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IRS Applies Strict Reading of Section 72(s)

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In August 2015, the Internal Revenue Service (IRS) released PLR 201532026 (April 23, 2015) (or the "Ruling") applying the after-death distribution rules for nonqualified annuity contracts under section 72(s)[1] to a non-spouse beneficiary ("Taxpayer") under two nonqualified deferred annuity contracts.[2] Even though Taxpayer requested to receive her interest in the contracts over her life expectancy, the requested distributions did not actually begin within one year after the holder's death as required by the "life expectancy rule" under section 72(s)(2) (described below) because of delays related to another individual's competing claim to the proceeds of the contracts. Accordingly, the IRS concluded that Taxpayer's interests in the contracts must be distributed within five years of the contract holder's death under section 72(s)(1)(B) (the "five-year rule"). This Ruling appears to be the first private letter ruling addressing the consequences of failing to begin distributions from a nonqualified annuity contract under the life expectancy rule within one year after the holder's death.

Set forth below is a discussion of the rules and background of section 72(s), followed by a discussion of the Ruling. In addition, this article considers whether the IRS might have reached a different conclusion in the Ruling if (1) the requested distributions actually commenced within one year of the contract holder's death, *e.g.*, the distributions were paid into an escrow account, (2) the required minimum distribution (RMD) rules that apply to individual retirement arrangements (IRAs), section 403(b) plans, and qualified retirement plans (collectively, "qualified arrangements") could be applied, or (3) the facts and circumstances could cause a taxpayer to be in constructive receipt of the missed payments under the life expectancy rule.

SECTION 72(s) IN GENERAL

Section 72(s) provides that, with certain exceptions, a nonqualified annuity contract will not be treated as an annuity contract for federal income tax purposes unless it provides certain distribution requirements that apply after the death of any "holder" of the contract. These requirements differ depending on whether a holder dies before the "annuity starting date"[3] or dies on or after that date. Specifically, if a holder dies on or after the annuity starting date, any remaining interest must be distributed at least as rapidly as under the method of distributions being used as of the date of his death.[4] If a holder dies before the annuity starting date (as under the facts in the Ruling), the entire interest in the contract must be distributed within five years after the death of the holder (*i.e.*, under the five-year rule). However, section 72(s)(2) sets forth an exception (the life expectancy rule) under which any portion of the holder's interest may be distributed over the life of the "designated beneficiary,"[5] or over a period not extending beyond the designated beneficiary's life expectancy, if "such distributions begin not later than 1 year after the date of the holder's death or such later date as the Secretary may by regulations prescribe." The regulations under section 72 do not address the after-death distribution rules in section 72(s).

Section 72(s) also includes several special rules and exceptions not relevant to the Ruling. In particular, section 72(s)(3) provides generally that if the designated beneficiary is the holder's surviving spouse, the surviving spouse is treated as the holder of the contract, thereby allowing the surviving spouse to continue the contract as his or her own contract. This spousal continuation delays the application of the after-death distribution rules until after the death of the surviving spouse.[6] In addition, section 72(s)(6) and (7) provide that if the contract holder is not an individual, the "primary annuitant"[7] is treated as the holder of the contract, and the death or change of the primary annuitant is treated as the death of the holder that triggers the after-death distribution requirements. Also, section 72(s)(5) provides generally that the after-death distribution rules do not apply to an annuity contract that (1) is issued as or in connection with a qualified arrangement, which is subject to the RMD rules in section 401(a)(9), or (2) is a "qualified funding asset" under rules for structured settlements in section 130(d).

THE LEGISLATIVE HISTORY OF SECTION 72(s)

Section 72(s) was added to the Code as part of the Deficit Reduction Act of 1984 to prevent continued deferral of the "inside build-up" under annuity contracts after the death of a contract holder.[8] Prior to enactment of section 72(s), no income was recognized to the recipient of an annuity by reason of the death of the contract owner. Rather, the income accumulated in the contract was includible in gross income only when the beneficiary chose to take distributions from the contract. Congress concluded that the continued deferral of tax on the income in an annuity contract should not be allowed when the annuity contract is passed to another generation (other than a spouse). Congress enacted section 72(s) as a means to address this post-death tax deferral.

