

# Is Life Insurance Tax Free?



**Below we will cover some basic information followed by Tax Law Codes in regards to Life Insurance, and understanding that the Law does allow Tax Free Distributions from a Life Insurance Policy. The Information below is actual codes from the US Tax codes.**

Prior to TEFRA, a loan against an annuity, endowment, or life insurance contract was treated as a bona fide loan from a third party lender, not as a distribution under the contract. See *Minnis v Commissioner*, 71 TC 1049 (1979), nonacq 1979-2 CB 2; and *Drake v US*, 597 F Supp 1271 (DNC 1984), 85-1 USTC ¶9146, 55 AFTR2d 85-823.

The IRS had taken a contrary position in Revenue Ruling 81-126, 1981-1 CB 206 and did not take kindly to its loss in the *Minnis* and *Drake*, *supra*. The IRS managed to *persuade* Congress to change the rules in 1982 to provide that loans do constitute distributions from the contract as a matter of law. See IRC Section 72(e)(4).

However, the life insurance industry was successful in preserving the pre-1982 rules for life insurance and endowment contracts. Following is an excerpt from the Committee Reports on P.L. 97-248 (Tax Equity and Fiscal Responsibility Act of 1982).

The Senate amendment provides that amounts received before the annuity starting date will be treated first as withdrawals of income earned on investments to the extent of such income, the remainder being treated as a return of capital. Likewise, loans under the contract, or amounts received upon assignment or pledging of the contract, will be treated as amounts received under the contract. These provisions apply as of July 1, 1982, but do not apply to income amounts allocable to investments made before July 2, 1982, to endowment or life insurance contracts (except to the extent prescribed in regulations), or to contracts purchased under qualified pension plans. [Emphasis supplied.]

The rules were modified again in 1988 to apply the post-1982 distribution provisions to so-called modified investment contracts entered into after June 21, 1988. I strongly suspect that the taxpayer's life insurance policy would be a modified endowment contract but for the fact that he purchased the policy before the effective date of this provision.

It seems to me the bottom line with respect to the whole issue of Taxed or Taxed Free is simplified by utilizing the proper structure within the means of the law does allow for Tax Free Distributions and is approved and allowed as it is written by the Tax Law Codes.

How long this will be allowed to be active or not changed to eliminate this avenue for Tax Shelter is questionable, my suggestion take advantage while you can.

## Sec. 7702. Life insurance contract defined

[TITLE 26](#), [Subtitle F](#), [CHAPTER 79](#), Sec. 7702.

### STATUTE

#### (a) General rule

For purposes of this title, the term "life insurance contract" means any contract which is a life insurance contract under the applicable law, but only if such contract -

(1) meets the cash value accumulation test of subsection (b), or

(2)

(A) meets the guideline premium requirements of subsection (c), and

(B) falls within the cash value corridor of subsection (d).

(b) Cash value accumulation test for subsection (a)(1)

(1) In general

A contract meets the cash value accumulation test of this subsection if, by the terms of the contract, the cash surrender value of such contract may not at any time exceed the net single premium which would have to be paid at such time to fund future benefits under the contract.

(2) Rules for applying paragraph (1)

Determinations under paragraph (1) shall be made -

(A) on the basis of interest at the greater of an annual effective rate of 4 percent or the rate or rates guaranteed on issuance of the contract,

(B) on the basis of the rules of subparagraph (B)(i) (and, in the case of qualified additional benefits, subparagraph (B)(ii)) of subsection (c)(3), and

(C) by taking into account under subparagraphs (A) and (D) of subsection (e)(1) only current and future death benefits and qualified additional benefits.

(c) Guideline premium requirements

For purposes of this section -

(1) In general

A contract meets the guideline premium requirements of this subsection if the sum of the premiums paid under such contract does not at any time exceed the guideline premium limitation as of such time.

(2) Guideline premium limitation

The term "guideline premium limitation" means, as of any date, the greater of -

(A) the guideline single premium, or

(B) the sum of the guideline level premiums to such date.

(3) Guideline single premium

(A) In general

The term "guideline single premium" means the premium at issue with respect to future benefits under the contract.

(B) Basis on which determination is made

The determination under subparagraph (A) shall be based on -

(i) reasonable mortality charges which meet the requirements (if any) prescribed in regulations and which (except as provided in regulations) do not exceed the mortality charges specified in the prevailing commissioners' standard tables (as defined in section [807\(d\)\(5\)](#)) as of the time the contract is issued,

(ii) any reasonable charges (other than mortality charges) which (on the basis of the company's experience, if any, with respect to similar contracts) are reasonably expected to be actually paid, and

(iii) interest at the greater of an annual effective rate of 6 percent or the rate or rates guaranteed on issuance of the contract.

(C) When determination made

Except as provided in subsection (f)(7), the determination under subparagraph (A) shall be made as of the time the contract is issued.

**(D) Special rules for subparagraph (B)(ii)**

**(i) Charges not specified in the contract**

If any charge is not specified in the contract, the amount taken into account under subparagraph (B)(ii) for such charge shall be zero.

**(ii) New companies, etc.**

If any company does not have adequate experience for purposes of the determination under subparagraph (B)(ii), to the extent provided in regulations, such determination shall be made on the basis of the industry-wide experience.

**(4) Guideline level premium**

The term "guideline level premium" means the level annual amount, payable over a period not ending before the insured attains age 95, computed on the same basis as the guideline single premium, except that paragraph (3)(B)(iii) shall be applied by substituting "4 percent" for "6 percent".

**(d) Cash value corridor for purposes of subsection (a)(2)(B)**

For purposes of this section -

**(1) In general**

A contract falls within the cash value corridor of this subsection if the death benefit under the contract at any time is not less than the applicable percentage of the cash surrender value.

**(2) Applicable percentage**

In the case of an insured The applicable percentage with an attained age as shall decrease by a of the beginning of the ratable portion for each contract year of: full year:

More than: 2 But not From: To:

more than:

0	40	250	250
40	45	250	215
45	50	215	185
50	55	185	150
55	60	150	130
60	65	130	120
65	70	120	115
70	75	115	105
75	90	105	105
90	95	105	100.

**(e) Computational rules**

**(1) In general**

For purposes of this section (other than subsection (d)) -

**(A)** the death benefit (and any qualified additional benefit) shall be deemed not to increase,

**(B)** the maturity date, including the date on which any benefit described in subparagraph (C) is payable, shall be deemed to be no earlier than the day on which the insured attains age 95, and no later than the day on which the insured attains age 100,

**(C)** the death benefits shall be deemed to be provided until the maturity date determined by taking into account subparagraph (B), and

**(D)** the amount of any endowment benefit (or sum of endowment benefits, including any cash surrender value on the maturity date determined by taking into account subparagraph (B)) shall be deemed not to exceed the least amount payable as a death benefit at any time under the contract.

**(2) Limited increases in death benefit permitted**

Notwithstanding paragraph (1)(A) -

**(A)** for purposes of computing the guideline level premium, an increase in the death benefit which is provided in the contract may be taken into account but only to the extent necessary to prevent a decrease in the excess of the death benefit over the cash surrender value of the contract,

**(B)** for purposes of the cash value accumulation test, the increase described in subparagraph (A) may be taken into account if the contract will meet such test at all times assuming that the net level reserve (determined as if level annual premiums were paid for the contract over a period not ending before the insured attains age 95) is substituted for the net single premium, and

**(C)** for purposes of the cash value accumulation test, the death benefit increases may be taken into account if the contract -

**(i)** has an initial death benefit of \$5,000 or less and a maximum death benefit of \$25,000 or less,

**(ii)** provides for a fixed predetermined annual increase not to exceed 10 percent of the initial death benefit or 8 percent of the death benefit at the end of the preceding year, and

**(iii)** was purchased to cover payment of burial expenses or in connection with prearranged funeral expenses. For purposes of subparagraph (C), the initial death benefit of a contract shall be determined by treating all contracts issued to the same contract owner as 1 contract.

**(f)** Other definitions and special rules

For purposes of this section -

**(1)** Premiums paid

**(A)** In general

The term "premiums paid" means the premiums paid under the contract less amounts (other than amounts includible in gross income) to which section [72\(e\)](#) applies and less any excess premiums with respect to which there is a distribution described in subparagraph (B) or (E) of paragraph (7) and any other amounts received with respect to the contract which are specified in regulations.

**(B)** Treatment of certain premiums returned to policyholder

If, in order to comply with the requirements of subsection (a)(2)(A), any portion of any premium paid during any contract year is returned by the insurance company (with interest) within 60 days after the end of a contract year, the amount so returned (excluding interest) shall be deemed to reduce the sum of the premiums paid under the contract during such year.

**(C)** Interest returned includible in gross income

Notwithstanding the provisions of section [72\(e\)](#), the amount of any interest returned as provided in subparagraph (B) shall be includible in the gross income of the recipient.

**(2)** Cash values

**(A)** Cash surrender value

The cash surrender value of any contract shall be its cash value determined without regard to any surrender charge, policy loan, or reasonable termination dividends.

**(B)** Net surrender value

The net surrender value of any contract shall be determined with regard to surrender charges but without regard to any policy loan.

**(3)** Death benefit

The term "death benefit" means the amount payable by reason of the death of the insured (determined without regard to any qualified additional benefits).

**(4)** Future benefits

The term "future benefits" means death benefits and endowment benefits.

**(5)** Qualified additional benefits

**(A)** In general

The term "qualified additional benefits" means any -

**(i)** guaranteed insurability,

**(ii)** accidental death or disability benefit,

**(iii)** family term coverage,

**(iv)** disability waiver benefit, or

**(v)** other benefit prescribed under regulations.

**(B) Treatment of qualified additional benefits**

For purposes of this section, qualified additional benefits shall not be treated as future benefits under the contract, but the charges for such benefits shall be treated as future benefits.

**(C) Treatment of other additional benefits**

In the case of any additional benefit which is not a qualified additional benefit -

- (i) such benefit shall not be treated as a future benefit, and
- (ii) any charge for such benefit which is not prefunded shall not be treated as a premium.

**(6) Premium payments not disqualifying contract**

The payment of a premium which would result in the sum of the premiums paid exceeding the guideline premium limitation shall be disregarded for purposes of subsection (a)(2) if the amount of such premium does not exceed the amount necessary to prevent the termination of the contract on or before the end of the contract year (but only if the contract will have no cash surrender value at the end of such extension period).

**(7) Adjustments**

**(A) In general**

If there is a change in the benefits under (or in other terms of) the contract which was not reflected in any previous determination or adjustment made under this section, there shall be proper adjustments in future determinations made under this section.

**(B) Rule for certain changes during first 15 years**

If -

- (i) a change described in subparagraph (A) reduces benefits under the contract,
- (ii) the change occurs during the 15-year period beginning on the issue date of the contract, and
- (iii) a cash distribution is made to the policyholder as a result of such change, section [72](#) (other than subsection (e)(5) thereof) shall apply to such cash distribution to the extent it does not exceed the recapture ceiling determined under subparagraph (C) or (D) (whichever applies).

