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ADDITIONAL IRS RULINGS ON CONTINGENT DEFERRED ANNUITIES

By John T. Adney and Bryan W. Keene

In the May 2011 issue of *Taxing Times*, we reported on two private letter rulings (201105004 and 201105005) released to the public last February in which the IRS again addressed the federal income tax treatment of insurance arrangements sometimes referred to as "stand-alone withdrawal benefits" or "contingent deferred annuities" ("CDAs"). Late in April 2011, the IRS released two more private rulings, PLRs 201117012 and 201117013, that it had issued on Jan. 20 of this year covering the same subject matter on largely similar facts. The new rulings went somewhat further, however, addressing two issues not covered in the prior rulings on CDAs.[1]

The CDA contract involved in the new rulings, which was a group annuity contract, provided guaranteed lifetime withdrawal benefits linked to an investment account that the owner of a certificate under the group contract established with a financial institution (called the "Sponsor" in the rulings) unrelated to the insurance company that issued the contract. PLR 201117013, discussed first below, was issued to a prospective certificate owner to address federal income tax issues pertinent to that taxpayer, while PLR 201117012 was issued to the insurer to provide guidance on its own tax treatment and reporting obligations.

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FACTS OF THE NEW RULINGS

PLRs 201117012 and 201117013 were companion rulings, and hence their facts are identical. According to the rulings, the insurer will issue the group annuity contract to the Sponsor and will provide an individual certificate under the contract to each of the certificate owners, evidencing the insurer's promise of lifetime withdrawal benefits linked to the investment account that each certificate owner establishes with the Sponsor. That owner may be an individual, in which case he or she will be the measuring life for the benefit provided under the certificate, or may be an entity as allowed by section 72(u),[2] in which case the measuring life will be a natural person possessing a beneficial interest in the related investment account. The rulings note that the group contract may be assigned by the Sponsor with the insurer's consent, whereas the certificates issued under the contract will be non-assignable.

The certificate owner may allocate values in the investment account established with the Sponsor among certain "permitted" investment "profiles." These profiles, according to the rulings, were designed to limit volatility and investment losses within the account (which limits, we note, enable the insurer to make its benefit promise and do so for the fees to be charged). The permitted investments may include mutual funds and exchange-traded funds; some of these funds may be managed by an affiliate of the insurer, although the permitted investments will not be limited to insurer-affiliated funds. The owner will be required to rebalance the account assets at least quarterly, and the insurer will monitor the account performance daily using a formula based on which the insurer may direct the Sponsor to reallocate account assets to or from a specified fixed income mutual fund. The certificate owner, however, is described in the rulings as the legal owner of all assets in the investment account.

The group contract, as noted above, will provide a guaranteed lifetime withdrawal benefit ("GLWB") for each certificate owner that is linked to that owner's investment account. The GLWB will be conditioned on the owner not withdrawing more than a specified annual income amount from the account each year. The crux of the GLWB promise is that if withdrawals conform to this requirement but the account nonetheless is exhausted during the life of the owner (or the beneficial owner in the case of an entity-owned certificate), the insurer will begin paying the owner an "annual benefit." This annual benefit will consist of a series of periodic payments equal to the specified annual income amount, and these payments will continue for the owner's remaining life. A joint and survivor version of this benefit will also be available for the owner and his or her spouse. The taxpayer seeking each ruling represented that this payout will comply with the distribution-at-death requirements imposed by section 72(s).

The initial annual income amount specified for a certificate owner will be determined by applying a "withdrawal factor" to a "withdrawal base" when that owner makes the first withdrawal from his or her investment account. The withdrawal base will be determined daily by reference to market values combined with a "guaranteed increase rate" and a "guaranteed base increase." A certificate owner's annual income amount will decrease only if the owner takes a withdrawal from the account in excess of that amount, in which case the annual income amount will reduce proportionately. The certificate also will entitle the owner to apply his or her account's value to purchase a more traditional stream of annuity payments, at rates specified in the group contract.

INDIVIDUAL TAX ISSUES ADDRESSED IN THE NEW AND PRIOR RULINGS

In its ruling issued to the prospective certificate owner (PLR 201117013), the IRS reached the following conclusions, each of which is either identical or similar to conclusions that the IRS reached in the earlier rulings (some of those earlier rulings also addressed other issues not dealt with in the new rulings):

(1) The group contract and each certificate under it will constitute an annuity contract for purposes of section 72.

(2) The annual benefit provided under the contract, and any traditional annuity payments provided, will be taxable as "amounts received as an annuity" using an "exclusion ratio" under section 72(b).

(3) For purposes of sections 72(c)(1) and 72(e)(6) (defining "investment in the contract"), the "aggregate amount of premiums or other consideration paid" for a certificate will equal the sum of all periodic charges paid for it plus any proceeds paid to the insurer upon liquidation of the investment account in consideration for annuity payments.

(4) Dividends that the certificate owner receives from the assets in the investment account will not fail to be treated as "qualified dividend income" within the meaning of section 1(h)(11)(B) merely because the owner also holds a certificate under the group contract.

(5) The ownership of both the certificate and the investment account will not be treated as a straddle under section 1092.

(6) The annual benefit will not constitute insurance or other compensation for any prior deductible losses in the account for purposes of section 165.

NEW ISSUES AFFECTING THE CERTIFICATE OWNER

In addition to the foregoing, PLR 201117013 addressed two issues pertinent to the certificate owner that were not involved in the earlier IRS rulings.

