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DEPARTMENT OF THE TREASURY Corrected October 4, 2005

Internal Revenue Service

26 CFR Part 1

TD 9223

RIN 1545-BC20

Value of Life Insurance Contracts when Distributed from a Qualified Retirement Plan

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations under section 402(a) of the Internal Revenue Code regarding the amount includible in a distributee's income when life insurance contracts are distributed by a qualified retirement plan and regarding the treatment of property sold by a qualified retirement plan to a plan participant or beneficiary for less than fair market value. This document also contains final regulations under sections 79 and 83 of the Internal Revenue Code regarding the amounts includible in income when an employee is provided permanent benefits in combination with group-term life insurance or when a life insurance contract is transferred in connection with the performance of services. These regulations will affect administrators of, participants in, and beneficiaries of qualified retirement plans. These regulations will also affect employers who provide permanent benefits in combination with group-term life insurance for their employees and employees who receive those permanent benefits, as well as service recipients who transfer life insurance contracts to

service providers in connection with the performance of services, and service providers to whom those life insurance contracts are transferred.

DATES: These regulations are effective August 29, 2005.

FOR FURTHER INFORMATION CONTACT: Concerning the section 79 regulations, Betty Clary at (202) 622-6080; concerning the section 83 regulations, Robert Misner at (202) 622-6030; concerning the section 402 regulations, Bruce Perlin or Linda Marshall at (202) 622-6090 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

A. In General

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under section 402(a) of the Internal Revenue Code (Code) relating to the amount includible in a distributee's income when a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection is distributed by a retirement plan qualified under section 401(a), and relating to the sale of property by a qualified retirement plan to a plan participant or beneficiary for less than the fair market value of the property. This document also contains amendments to the regulations under sections 79 and 83 relating, respectively, to permanent benefits that are provided to employees in combination with group-term life insurance, and to life insurance contracts that are transferred in connection with the performance of services.

Section 402(a) generally provides that any amount actually distributed to any distributee by any employees' trust described in section 401(a) which is exempt from tax under section 501(a) is taxable to the distributee in the taxable year of the distributee in which distributed, in accordance with section 72. Distributions from a qualified employees' trust generally are subject to withholding and reporting requirements pursuant to section 3405 and regulations thereunder. Section 1.402(a)-1(a)(1)(iii) provides, in general, that a distribution of property by a section 401(a) plan is taken into account by the distributee at its fair market value. Prior to its amendment by this Treasury decision, §1.402(a)-1(a)(2) (which was originally published in 1956) provided, in general, that upon the distribution of a life insurance contract, the "entire cash value" of the contract must be included in the distributee's income.[1] Section 1.402(a)-1(a) did not define fair market value or entire cash value, and questions have arisen regarding the interaction between these two provisions and regarding whether the term entire cash value includes a reduction for surrender charges.

On April 30, 1975, proposed regulations under section 402 regarding the taxation of certain lump sum distributions from qualified plans (the 1975 proposed regulations) were published in the **Federal Register** (40 FR 18798) to reflect changes to section 402 made by the Employee Retirement Income Security Act of 1974 (ERISA) (Public Law 93-406, 88 Stat. 829). Under §1.402(a)-1(a)(2) of the 1975 proposed regulations, the distribution of an annuity contract must be treated as a lump sum distribution under section 402(e) for purposes of determining the separate tax imposed under section 402(e)(1)(A),[2] even if the distribution of the annuity contract itself is not currently taxable. The 1975 proposed regulations also expanded the situations in which the

[1] Section 1.402(a)-1(a)(2) also provides rules regarding the taxation of the distribution of an annuity contract. In certain cases, the distribution of an annuity contract is not includible in the participant's gross income until distributions are made from the annuity contract.

[2] The tax imposed under section 402(e)(1)(A), as in effect at the time of the 1975 proposed regulations, generally was based on 10-year averaging of the tax otherwise payable with respect to a lump-sum distribution.

distribution of a retirement income, endowment, or other life insurance contract is not currently taxable to include the situation where, within 60 days after the distribution of such contract, the contract is treated as a rollover contribution under section 402(a)(5), as in effect after December 31, 1973.

