

63. Taxable income defined

- (a) In general. -- Except as provided in subsection (b), for purposes of this subtitle, the term "taxable income" means gross income minus the deductions allowed by this chapter (other than the standard deduction).
- (b) Individuals who do not itemize their deductions. -- In the case of an individual who does not elect to itemize his deductions for the taxable year, for purposes of this subtitle, the term "taxable income" means adjusted gross income, minus --
- (1) the standard deduction, and
 - (2) the deduction for personal exemptions provided in section 151.
- (c) Standard deduction. -- For purposes of this subtitle --
- (1) In general. -- Except as otherwise provided in this subsection, the term "standard deduction" means the sum of --
 - (A) the basic standard deduction, and
 - (B) the additional standard deduction.
 - (2) Basic standard deduction. -- For purposes of paragraph (1), the basic standard deduction is --
 - (A) \$5,000 in the case of --
 - (i) a joint return, or
 - (ii) a surviving spouse (as defined in section 2(a)),
 - (B) \$4,000 in the case of a head of household (as defined in section 2(b)),
 - (C) \$3,000 in the case of an individual who is not married and who is not a surviving spouse or head of household, or
 - (D) \$2,500 in the case of a married individual filing a separate return.
 - (3) Additional standard deduction for aged and blind. -- For purposes of paragraph (1), the additional standard deduction is the sum of each additional amount to which the taxpayer is entitled under subsection (f).
 - (4) Adjustments for inflation. -- In the case of any taxable year beginning in a calendar year after 1988, each dollar amount contained in paragraph (2) or (5)(A) or subsection (f) shall be increased by an amount equal to --
 - (A) such dollar amount, multiplied by
 - (B) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, by substituting "calendar year 1987" for "calendar year 1989" in subparagraph (B) thereof.
 - (5) Limitation on basic standard deduction in the case of certain dependents. -- In the case of an individual with respect to whom a deduction under section 151 is allowable to another taxpayer for a taxable year beginning in the calendar year in which the individual's taxable year begins, the basic standard deduction applicable to such individual for such individual's taxable year shall not exceed the greater of --
 - (A) \$500, or
 - (B) such individual's earned income.
 - (6) Certain individuals, etc., not eligible for standard deduction. -- In the case of --
 - (A) a married individual filing a separate return when either spouse itemizes deductions,
 - (B) A nonresident alien individual,
 - (C) an individual making a return under section 443(a)(1) for a period for less than 12 months on account of a change in his annual accounting period, or
 - (D) an estate or trust, common trust fund, or partnership,the standard deduction shall be zero.

(d) Itemized deductions. -- For purposes of this subtitle, the term "itemized deductions" means the deductions allowable under this chapter other than --

(1) the deductions allowable in arriving at adjusted gross income, and

(2) the deduction for personal exemptions provided by section 151.

(e) Election to itemize. --

(1) In general. -- Unless an individual makes an election under this subsection for the taxable year, no itemized deduction shall be allowed for the taxable year. For purposes of this subtitle, the determination of whether a deduction is allowable under this chapter shall be made without regard to the preceding sentence.

(2) Time and manner of election. -- Any election under this subsection shall be made on the taxpayer's return, and the Secretary shall prescribe the manner of signifying such election on the return.

(3) Change of election. -- Under regulations prescribed by the Secretary, a change of election with respect to itemized deductions for any taxable year may be made after the filing of the return for such year. If the spouse of the taxpayer filed a separate return for any taxable year corresponding to the taxable year of the taxpayer, the change shall not be allowed unless, in accordance with such regulations ---

(A) the spouse makes a change of election with respect to itemized deductions, for the taxable year covered in such separate return, consistent with the change of treatment sought by the taxpayer, and

(B) the taxpayer and his spouse consent in writing to the assessment (within such period as may be agreed on with the Secretary) of any deficiency, to the extent attributable to such change of election, even though at the time of the filing of such consent the assessment of such deficiency would otherwise be prevented by the operation of any law or rule of law.

This paragraph shall not apply if the tax liability of the taxpayer's spouse for the taxable year corresponding to the taxable year of the taxpayer has been compromised under section 7122.

(f) Aged or blind additional amounts. --

(1) Additional amounts for the aged. --- The taxpayer shall be entitled to an additional amount of \$600 --

(A) for himself if he has attained age 65 before the close of his taxable year, and

(B) for the spouse of the taxpayer if the spouse has attained age 65 before the close of the taxable year and an additional exemption is allowable to the taxpayer for such spouse under section 151(b),

(2) Additional amount for blind. -- The taxpayer shall be entitled to an additional amount of \$600 --

(A) for himself if he is blind at the close of the taxable year, and

(B) for the spouse of the taxpayer if the spouse is blind as of the close of the taxable year and an additional exemption is allowable to the taxpayer for such spouse under section 151(b).