**(C) Recapture ceiling where change occurs during first 5 years**

If the change referred to in subparagraph (B)(ii) occurs during the 5-year period beginning on the issue date of the contract, the recapture ceiling is -

- (i) in the case of a contract to which subsection (a)(1) applies, the excess of -
  - (I) the cash surrender value of the contract, immediately before the reduction, over
  - (II) the net single premium (determined under subsection (b)), immediately after the reduction, or
- (ii) in the case of a contract to which subsection (a)(2) applies, the greater of -
  - (I) the excess of the aggregate premiums paid under the contract, immediately before the reduction, over the guideline premium limitation for the contract (determined under subsection (c)(2), taking into account the adjustment described in subparagraph (A)), or
  - (II) the excess of the cash surrender value of the contract, immediately before the reduction, over the cash value corridor of subsection (d) (determined immediately after the reduction).

**(D) Recapture ceiling where change occurs after 5th year and before 16th year**

If the change referred to in subparagraph (B) occurs after the 5-year period referred to under subparagraph (C), the recapture ceiling is the excess of the cash surrender value of the contract, immediately before the reduction, over the cash value corridor of subsection (d) (determined immediately after the reduction and whether or not subsection (d) applies to the contract).

**(E) Treatment of certain distributions made in anticipation of benefit reductions**

Under regulations prescribed by the Secretary, subparagraph

**(B)** shall apply also to any distribution made in anticipation of a reduction in benefits under the contract. For purposes of the preceding sentence, appropriate adjustments shall be made in the provisions of subparagraphs (C) and (D); and any distribution which reduces the cash surrender value of a contract and which is made within 2 years before a reduction in benefits under the contract shall be treated as made in anticipation of such reduction.

**(8) Correction of errors**

If the taxpayer establishes to the satisfaction of the Secretary that -

- (A)** the requirements described in subsection (a) for any contract year were not satisfied due to reasonable error, and
- (B)** reasonable steps are being taken to remedy the error, the Secretary may waive the failure to satisfy such requirements.

**(9) Special rule for variable life insurance contracts**

In the case of any contract which is a variable contract (as defined in section [817](#)), the determination of whether such contract meets the requirements of subsection (a) shall be made whenever the death benefits under such contract change but not less frequently than once during each 12-month period.

**(g) Treatment of contracts which do not meet subsection (a) test**

**(1) Income inclusion**

**(A) In general**

If at any time any contract which is a life insurance contract under the applicable law does not meet the definition of life insurance contract under subsection (a), the income on the contract for any taxable year of the policyholder shall be treated as ordinary income received or accrued by the policyholder during such year.

**(B) Income on the contract**

For purposes of this paragraph, the term "income on the contract" means, with respect to any taxable year of the policyholder, the excess of -

- (i)** the sum of -
  - (I)** the increase in the net surrender value of the contract during the taxable year, and
  - (II)** the cost of life insurance protection provided under the contract during the taxable year, over
- (ii)** the premiums paid (as defined in subsection (f)(1)) under the contract during the taxable year.

**(C) Contracts which cease to meet definition**

If, during any taxable year of the policyholder, a contract which is a life insurance contract under the applicable law ceases to meet the definition of life insurance contract under subsection (a), the income on the contract for all prior taxable years shall be treated as received or accrued during the taxable year in which such cessation occurs.

**(D) Cost of life insurance protection**

For purposes of this paragraph, the cost of life insurance protection provided under the contract shall be the lesser of -

- (i)** the cost of individual insurance on the life of the insured as determined on the basis of uniform premiums (computed on the basis of 5-year age brackets) prescribed by the Secretary by regulations, or
- (ii)** the mortality charge (if any) stated in the contract.

**(2) Treatment of amount paid on death of insured**

If any contract which is a life insurance contract under the applicable law does not meet the definition of life insurance contract under subsection (a), the excess of the amount paid by the reason of the death of the insured over the net surrender value of the contract shall be deemed to be paid under a life insurance contract for purposes of section [101](#) and subtitle B.

**(3) Contract continues to be treated as insurance contract**

If any contract which is a life insurance contract under the applicable law does not meet the definition of life insurance contract under subsection (a), such contract shall, notwithstanding such failure, be treated as an insurance contract for purposes of this title.

**(h) Endowment contracts receive same treatment**

**(1) In general**

References in subsections (a) and (g) to a life insurance contract shall be treated as including references to a contract which is an endowment contract under the applicable law.

**(2) Definition of endowment contract**

For purposes of this title (other than paragraph (1)), the term "endowment contract" means a contract which is an endowment contract under the applicable law and which meets the requirements of subsection (a).

**(i) Transitional rule for certain 20-pay contracts**

**(1) In general**

In the case of a qualified 20-pay contract, this section shall be applied by substituting "3 percent" for "4 percent" in subsection (b)(2).

**(2) Qualified 20-pay contract**

For purposes of paragraph (1), the term "qualified 20-pay contract" means any contract which -

**(A)** requires at least 20 nondecreasing annual premium payments, and

**(B)** is issued pursuant to an existing plan of insurance.

**(3) Existing plan of insurance**

For purposes of this subsection, the term "existing plan of insurance" means, with respect to any contract, any plan of insurance which was filed by the company issuing such contract in 1 or more States before September 28, 1983, and is on file in the appropriate State for such contract.

**(j) Certain church self-funded death benefit plans treated as life insurance**

**(1) In general**

In determining whether any plan or arrangement described in paragraph (2) is a life insurance contract, the requirement of subsection (a) that the contract be a life insurance contract under applicable law shall not apply.

**(2) Description**

For purposes of this subsection, a plan or arrangement is described in this paragraph if -

**(A)** such plan or arrangement provides for the payment of benefits by reason of the death of the individuals covered under such plan or arrangement, and

**(B)** such plan or arrangement is provided by a church for the benefit of its employees and their beneficiaries, directly or through an organization described in section [414\(e\)\(3\)\(A\)](#) or an organization described in section [414\(e\)\(3\)\(B\)\(ii\)](#).

**(3) Definitions**

For purposes of this subsection -

**(A) Church**

The term "church" means a church or a convention or association of churches.

**(B) Employee**

The term "employee" includes an employee described in section [414\(e\)\(3\)\(B\)](#).

**(k) Regulations**

The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section.

**SECTION REFERRED TO IN OTHER SECTIONS**

This section is referred to in sections [56](#), [72](#), [264](#), [817](#), [817A](#), [953](#), [7702A](#), [7702B](#) of this title; title 15 section 6712.

[SOURCE](#)

[AMENDMENTS](#)

[EFFECTIVE DATE OF 1988 AMENDMENT](#)

[EFFECTIVE DATE OF 1986 AMENDMENT](#)

[EFFECTIVE DATE](#)

[INTERIM RULES; REGULATIONS; STANDARDS BEFORE REGULATIONS TAKE EFFECT](#)

[PLAN AMENDMENTS NOT REQUIRED UNTIL JANUARY 1, 1989](#)

# Sec. 953. Insurance income

*TITLE 26, Subtitle A, CHAPTER 1, Subchapter N, PART III, Subpart F, Sec. 953.*

## STATUTE

### (a) Insurance income

#### (1) In general

For purposes of section [952\(a\)\(1\)](#), the term "insurance income" means any income which -

(A) is attributable to the issuing (or reinsuring) of an insurance or annuity contract, and

(B) would (subject to the modifications provided by subsection (b)) be taxed under subchapter L of this chapter if such income were the income of a domestic insurance company.

#### (2) Exception

Such term shall not include any exempt insurance income (as defined in subsection (e)).

### (b) Special rules

For purposes of subsection (a) -

(1) The following provisions of subchapter L shall not apply:

(A) The small life insurance company deduction.

(B) Section [805\(a\)\(5\)](#) (relating to operations loss deduction).

(C) Section [832\(c\)\(5\)](#) (relating to certain capital losses).

(2) The items referred to in -

(A) section [803\(a\)\(1\)](#) (relating to gross amount of premiums and other considerations),

(B) section [803\(a\)\(2\)](#) (relating to net decrease in reserves),

(C) section [805\(a\)\(2\)](#) (relating to net increase in reserves), and

(D) section [832\(b\)\(4\)](#) (relating to premiums earned on insurance contracts), shall be taken into account only to the extent they are in respect of any reinsurance or the issuing of any insurance or annuity contract described in subsection (a)(1).

(3) Reserves for any insurance or annuity contract shall be determined in the same manner as under section [954\(i\)](#).

(4) All items of income, expenses, losses, and deductions shall be properly allocated or apportioned under regulations prescribed by the Secretary.

### (c) Special rule for certain captive insurance companies

#### (1) In general

For purposes only of taking into account related person insurance income -

(A) the term "United States shareholder" means, with respect to any foreign corporation, a United States person (as defined in section [957\(c\)](#)) who owns (within the meaning of section [958\(a\)](#)) any stock of the foreign corporation,

- (B) the term "controlled foreign corporation" has the meaning given to such term by section [957\(a\)](#) determined by substituting "25 percent or more" for "more than 50 percent", and
- (C) the pro rata share referred to in section [951\(a\)\(1\)\(A\)\(i\)](#) shall be determined under paragraph (5) of this subsection.
- (2) Related person insurance income  
For purposes of this subsection, the term "related person insurance income" means any insurance income (within the meaning of subsection (a)) attributable to a policy of insurance or reinsurance with respect to which the person (directly or indirectly) insured is a United States shareholder in the foreign corporation or a related person to such a shareholder.
- (3) Exceptions
- (A) Corporations not held by insureds  
Paragraph (1) shall not apply to any foreign corporation if at all times during the taxable year of such foreign corporation -
- (i) less than 20 percent of the total combined voting power of all classes of stock of such corporation entitled to vote, and
- (ii) less than 20 percent of the total value of such corporation, is owned (directly or indirectly under the principles of section [883\(c\)\(4\)](#)) by persons who are (directly or indirectly) insured under any policy of insurance or reinsurance issued by such corporation or who are related persons to any such person.
- (B) De minimis exception  
Paragraph (1) shall not apply to any foreign corporation for a taxable year of such corporation if the related person insurance income (determined on a gross basis) of such corporation for such taxable year is less than 20 percent of its insurance income (as so determined) for such taxable year determined without regard to those provisions of subsection (a)(1) which limit insurance income to income from countries other than the country in which the corporation was created or organized.
- (C) Election to treat income as effectively connected  
Paragraph (1) shall not apply to any foreign corporation for any taxable year if -
- (i) such corporation elects (at such time and in such manner as the Secretary may prescribe) -
- (I) to treat its related person insurance income for such taxable year as income effectively connected with the conduct of a trade or business in the United States, and
- (II) to waive all benefits (other than with respect to section [884](#)) with respect to related person insurance income granted by the United States under any treaty between the United States and any foreign country, and
- (ii) such corporation meets such requirements as the Secretary shall prescribe to ensure that the tax imposed by this chapter on such income is paid. An election under this subparagraph made for any taxable year shall not be effective if the corporation (or any

predecessor thereof) was a disqualified corporation for the taxable year for which the election was made or for any prior taxable year beginning after 1986.

**(D) Special rules for subparagraph (C)**

**(i) Period during which election in effect**

**(I) In general**

Except as provided in subclause (II), any election under subparagraph (C) shall apply to the taxable year for which made and all subsequent taxable years unless revoked with the consent of the Secretary.

