the participants covered under the plan, an adjustment may have to be made with respect to the life insurance purchased under the plan for any owner-employee after any amount previously allocated to his account has been repaid to him. Furthermore, if, for example, an owner-employee has received annuity payments which were taxable under the exclusion ratio rule of section 72, and if such exclusion ratio took into account any amount credited to the account of the owner-employee which is subsequently repaid to him, then such exclusion ratio must be recomputed after the adjustment in such owner-employee's account has taken place.

(8) Notwithstanding any other provision of law, in any case in which the plan is treated as not satisfying the requirements for qualification with respect to any owner-employee by reason of the provisions of section 401(e), the period for assessing, with respect to such owner-employee, any deficiency arising by reason of—

(i) The disallowance of any deduction under section 404 by reason of the provisions of subparagraph (3) of this paragraph, or

(ii) The inclusion of amounts in the gross income of the owner-employee by reason of the provisions of subparagraph (5) of this paragraph,

shall not expire prior to 18 months after the day the district director mails the notice with respect to the excess contribution (described in subparagraph (2)(i) of this paragraph) which gives rise to such disallowance or inclusion. Thus, for example, notwithstanding the provisions of section 6212(c) (relating to the restriction on the determination of additional deficiencies), if, after a final determination by the Tax Court of the income tax liability of an owner-employee for a taxable year in which an excess contribution was made, the amount of such excess contribution and the net income attributable thereto is not paid to the owner-employee before the end of the six-month period described in subparagraph (2)(i) of this paragraph, an additional deficiency assessment may be made for such taxable year with respect to such excess contribution.

(e) *Effect of an excess contribution which is determined to have been willfully made.* If an excess contribution (as defined in paragraph (b) of this section) on behalf of an owner-employee is determined to have been willfully made, then—

(1) Only the provisions of this paragraph apply to such contribution;

(2) There shall be distributed to the owner-employee on whose behalf such contribution was willfully made his entire interest in all plans in which he is a participant as an owner-employee;

(3) The amount distributed under each such plan is an amount to which section 72 does apply (see section 72(m)(5)(A)(iii)); and

(4) For purposes of section 404, no plan in which such individual is covered as an owner-employee shall be considered as meeting the requirements for qualification with respect to such owner-employee for any taxable year of the plan beginning with or within the calendar year in which it is determined that the excess contribution has been willfully made and with or within the five calendar years following such year.

PAR. 8. Section 1.402(a) is amended by revising section 402(a)(2) and by adding a historical note. These amended and added provisions read as follows:

§ 1.402(a) Statutory provisions; taxability of beneficiary of employees' trust; exempt trust.

SEC. 402. *Taxability of beneficiary of employees' trust*—(a) *Taxability of beneficiary of exempt trust.* * * *

(2) *Capital gains treatment for certain distributions.* In the case of an employees' trust described in section 401(a), which is exempt from tax under section 501(a), if the total distributions payable with respect to any employee are paid to the distributee within 1 taxable year of the distributee on account of the employee's death or other separation from the service, or on account of the death of the employee after his separation from the service, the amount of such distribution, to the extent exceeding the amounts contributed by the employee (determined by applying section 72(f)), which employee contributions shall be reduced by any amounts theretofore distributed to him which were not includible in gross income, shall be considered a gain from the sale or exchange of a capital asset held for more than 6 months. Where such total distributions include securities of the employer corporation, there shall be excluded from such excess the net unrealized appreciation attributable to that part of the total distributions which consists of the securities of the employer corporation so distributed. The amount of such net unrealized appreciation and the resulting adjustments to basis of the securities of the employer corporation so distributed shall be determined in accordance with regulations prescribed by the secretary or his delegate. This paragraph shall not apply to distributions paid to any distributee to the extent such distributions are attributable to contributions made on behalf of the employee while he was an employee within the meaning of section 401(c)(1).

* * * * *

[Sec. 402(a) as amended by sec. 4(c), Self-Employed Individuals Tax Retirement Act 1962 (76 Stat. 825)]

PAR. 9. Section 1.402(a)–1 is amended by revising paragraph (a)(2), (3), (4), and (5), by adding new subdivisions (vi) and (vii) at the end of paragraph (a)(6), and by adding paragraph (a)(7) and (8). These amended and added provisions read as follows:

§ 1.402(a)–1 Taxability of beneficiary under a trust which meets the requirements of section 401(a).

