

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

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

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

- (i) Are received before the annuity starting date; and
- (ii) Are not received as an annuity.

For the definition of annuity starting date, see paragraph (b) of § 1.72-4 and subparagraph (4) of this paragraph. As to what constitutes amounts not received as an annuity, see paragraphs (c) and (d) of § 1.72-11.

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

was an owner-employee, including any such deductions taken in the taxable year of receipt.

(3) Any amounts to which this paragraph applies and which are not includible in gross income under the rules of subparagraph (2) of this paragraph shall be subject to the provisions of section 72(e) and § 1.72-11. However, for taxable years beginning before January 1, 1964, section 72(e)(3), as in effect before such date, shall not apply to such amounts. For taxable years beginning after December 31, 1963, such amounts (other than amounts subject to a penalty under section 72(m)(5) and paragraph (e) of this section) may be taken into account in computations under sections 1301 through 1305 (relating to income averaging).

(4) Under section 401(d)(4), a qualified pension, profit-sharing, or annuity plan may not provide for distributions to an owner-employee before he reaches age 59½ years, except in the case of his earlier disability. Therefore, in the case of a distribution from a qualified plan to an individual for whom contributions have been made to the plan as an owner-employee, the annuity starting date cannot be prior to the time such individual attains the age 59½ years unless he is entitled to benefits before reaching such age because of his disability. For taxable years beginning after December 31, 1966, see section 72(m)(7) and paragraph (f) of this section for the meaning of disabled. For taxable years beginning before January 1, 1967, see section 213(g)(3) for the meaning of disabled.

(5) The rules of this paragraph are not applicable to amounts credited to an individual in his capacity as a policy-holder of an annuity, endowment, or life insurance contract which are in the nature of a dividend or refund of premium, and which are applied in accordance with paragraph (a)(4) of § 1.404(a)-8 towards the purchase of benefits under the policy.

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

Example. B, a self-employed individual, received \$8,000 as a distribution under a qualified pension plan before the annuity starting date. At the time of such distribution, \$10,000 had been contributed (the whole amount

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

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

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

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

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

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

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

distribution from the trust or as an amount received under the contract during such taxable year.

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

(e) *Penalties applicable to certain amounts received by owner-employees.*

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

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

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

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

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

(a) Amounts received by reason of the owner-employee becoming disabled, or

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

Amounts attributable to contributions paid on behalf of an owner-employee and which are paid to a person other than the owner-employee before the owner-employee dies or reaches the age 59½ shall be considered received by the owner-employee for purposes of this paragraph. For taxable years beginning after December 31, 1966, see section 72(m)(7) and paragraph (f) of this section for the meaning of disabled. For taxable years beginning before January 1, 1967, see section 213(g)(3) for the meaning of disabled. For taxable years beginning after December 31, 1968, if an amount is not included in the amounts referred to in subdivision (i)(a) of this subparagraph solely by reason of the owner-employee becoming disabled and if a penalty would otherwise be applicable with respect to all or a portion of such amount, then for the taxable year in which such amount is received, there must be submitted with the owner-employee's income tax return a doctor's statement as to the impairment, and a statement by the owner-employee with respect to the effect of such impairment upon his substantial gainful activity and the date such impairment occurred. For taxable years which are subsequent to the first taxable year beginning after December 31, 1968, with respect to which the statements referred to in the preceding sentence are submitted, the owner-employee may, in lieu of such statements, submit a statement declaring the continued existence (without substantial diminution) of the impairment and its continued effect upon his substantial gainful activity.

(iii) This paragraph applies to amounts described in subdivision (i)(b) of this subparagraph (relating to excess benefits) even though a portion of such amounts may be attributable to contributions made on behalf of an individual while he was not an owner-employee and even though the amounts

are received by his successor. However, these amounts do not include the portion of a distribution to which section 402(a)(2) or 403(a)(2) (relating to certain total distributions in one taxable year) applies.

