Article from:

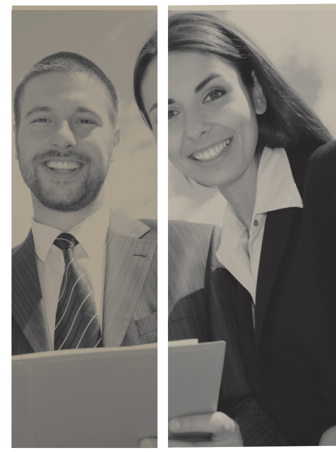
Taxing Times

February 2011 – Volume 7 Issue 1

SOCIETY OF ACTUARIES Taxation Section

Taxing TIMES

VOLUME 7 | ISSUE 1 | FEBRUARY 2011



Congress Clarifies Treatment of Partial Annuitizations

*By Bryan W. Keene**

Congress recently provided helpful clarification of the tax treatment of non-qualified deferred annuities that are "partially" annuitized. The clarification, enacted this fall as part of the Small Business Jobs Act,[1] essentially treats partial annuitizations the same way that full annuitizations are treated under current law, provided that certain conditions are met. The result is that payments from a compliant partial annuitization will be taxed using an exclusion ratio, thereby allowing the owner to recover basis *pro rata* over the payment term, rather than taxed using the income-first ordering rule that applies to withdrawals and other non-annuity payments.

Treasury Department and Internal Revenue Service (IRS) officials had previously questioned whether this result could be achieved technically under existing IRS regulations, despite more than a decade of insurance industry advocacy that it could. Ultimately, Congress stepped in, eliminated the technical hurdles, and facilitated partial annuitization in the interest of encouraging Americans to annuitize their retirement savings. The fact that the provision was projected to increase federal revenues by about $1 billion over the next 10 years almost certainly had a helping hand in its legislative fate. Given the government's need for more revenue, as well as the insurance industry's support for the provision and the absence of any constituency against it, the proposal became low-hanging fruit for Congress to pluck as a revenue raiser, while at the same time promoting an important tax policy goal.

The new law applies to partial annuitizations under life insurance contracts and endowment contracts, in addition to those under annuity contracts, but this article focuses on the latter. The article summarizes the new legislation and provides some background on how it

CONTINUED ON PAGE 6

became law, including the technical obstacles that heretofore discouraged partial annuitizations of annuity contracts. The article also briefly discusses the relationship between the new partial annuitization rule and existing IRS guidance on partial exchanges of deferred annuity contracts.

WHY PARTIAL ANNUITIZATION?

The insurance industry and many economists have argued that public policy should encourage annuitization—especially lifetime annuitization—to provide a guaranteed stream of retirement income. The reasons for this are well known: individuals are living longer; defined benefit plan coverage is declining; pressure on Social Security is growing; and only a life annuity can assure that an individual's assets will provide income for the whole of life. The Treasury Department itself recently focused on the public policy benefits that annuitization can bring,[2] and identified the enactment of partial annuitization legislation as one possible means to promote it.[3]

A partial annuitization is a transaction in which the owner of a deferred annuity contract applies a portion of the contract's cash value to purchase a stream of annuity payments under the contract, while leaving the remaining cash value accessible within the contract. There are many reasons that an individual may wish to conduct such a transaction. For example, the person may wish to annuitize a portion of his or her cash value to cover basic ongoing living expenses like food and housing, while leaving the remaining cash value intact for future needs. Or a person may wish to "dollar cost average" his or her annuity income purchases, in order to take advantage of changes in the annuity market or maximize his or her annuity purchasing power.[4]

Forcing all annuitizations to be full annuitizations would thwart these types of legitimate planning goals. More generally, individuals may be reluctant to annuitize the full amount of their deferred annuity savings to provide retirement income, due to uncertainty about future financial needs and concerns over the loss of liquidity that sometimes accompanies annuitization. As a result, the inability to partially annuitize has been viewed as a potential disincentive to annuitization in general. The new law is designed to remove that disincentive and thereby better promote the societal benefits of annuitization.

TECHNICAL OBSTACLES

Before Congress enacted the new law, officials within the IRS and Treasury Department had voiced technical concerns with achieving exclusion ratio treatment for partial annuitizations under existing IRS regulations. Of course, to qualify for exclusion ratio treatment, an annuity distribution must be an "amount received as an annuity" within the meaning of section 72(b).[5] Otherwise, distributions from non-qualified annuities are taxed using the income-first ordering rule of section 72(e). The technical problem with partial annuitizations stemmed from how the regulations define "amounts received as an annuity."

