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IRS APPROVES ANNUITY TREATMENT FOR TERM CERTAIN VARIABLE PAYOUT

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Nearly 60 years ago, the IRS and the Treasury Department promulgated regulations implementing an innovation for taxing annuity payments under the then new Internal Revenue Code of 1954: the exclusion ratio approach of IRC section 72(b). This approach to tax-free recovery of the investment in the contract, unlike its 1939 Code predecessor, was tailored to the financial characteristics of each annuity contract, and it required the issuance of detailed regulations in order for it to operate successfully. This the regulations issued in 1956 managed to do, drawing on the features of annuity contracts and their payout forms then known. Notably, at the time these regulations were written, the variable payout annuity was new, and there were no deferred annuities with enhanced death benefits or guaranteed minimum withdrawal benefits. There also were no cell phones or personal computers, one could drink a Coca-Cola but not a Diet Coke, the Beatles were still in high school, and the Internet did not exist.

Today's nonqualified annuity contract, whether deferred or immediate, variable or fixed, differs markedly in its features from its 1950s counterpart. And yet, in assessing the federal income tax treatment of distributions from the modern nonqualified annuity, the tax professional must refer to regulations issued during the Eisenhower Administration. While the relevant portion of these regulations was updated in 1986 to reflect mortality improvements and make use of unisex mortality rates, the rules were not changed to record the significant rewrite of the statute by the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97-248 (TEFRA). Accordingly, when an insurer recently sought to determine the tax treatment of new features that it planned to add to its nonqualified deferred variable annuity offerings, the determination needed to be made by deciphering the import of the aging IRC section 72 regulations. As has often been done in recent years, this determination was made by asking the IRS to apply the regulations to the circumstances of the insurer's new product.

In PLR 201424014 (March 10, 2014), released to the public on June 13, 2014, the IRS addressed the income tax treatment of periodic payments to be made under a term certain annuity option—styled the "New Annuity Option" in the ruling letter—to be offered under a nonqualified deferred variable annuity contract. Significantly, as explained below, the payments under the New Annuity Option are to be determined and redetermined annually by dividing the account value of the variable annuity by the number of years remaining in the term certain. In other words, after the periodic payments begin, the contract would continue to provide an account value, which could be obtained by the contract owner (or the death beneficiary) by commuting (i.e., surrendering) the contract in whole or part. The IRS agreed with the insurer's requests that the taxable portion of each of the periodic payments would be computed by applying an exclusion ratio under the IRC section 72(b) regulations, and that the existence of the commutation rights would not give rise to constructive receipt of the account value.

THE FACTS

According to the IRS's ruling letter, the New Annuity Option is to be made available to owners of the insurer's nonqualified deferred variable annuity contracts to obtain a term certain annuity with variable payments. If a contract owner elects the New Annuity Option, the owner must select the number of years in the term certain annuity period, which must be at least an insurer-specified minimum number of years but must not extend beyond a stated age of the owner (or in the case of joint or contingent owners, that of the younger owner). The owner's election may be revoked, but only before the first periodic payment is made. Unless the election is revoked, there can be no change in the contract's ownership, the identity of the annuitant, or (absent a commutation) the duration of the annuity term.

The annual amount of the periodic payments to be made in the first year under the New Annuity Option is to be determined when the insurer receives the contract owner's election, and the amount payable in each of the subsequent years is to be determined on the day before each anniversary of that election. For each year, the annual amount is calculated by dividing the contract's account value at that time by the number of years remaining in the annuity term. Because the underlying contract is a variable one, with values reflecting gains and losses in the variable subaccount investments, this account value is expected to fluctuate, and so the annual amount also is expected to fluctuate in relation to it. The IRS ruling letter notes, however, that the account value always would decrease as the annuity term progresses, and would reach zero at the term's end. By way of (a highly oversimplified) example, assume that in year x, when a 20-year payout begins, the account value is $10,000. The annual payment amount for that year would be $10,000/20 = $500. Then, for year x+1, the account value has been increased by $400 in earnings. The annual payment amount for x+1 would be ($10,000 - $500 + $400)/19 = $521 (with rounding).

Under the New Annuity Option, the contract owner may take the annual amount of the periodic payments in monthly or quarterly installments as well as in an annual sum. The owner also may commute (the ruling letter uses the term "redeem") the contract's account value, in whole or part, after the periodic payments begin. A complete commutation terminates the payments and the contract, while a partial commutation results in a *pro rata* reduction of the future periodic payments. On the death of an owner (or annuitant in the case of a contract held by a non-natural person) during the annuity term, the periodic payments are required to continue for the remainder of the term as required by IRC section 72(s)(1)(A), subject to a death beneficiary's right to commute the account value in whole or part.

