

Treas. Reg. Section 1.402(a)-1(b)(1)

Taxability of beneficiary under a trust which meets the requirements of section 401(a).

(a) In general.

(1)

(i) Section 402 relates to the taxation of the beneficiary of an employees' trust. If an employer makes a contribution for the benefit of an employee to a trust described in section 401(a) for the taxable year of the employer which ends within or with a taxable year of the trust for which the trust is exempt under section 501(a), the employee is not required to include such contribution in his income except for the year or years in which such contribution is distributed or made available to him. It is immaterial in the case of contributions to an exempt trust whether the employee's rights in the contributions to the trust are forfeitable or nonforfeitable either at the time the contribution is made to the trust or thereafter.

(ii) The provisions of section 402(a) relate only to a distribution by a trust described in section 401(a) which is exempt under section 501(a) for the taxable year of the trust in which the distribution is made. With two exceptions, the distribution from such an exempt trust when received or made available is taxable to the distributee to the extent provided in section 72 (relating to annuities). First, for taxable years beginning before January 1, 1964, section 72(e)(3) (relating to the treatment of certain lump sums), as in effect before such date, shall not apply to such distributions. For taxable years beginning after December 31, 1963, such distributions may be taken into account in computations under sections 1301 through 1305 (relating to income averaging). Secondly, certain total distributions described in section 402(a)(2) are taxable as long-term capital gains. For the treatment of such total distributions, see subparagraph (6) of this paragraph. Under certain circumstances, an amount representing the unrealized appreciation in the value of the securities of the employer is excludable from gross income for the year of distribution. For the rules relating to such exclusion, see paragraph (b) of this section. Paragraph (e) of this section provides rules relating to use of a qualified pension, annuity, profit-sharing, or stock bonus plan to provide accident or health benefits or coverage otherwise described in sections 104, 105, or 106.

(iii) Except as provided in paragraph (b) of this section, a distribution of property by a trust described in section 401(a) and exempt under section 501(a) shall be taken into account by the distributee at its fair market value. In the case of a distribution of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, or any interest therein, the policy cash value and all other rights under such contract (including any supplemental agreements thereto and whether or not guaranteed) are included in determining the fair market value of the contract. In addition, in the case of a

transfer of property that occurs on or after August 29, 2005 where a trust described in section 401(a) and exempt under section 501(a) transfers property to a plan participant or beneficiary in exchange for consideration and where the fair market value of the property transferred exceeds the value of the consideration, then the excess of the fair market value of the property transferred by the trust over the value of the consideration received by the trust is treated as a distribution to the distributee under the plan for all purposes under the Internal Revenue Code. Where such a transfer occurs before that date, the excess of the fair market value of the property transferred by the trust over the value of the consideration received by the trust is includible in the gross income of the participant or beneficiary under section 61. However, such a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection occurring before that date is not treated as a distribution for purposes of applying the requirements of subchapter D of chapter 1 of subtitle A of the Internal Revenue Code.

(iv) If a trust is exempt for the taxable year in which the distribution occurs, but was not so exempt for one or more prior taxable years under section 501(a) (or under section 165(a) of the Internal Revenue Code of 1939 for years to which such section was applicable), the contributions of the employer which were includible in the gross income of the employee for the taxable year when made shall, in accordance with section 72(f), also be treated as part of the consideration paid by the employee.

(v) If the trust is not exempt at the time the distribution is received by or made available to the employee, see section 402(b) and paragraph (b) of §1.402(b)-1.

(vi) For the treatment of amounts paid to provide medical benefits described in section 401(h) as defined in paragraph (a) of §1.401-14, see paragraph (h) of §1.72-15.

(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 in which the trust is exempt, and the contract contains 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 §1.401-9(b)(1). For additional requirements regarding distributions of annuity contracts, see, e.g., §§1.401(a)-20, Q&A-2, 1.401(a)(31)-1, Q&A-17, and 1.401(a)(9)-6, Q&A-4. However, the distribution of an annuity contract must be treated as a lump sum distribution for purposes of determining the amount of tax under the 10-year averaging rule of section 402(e) (as in effect prior to amendment by the Tax Reform Act of 1986, Public Law 99-514, 100 Stat. 2085). If, however, the contract distributed by such exempt trust is a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, the fair market value of the 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 the 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), or the contract is treated as a rollover contribution under section 402(c). If the contract distributed by such trust is a transferable annuity contract, or a retirement income, endowment, or other life insurance contract and such contract is not treated as a rollover contribution under section 402(c), then, notwithstanding the preceding sentence, the fair market value of the contract is includible in the distributee's gross income unless, within such 60 days, such contract is 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)