In particular, the regulations provide that only certain types of payments made on or after the "annuity starting date" can qualify as amounts received as an annuity.[6] The annuity starting date is generally the date on which the obligations under "the contract" become fixed.[7] The most significant technical question that arose was whether the obligations under "the contract" have become fixed when a partial annuitization occurs, given that the owner can still take various actions with respect to the contract's remaining, non-annuitized portion. In essence, the question was whether a contract can have more than one annuity starting date, or whether the regulations require each contract to have only one annuity starting date.

Advocates of partial annuitization argued that the regulations could be read as allowing multiple annuity starting dates with respect to amounts held under one annuity contract, and pointed out that no published guidance has ever reached a contrary conclusion.[8] Still, the government's technical concerns persisted, and the IRS ultimately placed partial annuitization on the "no rule" list as an area under study, where it has remained for the last three years.[9]

THE TREASURY DEPARTMENT'S PROPOSAL

In early 2010, the Treasury Department set out to eliminate the uncertainty surrounding partial annuitizations by proposing a legislative fix. In particular, the Administration's budget for the 2011 fiscal year included a proposal to amend section 72 in a manner that would facilitate partial annuitizations for non-qualified annuities. The Treasury Department explained that the proposal was needed because "the possibility that a partial annuitization could be taxed on an income-first basis rather than on a proportionate basis discourages some taxpayers from annuitizing existing deferred annuity contracts at a time when annuity payments are needed to fund their retirement."[10]

The Treasury Department also explained that its proposal was aimed at promoting consistency between partial annuitizations and partial exchanges. In that regard, as a mechanical matter, a partial annuitization can be accomplished in two different ways. First, a portion of a deferred annuity's cash value can be applied to an annuity option under that contract—a so-called "direct" partial annuitization. Alternatively, a portion of the cash value can be exchanged tax-free for a second deferred annuity, and then one of those contracts can be annuitized—a so-called "indirect" partial annuitization. The Treasury Department noted that current law does not address direct partial annuitizations, whereas it does allow indirect partial annuitizations in certain circumstances.[11]

As a result, the Treasury Department proposed in February 2010 that legislation be enacted to expressly allow direct partial annuitizations. The proposed legislation was similar to a provision in a bill that former Rep. Earl Pomeroy (D-ND) introduced in the 111th Congress. Mr. Pomeroy's bill, which included two additional provisions that also were aimed at encouraging annuitization, would have provided an exclusion ratio for any partial annuitization, regardless of the payment term.[12] The Treasury proposal, on the other hand, limited exclusion ratio treatment to certain forms of payout. The legislation that Congress ultimately enacted followed the Treasury approach. The specifics of the final legislation are discussed next.

THE NEW LEGISLATION

The new legislation amends section 72 to provide exclusion ratio treatment for certain amounts received pursuant to a partial annuitization of a non-qualified deferred annuity. To be eligible for the exclusion ratio, the amounts must be received as an annuity for a period of 10 years or more, or for the lives of one or more individuals.

If the payment stream satisfies this requirement, the annuitized and non-annuitized portions of the contract are treated as separate contracts for purposes of section 72. The new law also clarifies that the after-tax "investment in the contract" is allocated on a *pro rata* basis between the annuitized and non-annuitized portions of the contract. This *pro rata* allocation applies for purposes of the rules of section 72 governing the exclusion ratio, investment in the contract, expected return, annuity starting date, and amounts not received as an annuity. The new law also expressly provides that a separate annuity starting date is determined with respect to the annuitized and non-annuitized portions of the contract. These clarifications effectively eliminate the technical obstacles to partial annuitization that had been raised in the past.

Indeed, the Treasury Department described a desire to treat direct and indirect partial annuitizations consistently as a rationale for proposing the new legislation in the first instance.

The provision will become effective with respect to amounts received in taxable years beginning after Dec. 31, 2010. The provision does not, however, change the current law rules governing distributions from qualified retirement plans (such as 401(k) plans) or IRAs. Such distributions are governed by different rules than non-qualified annuities, and those rules already allow for a *pro rata* recovery of any basis (*e.g.*, after-tax contributions) irrespective of the form of distribution from the annuity.

COMPARISON TO PARTIAL EXCHANGES

As explained above, the new legislation addresses only "direct" partial annuitizations that occur within a deferred annuity contract; it does not address "indirect" partial annuitizations that occur in two steps using a partial exchange followed by an annuitization. Although not covered by the legislation, the latter type of transaction has been the subject of recent IRS guidance.

