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ONE OF THE PRIMARY REASONS for the steady growth in the number of qualified deferred compensation plans described in Section 401(a) of the Internal Revenue Code of 1954[1] is their usefulness as tax planning devices. An important tax consideration in adopting such a plan is that the taxation of plan benefits to employee-participants or their beneficiaries, provided by current employer contributions, will be deferred to some future time.[2] The considerations applicable to the tax treatment of plan benefits can be incorporated in the plan when it is initially adopted or later by amendments.[3] Because of the rapid changes that occur in the income tax law this article will cover general tax considerations applicable to such benefits that exist presently. Consideration will be given the taxation of usual plan benefits, but of necessity the article will not be all-inclusive nor will it cover all possible tax consequences.

Reference to a "qualified plan" means (1) a plan which meets the requirements of Section 401(a) and its corresponding trust which is exempt under Section 501(a), or (2) a non-trusteed annuity plan meeting the requirements of Section 401 (a)(3), (4), (5) and (6) and which is adopted by a private employer. This article will deal with benefits received under a plan which qualified at its inception and has remained qualified throughout its entire existence. This article will not deal with benefits received under (1) a plan which at any time did not meet the definition of a qualified plan or (2) a method of compensation having the effect of a plan deferring compensation (described in Section 404(b)).[4]

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(Note: This article should not be taken to represent the official views or policies of the Internal Revenue Service. Unless otherwise indicated, section references are to sections of the I. R. C. 1954.)

1 A study showing the increase in the number of qualified plans over the years is shown in P-H Pension & Profit-Sharing Serv. ¶ 1012.

2 Treas. Regs. 1.402(a)-1(a)(2) and 1.403(a)-1(b), (1956).

3 The procedure to be followed when amending a plan or related trust is described in Rev. Proc. 56-12, 1956-1 Cum. Bull. 1029.

4 These exceptions are made because it is felt that anyone doing tax planning will not employ either of these arrangements.

A qualified plan must be a stock bonus, pension, or profit-sharing plan.[5] Each of these is a plan established and maintained by an employer for employee-participants or their beneficiaries with the following purposes:

(1) Pension plan—to provide definitely determinable benefits over a period of years, usually for life, after retirement. Such benefits are not dependent upon the employer's profits. A pension plan may provide for payment of a pension due to disability, and may also provide for the payment of incidental death benefits through insurance or otherwise.[6]

(2) Profit-sharing plan—to provide for participation in the employer's profits. The plan must provide for the distribution of funds after a fixed number of years, the attainment of a stated age, or upon the happening of some specified prior event, such as, layoff, illness, disability, retirement, death, or severance of employment.[7]

(3) Stock bonus plan—to provide benefits similar to those of a profit-sharing plan, except that contributions are not necessarily dependent upon profits and benefits are distributable in the stock of the employer company.[8]

The benefits provided by these plans can be generally classified as follows:

(1) Retirement benefits which include benefits distributed upon attainment of a stated age, after a fixed number of years, or upon severance of employment,

(2) Life insurance,

(3) Death benefits,[9]

(4) Disability benefits,

(5) Hardship benefits which can only be provided in profit-sharing or stock bonus plans but not in pension plans.[10]

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[5] Sec. 401(a).

[6] Treas. Reg. 1.401-1(b) (1) (i), (1958), as amended T. D. 6301, 1958-2 Cum. Bull. 197.

[7] Treas. Reg. 1.401-1(b) (1) (ii), (1958), as amended T. D. 6301, 1958-2 Cum. Bull. 197.

[8] Treas. Reg. 1.401-1(b) (1) (iii), (1958), as amended T. D. 6301, 1958-2 Cum. Bull. 197.

[9] Described in Sec. 101(b).

[10] Rev. Rul. 57-163, Part 5(k), 1957-1 Cum. Bull. 128, at 152

Such benefits include layoff, other financial hardships, and accident and health benefits.

Plan benefits can be financed by the employer alone or through employer and employee contributions. Employee contributions may be mandatory[11] or voluntary[12] or both. The rules governing the taxation of plan benefits will vary to some extent depending upon whether or not employee contributions are involved as will be demonstrated within this article.

