age is age 70 (January 1, 1977). D had contributed $6,000 toward the cost of the annuity contract under such plan. For 1965 and 1966, D excluded under section 105(d) the entire amount received under the plan ($1600 and $1,200 respectively). For 1967 through 1973, D excluded $330 per year under section 72(b), or 27.5 percent of the $1,200 payment received under the plan per year.

(ii) In 1974, D realized that he will be entitled to use the exclusion provided in section 105(d) up until January 1, 1977, when he reaches his mandatory retirement age, and that he improperly applied section 72 to payments received in the years 1967 through 1973. In 1974, D filed a timely claim for refund with respect to the section 105(d) wage continuation benefits, for 1971, 1972 and 1973 (refunds for taxable year 1970 and prior years were barred by the statute of limitations), and continues to claim the section 105(d) exclusion for 1974, 1975 and 1976. D is entitled to an additional exclusion of $870 ($1,200−$330) for each of the years 1971, 1972 and 1973.

(iii) Upon reaching mandatory retirement age on January 1, 1977, D treats such date as the annuity starting date, and treats $6,000 as the investment in the contract. The investment in the contract is not reduced, because the amount excluded under section 72(b) for 1967 through 1970 ($330 per year) does not exceed the amount excludable under section 105(d) ($1,200 per year), and the $330 per year excluded for 1971, 1972, and 1973 were restored to the investment in the contract. Therefore, assuming that D would be entitled to exclude 41.3 percent of the payments under the plan if the annuity starting date is January 1, 1977, D would be entitled to exclude $495.60 (41.3 percent of $1,200) per annum.

Example (6). Assume the facts stated in example (5) except that D's investment in his annuity contract is $100,000 and he received payments equaling $10,000 per year. Assume also, that D had excluded under section 72(b) 54.9 percent of the payments received under the plan through 1974. Consequently, he excluded $5,490 (54.9 percent of $10,000) from his gross income for the years 1967 through 1974. D need not file amended returns for 1971, 1972, 1973, and 1974, even though the amount he excluded under section 72(b) exceeded the amounts he was entitled to exclude under section 105(d). He must, however, recompute the amount that will be treated as his investment in his annuity contract. Thus, on January 1, 1977, D's annuity starting date, his investment in his annuity contract would be $97,680. This figure represents the original investment ($100,000) reduced by the amount excluded under section 72(b) for the years 1967–1974 (8×$5,490 = $43,920) over the amount properly excludable during those years under section 105(d) ($5,200×8 = $41,600).

Example (7). Assume the same facts as in example (6) except that D's mandatory retirement age is 63 (January 1, 1970). D would redetermine his exclusion ratio for purposes of section 72(b) as of January 1, 1970, since D's mandatory retirement age is D's annuity starting date. D would treat $99,130 as his investment in his annuity contract as of such date for purposes of section 72(b). Assuming refunds for 1970 and prior taxable years were barred by the statute of limitations, the $99,130 represents the original investment of $100,000 reduced by the excess of the amount excluded under section 72(b) for 1967, 1968, and 1969 ($5,490×3 = $16,470) over the amount otherwise excludable during those years under section 105(d) ($5,200×3 = $15,600). Therefore, assuming that D would be entitled to exclude 61.2 of the payments received under the plan if the annuity starting date is January 1, 1970, D would be entitled to exclude $6,120 (61.2 percent of the $10,000 received under the plan) per annum for 1971 and subsequent years. However, D is not entitled to exclude the additional $630 ($6,120−$5,490) for 1970, because credit or refund for 1970 and prior years is barred by the statute of limitations.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6676, 28 FR 10135, Sept. 17, 1963; T.D. 6722, 29 FR 5069, Apr. 14, 1964; T.D. 6770, 29 FR 15366, Nov. 17, 1964; T.D. 7352, 40 FR 16664, Apr. 14, 1975]

§ 1.72–16 Life insurance contracts purchased under qualified employee plans.

(a) *Applicability of section.* This section provides rules for the tax treatment of premiums paid under qualified pension, annuity, or profit-sharing plans for the purchase of life insurance contracts and rules for the tax treatment of the proceeds of such a life insurance contract and of annuity contracts purchased under such plans. For purposes of this section, the term ''life insurance contract'' means a retirement income, an endowment, or other contract providing life insurance protection. The rules of this section apply to plans covering only common-law employees as well as to plans covering self-employed individuals.