(a) *In general.* * * *

(2) If a trust described in section 401(a) and exempt under section 501(a) purchases an annuity contract for an employee and distributes it to the employee in a year for which the trust is exempt, the contract containing a cash surrender value which may be available to an employee by surrendering the contract, such cash surrender value will not be considered income to the employee unless and until the contract is surrendered. For the rule as to nontransferability of annuity contracts issued after 1962, see paragraph (b)(2) of § 1.401–9. If, however, the contract distributed by such exempt trust is a retirement income, endowment, or other life insurance contract and is distributed after October 26, 1956, the entire cash value of such contract at the time of distribution must be included in the distributee's income in accordance with the provisions of section 402(a), except to the extent that,

within 60 days after the distribution of such contract, all or any portion of such value is irrevocably converted into a contract under which no part of any proceeds payable on death at any time would be excludable under section 101(a) (relating to life insurance proceeds). If the contract distributed by such trust is a transferable annuity contract issued after 1962, or a retirement income, endowment, or other life insurance contract which is distributed after 1962 (whether or not transferable), then notwithstanding the preceding sentence the entire cash value of the contract is includible in the distributee's gross income, unless within such 60 days such contract is also made nontransferable.

(3) For the rules applicable to premiums paid by a trust described in section 401(a) and exempt under section 501(a) for the purchase of retirement income, endowment, or other contracts providing life insurance protection payable upon the death of the employee-participant, see paragraph (b) of § 1.72–16.

(4) For the rules applicable to the amounts payable by reason of the death of an employee under a contract providing life insurance protection, or an annuity contract, purchased by a trust described in section 401(a) and exempt under section 501(a), see paragraph (c) of § 1.72–16.

(5) If pension or annuity payments or other benefits are paid or made available to the beneficiary of a deceased employee or a deceased retired employee by a trust described in section 401(a) which is exempt under section 501(a), such amounts are taxable in accordance with the rules of section 402(a) and this section. In case such amounts are taxable under section 72, the "investment in the contract" shall be determined by reference to the amount contributed by the employee and by applying the applicable rules of sections 72 and 101(b)(2)(D). In case the amounts paid to, or includible in the gross income of, the beneficiaries of the deceased employee or deceased retired employee constitute a distribution to which subparagraph (6) of this paragraph is applicable, the extent to which the distribution is taxable is determined by reference to the contributions of the employee, by reference to any prior distributions which were excludable from gross income as a return of employee contributions, and by applying the applicable rules of sections 72 and 101(b).

(6) * * *

(vi) The term "total distributions payable" does not include United States Retirement Plan Bonds held by a trust to the credit of an employee. Thus, a distribution by a qualified trust may constitute a total distributions payable with respect to an employee even though the trust retains retirement plan bonds registered in the name of such employee. Similarly, the proceeds of a retirement plan bond received as a part of the total amount to the credit of an employee will not be entitled to capital gains treatment. See section 405(e) and paragraph (a)(4) of § 1.405–3.

(vii) For purposes of determining whether the total distributions payable to an employee have been distributed within one taxable year, the term "total distributions payable" includes amounts held by a trust to the credit of an employee which are attributable to contributions on behalf of the employee while he was a self-employed individual in the business with respect to which the plan was established. Thus, a distribution by a qualified trust is not a total distributions payable with respect to an employee if the trust retains amounts which are so attributable.

(7) The capital gains treatment provided by section 402(a)(2) and subparagraph (6) of this paragraph is not applicable to distributions paid to a distributee to the extent such distributions are attributable to contributions made on behalf of an employee while he was a self-employed individual in the business with respect to which the plan was established. For the taxation of such amounts, see § 1.72–18. For the rules for determining the amount attributable to contributions on behalf of an employee while he was self-employed, see paragraphs (b)(4) and (c)(2) of such section.

(8) For purposes of this section, the term "employee" includes a self-employed individual who is treated as an employee under section 401(c)(1), and paragraph (b) of § 1.401–10, and the term "employer" means the person treated as the employer of such individual under section 401(c)(4).