(i) If the total distributions payable with respect to any employee under a trust described in section 401(a) which in the year of distribution is exempt under section 501(a) are paid to, or includible in the gross income of, the distributee within one taxable year of the distributee on account of the employee's death or other separation from the service, or death after such separation from service, the amount of such distribution, to the extent it exceeds the net amount contributed by the employee, shall be considered a gain from the sale or exchange of a capital asset held for more than six months. The total distributions payable are includible in the gross income of the distributee within one taxable year if they are made available to such distributee and the distributee fails to make a timely election under section 72(h) to receive an annuity in lieu of such total distributions. The "net amount contributed by the employee" is the amount actually contributed by the employee plus any amounts considered to be contributed by the employee under the rules of section 72(f), 101(b), and subparagraph (3) of this paragraph, reduced by any amounts theretofore distributed to him which were excludable from gross income as a return of employee contributions. See, however,

paragraph (b) of this section for rules relating to the exclusion of amounts representing net unrealized appreciation in the value of securities of the employer corporation. In addition, all or part of the amount otherwise includible in gross income under this paragraph by a nonresident alien individual in respect of a distribution by the United States under a qualified pension plan may be excludable from gross income under section 402(a)(4). For rules relating to such exclusion, see paragraph (c) of this section. For additional rules relating to the treatment of total distributions described in this subdivision in the case of a nonresident alien individual, see sections 871 and 1441 and the regulations thereunder.

(ii) The term "total distributions payable" means the balance to the credit of an employee which becomes payable to a distributee on account of the employee's death or other separation from the service or on account of his death after separation from the service. Thus, distributions made before a total distribution (for example, annuity payments received by the employee after retirement), will not defeat application of the capital gains treatment with respect to the total distributions received by a beneficiary upon the death of the employee after retirement. However, a distribution on separation from service will not receive capital gains treatment unless it constitutes the total amount in the employee's account at the time of his separation from service. If the total amount in the employee's account at the time of his death or other separation from the service or death after separation from the service is paid or includible in the gross income of the distributee within one taxable year of the distributee, such amount is entitled to the capital gains treatment notwithstanding that in a later taxable year an additional amount, attributable to the last year of service, is credited to the account of the employee and distributed.

(iii) If an employee retires and commences to receive an annuity but subsequently, in some succeeding taxable year, is paid a lump sum in settlement of all future annuity payments, the capital gains treatment does not apply to such lump sum settlement paid during the lifetime of the employee since it is not a payment on account of separation from the service, or death after separation, but is on account of the settlement of future annuity payments.

(iv) If the "total distributions payable" are paid or includible in the gross income of several distributees within one taxable year on account of the employee's death or other separation from the service or on account of his death after separation from the service, the capital gains treatment is applicable. The total distributions payable are paid within one taxable year of the distributees when, for example, a portion of such total is distributed in cash to one distributee and the balance is used to purchase an annuity contract which is distributed to the other distributee. However, if the share of any distributee is not paid or includible in his gross income within the same taxable year in which the shares of the other distributees are paid or includible in their gross income, none of the distributees is entitled to the capital gains treatment, since the total distributions payable are not paid or includible in the distributees' gross income within one taxable year. For example, if the total distributions payable are made available to each of two distributees and one elects to receive his share in cash while the other makes a timely election

under section 72(h) to receive his share in installment payments from the trust, the capital gains treatment does not apply to either distributee.

(v) [Reserved.]

(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.

(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.

(viii) The term "total distributions payable" does not include any amount which has been placed in a separate account for the funding of medical benefits described in section 401(h) as defined in paragraph (a) of §1.401-14. Thus, a distribution by a qualified trust may constitute a total distributions payable with respect to an employee even though the trust retains amounts attributable to the funding of medical benefits described in section 401(h).

(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).

(b) Distributions including securities of the employer corporation.

(1) In general.