Section 79 generally requires that the cost of group-term life insurance coverage provided by an employer on the life of an employee that is in excess of $50,000 of coverage be included in the income of the employee. Pursuant to §1.79-1(b), under specified circumstances, group-term life insurance may be combined with other benefits, referred to as permanent benefits. A permanent benefit is defined in §1.79-0 as an economic value extending beyond one policy year (for example, a paid-up or cash surrender value) that is provided under a life insurance policy. Section 1.79-0 further provides that certain features are not permanent benefits, including: (a) a right to convert (or continue) life insurance after group life insurance coverage terminates, (b) any other feature that provides no economic benefit (other than current insurance protection) to the employee, and (c) a feature under which term life insurance is provided at a level premium for a period of five years or less.

Permanent benefits provided to an employee are subject to taxation under rules described in §1.79-1(d). Under those rules, the cost of the permanent benefits, reduced by the amount paid for those benefits by the employee, is included in the employee's income. Section 1.79-1(d) provides that the cost of the permanent benefits cannot be less than an amount determined under a formula set forth in the regulations. Prior to its amendment by this Treasury decision, §1.79-1(d) provided that one of the factors used in the formula for determining the cost of permanent benefits was "the net level premium reserve at the end of that policy year for all benefits provided to the employee by the policy or, if greater, the cash value of the policy at the end of that policy year."

Section 83(a) generally provides that when property is transferred to any person in connection with the performance of services, the service provider must include in gross income (as compensation income) the excess of the fair market value of the property over the amount (if any) paid for the property. For this purpose, the fair market value of the property is determined without regard to lapse restrictions and is determined at the first time that the transferee's rights in the property are either transferable or not subject to a substantial risk of forfeiture. Prior to its amendment by this Treasury decision, §1.83-3(e) generally provided that in the case of "a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, only the cash surrender value of the contract is considered to be property."

In TD 9092, published in the **Federal Register** on September 17, 2003 (68 FR 54336), relating to split-dollar life insurance arrangements, §1.83-3(e) was amended to add the following sentence: "Notwithstanding the previous sentence, in the case of a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, or any undivided interest therein, that is part of a split-dollar life insurance arrangement (as defined in §1.61-22(b)(1) or (2)) that is entered into, or materially modified (within the meaning of §1.61- 22(j)(2)), after September 17, 2003, the policy cash value and all other rights under such contract (including any supplemental agreements thereto and whether or not guaranteed), other than current life insurance protection, are treated as property for purposes of this section."

The prohibited transaction provisions of ERISA generally prohibit various transactions between plans covered by Title I of ERISA and certain parties in interest (including plan participants) with respect to such plans. Specifically, unless an exemption from the prohibited transaction rules applies, sections 406(a)(1)(A) and (D) of ERISA provide that a fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect sale or exchange, or leasing, of any property between the plan and a party in interest; or transfer to, or use by or for the benefit of, a party in interest of any assets of the plan. Accordingly, unless a statutory or administrative exemption is applicable, the prohibited transaction rules are applicable to the sale of a life insurance contract, or annuity contract, by a plan to a party in interest.

Section 4975 of the Code sets forth parallel rules that impose excise taxes on the amount involved with respect to prohibited transactions involving certain plans. The prohibited transaction provisions under section 4975, as well as the exemptions from the application of such rules, generally parallel the prohibited transaction provisions under Title I of ERISA.

Prohibited Transaction Exemption (PTE) 77-8 (1977-2 C.B. 425), subsequently amended and redesignated as Prohibited Transaction Exemption 92-6, was jointly issued in 1977 by the Department of Labor and the IRS to provide an exemption from the restrictions of sections 406(a) and 406(b)(1) and (b)(2) of ERISA and from the taxes imposed by sections 4975(a) and (b) of the Code for certain transactions. Under the exemption set forth in PTE 77-8 and PTE 92-6, an employee benefit plan is permitted to sell individual life insurance contracts and annuities for the cash surrender value of the contracts to certain specified parties, provided conditions are satisfied. Under PTE 77-8 and PTE 92-6, such specified parties are: (1) a plan participant insured under such policies, (2) a relative of such insured participant who is the beneficiary under the contract, (3) an employer any of whose employees are covered by the plan, or (4) another employee benefit plan.