PAR. 10. Section 1.403(a) is amended by revising paragraph (2)(A) of, and by adding a new paragraph (3) to, section 403(a) and by adding a historical note. These amended and added provisions read as follows:

§ 1.403(a) Statutory provisions; taxation of employee annuities; qualified annuity plan.

SEC. 403. *Taxation of employee annuities*—(a) *Taxability of beneficiary under a qualified annuity plan.* * * *

(2) *Capital gains treatment for certain distributions*—(A) *General rule.* If—

(i) An annuity contract is purchased by an employer for an employee under a plan described in paragraph (1);

(ii) Such plan requires that refunds of contributions with respect to annuity contracts purchased under such plan be used to reduce subsequent premiums on the contracts under the plan; and

(iii) The total amounts payable by reason of an employee's death or other separation from the service, or by reason of the death of an employee after the employee's separation from the service, are paid to the payee within one taxable year of the payee,

then the amount of such payments, to the extent exceeding the amount contributed by the employee (determined by applying section 72(f)), which employee contributions shall be reduced by any amounts theretofore paid to him which were not includible in gross income, shall be considered a gain from the sale or exchange of a capital asset held for more than 6 months. This subparagraph shall not apply to amounts paid to any payee to the extent such amounts are attributable to contributions made on behalf of the employee while he was an employee within the meaning of section 401(c)(1).

* * * * *

(3) *Self-employed individuals.* For purposes of this subsection, the term "employee" includes an individual who is an employee within the meaning of section 401(c)(1), and the employer of such individual is the person treated as his employer under section 401(c)(4).

[Sec. 403(a) as amended by sec. 4(d), Self-Employed Individuals Tax Retirement Act 1962 (76 Stat. 825)]

PAR. 11. Section 1.403(a)–1 is amended by revising paragraph (d) and by adding a new paragraph at the end thereof. These amended and added provisions read as follows:

§ 1.403(a)–1 Taxability of beneficiary under a qualified annuity plan.

* * * * *

(d) An individual contract issued after December 31, 1962, or a group contract, which provides incidental life insurance protection may be purchased under a qualified annuity plan. For the rules as to nontransferability of such contracts issued after December 31, 1962, see § 1.401–9. For the rules relating to the taxation of the cost of the life insurance protection and the proceeds thereunder, see § 1.72–16. Section 403(a) is not applicable to premiums paid after October 26, 1956, for individual contracts which were issued prior to January 1, 1963, and which provide life insurance protection.

* * * * *

(f) For purposes of this section and § 1.403(a)–2, the term "employee" includes a self-employed individual who is treated as an employee under section 401(c)(1) and paragraph (b) of § 1.401–10, and the term "employer" means the person treated as the employer of such individual under section 401(c)(4). For the rules relating to annuity plans covering self-employed individuals, see section 404(a)(2) and §§ 1.404(a)–8 and 1.401–10 through 1.401–13.

PAR. 12. Section 1.403(a)–2 is amended by revising subparagraph (1) of paragraph (a), by adding a new subparagraph to paragraph (b), and by inserting immediately after paragraph (b) a new paragraph (c). These amended and added provisions read as follows:

§ 1.403(a)–2 Capital gains treatment for certain distributions.

(a) * * *

(1) Is a plan described in section 403(a)(1) and § 1.403(a)–1, and

* * * * *

(b) * * *

(5) For purposes of determining whether the total amounts payable to an employee have been paid within one taxable year, the term "total amounts" includes amounts under a plan which are attributable to contributions on behalf of an individual while he was self-employed in the business with respect to which the plan was established. Thus, the "total amounts" payable are not paid within one taxable year if amounts remain payable which are so attributable.

(c) The provisions of this section are not applicable to any amounts paid to a payee to the extent such amounts are attributable to contributions made on behalf of an employee while he was a self-employed individual in the business

with respect to which the plan was established. For the taxation of such amounts, see § 1.72–18. For the rules for determining the amount attributable to contributions on behalf of an employee while he was self-employed, see paragraphs (b)(4) and (c)(2) of such section.

PAR. 13. Section 1.404(a) is amended by revising section 404(a)(2), by adding paragraphs (8), (9), and (10) to section 404(a), and by adding a historical note. These amended and added provisions read as follows:

§ 1.404(a) Statutory provisions; deduction for contributions of an employer to an employees' trust or annuity plan and compensation under a deferred-payment plan; general rule.