(i) If a trust described in section 401(a) which is exempt under section 501(a) makes a distribution to a distributee, and such distribution includes securities of the employer corporation, the amount of any net unrealized appreciation in such securities shall be excluded from the distributee's income in the year of such distribution to the following extent:



(A) If the distribution constitutes a total distribution to which the regulations of paragraph (a)(6) of this section are applicable, the amount to be excluded is the entire net unrealized appreciation attributable to that part of the total distribution which consists of securities of the employer corporation; and

(B) If the distribution is other than a total distribution to which paragraph (a)(6) of this section is applicable, the amount to be excluded is that portion of the net unrealized appreciation in the securities of the employer corporation which is attributable to the amount considered to be contributed by the employee to the purchase of such securities.

The amount of net unrealized appreciation which is excludable under the regulations of (a) and (b) of this subdivision shall not be included in the basis of the securities in the hands of the distributee at the time of distribution for purposes of determining gain or loss on their subsequent disposition. In the case of a total distribution the amount of net unrealized appreciation which is not included in the basis of the securities in the hands of the distributee at the time of distribution shall be considered as a gain from the sale or exchange of a capital asset held for more than six months to the extent that such appreciation is realized in a subsequent taxable transaction. However, if the net gain realized by the distributee in a subsequent taxable transaction exceeds the amount of the net unrealized appreciation at the time of distribution, such excess shall constitute a long-term or short-term capital gain depending upon the holding period of the securities in the hands of the distributee.

(ii) For purposes of section 402(a) and of this section, the term "securities" means only shares of stock and bonds or debentures issued by a corporation with interest coupons or in registered form, and the term "securities of the employer corporation" includes securities of a parent or subsidiary corporation (as defined in subsections (e) and (f) of section 425) of the employer corporation.

(2) Determination of net unrealized appreciation.

(i) The amount of net unrealized appreciation in securities of the employer corporation which are distributed by the trust is the excess of the market value of such securities at the time of distribution over the cost or other basis of such securities to the trust. Thus, if a distribution consists in part of securities which have appreciated in value and in part of securities which have depreciated in value, the net unrealized appreciation shall be considered to consist of the net increase in value of all of the securities included in the distribution. For this purpose, two or more distributions made by a trust to a distributee in a single taxable year of the distributee shall be treated as a single distribution.

(ii) For the purpose of determining the net unrealized appreciation on a distributed security of the employer corporation, the cost or other basis of such security to the trust shall be computed in accordance with whichever of the following rules is applicable:

(A) If a security was earmarked for the account of a particular employee at the time it was purchased by or contributed to the trust so that the cost or

other basis of such security to the trust is reflected in the account of such employee, such cost or other basis shall be used.

(B) If as of the close of each taxable year of the trust (or other specified period of time not in excess of 12 consecutive calendar months) the trust allocates among the accounts of participating employees all securities acquired by the trust during the period (exclusive of securities unallocated under a plan providing for allocation in whole shares only), the cost or other basis to the trust of any securities allocated as of the close of a particular allocation period shall be the average cost or other basis to the trust of all securities of the same type which were purchased or otherwise acquired by the trust during such allocation period. For purposes of determining the average cost to the trust of securities included in a subsequent allocation, the actual cost to the trust of the securities unallocated as of the close of a prior allocation period shall be deemed to be the average cost or other basis to the trust of securities of the same type allocated as of the close of such prior allocation period.

(C) In a case where neither (a) nor (b) of this subdivision is applicable, if the trust fund, or a specified portion thereof, is invested exclusively in one particular type of security of the employer corporation, and if during the period the distributee participated in the plan none of such securities has been sold except for the purpose of paying benefits under the trust or for the purpose of enabling the trustee to obtain funds with which to exercise rights which have accrued to the trust, the cost or other basis to the trust of all securities distributed to such distributee shall be the total amount credited to the account of such distributee (or such portion thereof as was available for investment in such securities) reduced by the amount available for investment but uninvested on the date of distribution. If at the time of distribution to a particular distributee a portion of the amount credited to his account is forfeited, appropriate adjustment shall be made with respect thereto in determining the cost or other basis to the trust of the securities distributed.

(D)

(1) In all other cases, there shall be used the average cost (or other basis) to the trust of all securities of the employer corporation of the type distributed to the distributee which the trust has on hand at the time of the distribution, or which the trust had on hand on a specified inventory date which date does not precede the date of distribution by more than twelve calendar months. If a distribution includes securities of the employer corporation of more than one type, the average cost (or other basis) to the trust of each type of security distributed shall be determined. The average cost to the trust of securities of the employer corporation on hand on a specified inventory date (or on hand at the time of distribution) shall be computed on the basis of their actual cost, considering the securities most recently purchased to be those on hand, or by means of a moving average calculated by subtracting from the total

cost of securities on hand immediately preceding a particular sale or distribution an amount computed by multiplying the number of securities sold or distributed by the average cost of all securities on hand preceding such sale or distribution.