**(II) Termination**

If a foreign corporation which made an election under subparagraph (C) for any taxable year is a disqualified corporation for any subsequent taxable year, such election shall not apply to any taxable year beginning after such subsequent taxable year.

**(ii) Exemption from tax imposed by section [4371](#)**

The tax imposed by section [4371](#) shall not apply with respect to any related person insurance income treated as effectively connected with the conduct of a trade or business within the United States under subparagraph (C).

**(E) Disqualified corporation**

For purposes of this paragraph the term "disqualified corporation" means, with respect to any taxable year, any foreign corporation which is a controlled foreign corporation for an uninterrupted period of 30 days or more during such taxable year (determined without regard to this subsection) but only if a United States shareholder (determined without regard to this subsection) owns (within the meaning of section [958\(a\)](#)) stock in such corporation at some time during such taxable year.

**(4) Treatment of mutual insurance companies**

In the case of a mutual insurance company -

**(A) this subsection shall apply,**

**(B) policyholders of such company shall be treated as shareholders, and**

**(C) appropriate adjustments in the application of this subpart shall be made under regulations prescribed by the Secretary.**

**(5) Determination of pro rata share**

**(A) In general**

The pro rata share determined under this paragraph for any United States shareholder is the lesser of -

**(i) the amount which would be determined under paragraph (2) of section [951\(a\)](#) if -**

**(I) only related person insurance income were taken into account,**

**(II) stock owned (within the meaning of section [958\(a\)](#)) by United States shareholders on the last day of the taxable year were the only stock in the foreign corporation, and**

**(III) only distributions received by United States shareholders were taken into account under subparagraph (B) of such paragraph (2), or**

- (ii) the amount which would be determined under paragraph (2) of section [951\(a\)](#) if the entire earnings and profits of the foreign corporation for the taxable year were subpart F income.
- (B)** Coordination with other provisions  
The Secretary shall prescribe regulations providing for such modifications to the provisions of this subpart as may be necessary or appropriate by reason of subparagraph (A).
- (6)** Related person  
For purposes of this subsection -

  - (A)** In general  
Except as provided in subparagraph (B), the term "related person" has the meaning given such term by section [954\(d\)\(3\)](#).
  - (B)** Treatment of certain liability insurance policies  
In the case of any policy of insurance covering liability arising from services performed as a director, officer, or employee of a corporation or as a partner or employee of a partnership, the person performing such services and the entity for which such services are performed shall be treated as related persons.
- (7)** Coordination with section [1248](#)  
For purposes of section [1248](#), if any person is (or would be but for paragraph (3)) treated under paragraph (1) as a United States shareholder with respect to any foreign corporation which would be taxed under subchapter L if it were a domestic corporation and which is (or would be but for paragraph (3)) treated under paragraph (1) as a controlled foreign corporation -

  - (A)** such person shall be treated as meeting the stock ownership requirements of section [1248\(a\)\(2\)](#) with respect to such foreign corporation, and
  - (B)** such foreign corporation shall be treated as a controlled foreign corporation.
- (8)** Regulations  
The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection, including -

  - (A)** regulations preventing the avoidance of this subsection through cross insurance arrangements or otherwise, and
  - (B)** regulations which may provide that a person will not be treated as a United States shareholder under paragraph (1) with respect to any foreign corporation if neither such person (nor any related person to such person) is (directly or indirectly) insured under any policy of insurance or reinsurance issued by such foreign corporation.
- (d)** Election by foreign insurance company to be treated as domestic corporation
- (1)** In general  
If -

- (A) a foreign corporation is a controlled foreign corporation (as defined in section [957\(a\)](#) by substituting "25 percent or more" for "more than 50 percent" and by using the definition of United States shareholder under [953\(c\)\(1\)\(A\)](#)),
- (B) such foreign corporation would qualify under part I or II of subchapter L for the taxable year if it were a domestic corporation,
- (C) such foreign corporation meets such requirements as the Secretary shall prescribe to ensure that the taxes imposed by this chapter on such foreign corporation are paid, and
- (D) such foreign corporation makes an election to have this paragraph apply and waives all benefits to such corporation granted by the United States under any treaty, for purposes of this title, such corporation shall be treated as a domestic corporation.

(2) Period during which election is in effect

(A) In general

Except as provided in subparagraph (B), an election under paragraph (1) shall apply to the taxable year for which made and all subsequent taxable years unless revoked with the consent of the Secretary.

(B) Termination

If a corporation which made an election under paragraph (1) for any taxable year fails to meet the requirements of subparagraphs (A), (B), and (C), of paragraph (1) for any subsequent taxable year, such election shall not apply to any taxable year beginning after such subsequent taxable year.

(3) Treatment of losses

If any corporation treated as a domestic corporation under this subsection is treated as a member of an affiliated group for purposes of chapter 6 (relating to consolidated returns), any loss of such corporation shall be treated as a dual consolidated loss for purposes of section [1503\(d\)](#) without regard to paragraph (2)(B) thereof.

(4) Effect of election

(A) In general

For purposes of section [367](#), any foreign corporation making an election under paragraph (1) shall be treated as transferring (as of the 1st day of the 1st taxable year to which such election applies) all of its assets to a domestic corporation in connection with an exchange to which section [354](#) applies.

(B) Exception for pre-1988 earnings and profit

(i) In general

Earnings and profits of the foreign corporation accumulated in taxable years beginning before January 1, 1988, shall not be included in the gross income of the persons holding stock in such corporation by reason of subparagraph (A).

(ii) Treatment of distributions

For purposes of this title, any distribution made by a corporation to which an election under paragraph (1) applies out of earnings and profits accumulated in taxable years beginning before January 1, 1988, shall be treated as a distribution made by a foreign corporation.

- (iii)** Certain rules to continue to apply to pre-1988 earnings  
The provisions specified in clause (iv) shall be applied without regard to paragraph (1), except that, in the case of a corporation to which an election under paragraph (1) applies, only earnings and profits accumulated in taxable years beginning before January 1, 1988, shall be taken into account.
- (iv)** Specified provisions  
The provisions specified in this clause are:

  - (I)** Section [1248](#) (relating to gain from certain sales or exchanges of stock in certain foreign corporations).
  - (II)** Subpart F of part III of subchapter N to the extent such subpart relates to earnings invested in United States property or amounts referred to in clause (ii) or (iii) of section [951\(a\)\(1\)\(A\)](#).
  - (III)** Section [884](#) to the extent the foreign corporation reinvested 1987 earnings and profits in United States assets.
- (5)** Effect of termination  
For purposes of section [367](#), if -

  - (A)** an election is made by a corporation under paragraph (1) for any taxable year, and
  - (B)** such election ceases to apply for any subsequent taxable year, such corporation shall be treated as a domestic corporation transferring (as of the 1st day of such subsequent taxable year) all of its property to a foreign corporation in connection with an exchange to which section [354](#) applies.
- (6)** Additional tax on corporation making election

  - (A)** In general  
If a corporation makes an election under paragraph (1), the amount of tax imposed by this chapter for the 1st taxable year to which such election applies shall be increased by the amount determined under subparagraph (B).
  - (B)** Amount of tax  
The amount of tax determined under this paragraph shall be equal to the lesser of -

    - (i)** 3/4 of 1 percent of the aggregate amount of capital and accumulated surplus of the corporation as of December 31, 1987, or
    - (ii)** \$1,500,000.
- (e)** Exempt insurance income  
For purposes of this section -

  - (1)** Exempt insurance income defined

    - (A)** In general  
The term "exempt insurance income" means income derived by a qualifying insurance company which -

      - (i)** is attributable to the issuing (or reinsuring) of an exempt contract by such company or a qualifying insurance company branch of such company, and

(ii) is treated as earned by such company or branch in its home country for purposes of such country's tax laws.

**(B) Exception for certain arrangements**

Such term shall not include income attributable to the issuing (or reinsuring) of an exempt contract as the result of any arrangement whereby another corporation receives a substantially equal amount of premiums or other consideration in respect of issuing (or reinsuring) a contract which is not an exempt contract.

**(C) Determinations made separately**

For purposes of this subsection and section [954\(i\)](#), the exempt insurance income and exempt contracts of a qualifying insurance company or any qualifying insurance company branch of such company shall be determined separately for such company and each such branch by taking into account -

(i) in the case of the qualifying insurance company, only items of income, deduction, gain, or loss, and activities of such company not properly allocable or attributable to any qualifying insurance company branch of such company, and

(ii) in the case of a qualifying insurance company branch, only items of income, deduction, gain, or loss and activities properly allocable or attributable to such branch.

**(2) Exempt contract**

**(A) In general**

The term "exempt contract" means an insurance or annuity contract issued or reinsured by a qualifying insurance company or qualifying insurance company branch in connection with property in, liability arising out of activity in, or the lives or health of residents of, a country other than the United States.

**(B) Minimum home country income required**

**(i) In general**

No contract of a qualifying insurance company or of a qualifying insurance company branch shall be treated as an exempt contract unless such company or branch derives more than 30 percent of its net written premiums from exempt contracts (determined without regard to this subparagraph) -

**(I)** which cover applicable home country risks, and

**(II)** with respect to which no policyholder, insured, annuitant, or beneficiary is a related person (as defined in section [954\(d\)\(3\)](#)).

**(ii) Applicable home country risks**

The term "applicable home country risks" means risks in connection with property in, liability arising out of activity in, or the lives or health of residents of, the home country of the qualifying insurance company or qualifying insurance company branch, as the case may be, issuing or reinsuring the contract covering the risks.

**(C) Substantial activity requirements for cross border risks**

A contract issued by a qualifying insurance company or qualifying insurance company branch which covers risks other than applicable home country risks (as defined in

subparagraph (B)(ii)) shall not be treated as an exempt contract unless such company or branch, as the case may be -

- (i) conducts substantial activity with respect to an insurance business in its home country, and
  - (ii) performs in its home country substantially all of the activities necessary to give rise to the income generated by such contract.
- (3) Qualifying insurance company**  
The term "qualifying insurance company" means any controlled foreign corporation which -
- (A)** is subject to regulation as an insurance (or reinsurance) company by its home country, and is licensed, authorized, or regulated by the applicable insurance regulatory body for its home country to sell insurance, reinsurance, or annuity contracts to persons other than related persons (within the meaning of section [954\(d\)\(3\)](#)) in such home country,
  - (B)** derives more than 50 percent of its aggregate net written premiums from the issuance or reinsurance by such controlled foreign corporation and each of its qualifying insurance company branches of contracts -
    - (i) covering applicable home country risks (as defined in paragraph (2)) of such corporation or branch, as the case may be, and
    - (ii) with respect to which no policyholder, insured, annuitant, or beneficiary is a related person (as defined in section [954\(d\)\(3\)](#)), except that in the case of a branch, such premiums shall only be taken into account to the extent such premiums are treated as earned by such branch in its home country for purposes of such country's tax laws, and
  - (C)** is engaged in the insurance business and would be subject to tax under subchapter L if it were a domestic corporation.
- (4) Qualifying insurance company branch**  
The term "qualifying insurance company branch" means a qualified business unit (within the meaning of section [989\(a\)](#)) of a controlled foreign corporation if -
- (A)** such unit is licensed, authorized, or regulated by the applicable insurance regulatory body for its home country to sell insurance, reinsurance, or annuity contracts to persons other than related persons (within the meaning of section [954\(d\)\(3\)](#)) in such home country, and
  - (B)** such controlled foreign corporation is a qualifying insurance company, determined under paragraph (3) as if such unit were a qualifying insurance company branch.
- (5) Life insurance or annuity contract**  
For purposes of this section and section [954](#), the determination of whether a contract issued by a controlled foreign corporation or a qualified business unit (within the meaning of section [989\(a\)](#)) is a life insurance contract or an annuity contract shall be made without regard to sections [72\(s\)](#), [101\(f\)](#), [817\(h\)](#), and [7702](#) if -
- (A)** such contract is regulated as a life insurance or annuity contract by the corporation's or unit's home country, and