Benefits Distributed or Made Available

The question of when a taxable event has occurred is of fundamental importance. Income under a qualified plan attaches only at the time benefits are distributed or made available to the employee or his beneficiary.[13] In determining if a taxable event has occurred there is little difficulty where an actual distribution has been made. Whether or not a distribution has been "made available" is another problem. A participant's interest is made available to him when it is unconditionally credited to or set apart for him and made subject to his withdrawal or other disposition. Conditions upon such withdrawal or disposition which are without substance or inconsequential will not prevent the interest from being made available.[14] What constitutes substance and what is consequential depends upon the facts of a particular case.[15]

The following have been considered as having substance or being consequential therefore not making an interest available: Where a withdrawal by the participant would require discontinuance of participation in the plan,[16] or a forfeiture of a portion of the distributable interest;[17] an irrevocable election by the employee before his interest becomes distributable to have such interest deferred to some fixed or determinable time,[18] and

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[11] Rev. Rul. 57-163, Part 4(g), 1957-1 Cum. Bull. 128, at 141.

[12] Rev. Rul. 59-185, 1959-1 Cum. Bull. 86.

[13] Sec. 402(a)(1); Treas. Reg. 1.403(a)-1(b), (1956). It should be noted, however, that Sec. 403(a)(1) does not refer to amounts "made available" but only to amounts "received."

[14] Rev. Rul. 55-423, 1955-1 Cum. Bull. 41.

[15] *Ibid.*

[16] Dillis C. Knapp, 41 B. T. A. 23; A. M. Berry, 44 B. T. A. 1254.

[17] Rev. Rul. 55-423, 1955-1 Cum. Bull. 41.

[18] Rev. Rul. 55-425, 1955-1 Cum. Bull. 43; Rev. Rul. 57-260, 1957-1 Cum. Bull. 165.

it is immaterial that such election be evidenced by action or inaction on the part of the employee;[19] and in a profit sharing plan where distribution, after proof of financial hardship, is conditioned upon approval of an administrative committee.[20] But an election to take an annuity contract instead of a lump sum payment does not result in tax upon the lump sum that could have been taken.[21]

An employee's interest in a profit-sharing plan, however, is made available and therefore taxable to him on the earliest date upon which he could elect to receive a cash lump sum distribution. The fact that written application was not made to receive such benefits is considered a condition without substance.[22] It may be questioned if a condition of substance exists in a plan that requires the trustee to determine whether a lump sum or periodic distribution will be made where there exists a tacit agreement that the trustee will honor the employee's wishes and this policy is consistently followed in most distributions.

When a plan provides for suspension of participation upon a withdrawal of funds, the difference between the maximum permitted to be withdrawn and the amount actually withdrawn will be considered to have been made available to the participant.[23]

The order of approaching the taxation of particular plan benefits will be; first, distributions in general; second, miscellaneous matters; third, accident and health benefits; and fourth, life insurance.

Distributions In General

Generally, no income from a qualified plan attaches to an employee until the employer's contribution has been distributed or made available to the employee. Benefits other than life insurance or accident and health benefits become payable upon the happening of one or more of the following events: attainment of a specified age, after a fixed number of years, upon severance of employment, or upon the happening of some defined hardship (other than disability or sickness). The two considerations necessary in order to determine the tax impact of plan

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19 Rev. Rul. 55-423, 1955-1 Cum. Bull. 41.

20 Rev. Rul. 55-424, 1955-1 Cum. Bull. 42.

21 Rev. Rul. 59-94, 1959-1 Cum. Bull. 25.

22 Rev. Rul. 54-265, 1954-2 Cum. Bull. 239.

23 Rev. Rul. 58-230, 1958-1 Cum. Bull. 204.

distributions on the employee are (1) the amount of the distribution and (2) the proper tax treatment to be accorded the distribution.

In determining the amount of a distribution there is no particular problem where cash is involved. The general rule where property other than cash is distributed is that the fair market value of such property is the amount of the taxable distribution. The fair market value becomes the employee's basis for the property.[24]

The distribution of an annuity contract is the first exception to the general rule. The distribution of an annuity contract does not give rise to taxable income until the contract is cashed, even though the contract may have a cash value at the time of distribution,[25] or until payments are received from the issuer.[26]

If the employee receives a retirement income, endowment, or other life insurance contract, the entire cash value of such contract at the time of distribution is includable in the employee's gross income.[27] The employee can escape this taxable event completely or partially if, within 60 days after the distribution of such contract all or any portion of such value is irrevocably controverted to a contract under which no part of any proceeds payable upon death would be excludable as life insurance proceeds.[28] This is the second exception to the general rule.