(2) These methods of computing average cost may be illustrated by the following examples:

Example (1). A, a distributee who makes his income tax returns on the basis of a calendar year, receives on August 1, 1954, in a total distribution, to which paragraph (a)(6) of this section is applicable, ten shares of class D stock of the employer corporation. On July 1, 1954 (the specified inventory date of the trust), the trust had on hand 80 shares of class D stock. The average cost of the 10 shares distributed, on the basis of the actual cost method, is \$100 computed as follows:

Shares	Purchase date	Cost per share	Total cost
20	June 24, 1954	\$101	\$2,020
40	Jan. 10, 1953	102	4,080
20	Oct. 20, 1952	95	1,900
80			8,000

Example (2). B, a distributee who makes his income tax returns on the basis of a calendar year, receives on October 31, 1954, in a total distribution, to which paragraph (a)(6) of this section is applicable, 20 shares of class E stock of the employer corporation. The specified inventory date of the trust is the last day of each calendar year. The trust had on hand on December 31, 1952, 1,000 shares of class E stock of the employer corporation. During the calendar year 1953 the trust distributed to four distributees a total of 100 shares of such stock and acquired, through a number of purchases, a total of 120 shares. The average cost of the 20 shares distributed to B, on the basis of the moving average method, is \$52 computed as follows:

Shares	Total cost	Average cost	
On hand Dec. 31, 1952	1,000	\$50,000	\$50
Distributed during 1953 at average cost of \$50	100	5,000	
900	45,000		
Purchased during 1953	120	8,040	
On hand Dec. 31, 1953	1,020	53,040	52

(3) Unrealized appreciation attributable to employee contributions. In any case in which it is necessary to determine the amount of net unrealized appreciation in securities of the employer corporation which is attributable to contributions made by an employee:

(i) The cost or other basis of the securities to the trust and the amount of net unrealized appreciation shall first be determined in

accordance with the regulations in subparagraph (2) of this paragraph;

(ii) The amount contributed by the employee to the purchase of the securities shall be solely the portion of his actual contributions to the trust properly allocable to such securities, and shall not include any part of the increment in the trust fund expended in the purchase of the securities;

(iii) The amount of net unrealized appreciation in the securities distributed which is attributable to the contributions of the employee shall be that proportion of the net unrealized appreciation determined under the regulations of subparagraph (2) of this paragraph which the contributions of the employee properly allocable to such securities bear to the cost or other basis to the trust of the securities;

(iv) If a distribution consists solely of securities of the employer corporation, the contributions of the employee expended in the purchase of such securities shall be allocated to the securities distributed in a manner consistent with the principles set forth in subparagraph (2)(ii)(a), (b), (c), or (d) of this paragraph, whichever is applicable. Thus, the amount of the employee's contribution which can be identified as having been expended in the purchase of a particular security shall be allocated to such security, and the amount of such contribution which cannot be so identified shall be allocated ratably among the securities distributed. If a distribution consists in part of securities of the employer corporation and in part of cash or other property, appropriate allocation of a portion of the employee's contribution to such cash or other property shall be made unless such allocation is inconsistent with the terms of the plan or trust.

(v) The application of this subparagraph may be illustrated by the following example:

Example. A trust distributes ten shares of stock issued by the employer corporation each of which has an average cost to the trust of \$100, consisting of employee contributions in the amount of \$60 and employer contributions in the amount of \$40, and on the date of distribution has a fair market value of \$180. The portion of the net unrealized appreciation attributable to the contributions of the employee with respect to each of the shares of stock is \$48 computed as follows:

(1) Value of one share of stock on distribution	\$180
(2) Employee contributions	60
(3) Employer contributions	40
(4) Total contributions	100
(5) Net unrealized appreciation	80

(6) Portion of net unrealized appreciation attributable to employee contributions 60/100 (amount of employee contributions (item 2) over total contributions (item 4) of \$80 (item 5)) 48

(vi) For the purpose of determining gain or loss to the distributee in the year or years in which any share of stock referred to in the example in subdivision (v) of this subparagraph is sold or otherwise disposed of in a taxable transaction, the basis of each such share in the hands of the distributee at the time of the distribution by the trust will be \$132 computed as follows:

(a) Employee contributions \$ 60

(b) Employer contributions (taxable as ordinary income in the year the securities were distributed) 40

(c) Portion of net unrealized appreciation attributable to employer contributions (item (5) minus item (6)) (taxable as ordinary income in the year the securities were distributed) 32

(d) Basis of stock 132

(4) Change in exempt status of trust. For principles applicable in making appropriate adjustments if the trust was not exempt for one or more years before the year of distribution, see paragraph (a) of this section.