SEC. 404. *Deduction for contributions of an employer to an employees' trust or annuity plan and compensation under a deferred-payment plan*—(a) *General rule.*

* * *

(2) *Employees' annuities.* In the taxable year when paid, in an amount determined in accordance with paragraph (1), if the contributions are paid toward the purchase of retirement annuities and such purchase is a part of a plan which meets the requirements of section 401(a) (3), (4), (5), (6), (7), and (8), and, if applicable, the requirements of section 401(a) (9) and (10) and of section 401(d) (other than paragraph (1)), and if refunds of premiums, if any, are applied within the current taxable year or next succeeding taxable year towards the purchase of such retirement annuities.

* * * * *

(8) *Self-employed individuals.* In the case of a plan included in paragraph (1), (2), or (3) which provides contributions or benefits for employees some or all of whom are employees within the meaning of section 401(c)(1), for purposes of this section—

(A) The term "employee" includes an individual who is an employee within the meaning of section 401(c)(1), and the employer of such individual is the person treated as his employer under section 401(c)(4);

(B) The term "earned income" has the meaning assigned to it by section 401(c)(2);

(C) The contributions to such plan on behalf of an individual who is an employee within the meaning of section 401(c)(1) shall be considered to satisfy the conditions of section 162 or 212 to the extent that such contributions do not exceed the earned income of such individual derived from the trade or business with respect to which such plan is established, and to the extent that such contributions are not allocable (determined in accordance with regulations prescribed by the Secretary or his delegate) to the purchase of life, accident, health, or other insurance; and

(D) Any reference to compensation shall, in the case of an individual who is an employee within the meaning of section 401(c)(1), be considered to be a reference to the earned income of such individual derived from the trade or business with respect to which the plan is established.

(9) *Plans benefiting self-employed individuals.* In the case of a plan included in paragraph (1), (2), or (3) which provides contributions or benefits for employees some or all of whom are employees within the meaning of section 401(c)(1)—

(A) The limitations provided by paragraphs (1), (2), (3), and (7) on the amounts deductible for any taxable year shall be computed, with respect to contributions on behalf of employees (other than employees within the meaning of section 401(c)(1)), as if such employees were the only employees for whom contributions and benefits are provided under the plan;

(B) The limitations provided by paragraphs (1), (2), (3), and (7) on the amounts deductible for any taxable year shall be computed, with respect to contributions on behalf of employees within the meaning of section 401(c)(1)—

(i) As if such employees were the only employees for whom contributions and benefits are provided under the plan, and

(ii) Without regard to paragraph (1)(D), the second and third sentences of paragraph (3), and the second sentence of paragraph (7); and

(C) The amounts deductible under paragraphs (1), (2), (3), and (7), with respect to contributions on behalf of any employee within the meaning of section 401(c)(1), shall not exceed the applicable limitation provided in subsection (e).

(10) *Special limitation on amount allowed as deduction for self-employed individuals.* Notwithstanding any other provision of this section, the amount allowable as a deduction under paragraphs (1), (2), (3), and (7) in any taxable year with respect to contributions made on behalf of an individual who is an employee within the meaning of section 401(c)(1) shall be an amount equal to one-half of the contributions made on behalf of such individual in such taxable year which are deductible under such paragraphs (determined with the application of paragraph (9) and of subsection (e) but without regard to this paragraph). For purposes of section 401, the amount which may be deducted, or the amount deductible, under this section with respect to contributions made on behalf of such individual shall be determined without regard to the preceding sentence.

[Sec. 404(a) as amended by sec. 3(a), Self-Employed Individuals Tax Retirement Act 1962 (76 Stat. 819)]

PAR. 14. Paragraph (a)(1) of § 1.404(a)–1 is amended by adding two sentences at the end thereof. This amended provision reads as follows:

§ 1.404(a)–1 Contributions of an employer to an employees' trust or annuity plan and compensation under a deferred payment plan; general rule.