For purposes of subparagraph (B), if the spouse dies during the taxable year the determination of whether such spouse is blind shall be made as of the time of such death.

(3) Higher amount for certain unmarried individuals. -- In the case of an individual who is not married and is not a surviving spouse, paragraphs (1) and (2) shall be applied by substituting "\$750" for "\$600".

(4) Blindness defined. -- For purposes of this subsection, an individual is blind only if his central visual acuity does not exceed 20/200 in the better eye with correcting lenses, or if his visual acuity is greater than 20/200 but is accompanied by a limitation in the fields of vision such that the widest diameter of the visual field subtends an angle no greater than 20 degrees.

(g) Marital status. -- For purposes of this section, marital status shall be determined under section 7703.

64. Ordinary income defined

For purposes of this subtitle, the term "ordinary income" includes any gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b). Any gain from the sale or exchange of property which is treated or considered, under other provisions of this subtitle, as "ordinary income" shall be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b).

65. Ordinary loss defined

For purposes of this subtitle, the term "ordinary loss" includes any loss from the sale or exchange of property which is not a capital asset. Any loss from the sale or exchange of property which is treated or considered, under other provisions of this subtitle, as "ordinary loss" shall be treated as loss from the sale or exchange of property which is not a capital asset.

66. Treatment of community income

(a) Treatment of community income when spouses live apart. -- If --

(1) 2 individuals are married to each other at any time during a calendar year;

(2) such individuals --

(A) live apart at all times during the calendar year, and

(B) do not file a joint return under section 6013 with each other for a taxable year beginning or ending in the calendar year;

(3) one or both of such individuals have earned income for the calendar year which is community income; and

(4) no portion of this title, any community income of such individuals for the calendar year shall be treated in accordance with the rules provided by section 879(a).

(b) Secretary may disregard community property laws where spouse notified of community income. -- The Secretary may disallow the benefits of any community property law to any taxpayer with respect to any income if such taxpayer acted as if solely entitled to such income and failed to notify the taxpayers' spouse before the due date (including extensions) for filing the return for the taxable year in which the income was derived of the nature and amount of such income.

(c) Spouse relieved of liability in certain other cases. -- Under regulations prescribed by the Secretary, if --

(1) an individual does not file a joint return for any taxable year,

(2) such individual does not include in gross income for such taxable year an item of community income property includable therein which, in accordance with the rules contained in section 879(a), would be treated as the income of the other spouse,

(3) the individual establishes that he or she did not know of, and had no reason to know of, such item of community income, and

(4) the individual establishes that he or she did not know of, and had no reason to know of, such item of community income, and

(4) taking into account all facts and circumstances, it is inequitable to include such item of community income in such individual's gross income,

then for purposes of this title, such item of community income shall be included in the gross income of the other spouse (and not in the gross income of the individual).

(d) Definitions. -- For purposes of this section --

(1) Earned income. -- The term "earned income" has the meaning given to such term by section 911(d)(2).

(2) Community income. -- The term "community income" means income which, under applicable community property laws, is treated as community income.

(3) Community property laws. -- The term "community property laws" means the community property laws of a State, a foreign country, or a possession of the United States.

67. 2-percent floor on miscellaneous itemized deductions

(a) General rule. -- In the case of an individual, the miscellaneous itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income.

(b) Miscellaneous itemized deductions. -- For purposes of this section, the term "miscellaneous itemized deductions" means the itemized deductions other than --

(1) the deduction under section 163 (relating to interest),

(2) the deduction under section 164 (relating to taxes),

(3) the deduction under section 165(a) for losses described in subsection (c)(3) or (d) of section 165,

(4) the deductions under section 170 (relying to charitable, etc., contributions and gifts) and section 642(c) (relating to deduction for amount paid or permanently set aside for a charitable purpose),

(5) the deduction under section 213 (relating to medical, dental, etc., expenses),

(6) the deduction under section 217 (relying to moving expenses),

(7) any deduction allowable for impairment-related work expenses,

(8) the deduction under section 691(c) (relating to deduction for estate tax in case of income in respect of the decedent),

(9) any deduction allowable in connection with personal property used in a short sale,

(10) the deduction under section 1341 (relating to computation of tax where taxpayer restores substantial amount held under claim of right),

(11) the deduction under section 72(b)(3) (relating to deduction where annuity payments cease before investment recovered),

(12) the deduction under section 171 (relating to deduction for amortizable bond premium), and

(13) the deduction under section 216 (relating deductions in connection with cooperative housing corporations).

(c) Disallowance of indirect deduction through pass-thru entity. --

(1) In general. -- The Secretary shall prescribe regulations which prohibit the indirect deduction through pass-thru entities of amounts which are not allowable as a deduction if paid or incurred directly by an individual and which contains such reporting requirements as may be necessary to carry out the purposes of this subsection.