(b) *Treatment of cost of life insurance protection.* (1) The rules of this paragraph are applicable 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.

The proceeds of a contract described in subdivision (ii) of this subparagraph will be considered payable indirectly to a participant or beneficiary of such participant where they are payable to the trustee but under the terms of the plan the trustee is required to pay over all of such proceeds to the beneficiary.

(2) If under a plan or trust described in subparagraph (1) of this paragraph, amounts which were allowed as a deduction under section 404, or earnings of the trust, are applied toward the purchase of a life insurance contract described in subparagraph (1) of this paragraph, the cost of the life insurance protection under such contract shall be included in the gross income of the participant for the taxable year or years in which such contributions or earnings are so applied.

(3) If the amount payable upon death at any time during the year exceeds the cash value of the insurance policy at the end of the year, the entire amount of such excess is considered current life insurance protection. The cost of such insurance will be considered to be a reasonable net premium cost, as determined by the Commissioner, for such amount of insurance for the appropriate period.

(4) The amount includible in the gross income of the employee under this paragraph shall be considered as premiums or other consideration paid or contributed by the employee only with respect to any benefits attributable to the contract (within the meaning of paragraph (a)(3) of § 1.72–2) providing the life insurance protection. However, if under the rules of this paragraph an owner-employee is required to include any amounts in his gross income, such amounts shall not in any case be treated as part of his investment in the contract.

(5) The determination of the cost of life insurance protection may be illustrated by the following example:

Example. An annual premium policy purchased by a qualified trust for a common-law employee provides an annuity of $100 per month upon retirement at age 65, with a minimum death benefit of $10,000. The insurance payable if death occurred in the first year would be $10,000. The cash value at the end of the first year is 0. The net insurance is therefore $10,000 minus 0, or $10,000. Assuming that the Commissioner has determined that a reasonable net premium cost for the employee's age is $5.85 per $1,000, the premium for $10,000 of life insurance is therefore $58.50, and this is the amount to be reported as income by the employee for his taxable year in which the premium is paid. The balance of the premium is the amount contributed for the annuity, which is not taxable to the employee under a plan meeting the requirements of section 401(a), except as provided under section 402(a). Assuming that the cash value at the end of the second year is $500, the net insurance would then be $9,500 for the second year. With a net 1-year term rate of $6.30 for the employee's age in the second year, the amount to be reported as income to the employee would be $59.85.

(6) This paragraph shall not apply if the trust has a right under any circumstances to retain any part of the proceeds of the life insurance contract. But see paragraph (c)(4) of this section relating to the taxability of the distribution of such proceeds to a beneficiary.

(c) *Treatment of proceeds of life insurance and annuity contracts.* (1) If under a qualified pension, annuity, or profit-sharing plan, there is purchased either—

(i) A life insurance contract described in paragraph (b)(1) of this section, and the employee either paid the cost of the insurance or was taxable on the cost of the insurance under paragraph (b) of this section, or

(ii) An annuity contract,

the amounts payable under any such contract by reason of the death of the employee are taxable under the rules of subparagraph (2) of this paragraph, except in the case of a joint and survivor annuity.

(2)(i) In the case of an annuity contract, the death benefit is the accumulation of the premiums (plus earnings thereon) which is intended to fund pension or other deferred benefits under a pension, annuity, or profit-sharing plan. Such death benefits are not in the nature of life insurance and are not excludable from gross income under section 101(a).

(ii) In the case of a life insurance contract under which there is a reserve accumulation which is intended to fund pension or other deferred benefits under a pension, annuity, or profit-sharing plan, such reserve accumulation constitutes the source of the cash value of the contract and approximates the amount of such cash value. The portion of the proceeds paid upon the death of the insured employee which is equal to the cash value immediately before death is not excludable from gross income under section 101(a). The remaining portion, if any, of the proceeds paid to the beneficiary by reason of the death of the insured employee—that is, the amount in excess of the cash value—constitutes current insurance protection and is excludable under section 101(a).

