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THE TAXABLE DEFERRED ANNUITY WITH GUARANTEED LIFETIME WITHDRAWALS

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In PLRs 201515001 and 201519001 (each dated Oct. 10, 2014), the Internal Revenue Service (IRS) addressed the treatment of a non-qualified deferred annuity contract under the investor control doctrine and other applicable rules. The contract provides a guaranteed lifetime withdrawal benefit with respect to amounts held in the issuer's general account and separate account, the latter of which provides various investment options for the policyholder. Each investment option corresponds to a "publicly available" mutual fund, meaning shares in the fund also can be purchased outside of any variable insurance product. The taxpayer in the first ruling was the proposed purchaser of the contract, and the taxpayer in the second ruling was the issuer.

The taxpayers requested and received rulings that the investor control doctrine will apply to treat the contract purchaser, rather than the issuer, as the owner of the mutual fund shares for federal income tax purposes. The taxpayers also requested and received rulings on various other tax consequences flowing from this conclusion, including the status of the contract under section 72,[1] how the "cash value" and "investment in the contract" will be determined, how distributions from the contract will be taxed, and (in the ruling issued to the proposed purchaser) whether ownership of the contract and its guaranteed withdrawal benefit feature will limit the availability of certain tax benefits the policyholder would enjoy if he directly owned the underlying mutual funds.

The effect of the rulings is that the contract will be taxed similarly to a contingent deferred annuity (where the policyholder holds the mutual fund shares in his or her own brokerage account), while being structured like a traditional deferred variable annuity (where the insurance company holds the shares in its separate account).[2] The rulings also are noteworthy because they address various specific consequences of the investor control doctrine applying to the contract, including the treatment of in-kind contributions and distributions of mutual fund shares allowed under the arrangement.

SUMMARY OF FACTS

A life insurance company ("Company") intends to issue a non-qualified deferred annuity contract ("Contract") to an individual ("Individual"). The Contract provides a "Contractual Cash Value" that equals the sum of the "Fixed Account Value" and the "Separate Account Value." The Contract allows the owner to apply the Contractual Account Value to generate "Annuity Payments." The Contract also provides for "Income Benefit Payments" that are similar to guaranteed lifetime withdrawal benefits. The key features of the Contract are summarized below.

The Accounts: The Fixed Account Value is credited with interest and is supported solely by the Company's general account. The Separate Account Value equals the market value of certain mutual funds the Company holds in its Separate Account, based on allocations the Individual makes among the investment options the Company offers, which are subject to certain "Investment Guidelines" that impose parameters around such allocations. Each investment option corresponds to a sub-account of the Separate Account, and each sub-account invests in shares of a corresponding publicly available mutual fund (a "Public Mutual Fund"). The Company will hold legal title to the shares of the Public Mutual Funds.

Contributions: Contributions to the Contract may be made in cash or in kind. To make an in-kind contribution, the Individual will transfer to the Company ownership of shares in a Public Mutual Fund that is otherwise available as an investment option under the Contract. To facilitate this, the Contract will require the Individual to maintain a brokerage account with a Company-approved financial institution. A portion of each contribution must be allocated in cash to the Fixed Account according to a fixed percentage listed in the Contract, which may equal zero after a specified time frame.

Withdrawals: Withdrawals will be taken *pro rata* from the Fixed Account Value and the Separate Account Value. All withdrawals from the Fixed Account Value will be made in cash. However, the Individual may choose to receive withdrawals from the Separate Account in kind or in cash. For an in-kind withdrawal, the Company (or the Separate Account) will transfer to the Individual legal ownership of the shares of the relevant Public Mutual Fund(s). For a cash withdrawal, the Company will liquidate shares of those funds and forward the proceeds to the Individual.

Income Benefit: The Income Benefit appears to be typical of guaranteed lifetime withdrawal benefits. For example, it guarantees that if the Contractual Cash Value is reduced to zero for reasons other than withdrawals taken in excess of an annual "Guaranteed Amount," the Company will make "Income Benefit Payments" equal to the Guaranteed Amount for the Individual's remaining life.

Contract Fees and Charges: Certain "Contract Charges" are payable to the Company under the terms of the Contract. The owner may elect to pay some of these charges out-of-pocket or have them deducted *pro rata* from certain sub-accounts of the Separate Account. Charges will not be deducted from the Fixed Account.