First, the new ruling concludes that the "tax benefit doctrine" will not operate to tax the portion of annual benefits provided under the contract that otherwise would be excludable as a return of the certificate owner's investment in the contract. Generally, the tax benefit rule requires a taxpayer who received a tax benefit from a deduction in an earlier year to recognize income in a later year if an event occurs that is fundamentally inconsistent with the premise on which the earlier deduction was based. The ruling states that the non-taxable

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return of the "investment in the contract" *via* the exclusion ratio applicable to the annual benefit might be recharacterized as taxable income under the tax benefit rule if it were viewed as an event that is fundamentally inconsistent with the premise on which an earlier deduction was claimed with respect to losses in the account. The ruling concludes, however, that this will not be the case, employing the same reasoning used in support of the conclusion in item (6) above (regarding whether the annual benefit will constitute insurance or other compensation for any prior deductible losses in the investment account for purposes of section 165). In essence, the ruling reasons that the connection between any particular loss and the potential payment of annual benefits is too tenuous to "recapture" the prior tax benefit.

Second, the new ruling concludes that the existence of the investment account will not cause the group contract or the certificate to have a "cash value" or "cash surrender value" for purposes of section 72, and that the account itself will not otherwise be part of the contract or certificate for federal tax purposes. In reaching this conclusion, the ruling observes that section 72 does not define "cash value" or "cash surrender value." The ruling discusses how those terms have been defined more generally, and concludes that the account does not give rise to a cash value. In this regard, the ruling notes that the certificate owner can access the values in the investment account quite apart from the operation of the certificate but cannot "monetize" the certificate itself *via* withdrawals from it or by assigning or surrendering it. The ruling contrasts this arrangement with the so-called investment annuity described in Rev. Rul. 77-85, 1977-1 C.B. 12, which involved an annuity contract and a custodial account wherein a surrender of the contract would result in liquidation of the custodial account.

INSURANCE COMPANY TAX ISSUES

PLR 201117012, issued to the insurer, reached the following conclusions:

(1) The group contract and each certificate under it will constitute an annuity contract for purposes of section 72.

(2) The annual benefit and any traditional annuity payments will be taxable as "amounts received as an annuity" using an "exclusion ratio" under section 72(b).

(3) The investment account will not cause the contract or the certificate to have a "cash value" or "cash surrender value" for purposes of section 72, and the account will not otherwise be part of the contract or certificate for federal tax purposes.

(4) For purposes of sections 72(c)(1) and 72(e)(6), the "aggregate amount of premiums or other consideration paid" for a certificate will equal the sum of all periodic charges paid for it plus any proceeds paid to the insurer upon liquidation of the account in consideration for annuity payments.

As with the prior rulings on CDAs, these conclusions overlap with many of the IRS's conclusions reached with respect to certificate owners.

CONCLUDING OBSERVATIONS

Taken as a whole, the various private letter rulings issued to date appear to indicate that the IRS has become comfortable with the following key conclusions regarding the federal income tax treatment of CDAs and the GLWBs they provide:

(1) The products are treated as annuity contracts for federal income tax purposes and not as some other type of financial instrument, such as a derivative.

(2) The basic benefit payments made under the arrangement are treated as annuity payments taxable under section 72(b), applying an exclusion ratio determined using the contract charges as the investment in the contract.

(3) The CDA's interaction with the linked account does not interfere with the otherwise applicable tax treatment of the assets in the investment account, *e.g.*, the arrangement is not a straddle (which would defer the deduction of losses incurred in the account's investments).

Private rulings issued by the IRS, of course, do not constitute precedent and cannot be relied on by parties other than the taxpayers to whom they are issued.[3] Hence, as other insurers enter this market, there may well be further ruling activity along the lines we have seen thus far.

In addition, while the authors are not experts in the federal securities laws, we understand that the IRS's conclusion that the stand-alone withdrawal benefit is an annuity, with income taxed under section 72, also has significance for the treatment of the CDA under the Dodd-Frank Act (the "Act"). The Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") have each approved the issuance of a joint proposed rule relating to the definition of "swap," "security-based swap," and "security-based swap agreement" under the Act. The proposed rule provides that insurance products meeting certain requirements and issued by insurers or other entities satisfying certain other requirements will not be regulated as swaps or security-based swaps under the Act. Additionally, under proposed interpretive guidance from those agencies, certain products issued by regulated insurance companies, including annuity products that are taxable under IRC section 72, will be considered insurance and not swaps or security-based swaps regardless of whether such instruments meet the specific requirements set forth in the proposed rule. In light of the IRS's conclusion in the various private letter rulings that stand-alone withdrawal benefits are annuity contracts taxable under section 72, such products would appear to fall within the scope of the SEC and CFTC proposed exception for annuity products as described above, subject of course to review of the SEC and CFTC guidance (and consultation with securities law counsel).

END NOTES

1 The earlier rulings, apart from PLRs 201105004 and 201105005, were PLRs 201001016, 200949036 and 200949007. The latter rulings were discussed in an article published in *Taxing Times* in May 2010. See Joseph F. McKeever, III, and Bryan W. Keene, "IRS Confirms Annuity Status of 'Contingent Annuity Contracts'," *Taxing Times* vol. 6, issue 2 (May 2010).

2 Unless otherwise indicated, each reference herein to a "section" is to a section of the Internal Revenue Code of 1986, as amended.

3 Section 6110(k)(3).

John T. Adney is a partner with the Washington, D.C. law firm of Davis & Harman LLP and may be reached at *jtadney@davis-harman.com.*

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.*