The third exception to the fair market value rule deals with unrealized appreciation in the value of the stock of the employer which is distributed to the employee.[29] If the employee is entitled to long-term capital gain treatment on the distribution, no part of the unrealized appreciation is taken into account at the time of distribution.[30] Where the employer's stock is not received

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24 Treas. Reg. 1.402(a)-1(a)(1)(iii), (1956).

25 Treas. Reg. 1.402(a)-1(a)(2), (1956).

26 Sec. 72(a).

27 Treas. Reg. 1.402(a)-1(a)(2), (1956). This rule should probably be modified in the following respects: (1) If the contract provided only life insurance protection which was paid for from employee contributions or paid by employer contributions which were fully includable in the employee's gross income then none of the cash value would be taxable to the employee. (2) The cash value of the other contracts would be reduced by the cost to the employee or the premium cost taxable to the employee in the current and prior years.

28 Treas. Reg. 1.402(a)-1(a)(2), (1956).

29 Unrealized appreciation is the difference between the cost or other basis of the employer's stock to the exempt trust and its fair market value at the time of distribution. Treas. Reg. 1.402(a)-1(b)(2)(i), (1956).

30 Sec. 402(a)(2).

as part of a long-term capital gain distribution only the portion of unrealized appreciation attributable to employee contributions under the plan is excludable.[31] The basis of the employee's stock does not include unrealized appreciation.[32]

The general income tax treatment to be accorded distributions from a qualified plan are set out in the main in Sections 402(a)(1) and 403(a)(1) which provide that the amount received by the employee or his beneficiary shall be taxable, in the year distributed or made available, as an annuity[33] except that the ratable three year inclusion provision of Section 72(e)(3) cannot be applied to lump sum distributions. Long-term capital gain treatment which may be applicable to certain lump sum distributions will be dealt with later.

If long-term capital gain treatment doesn't apply and the employee has made no contributions under the plan, nor was he deemed to have made any contributions,[34] the plan distributions are ordinary income.[35]

Provided long-term capital gain treatment doesn't apply and the employee has made contributions under the plan, or was deemed to have made contributions, the provisions of Section 72 dealing with the annuity starting date,[36] investment in contract,[37] adjustment for refund feature,[38] expected return,[39] joint and survivor annuities,[40] amounts received as annuities,[41] amounts not received as annuities,[42] the exclusion ratio, and the three year recovery of cost rule[43] become matters of concern to the employee. The very general rules applicable are these:

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31 Treas. Reg. 1.402(a)-1(b)(1)(i)(b), (1956).

32 Treas. Reg. 1.402(a)-1(b)(1)(i), (1956).

33 Sec. 72 deals with the taxation of annuities.

34 Examples of contributions deemed made by an employee are (1) where the employee was required to include the employer's contribution in income, Sec. 72(f)(1), and (2) the death benefit exclusion, Sec. 101(b)(2)(d).

35 Secs. 61(a)(9), (10), & (11); Sec. 72(a).

36 Sec. 72(c)(4).

37 Sec. 72(c)(1).

38 Sec. 72(c)(2).

39 Sec. 72(c)(3).

40 Sec. 72(c)(3)(A).

41 Sec. 72(e).

42 Sec. 72(e).

43 Sec. 72(d).

(1) If the employee will recover his cost in three years or less none of the amounts received are taxed until the entire cost is recovered.

(2) If the employee will not recover his cost within three years a portion of each payment is excluded from income and a portion is included. The exclusion ratio is the per cent obtained by dividing the employee's cost by the expected return. This percentage is applied to the amount received in order to determine the amount excludable. The difference between the total received and the amount excluded is included as ordinary income.

More specific provisions applicable to these computations will not be further elaborated upon because they are beyond the scope of this article.