(c) Certain distributions by United States to nonresident alien individuals.

(1) This paragraph applies to a distribution-

(i) Which is made by the United States under a pension plan described in section 401(a);

(ii) Which is made in respect of services performed by an employee of the United States; and

(iii) Which is received by, or made available to, a nonresident alien individual (including a nonresident alien individual who is a beneficiary of a deceased employee) during a taxable year beginning after December 31, 1959.

The amount of such a distribution that is includible in the gross income of the nonresident alien individual under section 402(a)(1) or (2) shall not exceed an amount which bears the same ratio to the amount which would be includible in gross income if it were not for this paragraph, as-

(a) The aggregate basic salary paid by the United States to the employee for his services in respect of which the distribution is being made, reduced by the amount of such basic salary which was not includible in the employee's gross income by reason of being from sources without the United States, bears to

(b) The aggregate basic salary paid by the United States to the employee for his services in respect of which the distribution is being made.

See section 402(a)(4). See, also, paragraph (a) of this section for rules relating to the amount that is includible in gross income under section 402(a) (1) or (2) in the case of a distribution under a pension plan described in section 401(a).

(2) For purposes of applying section 402(a)(4) and this paragraph to distributions under the Civil Service Retirement Act (5 U.S.C. 2251), the term "basic salary" shall have the meaning provided in section 1(d) of such Act. In applying section 402(a)(4) and this paragraph to distributions under any other qualified pension plan of the United States, such term shall have a similar meaning. Thus, for example, "basic salary" does not, in any case, include bonuses, allowances, or overtime pay.

(3) The rules in this paragraph may be illustrated by the following examples:

Example (1). A, a retired employee of the United States who performed all of his services for the United States in a foreign country, receives, in respect of such services, a monthly pension of \$200 under the Civil Service Retirement Act (a pension plan described in section 401(a)). A received an aggregate basic salary for his services for the United States of \$100,000. A was a nonresident alien individual during the whole of his employment with the United States and, therefore, his basic salary from the United States was not includible in his gross income by reason of being from sources without the United States. A would be required, under section 72 but without regard to section 402(a)(4) and this paragraph, to include \$60 of each monthly pension payment in his gross income. The amount that is includible in A's gross income under section 402(a)(1) with respect to the monthly payments received during taxable years beginning after December 31, 1959, and while A is a nonresident alien individual, is computed as follows:

- (i) Amount of distribution includible in gross income under section 72 without regard to section 402(a)(4) \$60
- (ii) Aggregate basic salary for services for United States 100,000
- (iii) Aggregate basic salary for services for United States reduced by amount of such salary not includible in A's gross income by reason of being from sources without the United States 0
- (iv) Amount includible in A's gross income under section 402(a)(1)(iii) \div (ii) \times (i), or \$0]
\$100,000 \times \$60 0

Example (2). B, a retired employee of the United States who performed services for the United States both in a foreign country and in the United States, receives, in respect of such services, a monthly pension of \$240 under the Civil Service Retirement Act. B received an aggregate basic salary for his services for the United States of \$120,000; \$80,000 of which was for his services performed in the United States, and \$40,000 of which was for his services performed in the foreign country. B was a nonresident alien individual during the whole of his employment with the United States and, consequently, the \$40,000 basic salary for his services performed in the foreign country was not includible in his gross income by reason of being from sources without the United States. B would be required, under section 72 but without regard to section 402(a)(4) and this paragraph, to include \$165 of each monthly pension in his gross income. The amount that is includible in B's gross income under section 402(a)(1) with respect to the monthly payments received during taxable years beginning after December 31, 1959, and while B is a nonresident alien individual, is computed as follows:

- (i) Amount of distribution includible in gross income under section 72 without regard to section 402(a)(4) \$165
- (ii) Aggregate basic salary for services for United States 120,000

(iii) Aggregate basic salary for services for United States reduced by amount of such salary not includible in B's gross income by reason of being from sources without the United States (\$120,000 – \$40,000) 80,000

(iv) Amount includible in B's gross income under section 402(a)(1)((iii) ÷ (ii) × (i), or \$80,000] \$120,000 × \$165) 110

(d) Salary reduction, cash or deferred arrangements.