CONCLUSION UNDER THE INVESTOR CONTROL DOCTRINE

The taxpayers requested and received rulings that the investor control doctrine will apply to treat the Individual, rather than the Company, as the owner of

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the Public Mutual Fund shares for federal income tax purposes. Normally, for such purposes, the life insurance company is treated as the owner of the separate account assets it holds in support of variable annuity and life insurance contracts it issues. The IRS established a limited exception to this treatment in a series of revenue rulings colloquially known as the "investor control" rulings. Under those rulings, the policyholder, rather than the insurance company, is treated as the owner of the separate account assets if he or she has sufficient incidents of ownership in them. The result is that the tax benefits of the insurance contract are lost, and the policyholder is currently taxable on income generated by the separate account assets as if he or she held them directly.

The IRS revenue rulings on investor control often focus on the "public availability" of the investments supporting the contract. For example, in Rev. Rul. 81-225 the IRS considered five situations involving a deferred annuity with investment options that each corresponded to a different mutual fund the insurance company selected and held in its separate account. In four of the situations, shares of the mutual funds were publicly available, and in those situations the IRS concluded that the policyholder, rather than the insurance company, would be treated as owning the shares for tax purposes. Similarly, in Rev. Rul. 2003-92 the IRS concluded that interests in a partnership that an insurer held in its separate account as an investment option under life insurance and annuity contracts were owned by the policyholders for tax purposes because the partnership interests were publicly available.

In considering the applicability of these rulings to the facts in PLRs 201515001 and 201519001, the IRS observed that "each sub-account corresponds to a Public Mutual Fund that is identified in the prospectus or other materials accompanying the Contract … [and] … shares of the Public Mutual Funds will be available for direct purchase by the general public, including the Individual, without having to purchase a Contract." Citing Rev. Rul. 81-225 and related guidance, the IRS concluded that under these facts the Individual will be treated as owning the Public Mutual Fund shares for tax purposes. Expanding on this conclusion, the IRS also ruled as follows:

1. "Each year, the Individual should reflect in his gross income any gains, income, or losses with respect to the Public Mutual Fund shares, with the amount and tax character of such items being the same as if he held the shares directly. For this purpose, any redemption of Public Mutual Fund shares to (1) make a cash payment to the Individual or his designee, (2) reallocate the Separate Account Value among the Separate Account investment options, (3) pay Contract Charges, or (4) be applied to generate Annuity Payments will incur the same tax consequences to the Individual as if he redeemed the Public Mutual Fund shares directly and received the resulting cash."
2. "A transfer of legal ownership of Public Mutual Fund shares between the Company (or the Separate Account) and the Individual, whether as a Contribution to or a withdrawal from the Contract, will not be a taxable event." This conclusion reflects the interpretation that, because the Individual will be treated as owning the Public Mutual Fund shares both before and after any transfer of legal ownership between the Individual and Company, such a transfer will not represent a disposition of the shares.

Because the Company will hold legal title to the Public Mutual Fund while the Individual will be treated as owning the shares for federal income tax purposes, the Company could have information reporting obligations with respect to the shares. In that regard, the taxpayers represented that "[b]ased on Rev. Rul. 81-225, 1981-2 C.B. 12, the Company will be a nominee of the policyholder with respect to amounts the Separate Account receives from the relevant Public Mutual Funds on the policyholder's behalf. As a nominee, the Company will have, and intends to comply with, obligations to report such amounts to the Service and the policyholder."

ADDITIONAL ISSUES ADDRESSED

The taxpayers also requested and received rulings on various other tax consequences flowing from the conclusion under the investor control doctrine, as summarized below.

Tax Status of the Contract: The IRS concluded that, "[f]or federal income tax purposes, the Contract will constitute an annuity contract taxable under [section] 72, except for the portion of the Contract [comprising] the Separate Account Value where the Individual is treated as the owner of the Public Mutual Fund shares and taxable under [section] 61." In reaching this conclusion, the IRS observed that "except for the portion of the Contract [comprising] the Separate Account Value where the Individual is treated as the owner of the Public Mutual Fund shares and taxable under [section] 61, the Contract possesses the essential attributes of an annuity."