The preamble to PTE 77-8 (citing Rev. Rul. 59-195, 1959-1 C.B. 18) noted that, for Federal income tax purposes, the value of an insurance policy is not the same as, and may exceed, its cash surrender value, and that a purchase of an insurance policy at its cash surrender value may therefore be a purchase of property for less than its fair market value. At the time PTE 77-8 was issued, the regulations under section 402 did not address the consequences of a sale of property by a section 401(a) plan to a plan participant or beneficiary for less than the fair market value of that property. In this regard, the preamble to PTE 77-8 stated that the Federal income tax consequences of such a bargain purchase was required to be determined in accordance with generally applicable Federal income tax rules but that any income realized by a participant or relative of such participant upon such a purchase under the conditions of PTE 77-8 would not be deemed a distribution from the plan to such participant for purposes of subchapter D of chapter 1 of subtitle A of the Internal Revenue Code (i.e., sections 401 to 424 relating to qualified pension, profit-sharing, and stock bonus plans).

B. The 2004 Proposed Regulations

In February 2004, the IRS issued proposed amendments to the regulations under section 402(a) (69 FR 7384) to clarify that the requirement that a distribution of property be included in the distributee's income at fair market value is controlling in those situations where the regulations provided for the inclusion of the entire cash value of a retirement income, endowment, or other life insurance contract. The 2004 proposed regulations provided that the fair market value of a life insurance contract is determined taking into account the value of all rights under the contract, including any supplemental agreements thereto and whether or not guaranteed. The proposed regulations also provided that, if a qualified retirement plan transfers property to a plan participant or beneficiary for consideration that is less than the fair market value of the property, the transfer would be treated as a distribution by the plan to the participant or beneficiary to the extent the fair market value of the distributed property exceeds the value of the consideration received. Thus, under the proposed regulations, such a transfer would be treated as a distribution for purposes of applying the plan qualification requirements of section 401(a).

The 2004 proposed regulations also contained proposed amendments to existing regulations under section 83 to clarify that fair market value is also controlling with respect to a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection and thus all of the rights under the contract (including any supplemental agreements thereto and whether or not guaranteed) must be considered in determining that fair market value. The proposed regulations contained proposed amendments to §1.83-3(e), which generally apply the definition of property for new split-dollar life insurance arrangements to all situations subject to section 83 involving the transfer of life insurance contracts. The proposed regulations also contained proposed amendments to §1.79-1(d) to replace the term "cash value" in the formula for determining the cost of permanent benefits with the term "fair market value."

C. Determination of Fair Market Value

As noted under the heading In General, §1.402(a)-1(a)(1)(iii) does not define the term fair market value. In Rev. Rul. 59-195, the IRS addressed the determination of fair market value of a life insurance contract in situations similar to those in which an employer purchases and pays the premiums on an insurance policy on the life of one of its employees for several years and on which further premiums must be paid, and subsequently sells such policy. The IRS held that the value of such a policy for purposes of computing taxable gain to the employee in the year of purchase should be determined under the method of valuation prescribed in §25.2512-6 of the Gift Tax Regulations. Under this method, the value of such a policy is not its cash surrender value but the interpolated terminal reserve at the date of sale plus the proportionate part of any premium paid by the employer prior to the date of the sale which is applicable to a period subsequent to the date of the sale. Section 25.2512-6 also provides that if "because of the unusual nature of the contract such approximation is not reasonably close to the full value, this method may not be used." Thus, this method may not be used to determine the fair market value of an insurance policy where the reserve does not reflect the value of all of the relevant features of the policy.

Q&A-10 of Notice 89-25 (1989-1 C.B. 662) described a distribution from a qualified plan of a life insurance policy with a value substantially higher than the cash surrender value stated in the policy. The notice concluded that the practice of using cash surrender value as fair market value is not appropriate where the total policy reserves, including life insurance reserves (if any) computed under section 807(d), together with any reserves for advance premiums, dividend accumulations, etc., represent a much more accurate approximation of the policy's fair market value.