- (B) no policyholder, insured, annuitant, or beneficiary with respect to the contract is a United States person.
- (6) Home country  
For purposes of this subsection, except as provided in regulations -
- (A) Controlled foreign corporation  
The term "home country" means, with respect to a controlled foreign corporation, the country in which such corporation is created or organized.
- (B) Qualified business unit  
The term "home country" means, with respect to a qualified business unit (as defined in section [989\(a\)](#)), the country in which the principal office of such unit is located and in which such unit is licensed, authorized, or regulated by the applicable insurance regulatory body to sell insurance, reinsurance, or annuity contracts to persons other than related persons (as defined in section [954\(d\)\(3\)](#)) in such country.
- (7) Anti-abuse rules  
For purposes of applying this subsection and section [954\(i\)](#) -
- (A) the rules of section [954\(h\)\(7\)](#) (other than subparagraph (B) thereof) shall apply,
- (B) there shall be disregarded any item of income, gain, loss, or deduction of, or derived from, an entity which is not engaged in regular and continuous transactions with persons which are not related persons,
- (C) there shall be disregarded any change in the method of computing reserves a principal purpose of which is the acceleration or deferral of any item in order to claim the benefits of this subsection or section [954\(i\)](#),
- (D) a contract of insurance or reinsurance shall not be treated as an exempt contract (and premiums from such contract shall not be taken into account for purposes of paragraph (2)(B) or (3)) if -
- (i) any policyholder, insured, annuitant, or beneficiary is a resident of the United States and such contract was marketed to such resident and was written to cover a risk outside the United States, or
- (ii) the contract covers risks located within and without the United States and the qualifying insurance company or qualifying insurance company branch does not maintain such contemporaneous records, and file such reports, with respect to such contract as the Secretary may require,
- (E) the Secretary may prescribe rules for the allocation of contracts (and income from contracts) among 2 or more qualifying insurance company branches of a qualifying insurance company in order to clearly reflect the income of such branches, and
- (F) premiums from a contract shall not be taken into account for purposes of paragraph (2)(B) or (3) if such contract reinsures a contract issued or reinsured by a related person (as defined in section [954\(d\)\(3\)](#)). For purposes of subparagraph (D), the determination of where risks are located shall be made under the principles of section [953](#).
- (8) Coordination with subsection (c)  
In determining insurance income for purposes of subsection (c), exempt insurance income

shall not include income derived from exempt contracts which cover risks other than applicable home country risks.

**(9) Regulations**

The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection and section [954\(i\)](#).

**(10) Application**

This subsection and section [954\(i\)](#) shall apply only to taxable years of a foreign corporation beginning after December 31, 1998, and before January 1, 2007, and to taxable years of United States shareholders with or within which any such taxable year of such foreign corporation ends. If this subsection does not apply to a taxable year of a foreign corporation beginning after December 31, 2006 (and taxable years of United States shareholders ending with or within such taxable year), then, notwithstanding the preceding sentence, subsection (a) shall be applied to such taxable years in the same manner as it would if the taxable year of the foreign corporation began in 1998.

**(11) Cross reference**

For income exempt from foreign personal holding company income, see section [954\(i\)](#).

## **SECTION REFERRED TO IN OTHER SECTIONS**

This section is referred to in sections [512](#), [884](#), [898](#), [904](#), [952](#), [954](#), [956](#), [957](#), [6046](#) of this title.

### [SOURCE](#)

### [AMENDMENTS](#)

[EFFECTIVE DATE OF 2002 AMENDMENT](#)

[EFFECTIVE DATE OF 1999 AMENDMENT](#)

[EFFECTIVE DATE OF 1989 AMENDMENT](#)

[EFFECTIVE DATE OF 1988 AMENDMENT](#)

[EFFECTIVE DATE OF 1986 AMENDMENT](#)

[EFFECTIVE DATE OF 1984 AMENDMENT](#)

[EFFECTIVE DATE OF 1966 AMENDMENT](#)

## Sec. 72. Annuities; certain proceeds of endowment and life insurance contracts

[TITLE 26](#), [Subtitle A](#), [CHAPTER 1](#), [Subchapter B](#), [PART II](#), Sec. 72.

### STATUTE

#### (a) General rule for annuities

Except as otherwise provided in this chapter, gross income includes any amount received as an annuity (whether for a period certain or during one or more lives) under an annuity, endowment, or life insurance contract.

#### (b) Exclusion ratio

##### (1) In general

Gross income does not include that part of any amount received as an annuity under an annuity, endowment, or life insurance contract which bears the same ratio to such amount as the investment in the contract (as of the annuity starting date) bears to the expected return under the contract (as of such date).

##### (2) Exclusion limited to investment

The portion of any amount received as an annuity which is excluded from gross income under paragraph (1) shall not exceed the unrecovered investment in the contract immediately before the receipt of such amount.

##### (3) Deduction where annuity payments cease before entire investment recovered

##### (A) In general

If -

(i) after the annuity starting date, payments as an annuity under the contract cease by reason of the death of an annuitant, and

(ii) as of the date of such cessation, there is unrecovered investment in the contract, the amount of such unrecovered investment (in excess of any amount specified in subsection (e)(5) which was not included in gross income) shall be allowed as a deduction to the annuitant for his last taxable year.

##### (B) Payments to other persons

In the case of any contract which provides for payments meeting the requirements of subparagraphs (B) and (C) of subsection (c)(2), the deduction under subparagraph (A) shall be allowed to the person entitled to such payments for the taxable year in which such payments are received.

##### (C) Net operating loss deductions provided

For purposes of section [172](#), a deduction allowed under this paragraph shall be treated as if it were attributable to a trade or business of the taxpayer.

#### (4) Unrecovered investment

For purposes of this subsection, the unrecovered investment in the contract as of any date is -

(A) the investment in the contract (determined without regard to subsection (c)(2)) as of the annuity starting date, reduced by

(B) the aggregate amount received under the contract on or after such annuity starting date and before the date as of which the determination is being made, to the extent such amount was excludable from gross income under this subtitle.

#### (c) Definitions

##### (1) Investment in the contract

For purposes of subsection (b), the investment in the contract as of the annuity starting date is -

(A) the aggregate amount of premiums or other consideration paid for the contract, minus

(B) the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws.

##### (2) Adjustment in investment where there is refund feature

If -

(A) the expected return under the contract depends in whole or in part on the life expectancy of one or more individuals;

**(B)** the contract provides for payments to be made to a beneficiary (or to the estate of an annuitant) on or after the death of the annuitant or annuitants; and

**(C)** such payments are in the nature of a refund of the consideration paid, then the value (computed without discount for interest) of such payments on the annuity starting date shall be subtracted from the amount determined under paragraph (1). Such value shall be computed in accordance with actuarial tables prescribed by the Secretary. For purposes of this paragraph and of subsection (e)(2)(A), the term "refund of the consideration paid" includes amounts payable after the death of an annuitant by reason of a provision in the contract for a life annuity with minimum period of payments certain, but (if part of the consideration was contributed by an employer) does not include that part of any payment to a beneficiary (or to the estate of the annuitant) which is not attributable to the consideration paid by the employee for the contract as determined under paragraph (1)(A).

**(3) Expected return**

For purposes of subsection (b), the expected return under the contract shall be determined as follows:

**(A) Life expectancy**

If the expected return under the contract, for the period on and after the annuity starting date, depends in whole or in part on the life expectancy of one or more individuals, the expected return shall be computed with reference to actuarial tables prescribed by the Secretary.

**(B) Installment payments**

If subparagraph (A) does not apply, the expected return is the aggregate of the amounts receivable under the contract as an annuity.

**(4) Annuity starting date**

For purposes of this section, the annuity starting date in the case of any contract is the first day of the first period for which an amount is received as an annuity under the contract; except that if such date was before January 1, 1954, then the annuity starting date is January 1, 1954.

**(d) Special rules for qualified employer retirement plans**

**(1) Simplified method of taxing annuity payments**

**(A) In general**

In the case of any amount received as an annuity under a qualified employer retirement plan -

**(i)** subsection (b) shall not apply, and

**(ii)** the investment in the contract shall be recovered as provided in this paragraph.

**(B) Method of recovering investment in contract**

**(i) In general**

Gross income shall not include so much of any monthly annuity payment under a qualified employer retirement plan as does not exceed the amount obtained by dividing -

**(I)** the investment in the contract (as of the annuity starting date), by

**(II)** the number of anticipated payments determined under the table contained in clause (iii) (or, in the case of a contract to which subsection (c)(3)(B) applies, the number of monthly annuity payments under such contract).

**(ii) Certain rules made applicable**

Rules similar to the rules of paragraphs (2) and (3) of subsection (b) shall apply for purposes of this paragraph.

**(iii) Number of anticipated payments**

If the annuity is payable over the life of a single individual, the number of anticipated payments shall be determined as follows: If the age of the annuitant on the annuity starting date is: payments is: Not more than 55 360 More than 55 but not more than 60 310 More than 60 but not more than 65 260 More than 65 but not more than 70 210 More than 70 160.

**(iv) Number of anticipated payments where more than one life**

If the annuity is payable over the lives of more than 1 individual, the number of anticipated payments shall be determined as follows: If the combined ages of annuitants are: The number is: Not more than 110 410 More than 110 but not more than 120 360 More than 120 but not more than 130 310 More than 130 but not more than 140 260 More than 140 210.

**(C) Adjustment for refund feature not applicable**

For purposes of this paragraph, investment in the contract shall be determined under subsection (c)(1) without regard to subsection (c)(2).

**(D) Special rule where lump sum paid in connection with commencement of annuity payments**

If, in connection with the commencement of annuity payments under any qualified employer retirement plan, the taxpayer receives a lump-sum payment -

- (i)** such payment shall be taxable under subsection (e) as if received before the annuity starting date, and
- (ii)** the investment in the contract for purposes of this paragraph shall be determined as if such payment had been so received.

**(E) Exception**

This paragraph shall not apply in any case where the primary annuitant has attained age 75 on the annuity starting date unless there are fewer than 5 years of guaranteed payments under the annuity.

**(F) Adjustment where annuity payments not on monthly basis**

In any case where the annuity payments are not made on a monthly basis, appropriate adjustments in the application of this paragraph shall be made to take into account the period on the basis of which such payments are made.

**(G) Qualified employer retirement plan**

For purposes of this paragraph, the term "qualified employer retirement plan" means any plan or contract described in paragraph (1), (2), or (3) of section [4974\(c\)](#).

**(2) Treatment of employee contributions under defined contribution plans**

For purposes of this section, employee contributions (and any income allocable thereto) under a defined contribution plan may be treated as a separate contract.