One of the most important tax relief provisions applicable to distributions from a qualified plan from the standpoint of the employee is that long-term capital gain treatment may be available in the case of certain total distributions to employees. In order to receive long-term capital gain treatment three conditions must be present, viz., (1) the plan must be qualified when the distribution is made, (2) a total distribution must be made within one taxable year of the distributee, and (3) the distribution must be on account of the employee's death, or other separation from service, or on account of the employee's death after separation from service.[44] It must be noted that mere termination of the qualified plan is not sufficient to warrant long-term capital gain treatment for total distributions.[45] The form of the distribution, however, is not important, e.g., an annuity contract which is distributed and subsequently surrendered will qualify for the long-term capital gain treatment provided the three conditions are met.[46]

The question of whether a separation from service has occurred is one of interpretation in many cases and probably causes the most difficulty in determining if long-term capital gain provisions apply. This is especially true when the plan itself has been terminated.

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[44] Secs. 402(a)(2) & 403(a)(2).

[45] Edward J. Glinske, 17 T. C. 562; Clarence F. Buckley, 29 T. C. 455.

[46] Rev. Rul. 55-298, 1955-1 Cum. Bull. 394.

The following circumstances were considered as separations from service: A complete liquidation of a corporation in a reorganization even though the employees continue to work for the successor organization provided there is a substantial change in the make up of the employees of the successor;[47] a sale of assets, liquidation, and the business carried on by a successor corporation with the same employees provided there has been a real rather than technical change in the ownership of the business;[48] and where a corporation has liquidated and the assets are transferred to a successor partnership even though former shareholder-employees became partners.[49]

The following were not considered separations from service: Where the employee continued to render services and receive compensation for two years after the total distribution;[50] where the parent corporation disposed of some of a subsidiary's stock and the employee, who was no longer eligible to participate in the plan, received a total distribution but continued to work for the subsidiary;[51] nor, where there is a mere change in the employer's business activity and the employee rendered services without compensation after the change.[52] Long-term capital gain treatment was also not available where there was a lump sum payment under a group annuity after some payments had been received in prior years.[53]

Miscellaneous Matters

With the exception of certain lump sum distributions under qualified plans the death benefit exclusion provisions of Section 101(b) are applicable to but not peculiar to distributions received from qualified plans.[54]

The general rule is that amounts up to $5,000.00 which are paid to the beneficiaries or the estate of an employee by or on

[47] Rev. Rul. 58-94, 1958-1 Cum. Bull. 194; Rev. Rul. 58-383, 1958-2 Cum. Bull. 149; Lester B. Martin, 26 T. C. 100, Acq. 1958-2 Cum. Bull. 6.

[48] Rev. Rul. 58-95, 1958-1 Cum. Bull. 197; Rev. Rul. 58-96, 1958-1 Cum. Bull. 200; Rev. Rul. 58-97, 1958-1 Cum. Bull. 201.

[49] Rev. Rul. 58-98, 1958-1 Cum. Bull. 202.

[50] Estate of Frank B. Fry, 205 F. 2d 517 affirming 19 T. C. 461; Rev. Rul. 56-214, 1956-1 Cum. Bull. 196.

[51] McGowan v. United States, 175 F. Supp. 364; Rev. Rul. 58-99, 1958-1 Cum. Bull. 202.

[52] Rev. Rul. 57-115, 1957-1 Cum. Bull. 160.

[53] Treas. Reg. 1.403(a)-2(b)(3), (1956).

[54] These benefits are to be distinguished from life insurance proceeds. Treas. Reg. 1.101-2(b), (1957).

behalf of an employer shall be excluded from the gross income of the recipient.[55] Generally, the exclusion does not apply to amounts which the deceased employee possessed immediately before death, a non-forfeitable right to receive while living,[56] nor does it apply to amounts received as an annuity under a joint and survivor annuity obligation when the employee was the primary annuitant and the annuity starting date occurred before the death of the employee.[57]

If, however, a total distribution is payable from a qualified plan because of the death of the employee, either before or after retirement, within one taxable year of the distributee, the death benefit exclusion (limited to $5,000.00) is available to the distributee regardless of the employee's vested interest.[58] The amount included in the recipient's income is subject to long-term capital gain treatment.[59]

Subject to the statutory maximum the death benefit exclusion becomes part of the consideration paid by the employee for the purposes of Section 72.[60]

The retirement income credit is a tax relief provision which is applicable to other types of income[61] as well as pensions and annuities provided the conditions set out in Section 37 are met.