Since Notice 89-25 was issued, life insurance contracts have been marketed that are structured in a manner which results in a temporary period during which neither a contract's reserves nor its cash surrender value represent the fair market value of the contract. For example, some life insurance contracts may provide for large surrender charges and other charges that are not expected to be paid because they are expected to be eliminated or reversed in the future (under the contract or under another contract for which the first contract is exchanged), but this future elimination or reversal is not always reflected in the calculation of the contract's reserve. If such a contract is distributed prior to the elimination or reversal of those charges, both the cash surrender value and the reserve under the contract could significantly understate the fair market value of the contract. Thus, in some cases, it would not be appropriate to use either the net surrender value (i.e., the contract's cash value after reduction for any surrender charges) or, because of the unusual nature of the contract, the contract's reserves to determine the fair market value of the contract. Accordingly, Q&A-10 of Notice 89-25 should not be interpreted to provide that a contract's reserves (including life insurance reserves (if any) computed under section 807(d), together with any reserves for advance premiums, dividend accumulations, etc.) are always an accurate representation of the contract's fair market value.

The IRS and Treasury recognized that taxpayers could have difficulty determining the fair market value of a life insurance contract for which the contract's reserves (including life insurance reserves (if any) computed under section 807(d), together with any reserves for advance premiums, dividend accumulations, etc.) are not an accurate representation of the contract's fair market value. Accordingly, the IRS issued Rev. Proc. 2004-16 (2004-10 I.R.B. 559), which provided interim rules under which the cash value (without reduction for surrender charges) of a life insurance contract distributed from a qualified plan may be treated as the fair market value of that contract, provided that certain requirements are satisfied. This safe harbor for determining fair market value was also available for purposes of sections 79 and 83.

D. Comments and Public Hearing on the 2004 Proposed Regulations and Rev. Proc. 2004-16

The IRS received comments on the 2004 proposed regulations, and a public hearing was held on June 9, 2004. While none of the commentators objected to the proposed amendments to the regulations, a number of commentators raised concerns regarding the safe harbor formula for fair market value set forth in Rev. Proc. 2004-16. Several commentators recommended that final guidance provide more than one safe harbor for determining the fair market value of a policy and asserted that the safe harbor formulas under Rev. Proc. 2004-16 produce a value that is too high and does not reflect market realities. Suggestions were made that the interpolated terminal reserve (ITR) and tax reserve valuation methods under section 807(d) be used as alternatives to the interim safe harbor formula.

Some commentators claimed that the interim safe harbor provided by Rev. Proc 2004-16 was not usable for all types of life insurance policies. In particular, these commentators asserted that the formulas did not function well for traditional whole life policies. In addition, commentators were concerned about the possible double-counting of certain dividends under the formulas, and the fact that the formulas did not make an explicit adjustment for withdrawals or distributions, nor did they provide for any recognition of the possibility that a surrender charge would apply in the future.

E. Rev. Proc. 2005-25 -- Safe Harbors for Determining Fair Market Value

After reviewing the comments to the prior guidance, the IRS and Treasury concluded that the safe harbor formulas in Rev. Proc. 2004-16 did not function well for certain types of traditional policies, and also should be revised to reflect a discount for the possibility that a surrender charge would apply in certain situations. Accordingly, Rev. Proc. 2005-25 (2005-17 I.R.B. 962) was issued to modify and supersede Rev. Proc. 2004-16 in order to make adjustments to the safe harbor formulas. These new safe harbor formulas replace the formulas in Rev. Proc. 2004-16 for distributions, sales, and other transfers made on or after February 13, 2004, and for permanent benefits provided on or after February 13, 2004. For all periods, including periods before May 1, 2005, taxpayers may rely on the safe harbors in Rev. Proc. 2005-25. In addition, for periods on or after February 13, 2004, and before May 1, 2005, taxpayers may rely on the safe harbors in Rev. Proc. 2004-16.

Explanation of Provisions

These final regulations retain the rules set forth in the 2004 proposed regulations under section 402(a) providing that the requirement that a distribution of property be included in the distributee's income at fair market value is controlling in those situations where the former regulations provided for the inclusion of the entire cash value of a retirement income, endowment, or other life insurance contract. Thus, these final regulations clarify that, in those cases where a qualified plan distributes a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, the fair market value of such a contract (i.e., the value of all rights under the contract, including any supplemental agreements thereto and whether or not guaranteed) is generally included in the distributee's income, and not merely the entire cash value of the contract. However, these final regulations retain the rules from existing final regulations setting forth the situations under which a distribution of such a contract is not currently includible in income.