**(e) Amounts not received as annuities**

**(1) Application of subsection**

**(A) In general**

This subsection shall apply to any amount which -

- (i)** is received under an annuity, endowment, or life insurance contract, and
- (ii)** is not received as an annuity, if no provision of this subtitle (other than this subsection) applies with respect to such amount.

**(B) Dividends**

For purposes of this section, any amount received which is in the nature of a dividend or similar distribution shall be treated as an amount not received as an annuity.

**(2) General rule**

Any amount to which this subsection applies -

- (A)** if received on or after the annuity starting date, shall be included in gross income, or
- (B)** if received before the annuity starting date -
  - (i)** shall be included in gross income to the extent allocable to income on the contract, and
  - (ii)** shall not be included in gross income to the extent allocable to the investment in the contract.

**(3) Allocation of amounts to income and investment**

For purposes of paragraph (2)(B) -

**(A) Allocation to income**

Any amount to which this subsection applies shall be treated as allocable to income on the contract to the extent that such amount does not exceed the excess (if any) of -

- (i)** the cash value of the contract (determined without regard to any surrender charge) immediately before the amount is received, over
- (ii)** the investment in the contract at such time.

**(B) Allocation to investment**

Any amount to which this subsection applies shall be treated as allocable to investment in the contract to the extent that such amount is not allocated to income under subparagraph (A).

**(4) Special rules for application of paragraph (2)(B)**

For purposes of paragraph (2)(B) -

**(A) Loans treated as distributions**

If, during any taxable year, an individual -

- (i)** receives (directly or indirectly) any amount as a loan under any contract to which this subsection applies, or
- (ii)** assigns or pledges (or agrees to assign or pledge) any portion of the value of any such contract, such amount or portion shall be treated as received under the contract as an amount not received as an annuity. The preceding sentence shall not apply for purposes of determining investment in the contract, except that the investment in the contract shall be increased by any amount included in gross income by reason of the amount treated as received under the preceding sentence.

**(B) Treatment of policyholder dividends**

Any amount described in paragraph (1)(B) shall not be included in gross income under paragraph (2)(B)(i) to the extent such amount is retained by the insurer as a premium or other consideration paid for the contract.

**(C) Treatment of transfers without adequate consideration**

**(i) In general**

If an individual who holds an annuity contract transfers it without full and adequate consideration, such individual shall be treated as receiving an amount equal to the excess of -

- (I)** the cash surrender value of such contract at the time of transfer, over
- (II)** the investment in such contract at such time, under the contract as an amount not received as an annuity.

**(ii) Exception for certain transfers between spouses or former spouses**

Clause (i) shall not apply to any transfer to which section [1041\(a\)](#) (relating to transfers of property between spouses or incident to divorce) applies.

**(iii) Adjustment to investment in contract of transferee**

If under clause (i) an amount is included in the gross income of the transferor of an annuity contract, the investment in the contract of the transferee in such contract shall be increased by the amount so included.

**(5) Retention of existing rules in certain cases**

**(A) In general**

In any case to which this paragraph applies -

- (i)** paragraphs (2)(B) and (4)(A) shall not apply, and
- (ii)** if paragraph (2)(A) does not apply, the amount shall be included in gross income, but only to the extent it exceeds the investment in the contract.

**(B) Existing contracts**

This paragraph shall apply to contracts entered into before August 14, 1982. Any amount allocable to investment in the contract after August 13, 1982, shall be treated as from a contract entered into after such date.

**(C) Certain life insurance and endowment contracts**

Except as provided in paragraph (10) and except to the extent prescribed by the Secretary by regulations, this paragraph shall apply to any amount not received as an annuity which is received under a life insurance or endowment contract.

**(D) Contracts under qualified plans**

Except as provided in paragraph (8), this paragraph shall apply to any amount received -

- (i)** from a trust described in section [401\(a\)](#) which is exempt from tax under section [501\(a\)](#),
- (ii)** from a contract -
  - (I)** purchased by a trust described in clause (i),
  - (II)** purchased as part of a plan described in section [403\(a\)](#),
  - (III)** described in section 403(b), or
  - (IV)** provided for employees of a life insurance company under a plan described in section [818\(a\)\(3\)](#), or
- (iii)** from an individual retirement account or an individual retirement annuity. Any dividend described in section [404\(k\)](#) which is received by a participant or beneficiary shall, for purposes of this subparagraph, be treated as paid under a separate contract to which clause (ii)(I) applies.

**(E) Full refunds, surrenders, redemptions, and maturities**

This paragraph shall apply to -

- (i)** any amount received, whether in a single sum or otherwise, under a contract in full discharge of the obligation under the contract which is in the nature of a refund of the consideration paid for the contract, and
- (ii)** any amount received under a contract on its complete surrender, redemption, or maturity. In the case of any amount to which the preceding sentence applies, the rule of paragraph (2)(A) shall not apply.

**(6) Investment in the contract**

For purposes of this subsection, the investment in the contract as of any date is -

- (A)** the aggregate amount of premiums or other consideration paid for the contract before such date, minus
- (B)** the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws. [(7) Repealed. Pub. L. 100-647, title I, Sec. 1011A(b)(9)(A), Nov. 10, 1988, 102 Stat. 3474]

**(8) Extension of paragraph (2)(b)<sup>1</sup> to qualified plans**

**(A) In general**

Notwithstanding any other provision of this subsection, in the case of any amount received before the annuity starting date from a trust or contract described in paragraph (5)(D), paragraph (2)(B) shall apply to such amounts.

**(B) Allocation of amount received**

For purposes of paragraph (2)(B), the amount allocated to the investment in the contract shall be the portion of the amount described in subparagraph (A) which bears the same ratio to such amount as the investment in the contract bears to the account balance. The determination under the preceding sentence shall be made as of the time of the distribution or at such other time as the Secretary may prescribe.

**(C) Treatment of forfeitable rights**

If an employee does not have a nonforfeitable right to any amount under any trust or contract to which subparagraph (A) applies, such amount shall not be treated as part of the account balance.

**(D) Investment in the contract before 1987**

In the case of a plan which on May 5, 1986, permitted withdrawal of any employee contributions before separation from service, subparagraph (A) shall apply only to the extent that amounts received before the annuity starting date (when increased by amounts previously received under the contract after December 31, 1986) exceed the investment in the contract as of December 31, 1986.

**(9) Extension of paragraph (2)(B) to qualified tuition programs and Coverdell education savings accounts**

Notwithstanding any other provision of this subsection, paragraph (2)(B) shall apply to amounts received under a qualified tuition program (as defined in section [529\(b\)](#)) or under a Coverdell education savings account (as defined in section [530\(b\)](#)). The rule of paragraph (8)(B) shall apply for purposes of this paragraph.

**(10) Treatment of modified endowment contracts**

**(A) In general**

Notwithstanding paragraph (5)(C), in the case of any modified endowment contract (as defined in section [7702A](#)) -

- (i)** paragraphs (2)(B) and (4)(A) shall apply, and
- (ii)** in applying paragraph (4)(A), "any person" shall be substituted for "an individual".

**(B) Treatment of certain burial contracts**

Notwithstanding subparagraph (A), paragraph (4)(A) shall not apply to any assignment (or pledge) of a modified endowment contract if such assignment (or pledge) is solely to cover the payment of expenses referred to in section [7702\(e\)\(2\)\(C\)\(iii\)](#) and if the maximum death benefit under such contract does not exceed \$25,000.

**(11) Anti-abuse rules**

**(A) In general**

For purposes of determining the amount includible in gross income under this subsection -

- (i)** all modified endowment contracts issued by the same company to the same policyholder during any calendar year shall be treated as 1 modified endowment contract, and
- (ii)** all annuity contracts issued by the same company to the same policyholder during any calendar year shall be treated as 1 annuity contract. The preceding sentence shall not apply to any contract described in paragraph (5)(D).

**(B) Regulatory authority**

The Secretary may by regulations prescribe such additional rules as may be necessary or appropriate to prevent avoidance of the purposes of this subsection through serial purchases of contracts or otherwise.

**(f) Special rules for computing employees' contributions**

In computing, for purposes of subsection (c)(1)(A), the aggregate amount of premiums or other consideration paid for the contract, and for purposes of subsection (e)(6), the aggregate premiums or other consideration paid, amounts contributed by the employer shall be included, but only to the extent that -

- (1)** such amounts were includible in the gross income of the employee under this subtitle or prior income tax laws; or
- (2)** if such amounts had been paid directly to the employee at the time they were contributed, they would not have been includible in the gross income of the employee under the law applicable at the time of such contribution.

Paragraph (2) shall not apply to amounts which were contributed by the employer after December 31, 1962, and which would not have been includible in the gross income of the employee by reason of the application of section [911](#) if such amounts had been paid directly to the employee at the time of contribution. The preceding sentence shall not apply to amounts which were contributed by the employer, as determined under regulations prescribed by the Secretary, to provide pension or annuity credits, to the extent such credits are attributable to services performed before January 1, 1963, and are provided pursuant to pension or annuity plan provisions in existence on March 12, 1962, and on that date applicable to such services, or to the extent such credits are attributable to services performed as a foreign missionary (within the meaning of section 403(b)(2)(D)(iii), as in effect before the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001.<sup>2</sup>

**(g) Rules for transferee where transfer was for value**

Where any contract (or any interest therein) is transferred (by assignment or otherwise) for a valuable consideration, to the extent that the contract (or interest therein) does not, in the hands of the transferee, have a basis which is determined by reference to the basis in the hands of the transferor, then -

- (1)** for purposes of this section, only the actual value of such consideration, plus the amount of the premiums and other consideration paid by the transferee after the transfer, shall be taken into account in computing the aggregate amount of the premiums or other consideration paid for the contract;
- (2)** for purposes of subsection (c)(1)(B), there shall be taken into account only the aggregate amount received under the contract by the transferee before the annuity starting date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws; and
- (3)** the annuity starting date is January 1, 1954, or the first day of the first period for which the transferee received an amount under the contract as an annuity, whichever is the later. For purposes of this subsection, the term "transferee" includes a beneficiary of, or the estate of, the transferee.

**(h) Option to receive annuity in lieu of lump sum**

If -

- (1)** a contract provides for payment of a lump sum in full discharge of an obligation under the contract, subject to an option to receive an annuity in lieu of such lump sum;
- (2)** the option is exercised within 60 days after the day on which such lump sum first became payable; and
- (3)** part or all of such lump sum would (but for this subsection) be includible in gross income by reason of subsection (e)(1), then, for purposes of this subtitle, no part of such lump sum shall be considered as includible in gross income at the time such lump sum first became payable. [(i) Repealed. Pub. L. 94-455, title XIX, Sec. 1951(b)(1)(A), Oct. 4, 1976, 90 Stat. 1836]

**(j) Interest**

Notwithstanding any other provision of this section, if any amount is held under an agreement to pay interest thereon, the interest payments shall be included in gross income. [(k) Repealed. Pub. L. 98-369, div. A, title IV, Sec. [421\(b\)\(1\)](#), July 18, 1984, 98 Stat. 794]

**(l) Face-amount certificates**

For purposes of this section, the term "endowment contract" includes a face-amount certificate, as defined in section 2(a)(15) of the Investment Company Act of 1940 (15 U.S.C., sec. 80a-2), issued after December 31, 1954.