This credit is a dollar for dollar offset against the income tax limited to a maximum of $240.00 for each individual [62] and is applicable to a maximum of $1,200.00 of retirement income.[63] Retirement income can include private pensions and annuities for persons over age 65 at the close of their taxable year.[64] Earned income, which is offset against retirement income in the case of persons under age 72 for the purpose of determining the base upon which the credit is computed, does not include any amount received as a pension or annuity,[65] or a pension or an-

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55 Treas. Reg. 1.101-2(a)(1), (1957).

56 Treas. Reg. 1.101-2(a)(2), (1957).

57 *Ibid.*

58 Sec. 101(b)(2)(B).

59 Treas. Reg. 1.402(a)-1(a)(4)(ii)(c) & (d), (1956).

60 Sec. 101 (b) (2) (D).

61 Sec. 37(c)(1)(B) interest; Sec. 37(c)(1)(C) rents; Sec. 37(c)(1)(D) dividends.

62 Sec. 37(a) & (d).

63 Sec. 37(d).

64 Sec. 37(c)(1)(A).

65 Sec. 37(g).

nuity excluded from income under sections 72 (relating to annuities), 101 (relating to life insurance proceeds), 104 (relating to compensation for injuries or sickness), 105 (relating to amounts received under accident or health plans), or 402 and 403.[66] However, a pension received as a gift from one for whom no services have been performed will be used to reduce retirement income.[67] Pensions and annuities excluded from income under Section 105 are not used to reduce retirement income but other amounts received under wage continuation plans, whether excludable under Section 105 or not, constitute earned income and should be taken into consideration for the purposes of the limitation on retirement income.[68]

Since this credit is computed separately for husband and wife on a joint return[69] the credit can be maximized by transferring other retirement income to the spouse who is not receiving a pension. In community property states, however, if the pension constitutes community income then it is divided between the two spouses.[70]

There is also a major tax relief provision for estate tax purposes applicable to distributions from a qualified plan. The relief provision can be summarized as follows: The value of the annuity or other payment receivable by a beneficiary other than the employee's executor or estate will pass tax free if the qualified plan was non-contributory. In a contributory plan only the proceeds attributable to the employees contribution will be subject to estate tax.[71] These provisions do not apply to insurance under policies on the life of the decedent.[72]

For gift tax purposes the value of an annuity or other payment under a qualified plan that becomes payable to a beneficiary after the employee's death will not be subject to gift tax if the plan was non-contributory.[73] In a contributory plan the value attributable to employee contributions will be subject to gift tax.[74]

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[66] Sec. 37(e).

[67] Sec. 37(d)(1)(C); Rev. Rul. 56-12, 1956-1 Cum. Bull. 52.

[68] Rev. Rul. 57-101, 1957-1 Cum. Bull. 13.

[69] Treas. Reg. 1.37-1(d)(1)(i), (1956).

[70] Rev. Rul. 55-598, 1955-2 Cum. Bull. 15.

[71] Sec. 2039(c).

[72] Treas. Reg. 20.2039-1(d), (1958).

[73] Sec. 2517(a).

[74] Sec. 2517(b).

Accident and Health Benefits

Accident and health benefits are an exception to the rule that benefits from a qualified plan will be taxed as an annuity.[75] In general, an accident or health benefit is the payment of an amount to an employee in the event of a personal injury or sickness[76] and the tax treatment of amounts received as an accident or health benefit is determined by Sections 104 and 105.[77] Employer contributions to accident and health plans are not includable in the employee's gross income.[78]

The terms "disability" in any type of plan and "hardship" if used in a profit-sharing or stock bonus plan will probably be defined in such a way as to have benefits payable in the event of disability or certain hardship cases qualify as accident or health benefits.[79]

Section 104(a) (3) contains the rule governing the tax status of accident and health benefits provided by employee contributions and Section 105 deals with accident and health benefits attributable to contributions made by the employer. It becomes necessary to determine whether the accident or health benefits were provided by employer or employee because the tax treatment accorded these benefits differs depending upon whether Section 104(a) (3) or 105 applies. Accident and health benefits are provided by employee contributions if the plan expressly specifies that employee contributions will be used to provide such benefits in whole or in part and the portion to be so used.[80] If the plan does not make such an express provision it is presumed such benefits are provided by employer contributions or the earnings thereon.[81]

Amounts received through accident and health insurance for personal injuries or sickness, if provided by employee contributions, are wholly excludable from the employee's gross income.[82] The exception to this rule is that amounts received as accident and health insurance attributable to a deduction al-

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75 Treas. Reg. 1.72-15(b), (1960).