Rev. Proc. 2008-24 permits the tax-free exchange of a portion of a deferred annuity contract under section 1035 if certain conditions are met. The IRS placed restrictions on

CONTINUED ON **PAGE 8**

the tax-free exchange treatment in light of concerns that taxpayers might use partial exchanges to avoid the income-first ordering rule of section 72(e).[13] As a result, the guidance provides that tax-free treatment applies to a partial exchange only if 1) no withdrawal or surrender with regard to either contract is made within 12 months of the partial exchange, or 2) an enumerated exception in section 72(q)(2), or any similar life event, occurred between the exchange and the withdrawal or surrender.

Section 72(q)(2) generally lists exceptions to the 10 percent penalty tax that section 72(q)(1) otherwise imposes on certain premature distributions from non-qualified annuity contracts. Rev. Proc. 2008-24 borrows some, but not all, of those exceptions and incorporates them as exceptions to the 12-month waiting period that the revenue procedure imposes on withdrawals and surrenders following a partial exchange. Noticeably absent from the list of section 72(q)(2) exceptions that Rev. Proc. 2008-24 incorporates are the exception for substantially equal periodic payments (SEPPs) for life or life expectancy and the exception for payments under an immediate annuity.[14] The revenue procedure suggests that such payments were excluded from the list of exceptions to the 12-month waiting period because partial annuitization is on the IRS "no rule" list. In other words, the IRS apparently viewed SEPP and immediate annuity distributions following a partial exchange as a mechanism to accomplish a two-step partial annuitization, which the IRS was not willing to sanction at the time.

Now that Congress itself has blessed *direct* partial annuitizations, however, it would seem appropriate for the IRS and Treasury Department to facilitate *indirect* partial annuitizations that are accomplished through a partial exchange. Indeed, the Treasury Department described a desire to treat direct and indirect partial annuitizations consistently as a rationale for proposing the new legislation in the first instance. It is widely understood that the IRS and Treasury Department are actively working on updating the partial exchange guidance, although it is unclear whether any attempt will be made to harmonize the treatment of direct and indirect partial annuitizations.[15]

If the government undertakes such a harmonization effort, another aspect that might be considered relates to the limitations that Congress placed on direct partial annuitizations. As summarized above, only those direct partial annuitizations that are for life or at least 10 years will receive exclusion ratio treatment under the legislation. This payment term requirement presumably reflects a concern by the government that a partial annuitization could be used to avoid the income-first ordering rule of section 72(e)—the same basic concern at which the partial exchange guidance of Rev. Proc. 2008-24 is directed.

In that regard, section 72(e) was enacted to discourage the use of annuities as short-term investments and to encourage their use for long-term retirement security.[16] By limiting exclusion ratio treatment for direct partial annuitizations to those that provide payments for life or 10 years, the Treasury Department (in the 2010 Green Book) and Congress (in the new law) apparently were comfortable that the intent of section 72(e) would be preserved. It will be interesting to see if the Treasury Department and the IRS adopt a similar view with respect to two-step, indirect partial annuitizations that occur through partial exchanges, or whether some differences between direct and indirect partial annuitizations will persist.

For consumers, any such differences between the treatment of direct and indirect partial annuitizations could have unfortunate consequences. In that regard, there are non-tax reasons why one might prefer an indirect partial annuitization to a direct one, and *vice versa*. For example, a contract that is newly issued in a partial exchange may offer investment guarantees and features that are not available under the existing contract. Likewise, an existing contract may guarantee payments based on a higher interest rate and a more favorable mortality table than would be available under a contract newly issued following a partial exchange. It would be somewhat unfortunate if such non-tax factors were given a backseat to tax concerns based on any lingering differences between the treatment of direct and indirect partial annuitizations.

CONCLUSION

In sum, the new legislation provides a clarification on the tax treatment of direct partial annuitizations that the life insurance industry has been seeking for over a decade. It is certainly a welcomed development, and should make a significant contribution to the government's and the life insurance industry's common goal of providing greater retirement income security to retired Americans.

END NOTES

* The author thanks Joe McKeever and Mark Griffin, both with Davis & Harman LLP, for their helpful comments and suggestions on this article.

1 Pub. L. No. 111-240 § 2113 (2010).

2 *See, e.g.*, Department of Labor and Department of the Treasury, Request for Information on Lifetime Income Options for Participants and Beneficiaries in Retirement Plans, 75 Fed. Reg. 5253 (Feb. 2, 2010) (requesting public comment on how to better facilitate and promote annuitization in qualified retirement plans).