**(m) Special rules applicable to employee annuities and distributions under employee plans**

[(1) Repealed. Pub. L. 93-406, title II, Sec. 2001(h)(2), Sept. 2, 1974, 88 Stat. 957]

**(2)** Computation of consideration paid by the employee  
In computing -

**(A)** the aggregate amount of premiums or other consideration paid for the contract for purposes of subsection (c)(1)(A) (relating to the investment in the contract), and

**(B)** the aggregate premiums or other consideration paid for purposes of subsection (e)(6) (relating to certain amounts not received as an annuity), any amount allowed as a deduction with respect to the contract under section [404](#) which was paid while the employee was an employee within the meaning of section [401\(c\)\(1\)](#) shall be treated as consideration contributed by the employer, and there shall not be taken into account any portion of the premiums or other consideration for the contract paid while the employee was an owner-employee which is properly allocable (as determined under regulations prescribed by the Secretary) to the cost of life, accident, health, or other insurance.

**(3)** Life insurance contracts

**(A)** This paragraph shall apply to any life insurance contract -

**(i)** purchased as a part of a plan described in section [403\(a\)](#), or

**(ii)** purchased by a trust described in section [401\(a\)](#) which is exempt from tax under section [501\(a\)](#) if the proceeds of such contract are payable directly or indirectly to a participant in such trust or to a beneficiary of such participant.

**(B)** Any contribution to a plan described in subparagraph (A)(i) or a trust described in subparagraph (A)(ii) which is allowed as a deduction under section [404](#), and any income of a trust described in subparagraph (A)(ii), which is determined in accordance with regulations prescribed by the Secretary to have been applied to purchase the life insurance protection under a contract described in subparagraph (A), is includible in the gross income of the participant for the taxable year when so applied.

**(C)** In the case of the death of an individual insured under a contract described in subparagraph (A), an amount equal to the cash surrender value of the contract immediately before the death of the insured shall be treated as a payment under such plan or a distribution by such trust, and the excess of the amount payable by reason of the death of the insured over such cash surrender value shall not be includible in gross income under this section and shall be treated as provided in section [101](#). [(4) Repealed. Pub. L. 97-248, title II, Sec. 236(b)(1), Sept. 3, 1982, 96 Stat. 510]

**(5)** Penalties applicable to certain amounts received by 5-percent owners

**(A)** This paragraph applies to amounts which are received from a qualified trust described in section [401\(a\)](#) or under a plan described in section [403\(a\)](#) at any time by an individual who is, or has been, a 5-percent owner, or by a successor of such an individual, but only to the extent such amounts are determined, under regulations prescribed by the Secretary, to exceed the benefits provided for such individual under the plan formula.

**(B)** If a person receives an amount to which this paragraph applies, his tax under this chapter for the taxable year in which such amount is received shall be increased by an amount equal to 10 percent of the portion of the amount so received which is includible in his gross income for such taxable year.

**(C)** For purposes of this paragraph, the term "5-percent owner" means any individual who, at any time during the 5 plan years preceding the plan year ending in the taxable year in which the amount is received, is a 5-percent owner (as defined in section [416\(i\)\(1\)\(B\)](#)).

**(6)** Owner-employee defined

For purposes of this subsection, the term "owner-employee" has the meaning assigned to it by section [401\(c\)\(3\)](#) and includes an individual for whose benefit an individual retirement account or annuity described in section [408\(a\)](#) or (b) is maintained. For purposes of the preceding sentence, the term "owner-employee" shall include an employee within the meaning of section [401\(c\)\(1\)](#).

**(7)** Meaning of disabled

For purposes of this section, 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. An individual shall not be considered to be disabled unless he furnishes proof of the existence thereof in such form and manner as the Secretary may require. [(8) Repealed. Pub. L. 97-248, title II, Sec. 236(b)(1), Sept. 3,

1982, 96 Stat. 510] [(9) Repealed. Pub. L. 98-369, div. A, title VII, Sec. 713(d)(1), July 18, 1984, 98 Stat. 957]

**(10) Determination of investment in the contract in the case of qualified domestic relations orders**

Under regulations prescribed by the Secretary, in the case of a distribution or payment made to an alternate payee who is the spouse or former spouse of the participant pursuant to a qualified domestic relations order (as defined in section [414\(p\)](#)), the investment in the contract as of the date prescribed in such regulations shall be allocated on a pro rata basis between the present value of such distribution or payment and the present value of all other benefits payable with respect to the participant to which such order relates.

**(n) Annuities under retired serviceman's family protection plan or survivor benefit plan**

Subsection (b) shall not apply in the case of amounts received after December 31, 1965, as an annuity under chapter 73 of title 10 of the United States Code, but all such amounts shall be excluded from gross income until there has been so excluded (under section [122\(b\)\(1\)](#) or this section, including amounts excluded before January 1, 1966) an amount equal to the consideration for the contract (as defined by section [122\(b\)\(2\)](#)), plus any amount treated pursuant to section 101(b)(2)(D) (as in effect on the day before the date of the enactment of the Small Business Job Protection Act of 1996) as additional consideration paid by the employee. Thereafter all amounts so received shall be included in gross income.

**(o) Special rules for distributions from qualified plans to which employee made deductible contributions**

**(1) Treatment of contributions**

For purposes of this section and sections [402](#) and [403](#), notwithstanding section [414\(h\)](#), any deductible employee contribution made to a qualified employer plan or government plan shall be treated as an amount contributed by the employer which is not includible in the gross income of the employee. [(2) Repealed. Pub. L. 100-647, title I, Sec. 1011A(c)(8), Nov. 10, 1988, 102 Stat. 3476]

**(3) Amounts constructively received**

**(A) In general**

For purposes of this subsection, rules similar to the rules provided by subsection (p) (other than the exception contained in paragraph (2) thereof) shall apply.

**(B) Purchase of life insurance**

To the extent any amount of accumulated deductible employee contributions of an employee are applied to the purchase of life insurance contracts, such amount shall be treated as distributed to the employee in the year so applied.

**(4) Special rule for treatment of rollover amounts**

For purposes of sections [402\(c\)](#), [403\(a\)\(4\)](#), and [403\(b\)\(8\)](#), [408\(d\)\(3\)](#), and [457\(e\)\(16\)](#), the Secretary shall prescribe regulations providing for such allocations of amounts attributable to accumulated deductible employee contributions, and for such other rules, as may be necessary to insure that such accumulated deductible employee contributions do not become eligible for additional tax benefits (or freed from limitations) through the use of rollovers.

**(5) Definitions and special rules**

For purposes of this subsection -

**(A) Deductible employee contributions**

The term "deductible employee contributions" means any qualified voluntary employee contribution (as defined in section [219\(e\)\(2\)](#)) made after December 31, 1981, in a taxable year beginning after such date and made for a taxable year beginning before January 1, 1987, and allowable as a deduction under section [219\(a\)](#) for such taxable year.

**(B) Accumulated deductible employee contributions**

The term "accumulated deductible employee contributions" means the deductible employee contributions -

**(i)** increased by the amount of income and gain allocable to such contributions, and

**(ii)** reduced by the sum of the amount of loss and expense allocable to such contributions and the amounts distributed with respect to the employee which are attributable to such contributions (or income or gain allocable to such contributions).

**(C) Qualified employer plan**

The term "qualified employer plan" has the meaning given to such term by subsection (p)(3)(A)(i).

**(D) Government plan**

The term "government plan" has the meaning given such term by subsection (p)(3)(B).

**(6) Ordering rules**

Unless the plan specifies otherwise, any distribution from such plan shall not be treated as being made from the accumulated deductible employee contributions, until all other amounts to the credit of the employee have been distributed.

**(p) Loans treated as distributions**

For purposes of this section -

**(1) Treatment as distributions**

**(A) Loans**

If during any taxable year a participant or beneficiary receives (directly or indirectly) any amount as a loan from a qualified employer plan, such amount shall be treated as having been received by such individual as a distribution under such plan.

**(B) Assignments or pledges**

If during any taxable year a participant or beneficiary assigns (or agrees to assign) or pledges (or agrees to pledge) any portion of his interest in a qualified employer plan, such portion shall be treated as having been received by such individual as a loan from such plan.

**(2) Exception for certain loans**

**(A) General rule**

Paragraph (1) shall not apply to any loan to the extent that such loan (when added to the outstanding balance of all other loans from such plan whether made on, before, or after August 13, 1982), does not exceed the lesser of -

**(i)** \$50,000, reduced by the excess (if any) of -

**(I)** the highest outstanding balance of loans from the plan during the 1-year period ending on the day before the date on which such loan was made, over

**(II)** the outstanding balance of loans from the plan on the date on which such loan was made, or

**(ii)** the greater of (I) one-half of the present value of the nonforfeitable accrued benefit of the employee under the plan, or (II) \$10,000. For purposes of clause (ii), the present value of the nonforfeitable accrued benefit shall be determined without regard to any accumulated deductible employee contributions (as defined in subsection (o)(5)(B)).

**(B) Requirement that loan be repayable within 5 years**

**(i) In general**

Subparagraph (A) shall not apply to any loan unless such loan, by its terms, is required to be repaid within 5 years.

**(ii) Exception for home loans**

Clause (i) shall not apply to any loan used to acquire any dwelling unit which within a reasonable time is to be used (determined at the time the loan is made) as the principal residence of the participant.

**(C) Requirement of level amortization**

Except as provided in regulations, this paragraph shall not apply to any loan unless substantially level amortization of such loan (with payments not less frequently than quarterly) is required over the term of the loan.

**(D) Related employers and related plans**

For purposes of this paragraph -

**(i)** the rules of subsections (b), (c), and (m) of section [414](#) shall apply, and

**(ii)** all plans of an employer (determined after the application of such subsections) shall be treated as 1 plan.

**(3) Denial of interest deductions in certain cases**

**(A) In general**

No deduction otherwise allowable under this chapter shall be allowed under this chapter for any interest paid or accrued on any loan to which paragraph (1) does not apply by reason of paragraph (2) during the period described in subparagraph (B).

**(B) Period to which subparagraph (A) applies**

For purposes of subparagraph (A), the period described in this subparagraph is the period -

**(i)** on or after the 1st day on which the individual to whom the loan is made is a key employee (as defined in section [416\(i\)](#)), or

(ii) such loan is secured by amounts attributable to elective deferrals described in subparagraph (A) or (C) of section [402\(g\)\(3\)](#).

(4) Qualified employer plan, etc.

For purposes of this subsection -

(A) Qualified employer plan

(i) In general

The term "qualified employer plan" means -

(I) a plan described in section [401\(a\)](#) which includes a trust exempt from tax under section [501\(a\)](#),

(II) an annuity plan described in section [403\(a\)](#), and

(III) a plan under which amounts are contributed by an individual's employer for an annuity contract described in section 403(b).

(ii) Special rule

The term "qualified employer plan" shall include any plan which was (or was determined to be) a qualified employer plan or a government plan.

(B) Government plan

The term "government plan" means any plan, whether or not qualified, established and maintained for its employees by the United States, by a State or political subdivision thereof, or by an agency or instrumentality of any of the foregoing.