76 Treas. Reg. 1.105-5, (1956).

77 Treas. Reg. 1.72-15(b), (1960).

78 Sec. 106.

79 Rev. Rul. 57-163, Part 5(k), 1957-1 Cum. Bull. 128, at 152 leaves the definition of these terms to the person drafting the plan.

80 Treas. Reg. 1.72-15(c) (2), (1960).

81 *Ibid.*

82 Sec. 104(a) (3).

lowed for medical expenses (under Section 213) for any prior taxable year must be included in gross income.[83] Of course the medical expense deduction claimed in a current taxable year must be reduced by the amount compensated for by insurance in the current year.[84] Such accident and health benefits are excludable from income even if received after retirement.[85] Employee contributions used to provide accident and health insurance are not included for the purposes of section 72 (dealing with the tax treatment of annuities) in determining aggregate premiums or consideration paid,[86] the annuity starting date[87] or the investment in the contract.[88] Under a profit-sharing plan providing for distributions from the participant's account because of injury or sickness, an adjustment to the employee's contributions is required only for amounts actually distributed from his account in computing the exclusion ratio under Section 72.[89]

If accident and health benefits are provided by employer contributions they may be excludable from gross income up to the rate of $100.00 per week provided the conditions set out in Section 105(d) are met[90] or wholly excludable if Section 105(c) is applicable.[91] The amount so excluded is not used to reduce medical expenses claimed as a deduction.[92] Benefits which are not excludable under Section 105 must be included in the employee's gross income[93] and such amounts are not taxed as annuities.[94] The exclusion provisions of Section 105(d) apply only to amounts attributable to periods during which the employee would be at work were it not for the personal injury or sickness. Thus an employee is not absent from work if he is not expected

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83 Sec. 104(a); Treas. Reg. 1.213-1(g)(4), examples (1) and (2), (1957) as amended, T. D. 6451, 1960-1 Cum. Bull. 132.

84 Sec. 213(a); Treas. Reg. 1.213-1(a)(3), (1957) as amended, T. D. 6451, 1960-1 Cum. Bull. 132.

85 Treas. Reg. 1.72-15(c)(1), (1960).

86 Treas. Reg. 1.72-15(c)(3), (1960).

87 Treas. Reg. 1.72-15(e), (1960).

88 *Ibid.*

89 Treas. Reg. 1.72-15(c)(3), (1960).

90 As a part of a wage continuation plan.

91 Permanent loss of a member or function of the body or permanent disfigurement where the benefit received is computed without regard to the nature of the injury or period of absence.

92 Treas. Reg. 1.213-1(a)(3)(ii), (1957) as amended T. D. 6451, 1960-1 Cum. Bull. 132.

93 Treas. Reg. 1.72-15(d), (1960).

94 *Ibid.*

to work because, for example, he has reached retirement age. After the employee reaches retirement age any disability pension becomes taxable as any other pension would be taxed.[95]

Life Insurance

The taxation of life insurance premiums and proceeds is treated somewhat differently from other plan benefits.

The premium cost of life insurance protection is not taxable to an employee-participant at all if (1) the exempt trust has a right under any circumstances to retain any part of the proceeds of the life insurance contract,[96] or (2) if such premiums are paid from employee contributions.[97]

The premium cost of life insurance protection paid from employer's contributions or the earnings of the exempt trust, however, is considered an actual distribution to the insured employee. The employee will include the cost of such protection in gross income in the year of the expenditure for life insurance. This rule applies if the life insurance proceeds are payable to a beneficiary of the employee or to the exempt trust which by the terms of the plan is required to pay over all proceeds to a beneficiary of the employee.[98]

The same rules apply to life insurance protection provided under a group permanent[99] or a group term policy.[100]

It now becomes necessary to define the term "life insurance contract" and to compute the cost of life insurance protection in order to determine the amount to be included currently in the gross income of the employee.