These final regulations also set forth a portion of the rules included in the 1975 proposed regulations. Under those rules, the distribution of an annuity contract must be treated as a lump sum distribution for purposes of determining the amount of tax under the 10-year averaging rule of section 402(e) (as in effect prior to the amendment by the Tax Reform Act of 1986, Public Law 99-514, 100 Stat. 2085), even if the distribution of the annuity contract itself is not currently taxable. The distribution of a retirement income, endowment, or other life insurance contract is not taxable in the situation where within 60 days after the distribution of such contract, the contract is treated as a rollover contribution under section 402(a)(5), as in effect after December 31, 1973. Although the final regulations reject the use of the term <u>entire cash value</u> as found in the 1975 proposed regulations, no inference should be made that other rules in the 1975 proposed regulations that have not been included in these final regulations have also been rejected.

These final regulations retain the rules provided in the 2004 proposed regulations that, if a qualified plan transfers property to a plan participant or beneficiary for consideration that is less than the fair market value of the property, the transfer is treated as a distribution under the plan to the participant or beneficiary to the extent the fair market value of the distributed property exceeds the value of the consideration. Thus, in contrast to the statement to the contrary in the preamble to PTE 77-8, these regulations provide that any bargain element in the sale is treated as a distribution under section 402(a). In addition, any such bargain element is treated as a distribution under the plan for all other purposes of the Code, including the qualification requirements of section 401(a). Thus, for example, this bargain element is treated as a distribution for purposes of applying the limitations on in-service distributions from certain qualified retirement plans and the limitations of section 415. The rule treating the bargain element in a sale as a distribution from a qualified plan applies to transfers that occur on or after August 29, 2005. For transfers before that date, the bargain element in the sale must be included in the plan participant's income under section 61. However, such a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection occurring before that date is deemed not to give rise to a distribution for purposes of applying the requirements of subchapter D of chapter 1 of subtitle A of the Code.

These final regulations also retain the rules set forth in the 2004 proposed regulations under sections 79 and 83 that clarify that fair market value is also controlling with respect to life insurance contracts under those sections and, thus, that all of the rights under the contract (including any supplemental agreements thereto and whether or not guaranteed) must be considered in determining that fair market value. These final regulations amend §1.79-1(d) to replace the term cash value in the formula for determining the cost of permanent benefits with the term fair market value. These final regulations also amend §1.83-3(e) generally to apply the definition of property for new split-dollar life insurance arrangements to all situations involving the transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection. Section 83(a) requires that the excess of the fair market value of the property over the amount paid for the property be included in income. The purpose of the changes to the regulations is to clarify that, unless specifically excepted from the definition of permanent benefits or fair market value, the value of all features of a life insurance policy providing an economic benefit to a service provider (including, for example, the value of a springing cash value feature) must be included in determining the employee's income.

These final regulations do not affect the relief granted by the provisions of Section IV, paragraph 4 of Notice 2002-8 (2002-1 C.B. 398) to the parties to any insurance contract that is part of a pre-January 28, 2002, split-dollar life insurance arrangement. Also, consistent with the effective date of the final split-dollar life insurance regulations at §1.61-22(j), these final regulations do not apply to the transfer of a life insurance contract which is part of a split-dollar life insurance arrangement entered into on or before September 17, 2003, and not materially modified after that date. However, taxpayers are reminded that, in determining the fair market value of property transferred under section 83, lapse restrictions (such as life insurance contract surrender charges) are ignored.

Effective Date

These regulations are effective August 29, 2005. The amendments to §1.402(a)-1(a) apply to any distribution of a retirement income, endowment, or other life insurance contract occurring on or after February 13, 2004. The amendment to §1.79-1 is applicable to permanent benefits provided on or after February 13, 2004. The amendment to §1.83-3(e) is applicable to any transfer occurring on or after February 13, 2004.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. In addition, because no collection of information is imposed on small entities, the provisions of the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply, and therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are Bruce Perlin and Linda Marshall, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury participated in the development of these regulations.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In §1.79-1, paragraph (d)(3) is revised to read as follows:

<u>§1.79-1 Group-term life insurance--general rules</u>.