3 *See* Department of the Treasury, General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals, at 74 (Feb. 2010) (hereinafter, the "2010 Green Book").

4 The purchasing power of annuity premiums can fluctuate with interest rates, but generally increases with age. As a result, many financial advisors counsel individuals to gradually annuitize their assets. *See, e.g.*, Jonathan Clements, *Retirement on the Installment Plan: A Less-Risky Way to Buy Annuities*, Wall Street Journal, Nov. 23, 2005.

5 Unless otherwise indicated, references to sections mean sections of the Internal Revenue Code of 1986, as amended.

6 The regulations impose two additional definitional requirements regarding amounts received as an annuity. Such amounts must be payable in periodic installments at regular intervals over a period of more than one full year, and the total of the amounts payable must be determinable at the annuity starting date (or must be payable for a definite or determinable time, in the case of a variable contract). Treas. Reg. section 1.72-2(b).

7 Section 72(c)(4) provides, in relevant part, that for purposes of section 72 "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." Similarly, and subject to certain exceptions not relevant here, Treas. Reg. section 1.72-4(b)(1) defines annuity starting date as the later of "(i) The date upon which the obligations under the contract became fixed, or (ii) The first day of the period … which ends on the date of the first annuity payment."

8 Although there has been no published guidance on the issue, one private letter ruling that the IRS has since revoked suggested that the regulations under section 72 preclude partial annuitizations. *See* PLR 8720011 (Feb. 9, 1987) (considering the tax treatment of a deferred annuity and an immediate annuity purchased simultaneously, and stating that if the contracts are considered a single, integrated contract, "the amounts received with respect to the Immediate Annuity would be considered cash withdrawals prior to the annuity starting date. See section 1.72-4(b)(1) of the Income Tax Regulations, which defines the annuity starting date in terms that preclude a partial annuitization of the contract.") The IRS revoked this private letter ruling in PLR 9015010 (Jan. 8, 1990).

9 *See* section 5.02 of Rev. Proc. 2010-3, 2010-1 I.R.B. 110; Rev. Proc. 2009-3, 2009-1 I.R.B. 107; and Rev. Proc. 2008-3, 2008-1 I.R.B. 110.

10 2010 Green Book, *supra* note 3, at 74.

11 *See* Rev. Proc. 2008-24, 2008-13 I.R.B. 684. The relationship between the partial exchange guidance and the partial annuitization legislation is discussed further below.

12 *See* H.R. 2748, 111th Cong. § 4 (2009). In addition to providing exclusion ratio treatment for partial annuitizations, the bill would encourage annuitization by 1) excluding from income a portion of lifetime income payments received from IRAs, qualified retirement plans (other than defined benefit plans), and non-qualified annuities, and 2) excluding the value of longevity insurance from amounts subject to required minimum distributions under section 401(a)(9). The bill also includes a provision stating that the prospective enactment of the partial annuitization rule creates no inference as to the treatment of partial annuitizations in prior years. The same partial annuitization provisions were included in a bill that Mr. Pomeroy introduced in the 110th Congress. *See* H.R. 4150, 110th Cong. § 4 (2007).

13 For example, assume that a deferred annuity has a cash value of $100, comprised of a $50 investment in the contract and $50 of gain. If the owner wished to withdraw $50, he could request a partial withdrawal in that amount and pay tax on the full $50 under the income-first rule of section 72(e). Alternatively, the individual could exchange the contract for two contracts, each with a $50 cash value, $25 investment in the contract, and $25 built-in gain. He then could surrender one of those contracts for $50, recover $25 of his investment in the contract, and pay tax only on the $25 gain in the surrendered contract.

14 The SEPP and immediate annuity rules are in section 72(q)(2)(D) and section 72(q)(2)(I), respectively.

15 The "Priority Guidance Plan" for 2010-2011 that the IRS and Treasury Department jointly released on Dec. 7, 2010, indicated that published guidance is forthcoming on "the tax treatment of a partial exchange of an annuity contract." A similar item, but which also included guidance on partial annuitizations, has been on the Priority Guidance Plan since 2008-2009.

16 Staff of the J. Comm. on Tax'n, 97th Cong., General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, at 361 (Comm. Print 1982).

Bryan W. Keene is a partner in the Washington, D.C. law firm of Davis & Harman LLP and may be reached at *bwkeene@davis-harman.com*.