For the purposes of Sections 402 and 403 an annuity contract is one which provides payments in periodic installments to the named annuitant. Death benefits cannot exceed the larger of the reserve (cash value) or the total premiums paid. There is no pure insurance protection at any time.[101]

As opposed to an annuity contract any other type of contract which involves life contingencies is a life insurance contract.

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[95] Treas. Reg. 1.105-4(a)(3)(i), (1956) as amended, T. D. 6169, 1956-1 Cum. Bull. 63.

[96] Treas. Regs. 1.402(a)-1(a)(3)(ii), (1956), & 1.403(a)-1(d), (1956).

[97] Treas. Regs. 1.402(a)-1(a)(3)(i), (1956), & 1.403(a)-1(d), (1956).

[98] Treas. Reg. 1.402(a)-1(a)(3)(i), (1956).

[99] Treas. Reg. 1.403(a)-1(d), (1956).

[100] Rev. Rul. 54-52, 1954-1 Cum. Bull. 150, at 151.

[101] Rev. Rul. 55-639, 1955-2 Cum. Bull. 230.

This includes any type of contract which provides pure insurance protection, i.e., a death benefit which at any time may exceed the larger of the reserve or aggregate premiums paid, such as, a retirement income contract, an endowment contract, or a regular life insurance contract. The fact that such a contract provides for the application or conversion of its reserve, cash surrender value, or maturity value to provide annuity benefits does not make such a contract an annuity contract until such conversion actually takes place. A contract is never an annuity and a life insurance contract at the same time. Any contract providing pure insurance protection will be considered a life insurance contract regardless of the name given to the contract.[102]

A life insurance contract as defined may include features other than life insurance protection. The cost of the life insurance protection is computed as follows:

(1) Determine the death benefit payable at the end of the contract year,

(2) deduct from this death benefit the cash value of the contract at the end of the contract year.

(3) The difference is the amount of life insurance protection. In the absence of actual cost figures, the cost of this protection is determined by applying the table of uniform one year term premiums set out in Revenue Ruling 55-747, 1955-2 Cum. Bull. 228.[103]

The tax treatment of the life insurance proceeds depends upon which of the following circumstances existed: (1) The employee did not pay the total cost of the insurance nor was he taxable with the cost of the insurance. If these circumstances existed then the entire proceeds are taxable to the employee's beneficiaries under Section 402(a) as an annuity or as a long-term capital gain. The death benefit exclusion of up to $5,000.00 provided in Section 101(b) also may be allowable.[104] The amount taxable to the beneficiaries (other than the executor) is excludable from the employee's gross estate (therefore not subject to estate tax) to the extent it was provided by the employer's contributions.[105] (2) The employee paid the cost of the insur-

102 Rev. Rul. 57-191, 1957-1 Cum. Bull. 163.

103 Treas. Reg. 1.402(a)-1(a)(3)(ii), (1956).

104 Treas. Reg. 1.402(a)-1(a)(4)(iv), (1956).

105 Sec. 2039(c).

ance or was taxable with the cost of the insurance. If these circumstances existed the reserve (cash value) of the contract intended to fund deferred benefits is taxable under Section 402(a) as an annuity or as a long-term capital gain. The death benefit exclusion of up to $5,000.00 provided in Section 101(b) also may be allowable. The excess of the proceeds over the reserve is excludable from the beneficiaries income under Section 101(a).[106] The amount taxable as an annuity to the beneficiaries (other than the executor) is excludable from the employee's gross estate (therefore not subject to estate tax) to the extent it was provided by the employer's contributions.[107] The life insurance proceeds are excludable from the employee's gross estate unless the proceeds are payable to the employee's executor[108] or unless the employee had "incidents of ownership" in the policy.[109]

Conclusion

The adoption of a qualified plan involves many considerations, such as, labor law, corporate finance, and employee relations as well as tax planning. The tax planning considerations exist at the level of the employer and the exempt trust as well as at the employee level. However, since this paper deals with the tax treatment accorded plan benefits at the employee level it is believed that certain general conclusions can be drawn dealing with tax planning that will be of value to the employee-distributee and possibly of incidental value to the employer.