* * * * *

(d) * * *

(3) <u>Formula for determining deemed death benefit</u>. The deemed death benefit (DDB) at the end of any policy year for any particular employee is equal to--

R/Y

where--

R is the net level premium reserve at the end of that policy year for all benefits provided to the employee by the policy or, if greater, the fair market value of the policy at the end of that policy year; and

Y is the net single premium for insurance (the premium for one dollar of paid-up, whole life insurance) at the employee's age at the end of that policy year.

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Par. 3. In §1.83-3, paragraph (e), the fourth and fifth sentences are revised to read as follows:

§1.83-3 Meaning and use of certain terms.

* * * * *

(e) * * * In the case of a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, or any undivided interest therein, the policy cash value and all other rights under such contract (including any supplemental agreements thereto and whether or not guaranteed), other than current life insurance protection, are treated as property for purposes of this section. However, in the case of the transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, which was part of a split-dollar arrangement (as defined in §1.61-22(b)) entered into (as defined in §1.61-22(j)) on or before September 17, 2003, and which is not materially modified (as defined in §1.61-22(j)(2)) after September 17, 2003, only the cash surrender value of the contract is considered to be property. * * *

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Par. 4. Section 1.402(a)-1 is amended by:

1. Revising paragraph (a)(1)(iii).

2. Revising paragraph (a)(2).

The revisions read as follows:

§1.402(a)-1 Taxability of beneficiary under a trust which meets the requirements of section 401(a).

(a) * * *

(1) * * *

(iii) Except as provided in paragraph (b) of this section, a distribution of property by a trust described in section 401(a) and exempt under section 501(a) shall be taken into account by the distributee at its fair market value. In the case of a distribution of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, or any interest therein, the policy cash value and all other rights under such contract (including any supplemental agreements thereto and whether or not guaranteed) are included in determining the fair market value of the contract. In addition, in the case of a transfer of property that occurs on or after August 29, 2005, where a trust described in section 401(a) and exempt under section 501(a) transfers property to a plan participant or beneficiary in exchange for consideration and where the fair market value of the property transferred exceeds the value of the consideration, then the excess of the fair market value of the property transferred by the trust over the value of the consideration received by the trust is treated as a distribution to the distributee under the plan for all purposes under the Internal Revenue Code. Where such a transfer occurs before that date, the excess of the fair market value of the property transferred by the trust over the value of the consideration received by the trust is includible in the gross income of the participant or beneficiary under section 61. However, such a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection occurring before that date is not treated as a distribution for purposes of applying the requirements of subchapter D of chapter 1 of subtitle A of the Internal Revenue Code.

* * * * *

(2) If a trust described in section 401(a) and exempt under section 501(a) purchases an annuity contract for an employee and distributes it to the employee in a year in which the trust is exempt, and the contract contains a cash surrender value which may be available to an employee by surrendering the contract, such cash surrender value will not be considered income to the employee unless and until the contract is surrendered. For the rule as to nontransferability of annuity contracts issued after 1962, see §1.401-9(b)(1). For additional requirements regarding distributions of annuity contracts, see, e.g., §§1.401(a)-20, Q&A-2, 1.401(a)(31)-1, Q&A-17, and 1.401(a)(9)-6, Q&A-4. However, the distribution of an annuity contract must be treated as a lump sum distribution for purposes of determining the amount of tax under the 10-year averaging rule of section 402(e) (as in effect prior to amendment by the Tax Reform Act of 1986, Public Law 99-514, 100 Stat. 2085). If, however, the contract distributed by such exempt trust is a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, the fair market value of the contract at the time of distribution must be included in the distributee's income in accordance with the provisions of section 402(a), except to the extent that, within 60 days after the distribution of the contract, all or any portion of such value is irrevocably converted into a contract under which no part of any proceeds payable on death at any time would be excludable under section 101(a) (relating to life insurance proceeds), or the contract is treated as a rollover contribution under section 402(c). If the contract distributed by such trust is a transferable annuity contract, or a retirement income, endowment, or other life insurance contract and such contract is not treated as a rollover contribution under section 402(c), then, notwithstanding the

preceding sentence, the fair market value of the contract is includible in the distributee's gross income unless, within such 60 days, such contract is made nontransferable.

* * * * *

Mark E. Matthews,

Deputy Commissioner for Services and Enforcement.

Approved: August 9, 2005

Eric Solomon,

Acting Deputy Assistant Secretary for Tax Policy.