(a)(1) Section 404(a) prescribes limitations upon deductions for amounts contributed by an employer under a pension, annuity, stock bonus, or profit-sharing plan, or under any plan of deferred compensation. It is immaterial whether the plan covers present employees only, or present and former employees, or only former employees. Section 404(a) also governs the deductibility of unfunded pensions and death benefits paid directly to former employees or their beneficiaries (see § 1.404(a)–12). For taxable years beginning after 1962, certain self-employed individuals may be covered by pension, annuity, or profit-sharing plans. For the rules relating to the deduction of contributions on behalf of such individuals, see paragraph (a)(2) of § 1.404(a)–8 and § 1.404(e)–1.

PAR. 15. Section 1.404(a)–2 is amended by adding new paragraphs (g) and (h) at the end thereof. These added provisions read as follows:

§ 1.404(a)–2 Information to be furnished by employer claiming deductions.

* * * * *

(g) In the case of a plan which covers employees, some or all of whom are self-employed individuals and with respect to which a deduction is claimed under section 404(a) (1), (2), (3), or (7), paragraphs (a) and (b) of this section, and the provision of paragraph (d) of this section relating to the time for filing the information required by this section, shall not apply, but in lieu of the information required to be submitted by paragraphs (a) and (b) of this section, the employer shall, with the return for the taxable year in which the deduction is claimed, submit the information required by the form provided by the Internal Revenue Service for such purpose.

(h) When a custodial account forms a part of a plan for which a deduction is claimed under section 404(a) (1), (2), (3), or (7), the information which under this section is to be submitted with respect to a qualified trust must be submitted with respect to such custodial account. Thus, for purposes of this section—

(1) The term "trust" includes custodial account,

(2) The term "trustee" includes custodian, and

(3) The term "trust indenture" includes custodial agreement.

PAR. 16. Paragraph (a) of § 1.404(a)–8 is amended by revising subparagraph (2) and by adding subparagraph (4). These amended and added provisions read as follows:

§ 1.404(a)–8 Contributions of an employer under an employees' annuity plan which meets the requirements of section 401(a); application of section 404(a)(2).

(a) * * *

(2) The contributions must be paid in a taxable year of the employer which ends with or within a year of the plan for which it meets the applicable requirements with respect to discrimination set out in section 401(a) (3), (4), (5), and (6), and in the case of a taxable year of a plan beginning after September 30, 1963, of section 401(a) (7) and (8). In the case of a plan that covers a self-employed individual, the contributions must be paid in a taxable year of the employer which begins after December 31, 1962, and which ends with or within a year of the plan for which it also meets the applicable requirements of section 401(a) (9) and (10) and of section 401(d) (other than paragraph (1)). See §§ 1.401–3, 1.401–4, 1.401–6, 1.401–7, 1.401–11, and 1.401–12. Any contributions of an employer which are paid in a taxable year of the employer ending with or within a year of the plan for which it meets the applicable requirements of section 401 may be carried over and deducted in a succeeding taxable year of the employer in accordance with section 404(a)(1)(D), whether or not such succeeding taxable year ends with or within a taxable year of the plan

for which it meets the requirements set out in section 401 (a) and (d). However, the provisions of section 404(a)(1)(D) are not applicable to contributions on behalf of self-employed individuals. Such contributions are deductible only in the taxable year in which paid. See paragraph (b)(3)(ii) of § 1.404(e)-1. The requirements set out in section 401 (a) (3), (4), (5), and (6) are considered to be satisfied for the period beginning with the date on which an annuity plan was put into effect and ending with the fifteenth day of the third month following the close of the taxable year of the employer in which the plan was put into effect, if all provisions of the plan which are necessary to satisfy such requirements are in effect by the end of such period and have been made effective for all purposes with respect to the whole of such period. See section 401(b) and § 1.401-5. It should be noted that the period in which a plan may be amended to qualify under section 401(b) ends before the date taxpayers, other than corporations, are required to file income tax returns.

* * * * *

(4) Any amounts described in subparagraph (3) of this paragraph which are attributable to contributions on behalf of a self-employed individual must be applied toward the purchase of retirement benefits. Amounts which are so applied are not contributions and thus are not taken into consideration in determining—

(i) The amount deductible with respect to contributions on his behalf, nor

(ii) In the case of an owner-employee, the maximum amount of contributions that may be made on his behalf.

PAR. 17. There are inserted immediately after § 1.404(d)-1 the following new sections:

§ 1.404(e) Statutory provisions; deduction for contributions of an employer to an employees' trust or annuity plan; special limitations for self-employed individuals.

