

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 and a calendar-year basis taxpayer, 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 1973, for which year, without regard to the distribution, he had a net operating loss and 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 \$25,750. 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 \$25,750, B's taxable income for 1973 is treated, under subparagraph (1)(ii) of this paragraph, as being 20 percent of \$25,000 (\$25,750 minus \$750, the amount of the deduction allowed for each personal exemption under section 151 for 1973). Thus, under subparagraph (1) of this paragraph, the tax attributable to the \$25,750 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.

[T.D. 6676, 28 FR 10138, Sept. 17, 1963, as amended by T.D. 6722, 29 FR 5070, Apr. 14, 1964, T.D. 6885, 31 FR 7800, June 2, 1966, T.D. 6985, 33 FR 19812, Dec. 27, 1968; T.D. 7114, 36 FR 9018, May 18, 1971]

§ 1.72(e)-1T Treatment of distributions where substantially all contributions are employee contributions (temporary).

Q-1: How did the Tax Reform Act (TRA) of 1984 change the law with regard to the treatment of non-annuity distributions (i.e., amounts distributed prior to the annuity starting date and not received as annuities) from a qualified plan that is treated as a single contract under section 72 and under which substantially all of the contributions are employee contributions?

A-1: (a) Prior to the amendment of section 72(e) by the TRA of 1984, non-annuity distributions from such a qualified plan generally were allocable, first, to nondeductible employee con-

tributions and thus were not includible in gross income. After distributions equaled the balance of nondeductible employee contributions, further non-annuity distributions generally were includible in gross income.

(b) Pursuant to section 72(e)(7), as added by the TRA of 1984, non-annuity distributions from such a qualified plan that are allocable to investment in the plan after August 13, 1982 (as determined in accordance with section 72(e)(5)(B)), generally will be treated, first, as allocable to income and, second, as allocable to nondeductible employee contributions. Distributions allocable to income are includible in gross income. Distributions allocable to nondeductible employee contributions are not includible in gross income.

Q-2: To which qualified plans and contracts does section 72(e)(7) apply?

A-2: Section 72(e)(7) applies to any plan or contract under which substantially all of the contributions are employee contributions if—

(a) Such plan is described in section 401(a) and the related trust or trusts are exempt from tax under section 501(a); or

(b) Such contract is—

(1) Purchased by a trust described in (a) above,

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

(3) Described in section 403(b).

Q-3: What is the definition of a qualified plan or contract under which substantially all of the contributions are employee contributions?

A-3: (a) A qualified plan or contract under which substantially all of the contributions are employee contributions is a plan or contract with respect to which 85 percent or more of the total contributions during the "representative period" are employee contributions. The "representative period" means the five-plan-year period preceding the plan year during which a distribution occurs. However, if less than 85 percent of the total contributions for all plan years during which the plan or contract is in existence prior to the plan year of distribution are employee contributions, then the plan or contract is not one with respect

to which substantially all of the contributions are employee contributions.

(b) For purposes of the 85 percent test, contributions made to a predecessor plan or contract are aggregated with contributions made to the plan or contract to which the 85 percent test is being applied (the successor plan or contract). For purposes of the preceding sentence, a predecessor plan or contract is a plan or contract the terms of which are substantially the same as the successor plan or contract.

Q-4: What is the definition of employee contributions for purposes of section 72(e)(7)?

A-4: For purposes of section 72(e)(7), employee contributions are those amounts contributed by the employee and those amounts considered contributed by the employee under section 72(f). For example, amounts contributed to a section 401(k) qualified cash or deferred arrangement, pursuant to an employee's election to defer such amounts, are employer contributions to the extent that such amounts are not currently includible in gross income. In addition, deductible employee contributions under section 72(o) are disregarded in their entirety (i.e., treated as neither employee contributions nor employer contributions) in determining whether substantially all the contributions are employee contributions.

Q-5: How is the 85 percent test of section 72(e)(7) applied to a qualified plan or contract?

A-5: (a) Except as provided in paragraphs (b), (c), and (d), the 85 percent test is applied separately with respect to each contract under section 72.

(b) If a single qualified plan described in section 401(a) or section 403(a) comprises more than one contract under section 72, regardless of whether such plan includes multiple trusts or combinations of profit-sharing and pension features, these contracts are aggregated for purposes of applying the 85 percent test. Thus, if substantially all of the contributions under a qualified plan comprising two contracts under section 72 are employee contributions, section 72(e)(5)(D) shall not apply to non-annuity distributions under either of the contracts.

(c) With respect to the plans maintained by the Federal Government or by instrumentalities of the Federal Government, the 85 percent test shall be applied by aggregating all such plans. This aggregation rule applies only to those plans that are actively administered by the Federal Government or an instrumentality thereof. Thus, if a plan of the Federal Government is administered by a commercial financial institution, it would not be aggregated with other plans of the Federal Government and its instrumentalities for purposes of applying the 85 percent test.

(d) In the case of a contract described in section 403(b), the 85 percent test is applied separately to each such contract.

Q-6: Is a loan from a qualified plan or contract described in section 72(e)(7) treated as a distribution under section 72(e)(4)(A)?

A-6: Yes. Pursuant to section 72(e)(4)(A), if an employee receives, either directly or indirectly, any amount as a loan from a qualified plan or contract described in section 72(e)(7), such amount shall be treated as a distribution from the plan or contract of an amount not received as an annuity. Similarly, if an employee assigns or pledges, or agrees to assign or pledge, any portion of the value of any qualified plan or contract, such portion shall be treated as a distribution from the plan or contract of an amount not received as an annuity.

Q-7: Does the five percent penalty for premature distributions from annuity contracts, as described in section 72(q), apply to distributions from a qualified plan or contract described in section 72(e)(7)?

A-7: No.

Q-8: When is section 72(e)(7) effective?

A-8: Section 72(e)(7) is effective for amounts received or loans made on or after October 17, 1984. For purposes of this effective date provision, loan amounts outstanding on October 16, 1984, which are renegotiated, extended, renewed, or revised after that date generally are treated as loans made on the date of the renegotiation, etc.

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