(5) Special rules for loans, etc., from certain contracts

For purposes of this subsection, any amount received as a loan under a contract purchased under a qualified employer plan (and any assignment or pledge with respect to such a contract) shall be treated as a loan under such employer plan.

(q) 10-percent penalty for premature distributions from annuity contracts

(1) Imposition of penalty

If any taxpayer receives any amount under an annuity contract, the taxpayer's tax under this chapter for the taxable year in which such amount is received shall be increased by an amount equal to 10 percent of the portion of such amount which is includible in gross income.

(2) Subsection not to apply to certain distributions

Paragraph 1 shall not apply to any distribution -

(A) made on or after the date on which the taxpayer attains age 59 1/2 ,

(B) made on or after the death of the holder (or, where the holder is not an individual, the death of the primary annuitant (as defined in subsection (s)(6)(B))),

(C) attributable to the taxpayer's becoming disabled within the meaning of subsection (m)(7),

(D) which is a part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of such taxpayer and his designated beneficiary,

(E) from a plan, contract, account, trust, or annuity described in subsection (e)(5)(D),

(F) allocable to investment in the contract before August 14, 1982, or<sup>3</sup>

(G) under a qualified funding asset (within the meaning of section [130\(d\)](#), but without regard to whether there is a qualified assignment),

(H) to which subsection (t) applies (without regard to paragraph (2) thereof),

(I) under an immediate annuity contract (within the meaning of section [72\(u\)\(4\)](#)), or

(J) which is purchased by an employer upon the termination of a plan described in section [401\(a\)](#) or [403\(a\)](#) and which is held by the employer until such time as the employee separates from service.

(3) Change in substantially equal payments

If -

(A) paragraph (1) does not apply to a distribution by reason of paragraph (2)(D), and

(B) the series of payments under such paragraph are subsequently modified (other than by reason of death or disability) -

**(i)** before the close of the 5-year period beginning on the date of the first payment and after the taxpayer attains age 59 1/2 , or

**(ii)** before the taxpayer attains age 59 1/2 , the taxpayer's tax for the 1st taxable year in which such modification occurs shall be increased by an amount, determined under regulations, equal to the tax which (but for paragraph (2)(D)) would have been imposed, plus interest for the deferral period (within the meaning of subsection (t)(4)(B)).

**(r)** Certain railroad retirement benefits treated as received under employer plans

**(1)** In general

Notwithstanding any other provision of law, any benefit provided under the Railroad Retirement Act of 1974 (other than a tier 1 railroad retirement benefit) shall be treated for purposes of this title as a benefit provided under an employer plan which meets the requirements of section [401\(a\)](#).

**(2)** Tier 2 taxes treated as contributions

**(A)** In general

For purposes of paragraph (1) -

**(i)** the tier 2 portion of the tax imposed by section [3201](#) (relating to tax on employees) shall be treated as an employee contribution,

**(ii)** the tier 2 portion of the tax imposed by section [3211](#) (relating to tax on employee representatives) shall be treated as an employee contribution, and

**(iii)** the tier 2 portion of the tax imposed by section [3221](#) (relating to tax on employers) shall be treated as an employer contribution.

**(B)** Tier 2 portion

For purposes of subparagraph (A) -

**(i)** After 1984

With respect to compensation paid after 1984, the tier 2 portion shall be the taxes imposed by sections [3201\(b\)](#), [3211\(b\)](#), and [3221\(b\)](#).

**(ii)** After September 30, 1981, and before 1985

With respect to compensation paid before 1985 for services rendered after September 30, 1981, the tier 2 portion shall be -

**(I)** so much of the tax imposed by section [3201](#) as is determined at the 2 percent rate, and

**(II)** so much of the taxes imposed by sections [3211](#) and [3221](#) as is determined at the 11.75 percent rate. With respect to compensation paid for services rendered after December 31, 1983, and before 1985, subclause (I) shall be applied by substituting "2.75 percent" for "2 percent", and subclause (II) shall be applied by substituting "12.75 percent" for "11.75 percent".

**(iii)** Before October 1, 1981

With respect to compensation paid for services rendered during any period before October 1, 1981, the tier 2 portion shall be the excess (if any) of -

**(I)** the tax imposed for such period by section [3201](#), [3211](#), or [3221](#), as the case may be (other than any tax imposed with respect to man-hours), over

**(II)** the tax which would have been imposed by such section for such period had the rates of the comparable taxes imposed by chapter 21 for such period applied under such section.

**(C)** Contributions not allocable to supplemental annuity or windfall benefits

For purposes of paragraph (1), no amount treated as an employee contribution under this paragraph shall be allocated to -

**(i)** any supplemental annuity paid under section 2(b) of the Railroad Retirement Act of 1974, or

**(ii)** any benefit paid under section 3(h), 4(e), or 4(h) of such Act.

**(3)** Tier 1 railroad retirement benefit

For purposes of paragraph (1), the term "tier 1 railroad retirement benefit" has the meaning given such term by section [86\(d\)\(4\)](#).

**(s)** Required distributions where holder dies before entire interest is distributed

**(1)** In general

A contract shall not be treated as an annuity contract for purposes of this title unless it provides that -

**(A)** if any holder of such contract dies on or after the annuity starting date and before the entire interest in such contract has been distributed, the remaining portion of such interest will be distributed at least as rapidly as under the method of distributions being used as of the date of his death, and

**(B)** if any holder of such contract dies before the annuity starting date, the entire interest in such contract will be distributed within 5 years after the death of such holder.

**(2)** Exception for certain amounts payable over life of beneficiary

If -

**(A)** any portion of the holder's interest is payable to (or for the benefit of) a designated beneficiary,

**(B)** such portion will be distributed (in accordance with regulations) over the life of such designated beneficiary (or over a period not extending beyond the life expectancy of such beneficiary), and

**(C)** such distributions begin not later than 1 year after the date of the holder's death or such later date as the Secretary may by regulations prescribe, then for purposes of paragraph (1), the portion referred to in subparagraph (A) shall be treated as distributed on the day on which such distributions begin.

**(3)** Special rule where surviving spouse beneficiary

If the designated beneficiary referred to in paragraph (2)(A) is the surviving spouse of the holder of the contract, paragraphs (1) and (2) shall be applied by treating such spouse as the holder of such contract.

**(4)** Designated beneficiary

For purposes of this subsection, the term "designated beneficiary" means any individual designated a beneficiary by the holder of the contract.

**(5)** Exception for certain annuity contracts

This subsection shall not apply to any annuity contract -

**(A)** which is provided -

**(i)** under a plan described in section [401\(a\)](#) which includes a trust exempt from tax under section [501](#), or

**(ii)** under a plan described in section [403\(a\)](#),

**(B)** which is described in section 403(b),

**(C)** which is an individual retirement annuity or provided under an individual retirement account or annuity, or

**(D)** which is a qualified funding asset (as defined in section [130\(d\)](#), but without regard to whether there is a qualified assignment).

**(6)** Special rule where holder is corporation or other non-individual

**(A)** In general

For purposes of this subsection, if the holder of the contract is not an individual, the primary annuitant shall be treated as the holder of the contract.

**(B)** Primary annuitant

For purposes of subparagraph (A), the term "primary annuitant" means the individual, the events in the life of whom are of primary importance in affecting the timing or amount of the payout under the contract.

**(7)** Treatment of changes in primary annuitant where holder of contract is not an individual

For purposes of this subsection, in the case of a holder of an annuity contract which is not an individual, if there is a change in a primary annuitant (as defined in paragraph (6)(B)), such change shall be treated as the death of the holder.

**(t)** 10-percent additional tax on early distributions from qualified retirement plans

**(1)** Imposition of additional tax

If any taxpayer receives any amount from a qualified retirement plan (as defined in section [4974\(c\)](#)), the taxpayer's tax

under this chapter for the taxable year in which such amount is received shall be increased by an amount equal to 10 percent of the portion of such amount which is includible in gross income.

**(2) Subsection not to apply to certain distributions**

Except as provided in paragraphs (3) and (4), paragraph (1) shall not apply to any of the following distributions:

**(A) In general**

Distributions which are -

- (i) made on or after the date on which the employee attains age 59 1/2 ,
- (ii) made to a beneficiary (or to the estate of the employee) on or after the death of the employee,
- (iii) attributable to the employee's being disabled within the meaning of subsection (m)(7),
- (iv) part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of such employee and his designated beneficiary,
- (v) made to an employee after separation from service after attainment of age 55,
- (vi) dividends paid with respect to stock of a corporation which are described in section [404\(k\)](#), or
- (vii) made on account of a levy under section [6331](#) on the qualified retirement plan.

**(B) Medical expenses**

Distributions made to the employee (other than distributions described in subparagraph (A), (C), or (D)) to the extent such distributions do not exceed the amount allowable as a deduction under section [213](#) to the employee for amounts paid during the taxable year for medical care (determined without regard to whether the employee itemizes deductions for such taxable year).

**(C) Payments to alternate payees pursuant to qualified domestic relations orders**

Any distribution to an alternate payee pursuant to a qualified domestic relations order (within the meaning of section [414\(p\)\(1\)](#)).

**(D) Distributions to unemployed individuals for health insurance premiums**

**(i) In general**

Distributions from an individual retirement plan to an individual after separation from employment -

- (I) if such individual has received unemployment compensation for 12 consecutive weeks under any Federal or State unemployment compensation law by reason of such separation,
- (II) if such distributions are made during any taxable year during which such unemployment compensation is paid or the succeeding taxable year, and
- (III) to the extent such distributions do not exceed the amount paid during the taxable year for insurance described in section [213\(d\)\(1\)\(D\)](#) with respect to the individual and the individual's spouse and dependents (as defined in section [152](#)).

**(ii) Distributions after reemployment**

Clause (i) shall not apply to any distribution made after the individual has been employed for at least 60 days after the separation from employment to which clause (i) applies.

**(iii) Self-employed individuals**

To the extent provided in regulations, a self-employed individual shall be treated as meeting the requirements of clause (i)(I) if, under Federal or State law, the individual would have received unemployment compensation but for the fact the individual was self-employed.

**(E) Distributions from individual retirement plans for higher education expenses**

Distributions to an individual from an individual retirement plan to the extent such distributions do not exceed the qualified higher education expenses (as defined in paragraph (7)) of the taxpayer for the taxable year. Distributions shall not be taken into account under the preceding sentence if such distributions are described in subparagraph (A), (C), or (D) or to the extent paragraph (1) does not apply to such distributions by reason of subparagraph (B).

**(F) Distributions from certain plans for first home purchases**

Distributions to an individual from an individual retirement plan which are qualified first-time homebuyer distributions

(as defined in paragraph (8)). Distributions shall not be taken into account under the preceding sentence if such distributions are described in subparagraph (A), (C), (D), or (E) or to the extent paragraph (1) does not apply to such distributions by reason of subparagraph (B).

**(3) Limitations**

**(A) Certain exceptions not to apply to individual retirement plans**

Subparagraphs (A)(v) and (C) of paragraph (2) shall not apply to distributions from an individual retirement plan.

**(B) Periodic payments under qualified plans must begin after separation**

Paragraph (2)(A)(iv) shall not apply to any amount paid from a trust described in section [401\(a\)](#) which is exempt from tax under section [501\(a\)](#) or from a contract described in section [72\(e\)\(5\)\(D\)\(ii\)](#) unless the series of payments begins after the employee separates from service.