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

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

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

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

Example. B was a member of the XYZ Partnership and a participant in the partnership's profit-sharing plan which was created in 1963. Until the end of 1967, B's interest in

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

	A	B	C
	Con-tribution	Number of years contribu-tion was in trust—	Con-tribution weight-ed for years in trust (A×B)
1972	\$1,000	0	0
1971	800	1	800
1970	1,200	2	2,400
1969	600	3	1,800
1968	200	4	800
1967	400	5	2,000
1966	2,000	6	12,000
1965	1,000	7	7,000
1964	1,500	8	12,000
1963	900	9	8,100
Total	\$9,600		46,900

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

Total weighted contributions—46,900.

$\$5,400 \times (5,800 + 46,900) = \667.80

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

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

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

able years in which such deductions were allowed.

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

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

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

(iii) In any case in which the application of subdivision (i) or (ii) of this subparagraph results in an increase in taxable income for any taxable year, the resulting increase in taxes imposed by section 1 or 3 for such taxable year shall be reduced by the credits against tax provided by section 31 (tax withheld on wages) and section 39 (certain uses of gasoline and lubricating oil), but shall not be reduced by any other credits against tax.

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

Example. B, a sole proprietor and a calendar-year 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 when he was 55 years old and not disabled and for which, without regard to the distribution, he had a net operating loss and for which he is allowed under section 151 a deduction for one

personal exemption. The portion of the distribution includible in B's gross income is \$25,750. In addition, B had a net operating loss for 1972. The other 3 taxable years involved in the computation under subparagraph (2)(i) of this paragraph were years of substantial income. For purposes of determining B's increase in tax attributable to the receipt of the \$25,750 (before the application of the provisions of subparagraph (2)(i)(b) of this paragraph), B's taxable income for the year he received the \$25,750 is treated, under subparagraph (3)(ii) of this paragraph, as being \$25,000 (\$25,750 minus \$750, the amount of the deduction allowed for each personal exemption under section 151 for 1973). For purposes of determining whether 110 percent of the aggregate increase in taxes which would have resulted if 20 percent of the amount of the withdrawal had been included in B's gross income for the year of receipt and for each of the 4 preceding taxable years is greater (and thus is the amount of his increase in tax attributable to the receipt of the \$25,750), B's taxable income for the taxable year of receipt, and for the immediately preceding taxable year, is treated, under subparagraph (3)(i) of this paragraph, as being \$5,150 (\$25,750 divided by 5).

(f) *Meaning of disabled.* (1) For taxable years beginning after December 31, 1966, section 72(m)(7) provides that an individual shall be considered to be disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration. In determining whether an individual's impairment makes him unable to engage in any substantial gainful activity, primary consideration shall be given to the nature and severity of his impairment. Consideration shall also be given to other factors such as the individual's education, training, and work experience. The substantial gainful activity to which section 72(m)(7) refers is the activity, or a comparable activity, in which the individual customarily engaged prior to the arising of the disability (or prior to retirement if the individual was retired at the time the disability arose).

(2) Whether or not the impairment in a particular case constitutes a disability is to be determined with reference to all the facts in the case. The following are examples of impairments which would ordinarily be considered

as preventing substantial gainful activity:

- (i) Loss of use of two limbs;
- (ii) Certain progressive diseases which have resulted in the physical loss or atrophy of a limb, such as diabetes, multiple sclerosis, or Buerger's disease;
- (iii) Diseases of the heart, lungs, or blood vessels which have resulted in major loss of heart or lung reserve as evidenced by X-ray, electrocardiogram, or other objective findings, so that despite medical treatment breathlessness, pain, or fatigue is produced on slight exertion, such as walking several blocks, using public transportation, or doing small chores;
- (iv) Cancer which is inoperable and progressive;
- (v) Damage to the brain or brain abnormality which has resulted in severe loss of judgment, intellect, orientation, or memory;
- (vi) Mental diseases (e.g. psychosis or severe psychoneurosis) requiring continued institutionalization or constant supervision of the individual;
- (vii) Loss or diminution of vision to the extent that the affected individual has a central visual acuity of no better than 20/200 in the better eye after best correction, or has a limitation in the fields of vision such that the widest diameter of the visual fields subtends an angle no greater than 20 degrees;
- (viii) Permanent and total loss of speech;
- (ix) Total deafness uncorrectible by a hearing aid.