(2) Treatment of publicly offered regulated investment companies. --

(A) In general. -- Paragraph (1) shall not apply with respect to any publicly offered regulated investment company.

(B) Publicly offered regulated investment companies. -- For purposes of this subsection --

(i) In general. -- The term "publicly offered regulated investment company" means a regulated investment company the shares of which are --

(I) continuously offered pursuant to a public offering (within the meaning of section 4 of the Securities Act of 1933, as amended (15 U.S.C. 77a to 77aa)),

- (II) regularly traded on an established securities market, or
- (III) held by or for no fewer than 500 persons at all times during the taxable year.
- (ii) Secretary may reduce 500 person requirement. -- The Secretary may by regulation decrease the minimum shareholder requirement of clause (i)(III) in the case of regulated investment companies which experience a loss of shareholders through net redemptions of their shares.
- (3) Treatment of certain other entities. -- Paragraph (1) shall not apply --
 - (A) with respect to cooperatives and real estate investment trusts, and
 - (B) except as provided in regulations, with respect to estates and trusts.
- (d) Impairment-related work expenses. -- For purposes of this section, the term "impairment-related work expenses" means expenses --
 - (1) of a handicapped individual (as defined in section 190(b)(3)) for attendant care services at the individual's place of employment and other expenses in connection with such place of employment which are necessary for such individual to be able to work, and
 - (2) with respect to which a deduction is allowable under section 162 (determined without regard to this section).
- (e) Determination of adjusted gross income in case of estates and trusts. -- For purposes of this section, the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that --
 - (1) the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate, and
 - (2) the deductions allowable under sections 642(b), 651, and 661, shall be treated as allowable in arriving at adjusted gross income. Under regulations, appropriate adjustments shall be made in the application of part I of subchapter J of this chapter to take into account the provisions of this section.
- (f) Coordination with other limitation. -- This section shall be applied before the application of the dollar limitation of the last sentence of section 162(a) (relating to trade or business expenses).

68. Overall limitation on itemized deductions

- (a) General rule. -- In the case of an individual whose adjusted gross income exceeds the applicable amount, the amount of the itemized deductions otherwise allowable for the taxable year shall be reduced by the lesser of --
 - (1) 3 percent of the excess of adjusted gross income over the applicable amount, or
 - (2) 80 percent of the amount of the itemized deductions otherwise allowable for such taxable year.
- (b) Applicable amount. --
 - (1) In general. -- For purposes of this section, the term "applicable amount" means \$100,000 (\$50,000 in the case of a separate return by a married individual within the meaning of section 7703).
 - (2) Inflation adjustments. -- In the case of any taxable year beginning in a calendar year after 1991, each dollar amount contained in paragraph (1) shall be increased by an amount equal to --
- (c) Exception for certain itemized deductions. -- For purposes of this section, the term "itemized deductions" does not include --
 - (1) the deduction under section 213 (relating to medical, etc. expenses).
 - (2) any deduction for investment interest (as defined in section 163(d)), and
 - (3) the deduction under section 165(a) for losses described in subsection (c)(3) or (d) of section 165.

- (d) Coordination with other limitations. -- This section shall be applied after the application of any limitation on the allowance of any itemized deduction.
- (e) Exception for estates and trusts. -- This section shall not apply to any estate or trust.
- (f) Termination. -- This section shall not apply to any taxable year beginning after December 31, 1995.

71. Alimony and separate maintenance payments

(a) General rule. -- Gross income includes amount received as alimony or separate maintenance payments.

(b) Alimony or separate maintenance payments defined. -- For purposes of this section --

(A) In general. -- The term "alimony or separate maintenance payment" means any payment in cash if --

(A) such payment is received by (or on behalf of) a spouse under a divorce or separation instrument,

(B) the divorce or separation instrument does not designate such payment as a payment which is not includable in gross income under this section and not allowable as a deduction under section 215,

(C) in the case of an individual legally separated from his spouse under a decree of divorce or separate maintenance, the payee spouse and the payer spouse are not members of the same household at the time such payment is made, and

(D) there is no liability to make any such payment for any period after the death of the payee spouse and there is no liability to make any payment (in cash or property) as a substitute for such payments after the death of the payee spouse.

(2) Divorce or separation instrument. -- The term "divorce or separation instrument" means --

(A) a decree of divorce or separate maintenance or a written instrument incident to such a decree,

(B) a written separation agreement, or

(C) a decree (not described in subparagraph (A)) requiring a spouse to make payments for the support or maintenance of the other spouse.

(c) Payments to support children. --

(1) In general. -- Subsection (a) shall not apply to that part of any payment which the terms of the divorce or separation instrument fix in terms of an amount of money or part of the payment) as a sum which is payable for the support of children of the payor spouse.