**(4) Change in substantially equal payments**

**(A) In general**

If -

**(i)** paragraph (1) does not apply to a distribution by reason of paragraph (2)(A)(iv), and

**(ii)** the series of payments under such paragraph are subsequently modified (other than by reason of death or disability) -

**(I)** before the close of the 5-year period beginning with the date of the first payment and after the employee attains age 59 1/2 , or

**(II)** before the employee attains age 59 1/2 , the taxpayer's tax for the 1st taxable year in which such modification occurs shall be increased by an amount, determined under regulations, equal to the tax which (but for paragraph (2)(A)(iv)) would have been imposed, plus interest for the deferral period.

**(B) Deferral period**

For purposes of this paragraph, the term "deferral period" means the period beginning with the taxable year in which (without regard to paragraph (2)(A)(iv)) the distribution would have been includible in gross income and ending with the taxable year in which the modification described in subparagraph (A) occurs.

**(5) Employee**

For purposes of this subsection, the term "employee" includes any participant, and in the case of an individual retirement plan, the individual for whose benefit such plan was established.

**(6) Special rules for simple retirement accounts**

In the case of any amount received from a simple retirement account (within the meaning of section [408\(p\)](#)) during the 2-year period beginning on the date such individual first participated in any qualified salary reduction arrangement maintained by the individual's employer under section [408\(p\)\(2\)](#), paragraph (1) shall be applied by substituting "25 percent" for "10 percent".

**(7) Qualified higher education expenses**

For purposes of paragraph (2)(E) -

**(A) In general**

The term "qualified higher education expenses" means qualified higher education expenses (as defined in section [529\(e\)\(3\)](#)) for education furnished to -

**(i)** the taxpayer,

**(ii)** the taxpayer's spouse, or

**(iii)** any child (as defined in section [151\(c\)\(3\)](#)) or grandchild of the taxpayer or the taxpayer's spouse, at an eligible educational institution (as defined in section [529\(e\)\(5\)](#)).

**(B) Coordination with other benefits**

The amount of qualified higher education expenses for any taxable year shall be reduced as provided in section [25A\(g\)\(2\)](#).

**(8) Qualified first-time homebuyer distributions**

For purposes of paragraph (2)(F) -

**(A) In general**

The term "qualified first-time homebuyer distribution" means any payment or distribution received by an individual to the extent such payment or distribution is used by the individual before the close of the 120th day after the day on which such payment or distribution is received to pay qualified acquisition costs with respect to a principal residence of a first-time homebuyer who is such individual, the spouse of such individual, or any child, grandchild, or ancestor of such individual or the individual's spouse.

**(B) Lifetime dollar limitation**

The aggregate amount of payments or distributions received by an individual which may be treated as qualified first-time homebuyer distributions for any taxable year shall not exceed the excess (if any) of -

**(i)** \$10,000, over

**(ii)** the aggregate amounts treated as qualified first-time homebuyer distributions with respect to such individual for all prior taxable years.

**(C) Qualified acquisition costs**

For purposes of this paragraph, the term "qualified acquisition costs" means the costs of acquiring, constructing, or reconstructing a residence. Such term includes any usual or reasonable settlement, financing, or other closing costs.

**(D) First-time homebuyer; other definitions**

For purposes of this paragraph -

**(i) First-time homebuyer**

The term "first-time homebuyer" means any individual if -

**(I)** such individual (and if married, such individual's spouse) had no present ownership interest in a principal residence during the 2-year period ending on the date of acquisition of the principal residence to which this paragraph applies, and

**(II)** subsection (h) or (k) of section [1034](#)<sup>4</sup> (as in effect on the day before the date of the enactment of this paragraph) did not suspend the running of any period of time specified in section [1034](#)<sup>4</sup> (as so in effect) with respect to such individual on the day before the date the distribution is applied pursuant to subparagraph (A).

**(ii) Principal residence**

The term "principal residence" has the same meaning as when used in section [121](#).

**(iii) Date of acquisition**

The term "date of acquisition" means the date -

**(I)** on which a binding contract to acquire the principal residence to which subparagraph (A) applies is entered into, or

**(II)** on which construction or reconstruction of such a principal residence is commenced.

**(E) Special rule where delay in acquisition**

If any distribution from any individual retirement plan fails to meet the requirements of subparagraph (A) solely by reason of a delay or cancellation of the purchase or construction of the residence, the amount of the distribution may be contributed to an individual retirement plan as provided in section [408\(d\)\(3\)\(A\)\(i\)](#) (determined by substituting "120th day" for "60th day" in such section), except that -

**(i)** section [408\(d\)\(3\)\(B\)](#) shall not be applied to such contribution, and

**(ii)** such amount shall not be taken into account in determining whether section [408\(d\)\(3\)\(B\)](#) applies to any other amount.

**(9) Special rule for rollovers to section [457](#) plans**

For purposes of this subsection, a distribution from an eligible deferred compensation plan (as defined in section [457\(b\)](#)) of an eligible employer described in section [457\(e\)\(1\)\(A\)](#) shall be treated as a distribution from a qualified retirement plan described in [4974\(c\)\(1\)](#) to the extent that such distribution is attributable to an amount transferred to an eligible deferred compensation plan from a qualified retirement plan (as defined in section [4974\(c\)](#)).

**(u) Treatment of annuity contracts not held by natural persons**

**(1) In general**

If any annuity contract is held by a person who is not a natural person -

**(A)** such contract shall not be treated as an annuity contract for purposes of this subtitle (other than subchapter L), and

**(B)** the income on the contract for any taxable year of the policyholder shall be treated as ordinary income received or accrued by the owner during such taxable year. For purposes of this paragraph, holding by a trust or other entity as an agent for a natural person shall not be taken into account.

## **(2) Income on the contract**

### **(A) In general**

For purposes of paragraph (1), the term "income on the contract" means, with respect to any taxable year of the policyholder, the excess of -

- (i)** the sum of the net surrender value of the contract as of the close of the taxable year plus all distributions under the contract received during the taxable year or any prior taxable year, reduced by
- (ii)** the sum of the amount of net premiums under the contract for the taxable year and prior taxable years and amounts includible in gross income for prior taxable years with respect to such contract under this subsection. Where necessary to prevent the avoidance of this subsection, the Secretary may substitute "fair market value of the contract" for "net surrender value of the contract" each place it appears in the preceding sentence.

### **(B) Net premiums**

For purposes of this paragraph, the term "net premiums" means the amount of premiums paid under the contract reduced by any policyholder dividends.

### **(3) Exceptions**

This subsection shall not apply to any annuity contract which -

- (A)** is acquired by the estate of a decedent by reason of the death of the decedent,
- (B)** is held under a plan described in section [401\(a\)](#) or [403\(a\)](#), under a program described in section 403(b), or under an individual retirement plan,
- (C)** is a qualified funding asset (as defined in section [130\(d\)](#), but without regard to whether there is a qualified assignment),
- (D)** is purchased by an employer upon the termination of a plan described in section [401\(a\)](#) or [403\(a\)](#) and is held by the employer until all amounts under such contract are distributed to the employee for whom such contract was purchased or the employee's beneficiary, or
- (E)** is an immediate annuity.

### **(4) Immediate annuity**

For purposes of this subsection, the term "immediate annuity" means an annuity -

- (A)** which is purchased with a single premium or annuity consideration,
  - (B)** the annuity starting date (as defined in subsection (c)(4)) of which commences no later than 1 year from the date of the purchase of the annuity, and
  - (C)** which provides for a series of substantially equal periodic payments (to be made not less frequently than annually) during the annuity period.
- (v)** 10-percent additional tax for taxable distributions from modified endowment contracts

### **(1) Imposition of additional tax**

If any taxpayer receives any amount under a modified endowment contract (as defined in section [7702A](#)), the taxpayer's tax under this chapter for the taxable year in which such amount is received shall be increased by an amount equal to 10 percent of the portion of such amount which is includible in gross income.

### **(2) Subsection not to apply to certain distributions**

Paragraph (1) shall not apply to any distribution -

- (A)** made on or after the date on which the taxpayer attains age 59 1/2 ,
- (B)** which is attributable to the taxpayer's becoming disabled (within the meaning of subsection (m)(7)), or
- (C)** which is part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of such taxpayer and his beneficiary.

### **(w) Cross reference**

For limitation on adjustments to basis of annuity contracts sold, see section [1021](#).

## **FOOTNOTES**

1. So in original. Probably should be paragraph "(2)(B)".
2. So in original. The period probably should be preceded by a closing parenthesis.

3. So in original. The word "or" probably should not appear.

4. See References in Text note below.

#### **SECTION REFERRED TO IN OTHER SECTIONS**

This section is referred to in

sections [22](#), [25B](#), [26](#), [67](#), [79](#), [101](#), [122](#), [135](#), [138](#), [220](#), [221](#), [223](#), [264](#), [401](#), [402](#), [402A](#), [403](#), [406](#), [407](#), [408](#), [408A](#), [414](#), [457](#), [529](#), [530](#), [691](#), [805](#), [817](#), [817A](#), [953](#), [1014](#), [1275](#), [4973](#), [4978](#), [5891](#), [6050G](#), [7702](#), [7702A](#), [7702B](#) of this title; title 5 section 8433; title 12 sections 24a, 1813; title 15 section 6712; title 29 sections 1002, 1345; title 45 section 726.

#### SOURCE

#### AMENDMENTS

#### EFFECTIVE AND TERMINATION DATES OF 2001 AMENDMENTS

#### EFFECTIVE DATE OF 1998 AMENDMENT

#### EFFECTIVE DATE OF 1997 AMENDMENT

#### EFFECTIVE DATE OF 1996 AMENDMENTS

#### EFFECTIVE DATE OF 1992 AMENDMENT

#### EFFECTIVE DATE OF 1989 AMENDMENT

#### EFFECTIVE DATE OF 1988 AMENDMENT

#### EFFECTIVE DATE OF 1986 AMENDMENT

#### EFFECTIVE DATE OF 1984 AMENDMENTS

#### EFFECTIVE DATE OF 1983 AMENDMENTS

#### EFFECTIVE DATE OF 1982 AMENDMENT

#### EFFECTIVE DATE OF 1981 AMENDMENT

#### EFFECTIVE DATE OF 1976 AMENDMENT

#### EFFECTIVE DATE OF 1974 AMENDMENT

#### EFFECTIVE DATE OF 1969 AMENDMENT

#### EFFECTIVE DATE OF 1966 AMENDMENT

#### EFFECTIVE DATE OF 1965 AMENDMENTS

#### EFFECTIVE DATE OF 1964 AMENDMENT

#### EFFECTIVE DATE OF 1962 AMENDMENTS

#### SAVINGS PROVISION

#### APPLICABILITY OF SUBSECTION (T)

#### PLAN AMENDMENTS NOT REQUIRED UNTIL JANUARY 1, 1998

#### PLAN AMENDMENTS NOT REQUIRED UNTIL JANUARY 1, 1994

#### PLAN AMENDMENTS NOT REQUIRED UNTIL JANUARY 1, 1989

#### REFERENCES IN TEXT

#### AMENDMENT OF SECTION