(1) Inclusion in income. Whether a contribution to an exempt trust or plan described in section 401(a) or 403(a) is made by the employer or the employee is determined on the basis of the particular facts and circumstances of each case. Nevertheless, an amount contributed to a plan or trust will, except as otherwise provided under paragraph (d)(2) of this section, be treated as contributed by the employee if it was contributed at the employee's election, even though the election was made before the year in which the amount was earned by the employee or before the year in which the amount became currently available to the employee. Any amount treated as contributed by the employee is includible in the gross income of the employee for the year in which the amount would have been received by the employee but for the election. Thus, for example, amounts contributed to an exempt trust or plan by reason of a salary reduction agreement under a cash or deferred arrangement are treated as received by the employee when they would have been received by the employee but for the election to defer. Accordingly, they are includible in the gross income of the employee for that year (except as provided under paragraph (d)(2) of this section). See §1.401(k)-1(a)(3)(iv) and (2)(iv) for the meaning of currently available and cash or deferred arrangement, respectively.

(2) Amounts not included in income.

(i) Qualified cash or deferred arrangement. Elective contributions as defined in §1.401(k)-6 for a plan year made by an employer on behalf of an employee pursuant to a cash or deferred election under a qualified cash or deferred arrangement, as defined in §1.401(k)-1(a)(4)(i), are not treated as received by or distributed to the employee or as employee contributions. For plan years beginning after December 31, 1992, whether a cash or deferred election is made under a qualified cash or deferred arrangement is determined without regard to the special rules for certain collectively bargained plans contained in §1.401(k)-1(a)(5)(iv)(B). As a result, elective contributions under these plans are treated as employee contributions for purposes of this section if the cash or deferred arrangement does not satisfy the actual deferral percentage test of section 401(k)(3) or otherwise fails to be a qualified cash or deferred arrangement.

(ii) Matching contributions. Matching contributions described in §1.401(m)-1(a)(2) and section 401(m)(4) are not treated as contributed by an employee merely because they are made by the employer as a result of an employee's election.

(iii) Effect of certain one-time elections. Amounts contributed to an exempt plan or trust described in section 401(a) or 403(a) pursuant to the one-time irrevocable employee election to participate in a plan described in §1.401(k)-1(a)(3)(v) are not treated as contributed by an employee. Similarly, amounts contributed to an exempt plan or trust described in section 401(a) or 403(a) in which self-employed

individuals may participate pursuant to the one-time irrevocable election described in §1.401(k)-1(a)(3)(v)(B) are not treated as contributed by an employee.

(3) Effective date and transition rules.

(i) Effective date. In the case of a plan or trust that does not include a salary reduction or cash or deferred arrangement in existence on June 27, 1974, this paragraph applies to taxable years ending after that date.

(ii) Transition rule for cash or deferred arrangements in existence on June 27, 1974.

(A) General rule. In the case of a plan or trust that includes a salary reduction or a cash or deferred arrangement in existence on June 27, 1974, this paragraph applies to plan years beginning after December 31, 1979 (or, in the case of a pre-ERISA money purchase plan, as defined in §1.401(k)-6, plan years beginning after July 18, 1984). For plan years beginning prior to January 1, 1980 (or, in the case of a pre-ERISA money purchase plan, plan years beginning before July 19, 1984), the taxable year of inclusion in gross income of the employee of any amount so contributed by the employer to the trust is determined in a manner consistent with Rev. Rul. 56-497, 1956-2 CB 284, Rev. Rul. 63-180, 1963-2 CB 189, and Rev. Rul. 68-89, 1968-1 CB 402.

(B) Meaning of cash or deferred arrangement in existence on June 27, 1974. A cash or deferred arrangement is considered as in existence on June 27, 1974, if, on or before that date, it was reduced to writing and adopted by the employer (including, in the case of a corporate employer, formal approval by the employer's board of directors and, if required, shareholders), even though no amounts had been contributed pursuant to the terms of the arrangement as of that date.