(2) Treatment of certain reductions related to contingencies involving child. -- For purposes of paragraph (1), if any amount specified in the instrument will be reduced --

(A) on the happening of a contingency specified in the instrument relating to a child (such as attaining a specified age, marrying, dying, leaving school, or a similar contingency), or

(B) at a time which can clearly be associated with a contingency of a kind specified in subparagraph (A),

an amount equal to the amount of such reduction will be treated as an amount fixed as payable for the support of children of the payor spouse.

(3) Special rule where payment is less than amount specified in instrument. -- For purposes of this subsection, if any payment is less than the amount specified in the instrument, then so much of such payment as does not exceed the sum payable for support shall be considered a payment for such support.

(d) Spouse. -- For purposes of this section, the term "spouse" includes a former spouse.

(e) Exception for joint returns. -- This section and section 215 shall not apply if the spouses make a joint return with each other.

(f) Recomputation where excess front-loading of alimony payments. ---

- (1) In general. -- If there are excess alimony payments --
- (A) the payor spouse shall include the amount of such excess payments in gross income for the payor spouse's taxable year beginning in the 3rd post-separation year, and
- (B) the payee spouse shall be allowed a deduction in computing adjusted gross income for the amount of such excess payments for the payee's taxable year beginning in the 3rd post-separation year.
- (2) Excess alimony payments. -- For purposes of this subsection, the term "excess alimony payments" mean the sum of --
- (A) the excess payments for the 1st post-separation year, and
- (B) the excess payments for the 2nd post-separation year.
- (3) Excess payments for 1st post-separation year. -- For purposes of this subsection, the amount of the excess payments for the 1st post-separation year is the excess (if any) of --
- (A) the amount of the alimony or separate maintenance payments paid by the payor spouse during the 1st post-separation year, over
- (B) the sum of --
- (i) the average of --
- (I) the alimony or separate maintenance payments paid by the payor spouse during the 2nd post-separation year, reduced by the excess payments for the 2nd post-separation year, and
- (II) the alimony or separate maintenance payments paid by the payor spouse during the 3rd post-separation year, plus
- (ii) \$15,000.
- (4) Excess payments for 2nd post-separation year. -- For purposes of this subsection, the amount of the excess payments for the 2nd post-separation year is the excess (if any) of --
- (A) the amount of the alimony or separate maintenance payments paid by the payor spouse during the 2nd post-separation year, over
- (B) the sum of --
- (i) the amount of the alimony or separate maintenance payments paid by the payor spouse during the 3rd post-separation year, plus (ii) \$15,000.
- (5) Exceptions. --
- (A) Where payment ceases by reason of death or remarriage. -- Paragraph (1) shall not apply if --
- (i) either spouse dies before the close of the 3rd post-separation year, or the payee spouse remarries before the close of the 3rd post-separation year, and
- (ii) the alimony or separate maintenance payments cease by reason of such death or remarriage.
- (B) Support payments. -- For purposes of this subsection, the term "alimony or separate maintenance payment" shall not include any payment received under a decree described in subsection (b)(2)(C).
- (C) Fluctuating payments not within control of payor spouse. -- For purposes of this subsection, the term "alimony or separate maintenance payment" shall not include any payment to the extent it is made pursuant to a continuing liability (over a period of not less than 3 year) to apply a fixed portion or portions of the income from a business or property or from compensation for employment or self-employment.
- (6) Post-separation year. -- For purposes of this subsection, the term "1st post-separation years" means the 1st calendar year in which the payor spouse paid to the payee spouse alimony or separate maintenance payments to which this section applies. The 2nd and 3rd post-separation years shall be the 1st and 2nd succeeding calendar years, respectively.

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

- (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 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. -- (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 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 construed 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) Treatment of employee contributions under defined contribution plans as separate contracts. -- 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) assign 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 on 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) form 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.

(8) Extension of paragraph (2)(b) 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.

(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.

(II) Anti-abuse rules. --

(A) In general. -- For purposes of determining the amount includable 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 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 includable 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 includable 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 includable 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.

(g) Rules for transferee where transfer was for value. -- Where any contract for 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 includable 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 includable in gross income at the time such lump sum first became payable.

(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.

(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. --

(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),

(B) the consideration for the contract contributed by the employee for purposes of subsection (d)(1)

(relating to employee's contributions revocable in 3 years) and subsection (e)(7) (relating to plans where substantially all contributions are employee contributions), and
(C) 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) 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 includable 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 includable in gross income under this section and shall be treated as provided in section 101.

(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 of 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 includable 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.

(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 additional consideration paid by the employee. Thereafter all amounts so received shall be included in gross income.

(o) Special rules for distribution from qualified plans to which employee made deductible contributions. --

(1) Treatment of contributions. -- For purposes of this section and section 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 includable in the gross income of the employee.

(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(a)(5), 402(a)(7), 403(d)(3), 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).