SEC. 404. *Deduction for contributions of an employer to an employees' trust or annuity plan and compensation under a deferred-payment plan.* * * *

(e) *Special limitations for self-employed individuals*—(1) *In general.* In the case of a plan included in subsection (a) (1), (2), or (3), which provides contributions or benefits for employees some or all of whom are employees within the meaning of section 401(c)(1), the amounts deductible under subsection (a) (determined without regard to paragraph (10) thereof) in any taxable year with respect to contributions on behalf of any employee within the meaning of section 401(c)(1) shall, subject to the provisions of paragraph (2), not exceed $2,500, or 10 percent of the earned income derived by such employee from the trade or business with respect to which the plan is established, whichever is the lesser.

(2) *Contributions made under more than one plan*—(A) *Overall limitation.* In any taxable year in which amounts are deductible with respect to contributions under two or more plans on behalf of an individual who is an employee within the meaning of section 401(c)(1) with respect to such plans, the aggregate amount deductible for such taxable year under all such plans with respect to contributions on behalf of such employee (determined without regard to subsection (a)(10)) shall not exceed $2,500, or 10 percent of the earned income derived by such employee from the trades or businesses with respect to which the plans are established, whichever is the lesser.

(B) *Allocation of amounts deductible.* In any case in which the amounts deductible under subsection (a) (with the application of the limitations of this subsection) with respect to contributions made on behalf of an employee within the meaning of section 401(c)(1) under two or more plans are, by reason of subparagraph (A), less than the amounts deductible under such subsection determined without regard to such subparagraph, the amount deductible under subsection (a) (determined without regard to paragraph (10) thereof) with respect to such contributions under each such plan shall be determined in accordance with regulations prescribed by the Secretary or his delegate.

(3) *Contributions allocable to insurance protection.* For purposes of this subsection, contributions which are allocable (determined under regulations prescribed by the Secretary or his delegate) to the purchase of life, accident, health, or other insurance shall not be taken into account.

[Sec. 404(e) as added by sec. 3(b), Self-Employed Individuals Tax Retirement Act 1962 (76 Stat. 820)]

§ 1.404(e)-1 Contributions on behalf of a self-employed individual to or under a pension, annuity, or profit-sharing plan meeting the requirements of section 401; application of section 404(a) (8), (9), and (10) and section 404 (e) and (f).

(a) *In general.* (1) The Self-Employed Individuals Tax Retirement Act of 1962 (76 Stat. 809) permits certain self-employed individuals to be treated as employees for purposes of pension, annuity, and profit-sharing plans included in paragraph (1), (2), or (3) of section 404(a). Therefore, for taxable years of an employer beginning after December 31, 1962, employer contributions to qualified plans on behalf of self-employed individuals are deductible under section 404 subject to the limitations of paragraphs (b) and (c) of this section.

(2) In the case of contributions to qualified plans on behalf of self-employed individuals, the amount deductible differs from the amount allowed as a deduction. In general, the amount deductible is 10 percent of the earned income derived by the self-employed individual from the trade or business with respect to which the plan is established, or $2,500, whichever is the lesser. This is the amount referred to in section 401 when reference is made to the amounts which may be deducted under section 404 or the amount of contributions deductible under section 404. Thus, this is the amount taken into consideration in determining whether contributions under the plan are discriminatory. The amount allowed as a deduction with respect to contributions on behalf of a self-employed individual is one-half of the amount deductible. The amount allowed as a deduction is relevant only for purposes of determining the amount an employer may deduct from gross income.

(b) *Determination of the amount deductible.* (1) If a plan covers employees, some of whom are self-employed individuals, the determination of the amount deductible is made on the basis of independent consideration of the common-law employees and of the self-employed individuals. See subparagraphs (2) and (3) of this paragraph. For purposes of determining the amount deductible with respect to contributions on behalf of a self-employed individual, such contributions shall be considered to satisfy the conditions of section 162 (relating to trade or business expenses) or 212 (relating to expenses for the production of income), but only to the extent that such contributions do not exceed the earned income of such individual derived from the trade or business with respect to which the plan is established. However, the portion of such contribution, if any, attributable to the purchase of life, accident, health, or other insurance protection shall be considered payment of a personal expense which does not satisfy the requirements of section 162 or 212. See paragraph (f) of this section. For the additional rules applicable where contributions are made by more than one employer on behalf of a self-employed individual, see paragraph (d) of this section.