Regarding general plan benefits it seems that the planner should strive for a plan which (1) provides for the maximum number of methods of distribution, (2) provides for long-term capital gain treatment wherever possible, and (3) encourages employee contributions. A plan with a variety of methods of distribution will allow the most suitable method of distribution, taxwise, to be used for a particular employee. Care should be used to avoid having the entire distribution made available and subject to tax regardless of the best interests of the employee. The tax saving which results from long-term capital gain treatment is self explanatory. Employee contributions provide a

[106] Treas. Reg. 1.402(a)-1(a)(4)(ii)(b), (1956).
[107] Sec. 2039(c).
[108] Sec. 2042(1).
[109] Sec. 2042(2).

means of currently tax free investment[110] and possible long-term capital gain treatment on the ultimate distributions. But it is questionable whether employee funds should be invested in accident and health insurance or life insurance.

The tax treatment to the distributee of accident and health benefits provided by a qualified plan through insurance or otherwise differs in no way from accident and health benefits provided by means other than a qualified plan. If such benefits are provided by the employer through insurance without the use of a qualified plan the employee does not have a tax reckoning event until an actual distribution has occurred. The employer is entitled to deduct the premium cost of insurance currently.[111] If such benefits are provided by means other than insurance and not through a qualified plan, distributions are deductible when made subject only to the ordinary and necessary limitations of Section 162.[112] The two disadvantages of providing non-insured accident and health benefits through a qualified plan are that funds contributed to the plan are not readily available for current use by the employer[113] and such benefits must be provided in a non-discriminatory manner[114] which does not permit the flexibility of expanded or contracted coverage that a Section 162 deduction allows. The principal advantage of using the qualified plan to provide accident and health benefits is that the employers funds which are not expended for insurance can be invested tax free. There is absolutely no tax advantage if employee contributions are used to purchase accident and health insurance. Such funds can be invested tax free if not used to purchase accident and health insurance but this feature applies to employee contributions in any event.

The tax treatment accorded premiums and proceeds of life insurance contracts purchased for the benefit of the employee or his beneficiaries, when provided for under a qualified plan, make the desirability of having such provisions in a plan questionable.

If employer contributions or trust earnings are used to purchase life insurance for the employee's benefit, either the em-

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110 The earnings of a Sec. 401 trust are exempt from taxation. Sec. 501(a).

111 Treas. Reg. 1.162-10(a), (1958).

112 *Ibid.*

113 The funds of the exempt trust must be used for the exclusive benefit of employees or their beneficiaries. Sec. 401(a)(2). The employer, however, can borrow from the trust or trust funds can be invested in the employer's stock subject to limitations. Treas. Reg. 1.401-1(b)(5)(i) & (ii), (1956).

114 Rev. Rul. 57-163, Part 5(a), 1957-1 Cum. Bull. 128, at 145.

ployee will realize fully taxable income when the premiums are paid (a result that could occur even if the benefit were not provided by a qualified plan[115]) or if premiums are not taxable to the employee, his beneficiary will receive fully taxable income after the employee's death (thus, in effect converting non-taxable income into taxable income). Insurance premiums which are taxable to the employee are deductible by the employer subject to the ordinary and necessary test if not provided for from a qualified plan.[116] In the case of group term insurance which is not provided under a qualified plan the employer is entitled to a current deduction for premium cost and the employee does not realize taxable income at all.[117] If the premium cost of life insurance is taxable to the employee under a qualified plan, the contributions for such purpose and the benefits must be non-discriminatory[118] which again does not allow the flexibility of increased and decreased coverage which a Section 162 expense allows.

The use of life insurance as a trust investment or as a means of funding planned benefits may or may not be desirable but these matters are not under consideration here.

Since plans should be tailored to fit into the overall plan of economic benefits to be provided by the employer it is felt that the factors mentioned may be of importance when considering the use of a qualified plan.

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115 Mim. 6477, 1950-1 Cum. Bull. 16; Frank D. Yuengling, 27 B. T. A. 782, Aff'd. 69 F. 2d 971.

116 Treas. Reg. 1.264-1(b), (1957).

117 Rev. Rul. 55-317, 1955-2 Cum. Bull. 13; Treas. Reg. 1.61-2(d) (2), (1957).

118 Rev. Rul. 57-163, Part 5(a), 1957-1 Cum. Bull. 128, at 145.