(iii) Reasonable interpretation for plan years beginning after 1979 and before 1992. For plan years beginning after December 31, 1979 (or in the case of a pre-ERISA money purchase plan, plan years beginning after July 18, 1984) and before January 1, 1992, a reasonable interpretation of the rules set forth in section 401(k) (as in effect during those years) may be relied upon to determine whether contributions were made under a qualified cash or deferred arrangement.

(iv) Special rule for collectively bargained plans. For plan years beginning before January 1, 1993, a nonqualified cash or deferred arrangement will be treated as satisfying section 401(k)(3) solely for purposes of paragraph (d)(2)(i) of this section if it is part of a plan (or portion of a plan) that automatically satisfies section 401(a)(4) under §1.401-1(a)(5)(iv)(B), relating to certain collectively bargained plans.

(v) Special rule for governmental plans. For plan years beginning before the later of January 1, 1996, or 90 days after the opening of the first legislative session beginning on or after January 1, 1996, of the governing body with authority to amend the plan, if that body does not meet continuously, in the case of

governmental plans described in section 414(d), a nonqualified cash or deferred arrangement will be treated as satisfying section 401(k)(3) solely for purposes of paragraph (d)(2)(i) of this section if it is part of a plan adopted by a state or local government before May 6, 1986. For purposes of this paragraph (d)(3)(v), the term governing body with authority to amend the plan means the legislature, board, commission, council, or other governing body with authority to amend the plan.

(e) Medical, accident, etc. benefits paid from a qualified pension, annuity, profit-sharing, or stock bonus plan.

(1) Payment of premiums.

(i) General rule. Except as provided in paragraph (e)(1)(iii) of this section, a payment made from a qualified trust that is a premium for accident or health insurance (including a qualified long-term care insurance contract under section 7702B) constitutes a distribution under section 402(a) to the participant for whose benefit the premium is charged. The amount of the distribution equals the amount of the premium charged against the participant's benefits under the plan. If a defined contribution plan pays these premiums from a current year contribution or forfeiture that has not been allocated to a participant's account, then the amount of the premium for each participant is treated as first being allocated to the participant and then charged against the participant's benefits under the plan, so that the amount of the distribution is treated in the same manner as determined under the preceding sentence. Except as provided in paragraphs (e)(2) and (e)(3) of this section, a distribution described in this paragraph (e)(1) is not excludable from gross income.

(ii) Treatment of amounts received through accident or health insurance. To the extent that the payment of a premium for accident or health insurance constitutes a distribution under this paragraph (e)(1), amounts received through accident or health insurance are neither paid by the employer nor attributable to contributions by the employer that are excludable from the gross income of the employee. Accordingly, to the extent the premium for accident or health insurance constitutes a distribution under this paragraph (e)(1), amounts received through the accident or health insurance for personal injuries or sickness are excludable from gross income under section 104(a)(3) and are not treated as distributions from the plan. If those amounts are paid to the plan instead of to the employee, those amounts are treated as having been paid to the employee and then contributed by the employee to the plan (and must satisfy the qualification requirements applicable to employee contributions).

(iii) Exception for disability insurance that replaces retirement contributions. The rules of paragraph (e)(1)(i) of this section do not apply to the payment made from a qualified trust that is a premium paid to an insurance company for a contract providing for payment of benefits to be made to the trust in the event of an employee's inability to continue employment with the employer due to disability, provided that the payment of benefits with respect to the employee's account for each year does not exceed the reasonable expectation of the annual contributions that would have been made to the plan on the employee's behalf for the period of disability within that year, reduced by any other contributions made on the

employee's behalf for the period of disability within that year. The payment of premiums described in the preceding sentence is not treated as a distribution under section 402(a), but instead constitutes incidental accident or health insurance as provided in §1.401-1(b)(1)(ii). The Commissioner may issue rules of general applicability in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin further describing the tax treatment of disability coverage described in this paragraph (e)(1)(iii).

(2)Medical benefits for retired employees provided under an account described in section 401(h). The payment of medical benefits under a pension or annuity plan from an account described in section 401(h) is treated in the same manner as a payment of accident or health benefits attributable to employer contributions, or employer-provided coverage under an accident or health plan. See §1.401-14(a) for the definition of medical benefits described in section 401(h). Accordingly, amounts applied for the payment of accident or health benefits, or for the payment of accident or health coverage, from a section 401(h) account are not includible in the gross income of the participant on whose behalf such contributions are made to the extent they are excludible from gross income under section 104, 105, or 106.