(2) If contributions are made to a plan included in section 404(a) (1), (2), or (3) on behalf of employees, some of whom are self-employed individuals, the amount deductible with respect to contributions on behalf of the common-law employees covered under the plan shall be determined as if such employees were the only employees for whom contributions and benefits are provided under the plan. Accordingly, for purposes of such determination, the percentage of compensation limitations of section 404(a) (1), (3), and (7) are applicable only with respect to the compensation otherwise paid or accrued during the taxable year by the employer to the common-law employees. Similarly, the costs referred to in section 404(a)(1)(B) and (C) shall be the costs of funding the benefits of the common-law employees. Also, the provisions of section 404(a)(1)(D), (3), and (7), relating to certain carryover deductions, shall be applicable only to amounts contributed, or to the amounts deductible, on behalf of such employees.

(3) If contributions are made to a plan included in section 404(a) (1), (2), or (3) on behalf of individuals some or all of whom are self-employed individuals, the amount deductible in any taxable year with respect to contributions on behalf of such individuals shall be determined as follows:

(i) The provisions of section 404(a) (1), (2), (3), and (7) shall be applied as if such individuals were the only participants for whom contributions and benefits are provided under the plan. Thus, the costs referred to in such provisions shall be the costs of funding the benefits of the self-employed individuals. If such costs are less than an amount equal to the amount determined under subdivision (iii) of this subparagraph, the maximum amount deductible with respect to such individuals shall be the costs of their benefits.

(ii) The provisions of section 404(a)(1)(D), the second and third sentences of section 404(a)(3)(A), and the second sentence of section 404(a)(7), relat-

ing to certain carryover deductions, are not applicable to contributions on behalf of self-employed individuals. Contributions on behalf of self-employed individuals are deductible, if at all, only in the taxable year in which the contribution is paid or deemed paid under section 404(a)(6).

(iii) The amount deductible for the taxable year of the employer with respect to contributions on behalf of a self-employed individual shall not exceed the lesser of $2,500 or 10 percent of the earned income derived by such individual for such taxable year from the trade or business with respect to which the plan is established.

(iv) If a self-employed individual receives in any taxable year earned income with respect to which deductions are allowable to two or more employers, the aggregate amounts deductible shall not exceed the lesser of $2,500 or 10 percent of such earned income. See paragraph (d) of this section.

(c) *Special limitation on the amount allowed as a deduction for self-employed individuals.* The amount allowed as a deduction under sectio n404(a) (1), (2), (3), and (7) in any taxable year with respect to contributions made on behalf of a self-employed individual shall be an amount equal to one-half of the amount deductible with respect to such contributions under paragraph (b)(3) of this section. However, for purposes of section 401, the amount which may be deducted, or the amount deductible, under section 404 with respect to contributions made on behalf of self-employed individuals shall be determined without regard to the special limitation of this paragraph.

(d) *Rules applicable where contributions are made by more than one employer on behalf of a self-employed individual.* (1) Under paragraph (b)(3)(iv) of this section, if a self-employed individual receives in any taxable year earned income with respect to which deductions are allowable to two or more employers, the aggregate amounts deductible shall not exceed the lesser of $2,500 or 10 percent of such earned income. This limitation does not apply to contributions made under a plan on behalf of an employee who is not self-employed in the trade or business with respect to which the plan is established, even though such employee may be covered as a self-employed individual under a plan or plans established by other trades or businesses.

(2) In any case in which the application of subparagraph (1) of this paragraph reduces the amount otherwise deductible, the amount deductible by each employer shall be that amount which bears the same ratio to the aggregate amount deductible with respect to all trades or businesses (as determined in subparagraph (1) of this paragraph) as the earned income derived from that employer bears to the aggregate of the earned income derived from all of the trades or businesses with respect to which plans are established. The amount allowed as a deduction to each employer is one-half of the amount determined (in accordance with the preceding sentence) to be deductible by such employer.

