

the annuity contract relating to the deceased employee, an annuity or other death benefit, the extent to which the amounts received by or made available to the beneficiary must be included in the beneficiary's income under section 403(a) shall be determined in accordance with the rules presented in paragraph (a)(5) of § 1.402(a)-1.

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

(e) As to inclusion of full-time life insurance salesmen within the class of persons considered to be employees, see section 7701(a)(20).

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

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

[T.D. 6500, 25 FR 11680, Nov. 26, 1960, as amended by T.D. 6676, 28 FR 10143, Sept. 17, 1963; T.D. 6722, 29 FR 5073, Apr. 14, 1964; T.D. 6783, 29 FR 18359, Dec. 24, 1964; T.D. 6885, 31 FR 7801, June 2, 1966]

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

(a) If the total amounts payable with respect to any employee for whom an annuity contract has been purchased by an employer under a plan which—

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

(2) Requires that refunds of contributions with respect to annuity contracts purchased under such plan be used to reduce subsequent premiums on the contracts under the plan,

are paid to, or includible in gross income of, the payee within one taxable year of the payee by reason of the employee's death or other separation from the service, or death after such separation from the service, such total payments, to the extent they exceed 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 "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 sections 72(f), 101(b), and paragraph (d) of § 1.403(a)-1, reduced by any amounts theretofore distributed to him which were excludable from his gross income as a return of employee contributions. For example, if under an annuity contract purchased under a plan described in this section, the total distributions payable to the employee's widow are paid to her in the year in which the employee dies, in the amount of \$8,000, and if \$5,000 thereof is excludable under section 101(b), and if the employee made contributions of \$600 and had received no payments, the remaining amount of \$2,400 will be considered a gain from the sale or exchange of a capital asset held for more than six months.

(b)(1) The term "total amounts" means the balance to the credit of an employee with respect to all annuities under the annuity plan which becomes payable to the payee by reason of the employee's death or other separation from the service, or by reason of his death after separation from the service. If an employee commences to receive annuity payments on retirement and then a lump sum payment is made to his widow upon his death, the capital gains treatment applies to the lump sum payment, but it does not apply to amounts received before the time the "total amounts" become payable. However, if the total amount to the credit of the employee 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 payee within one taxable year of the payee, such amount is entitled to the capital gains treatment notwithstanding that in a later taxable year an additional amount is credited to the employee and paid to the payee.

(2) If more than one annuity contract is received under the plan, the capital gains treatment does not apply to any amount received on the surrender thereof unless all contracts under the plan with respect to a particular employee are surrendered either at the time of the employee's death or other separation from the service or death after separation from the service. Thus, if an employee receives two contracts on separation from the service and surrenders one of them in the year of separation and receives payments under the other until his death, the capital gains treatment is applicable to the balance paid to his beneficiary on his death if paid within one taxable year of the beneficiary. The amount received by the employee on surrender of the contract in the year of his separation from the service, however, would not receive capital gains treatment since the balance to the credit of the employee with respect to all amounts under the plan did not become payable at that time.

(3) If an employee retires and commences to receive an annuity but subsequently in some succeeding taxable year, he 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.

(4) If the "total amounts" payable under all annuity contracts under the plan with respect to a particular employee are paid or includible in the gross income of several payees 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.

Thus, if the balance to the credit of a deceased employee under all annuity contracts provided under an annuity plan becomes payable to two payees, the capital gains treatment is applicable provided the "total amounts" payable are received by or includible in the gross income of both payees within the same taxable year. However, if the "total amounts" payable are made available to each payee and one elects to receive his share in cash while the other makes a timely election under section 72(h) to receive his share as an annuity, the capital gains treatment does not apply to either payee.

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

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

(c) The provisions of this section are not applicable to any amounts paid to a payee to the extent such amounts are attributable to contributions made on behalf of an employee while he was a self-employed individual in the business with respect to which the plan was established. For the taxation of such amounts, see §1.72-18. For the rules for determining the amount attributable to contributions on behalf of an employee while he was self-employed, see paragraphs (b)(4) and (c)(2) of such section.

[T.D. 6500, 25 FR 11681, Nov. 26, 1960, as amended by T.D. 6676, 28 FR 10143, Sept. 17, 1963; T.D. 6722, 29 FR 5073, Apr. 14, 1964]