The existence of one or more of the impairments described in this subparagraph (or of an impairment of greater severity) will not, however, in and of itself always permit a finding that an individual is disabled as defined in section 72(m)(7). Any impairment, whether of lesser or greater severity, must be evaluated in terms of whether it does in fact prevent the individual from engaging in his customary or any comparable substantial gainful activity.

(3) In order to meet the requirements of section 72(m)(7), an impairment must be expected either to continue for a long and indefinite period or to result in death. Ordinarily, a terminal illness because of disease or injury would result in disability. Indefinite is used in

the sense that it cannot reasonably be anticipated that the impairment will, in the foreseeable future, be so diminished as no longer to prevent substantial gainful activity. For example, an individual who suffers a bone fracture which prevents him from working for an extended period of time will not be considered disabled, if his recovery can be expected in the foreseeable future; if the fracture persistently fails to knit, the individual would ordinarily be considered disabled.

(4) An impairment which is remediable does not constitute a disability within the meaning of section 72(m)(7). An individual will not be deemed disabled if, with reasonable effort and safety to himself, the impairment can be diminished to the extent that the individual will not be prevented by the impairment from engaging in his customary or any comparable substantial gainful activity.

(g) *Years to which this section applies.* This section applies to taxable years ending before September 3, 1974. For taxable years ending after September 2, 1974, see § 1.72-17A.

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§ 1.72-17A Special rules applicable to employee annuities and distributions under deferred compensation plans to self-employed individuals and owner-employees.

(a) *In general.* Section 72(m) and this section contain special rules for the taxation of amounts received from qualified pension, profit-sharing, or annuity plans covering an owner-employee. This section applies to such amounts for taxable years of the recipient ending after September 2, 1974, unless another date is specified. For purposes of this section, the term “employee” shall include the self-employed individual who is treated as an employee by section 401(c)(1), and the term “owner-employee” has the meaning assigned to it in section 401(c)(3). Paragraph (b) of this section provides rules dealing with the computation of consideration paid by self-employed individuals and paragraph (c) of this section provides rules dealing with such

computation when insurance is purchased for owner-employees. Paragraph (d) of this section provides rules for constructive receipt and, for purposes of these rules, treats as an owner-employee an individual for whose benefit an individual retirement account or annuity described in section 408 (a) or (b) is maintained after December 31, 1974. Paragraph (e) of this section provides rules for penalties provided by section 72(m)(5) with respect to certain distributions received by owner-employees or their successors. Paragraph (f) of this section provides rules for determining whether a person is disabled within the meaning of section 72(m)(7). See § 1.72-16, relating to life insurance contracts purchased under qualified employee plans, for rules under section 72(m)(3).

(b) *Computation of consideration paid by self-employed individuals.* Under section 72(m)(2), consideration paid or contributed for the contract by any self-employed individual shall for purposes of section 72 be deemed not to include any contributions paid or contributed under a plan described in paragraph (a), or any other plan of deferred compensation described in section 404(a) (whether or not qualified), if the contributions are—

(1) Paid under such plan with respect to a time during which the employee was an employee only by reason of sections 401(c)(1) and 404(a)(8), and

(2) Deductible under section 404 by the employer, including an employer within the meaning of sections 401(c)(4) and 404(a)(8), of such self-employed individual at the time of such payment, or subsequent to such time of payment.

For purposes of this paragraph the term “consideration paid or contributed for the contract” has the same meaning as under subparagraphs (1), (2), and (3) of paragraph (c) of this section.

(c) *Amounts paid for life, accident, health, or other insurance.* Under section 72(m)(2), amounts used to purchase life, accident, health, or other insurance protection for an owner-employee shall not be taken into account in computing the following:

(1) The aggregate amount of premiums or other consideration paid for