(e) *Partner's distributive share of contributions and deductions.* For purposes of sections 702(a)(8) and 704, a partner's distributive share of contributions on behalf of self-employed individuals under a qualified pension, annuity, or profit-sharing plan is the contribution made on his behalf, and his distributive share of deductions allowed the partnership under section 404 for contributions on behalf of self-employed individuals is that portion of the deduction which is attributable to contributions made on his behalf under the plan. The contribution on behalf of a partner and the deduction with respect thereto must be accounted for separately by such partner, for his taxable year with or within which the partnership's taxable year ends, as an item described in section 702(a)(8).

(f) *Contributions allocable to insurance protection.* For purposes of determining the amount deductible with respect to contributions on behalf of a self-employed individual, amounts allocable to the purchase of life, accident, health, or other insurance protection shall not be taken into account. Such amounts are neither deductible nor considered as contributions for purposes of determining the maximum amount of contributions that may be made on behalf of an owner-employee. The amount of a contribution allocable to insurance shall be an amount equal to a reasonable net premium cost, as determined by the Commissioner, for such amount of insurance for the appropriate period. See paragraph (b)(5) of § 1.72–16.

(g) *Rules applicable to loans.* For purposes of section 404, any amount paid, directly or indirectly, by an owner-employee in repayment of any loan which under section 72(m)(4)(B) was treated as an amount received from a qualified trust or plan shall be treated as a contribution to such trust or under such plan on behalf of such owner-employee.

(h) *Definitions.* For purposes of section 404 and the regulations thereunder—

(1) The term "employee" includes an employee as defined in section 401(c)(1) and paragraph (b) of § 1.401–10, and the term "employer" means the person treated as the employer of such individual under section 401(c)(4);

(2) The term "owner-employee" means an owner-employee as defined in section 401(c)(3) and paragraph (d) of § 1.401–10;

(3) The term "earned income" means earned income as defined in section 401(c)(2) and paragraph (c) of § 1.401–10; and

(4) The term "compensation" when used with respect to an individual who is an employee described in subparagraph (1) of this paragraph shall be considered to be a reference to the earned income of such individual derived from the trade or business with respect to which the plan is established.

§ 1.404(f) Statutory provisions; deduction for contributions of an employer to an employees' trust or annuity plan; certain loan repayments considered as contributions.

SEC. 404. *Deduction for contributions of an employer to an employees' trust or annuity plan and compensation under a deferred-payment plan.* * * *

(f) *Certain loan repayments considered as contributions.* For purposes of this section, any amount paid, directly or indirectly, by an owner-employee (within the meaning of section 401(c)(3)) in repayment of any loan which under section 72(m)(4)(B) was treated as an amount received under a contract purchased by a trust described in section 401(a) which is exempt from tax under section 501(a) or purchased as a part of a plan described in section 403(a) shall be treated as a contribution to which this section applies on behalf of such owner-employee to such trust or to or under such plan.

[Sec. 404(f) as added by sec. 3(b), Self-Employed Individuals Tax Retirement Act 1962 (76 Stat. 821)]

[F.R. Doc. 63–9922; Filed, Sept. 16, 1963; 8:48 a.m.]

[T. D. 6677]

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

SUBCHAPTER F—PROCEDURE AND ADMINISTRATION

PART 301—PROCEDURE AND ADMINISTRATION

Information To Be Furnished With Regard to Certain Employee Retirement Plans, Criminal Penalties for the Submission of Fraudulent Information, and Other Technical Changes

On April 23, 1963, notice of proposed rule making with respect to the amendment of the Income Tax Regulations (26 CFR Part 1) and the Regulations on Procedure and Administration (26 CFR Part 301), prescribing regulations under section 6047 of the Internal Revenue Code of 1954 and amending the regulations under sections 6041, 6042, 6044, 6049, and 7207, was published in the FEDERAL REGISTER (28 F.R. 3981). After consideration of all such relevant matter as was presented by interested persons regarding the rules proposed, the amendment of the regulations is hereby adopted as proposed.

(Sec. 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805))

[SEAL] MORTIMER M. CAPLIN,
Commissioner of Internal Revenue.

Approved: September 10, 1963.

STANLEY S. SURREY,
Assistant Secretary of the Treasury.

The Income Tax Regulations (26 CFR Part 1) and the Regulations on Procedure and Administration (26 CFR Part 301) are hereby amended to conform to section 7(m) of the Self-Employed In-