Cash Value of the Contract: The IRS also concluded that, for purposes of section 72, "the Contract's 'cash value' or 'cash surrender value' will be [composed] solely of the Fixed Account Value and not the Separate Account Value." In reaching this conclusion, the IRS observed that because the investor control doctrine applies to treat the Individual as the owner of the Public Mutual Fund shares for federal income tax purposes, those shares cannot also comprise part of the Contract's "cash value" for section 72 purposes. Based on the conclusion that only the Fixed Account Value comprises the Contract's cash value, the IRS went on to rule that "[a]ny withdrawal from the Contract that is allocable to the Fixed Account Value will be taxable under [section] 72(e); and

[a]ny Contract Charges that are deducted from the Fixed Account Value will be treated as internal charges under the Contract that do not give rise to a taxable distribution."

Investment in the Contract: The IRS also concluded that "[a]ny Contributions that are allocated to the Fixed Account, any Separate Account Value that is applied to generate Annuity Payments, and any Contract Charges that are paid from the Separate Account Value or that the Individual pays directly from his checking or similar after-tax account will give rise to 'investment in the contract' within the meaning of section 72(c)(1) and 72(e)(6)." Presumably this conclusion is based on the fact that such amounts will be paid to the Company with after-tax dollars. In that regard, because the Individual is treated as owning the Public Mutual Fund shares for federal income tax purposes, any sale or redemption of those shares to generate Annuity Payments or pay Contract Charges will be taxable.

Exclusion Ratio Treatment: The IRS also concluded that the Income Benefit Payments and Annuity Payments "will be treated as 'amounts received as an annuity' using an 'exclusion ratio' under [section] 72(b)." As an exception to this conclusion, however, the IRS stated that "the initial Income Benefit Payment will be treated as an 'amount not received as an annuity' that is taxable under [section] 72(e) if such payment is not made within the same interval as the succeeding Income Benefit Payments or is not made on or after the annuity starting date as defined in [Treas. Reg. section] 1.72-4(b)." That regulation states that one of the requirements for payments to be treated as "amounts received as an annuity" is that the payments must be made in periodic installments at regular intervals.

Tax Benefits Available from Ownership of the Public Mutual Funds: Finally, in PLR 201515001, which was issued to the Individual, the IRS ruled favorably on three issues relating to whether the Individual's ownership of the Contract and right to receive the Income Benefit Payments will limit the availability of certain tax benefits that would be available if he owned the Public Mutual Funds directly. Specifically, the IRS concluded that the Contract will not give rise to a straddle under section 1092 (which would defer the deduction of losses incurred with respect to the Public Mutual Funds), will not reduce the Individual's holding period with respect to the Public Mutual Funds for purposes of sections 246(c)(4) and 1(h)(11)(A) (which could deny "qualified dividend income" treatment and thus the lower tax rate applicable to dividends received from the funds), and will not constitute "insurance" that would preclude deductions for investment losses or give rise to income under the "tax benefit rule." The IRS reached these same favorable conclusions in prior rulings involving contingent deferred annuities and followed the same analysis as in those earlier rulings.[4] ■

END NOTES

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

[2] For a discussion of the IRS rulings on contingent deferred annuities, see John T. Adney and Bryan W. Keene, "Additional IRS Rulings on Contingent Deferred Annuities," *Taxing Times* vol. 7, issue 3, at 28 (September 2011); Joseph F. McKeever, III, and Bryan W. Keene, "IRS Confirms Annuity Status of 'Contingent Annuity Contracts,'" *Taxing Times* vol. 6, issue 2, at 1 (May 2010).

[3] Rev. Rul. 2003-92, 2003-2 C.B. 350; Rev. Rul. 2003-91, 2003-2 C.B. 347; Rev. Rul. 82-55, 1982-1 C.B. 12; Rev. Rul. 82-54, 1982-1 C.B. 11; Rev. Rul. 81-225, 1981-2 C.B. 12, *modified* by Rev. Proc. 99-44, 1999-2 C.B. 598; Rev. Rul. 80-274, 1980-2 C.B. 27; Rev. Rul. 77-85, 1977-1 C.B. 12. *See also* Webber v. Commissioner, 144 T.C. No. 17 (2015); Christoffersen v. United States, 749 F.2d 513 (8th Cir. 1984).

[4] *See supra* note 2.

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