(iii) The death benefit under an annuity contract, or the portion of the death proceeds under a life insurance contract which is equal to the cash value of the contract immediately before death, constitutes a distribution under the plan consisting in whole or in part of deferred compensation and is taxable to the beneficiary in accordance with section 72(m)(3) and the provisions of this paragraph, except to the extent that the limited exclusion from income provided in section 101(b) is applicable.

(iv) In the case of a life insurance contract under which the benefits are paid at a date or dates later than the death of the employee, section 101(d) is applicable only to the portion of the benefits which is attributable to the amount excludable under section 101(a). The portion of such benefits which is attributable to the cash value of the contract immediately before death is taxable under section 72, and in such case, any amount excludable under section 101(b) is treated as additional consideration paid by the employee in accordance with section 101(b)(2)(D).

(3) The application of the rules under subparagraph (2) of this paragraph with respect to the taxability of proceeds of a life insurance contract paid by reason of the death of an insured common-law employee who has paid no contributions under the plan is illustrated by the following examples:

Example (1).

Total face amount of the contract payable in a lump sum at time of death	$25,000
Cash value of the contract immediately before death	11,000
Excess over cash value, excludable under section 101(a)	14,000
Cash value subject to limited exclusion under section 101(b)	11,000
Excludable under section 101(b) (assuming that there is no other death benefit paid by or on behalf of any employer with respect to the employee)	5,000
Balance taxable in accordance with section 402(a)(2) or 403(a)(2) (assuming a total distribution in one taxable year of the distributee)	6,000
Portion of premiums taxed to employee under the provisions of paragraph (b) of this section and considered as contributions of the employee	940
Balance taxable as long-term capital gain	5,060

Example (2). The facts are the same as in example (1), except that the contract provides that the beneficiary may elect within 60 days after the death of the employee either to take the $25,000 or to receive 10 annual installments of $3,000 each, and the beneficiary elects to receive the 10 installments. In addition, the employee's rights to the cash value immediately before his death were forfeitable at least to the extent of $5,000. Section 101(d) is applicable to the amount excludable under section 101(a), that is, $14,000. The portion of each annual installment of $3,000 which is attributable to this $14,000 is determined by allocating each installment in accordance with the ratio which this $14,000 bears to the total amount which was payable at death ($25,000). Accordingly, the portion of each annual installment which is subject to section 101(d) is $1,680 ($^{14}/_{25}$ of $3,000), of which $1,400 ($^{1}/_{10}$ of $14,000) is excludable under section 101(a), and the remaining $280 is includible in the gross income of the beneficiary. However, if the beneficiary is a surviving spouse as defined in section 101(d)(3), the exclusion provided by section 101(d)(1)(B) is applicable to such $280. The remaining portion of each annual $3,000 installment, $1,320, is attributable to the cash value of the contract and is treated under section 72, as follows:

Amount actually contributed by the employee	0
Amount considered contributed by employee by reason of section 101(b)	$5,000
Portion of premiums taxed to employee under the provisions of paragraph (b) of this section and considered as contributions of the employee	$940
Investment in the contract	$5,940
Expected return, 10×$1,320	$13,200
Exclusion ratio, $5,940÷$13,200	0.45
Annual exclusion, 0.45×$1,320	$594

Accordingly, $594 of the $1,320 portion of each annual installment is excludable each year under section 72, and the remaining $726 is includible. Thus, if the beneficiary is not a surviving spouse, a total of $1,006 ($280 plus

\$726) of each annual \$3,000 installment is includible in income each year. If the beneficiary is a surviving spouse, and can exclude all of the \$280 under section 101(d)(1)(B), the amount includible in gross income each year is \$726 of each annual \$3,000 installment.

(4) If an employee neither paid the total cost of the life insurance protection provided under a life insurance contract, nor was taxable under paragraph (b) of this section with respect thereto, no part of the proceeds of such a contract which are paid to the beneficiaries of the employee as a death benefit is excludable under section 101(a). The entire distribution is taxable to the beneficiaries under section 402(a) or 403(a) except to the extent that a limited exclusion may be allowable under section 101(b).

[T.D. 6676, 28 FR 10135, Sept. 17, 1963]

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

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

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

(i) Are received before the annuity starting date; and

(ii) Are not received as an annuity.

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

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

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

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