(3)Distributions to eligible retired public safety officers. See section 402(l) (and any guidance issued under section 402(l)) for a limited exclusion from gross income for distributions used to pay for certain accident or health premiums (including premiums for qualified long-term care insurance contracts). This limited exclusion applies to eligible retired public safety officers, as defined in section 402(l)(4)(B).

(4)Effect of distribution of insurance premiums on plan qualification. See §1.401-1(b)(1) for rules concerning the types and amount of medical coverage and benefits that are permitted to be provided under a plan that is part of a trust described in section 401(a). For example, §1.401-1(b)(1)(ii) provides that a profit-sharing plan is primarily a plan of deferred compensation, but the amounts allocated to the account of a participant may be used to provide incidental accident or health insurance for the participant and the participant's family. See also section 401(k)(2)(B) for certain restrictions on the distribution of elective contributions.

(5)Applicability to beneficiaries and alternate payees. This paragraph (e) applies to the payment of premiums charged against the benefits of a beneficiary or an alternate payee in the same manner as the payment of premiums charged against the account of a participant.

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

Example (1).

(i) Facts. Employer A sponsors a profit-sharing plan qualified under section 401(a). The plan provides solely for non-elective employer profit-sharing contributions. The plan's trustee enters into a contract with a third-party insurance carrier to provide health insurance for certain plan participants. The insurance contract provides for the payment of medical expenses incurred by those participants. The plan limits the amounts used to provide medical benefits to comply with the incidental benefit rules. The trustee makes monthly payments of \$1,000 to pay the premiums due for Participant P's health insurance

and Participant P's account balance is reduced by \$1,000 at the time of each premium payment. In June 2015, Participant P is admitted to the hospital for covered medical care, and in July 2015, the health insurer pays the hospital \$5,000 for the medical care provided to Participant P in June.

(ii) Conclusion. Under paragraph (e)(1) of this section, each of the trustee's payments of \$1,000 constitutes a taxable distribution under section 402(a) to Participant P on the date of each payment. The amount of these distributions may constitute payments for medical care under section 213. The \$5,000 payment to the hospital is excludable from Participant P's gross income under section 104(a)(3) and is not treated as a distribution from the plan.

Example (2).

(i) Facts. Employer B sponsors a profit-sharing plan qualified under section 401(a). The plan provides for elective contributions described in section 401(k) and matching contributions as well as non-elective employer profit-sharing contributions. The plan does not provide that a disabled participant's compensation for purposes of determining plan contributions includes amounts that the participant would have received in the absence of the disability, and accordingly Employer B does not make any contributions to the plan for the benefit of a disabled employee for the period of disability. The plan's trustee enters into a contract with a third-party insurance carrier to provide disability insurance for plan participants who elect to be covered under the insurance contract. The insurance contract provides for the payment of an amount to the trustee on a participant's behalf during the period of the participant's disability. Amounts to be paid to the trustee from the insurance contract with respect to a participant are equal to the sum of the elective, matching, and non-elective employer profit-sharing contributions that would have been made on the participant's behalf during the participant's disability (based on the participant's rate of compensation before becoming disabled) with the payments to continue for the duration of the disability until age 65 (or 5 years after the participant became disabled, if later). Participant Q elects to be covered under the insurance contract, and the trustee makes the periodic premium payments out of the account balance of Participant Q. In June 2015, Participant Q becomes disabled. During the period Participant Q is absent from employment due to disability, the insurer pays the trust the amount of the elective, matching, and non-elective employer profit-sharing contributions that would have been made to the trust with respect to Participant Q had Participant Q not been disabled. The amount of the premiums for the insurance contract satisfies the limitations on incidental benefits under §1.401-1(b)(1)(ii).

(ii) Conclusion. The payment of premiums from the trust is described in paragraph (e)(1)(iii) of this section. Accordingly, none of the premium payments under the contract constitute a distribution under section 402(a) to Participant Q. Further, amounts paid from the insurance contract to the trust also do not constitute a distribution to Participant Q. However, when Participant Q's account balance is distributed from the trust, the distribution will be subject to taxation in the year of distribution in accordance with the rules in section 402.

(7)Effective/applicability date. This paragraph (e) applies for taxable years beginning on or after January 1, 2015.