THE IRS'S RULINGS

Apart from summarizing the relevant rules of the tax law, the IRS ruling letter did not provide much by way of a rationale for the agency's holding on the treatment of the periodic payments under the New Annuity Option. The letter sets out the applicable portions of IRC section 72 and the regulations thereunder, explaining that under Treas. Reg. section 1.72-2(b)(2)-(3), payments from an annuity contract are considered "amounts received as an annuity" if (1) they are received on or after the "annuity starting date" as defined in in Treas. Reg. section 1.72-4(b)(1), (2) they are payable in periodic installments at regular intervals over a period of more than one full year from the annuity starting date, and (3) in the case of periodic payments that may vary in accordance with investment experience, they are to be received for a "definite or determinable time (whether for a period certain or for a life or lives)." The letter also states that, as provided in Treas. Reg. section 1.72-2(b)(3), to the extent each variable payment does not exceed the investment in the contract divided by the number of anticipated periodic payments, it is considered an amount received as an annuity and is excludable from income—that is, the exclusion ratio is 100 percent—and any excess is treated as an amount not received as an annuity. An amount not received as an annuity after the annuity starting date is fully includible in income pursuant to IRC section 72(e)(1)(A). This description is none other than the traditional exclusion ratio approach applied to a variable payout annuity.

Applying these rules to the facts of the New Annuity Option, the IRS concluded, as requested by the insurer, that the traditional exclusion ratio approach would apply as it normally would for variable annuity payments. Thus, the ruling letter held that each periodic payment under the New Annuity Option would be an "amount received as an annuity," and thus excludable from gross income, to the extent that it does not exceed the amount computed by dividing the investment in the contract by the number of payments anticipated during the annuity term. The remainder of each payment would be treated as an amount not received as an annuity, and thus fully includible in gross income. Using the 20-year term in the example given above, and assuming that the investment in the contract at the annuity starting date was $8,000, this would produce an annual exclusion of $400 ($8,000/20). Hence, of the $500 payment in the example for year x, $100 would be includible in income, and of the $521 payment in year x+1, $121 would be includible.

The insurer also asked the IRS to rule that following the election of the New Annuity Option, no amount would be includible in the owner's income before its actual payment under the option, *i.e.,* that there would be no constructive receipt of the contract's account value. The IRS so ruled, basing its holding

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on a number of observations. These included, first, that IRC section 72 provides a "comprehensive scheme" for the taxation of annuity contracts, namely, IRC sections 72(a) and (e) expressly require that amounts be "received" before they are included in gross income; in so saying, the IRS repeated what it had observed many times before. Second, prior to TEFRA the doctrine of constructive receipt did not apply to annuities, and the TEFRA changes to IRC section 72 did not alter this. Third, IRC section 72(e)(4)(A), which provides that a loan or a pledge of a nonqualified annuity is treated as a distribution, is inconsistent with application of the doctrine of constructive receipt in other circumstances. The ruling letter also mentions IRC section 72(u) (imposing current taxation on the cash value buildup of an annuity owned by a non-natural person) as a basis for its conclusion.

REFLECTIONS ON PLR 201424014

This private letter ruling is significant for two reasons. First, it is only the second ruling addressing whether periodic payments calculated in this manner, i.e., using an "RMD" type of method, are eligible for IRC section 72(b) "exclusion ratio" treatment. The earlier ruling addressing this manner of calculating annuity payments, PLR 200313016 (Dec. 20, 2002), also dealt with the implications of a full surrender after the periodic payments commenced, but it did not address the implications of a partial surrender. The new ruling indicates that allowing partial surrenders under this type of design does not preclude exclusion ratio treatment.

Second, the new ruling does not address the treatment of amounts received on a partial or complete commutation under the New Annuity Option. However, the ruling letter contains a statement that the insurer would treat amounts received in a partial commutation as fully includible in income. Hence, the insurer would not treat a portion of a partial commutation as a tax-free recovery of the investment in the contract under Treas. Reg. section 1.72-11(f)(2). According to IRS Publication 575, *Pension and Annuity Income*, this regulation applies to partial commutations, but the IRS has indicated in prior private letter rulings that it believes the regulation does not apply (see PLR 9237030 (June 16, 1992) and PLR 200030013 (April 27, 2000)).

Given the interest of insurers in developing new nonqualified payout annuity products while simultaneously providing access to a surrender value, it would not be at all surprising to see more rulings of this type. The accurate application of the aging regulations under IRC section 72, which govern the tax treatment of such products, is essential for both insurers and contract owners. The insurer in PLR 201424014 took the right step in seeking guidance from the IRS. ◂