Under the initial version of section 72(s) that was passed by the House of Representatives in 1984, the entire amount of the gain

in the contract as of the contract holder's death would have been includible in the holder's gross income, and the investment in the contract would have been increased by that amount. This approach effectively would have reversed the income in respect of a decedent rule that applied at that time (under which a taxpayer who inherited the right to income stood in the shoes of the decedent and included the amount in income when received) by shifting the tax on the income accumulated in a deferred annuity from the surviving beneficiary to the decedent contract holder.[9]

The House approach was rejected by the Senate,[10] and Congress ultimately adopted the approach reflected in the current statute. It appears Congress did not want to shift the income tax burden to the estate of the deceased owner and to overturn the rules applicable at that time to beneficiaries of annuity contracts.[11] Congress instead modified the rules to generally conform them to those applicable to qualified arrangements.[12] In this regard, Congress had indicated that deferral of tax on the investment income of annuities is justified by the retirement savings purpose of annuities.[13]

THE FACTS OF PLR 201532026

The deceased individual in PLR 201532026 owned two nonqualified deferred annuity contracts, each issued by a different insurance company. The individual died prior to the annuity starting date for each contract. Taxpayer was named a partial, non-spouse beneficiary under each of the contracts. Taxpayer received forms from each company setting forth distribution options, and she elected a ten-year payout option of her beneficiary share of each contract. The Ruling indicates that Taxpayer provided the election forms to each company within one year of the owner's death. Hence, if the requested distributions under the ten-year payout option had timely commenced, they would have been made in accordance with the life expectancy rule.

Unfortunately for Taxpayer, Individual B asserted a competing claim to the proceeds of the contracts. Individual B's counsel wrote letters to the two companies requesting that they defer distributions pending the conclusion of the legal dispute regarding the beneficiaries. As a result of these letters, the companies froze the distributions from the contracts before any distributions were made to Taxpayer.

Individual B eventually released any claim to the proceeds of the contracts. However, this release occurred more than a year after the contract owner's death. The companies took the position that since distributions under the contracts had not begun within one year of the contract holder's death, as required under the life expectancy rule, Taxpayer's interests in the contracts could not be distributed under that rule, and thus could not be distributed as Taxpayer requested under the ten-year payout option. Rather, the companies reasoned, section 72 requires that the entire proceeds payable to Taxpayer must be distributed within five years after the owner's death.

The IRS agreed with the companies' determination that the proceeds payable to Taxpayer must be distributed under the five-year rule, notwithstanding Taxpayer's timely election to begin receiving distributions under the ten-year payout option in accordance with the life expectancy rule. The IRS noted that section 72(s)(2)(C) fixes the time by which distributions under the life expectancy rule must begin to a date that is "not later than 1 year after the date of the holder's death or such later date as the Secretary may by regulations prescribe." Based on a strict reading of this section, the IRS reasoned that since this distribution commencement date under the life expectancy rule has not been extended under regulations, and the companies did not actually begin making distributions to Taxpayer until more than a year after the contract owner's death, the entire proceeds of

the contracts had to be paid out within five years of the owner's death, i.e., under the five-year rule.

THOUGHTS AND OBSERVATIONS

Query whether there might be facts or theories not expressed in the Ruling on which the IRS could have reached a different conclusion.

Actual commencement of payments. For instance, it is possible that the IRS would have permitted distributions to be made to Taxpayer under the ten-year payout option, in accordance with the life expectancy rule, if the companies actually began making the requested distributions within one year of the contract holder's death. In light of the uncertainty about who was entitled to the proceeds of the contracts, it is understandable that the companies would not want to make any distributions to Taxpayer. This explains why the companies did not honor Taxpayer's election of the ten-year payout option and froze distributions from the contracts.

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However, Taxpayer and Individual B could have directed the companies to pay the requested distributions into an escrow account pending the resolution of Individual B's competing claim. If so, perhaps the actual payment of such amounts from the contracts (albeit into the escrow account rather than to Taxpayer) could have been sufficient to satisfy the requirement under the life expectancy rule that distributions commence within one year of the holder's death. Even so, this approach might not have presented a clean resolution of the matter because the use of an escrow account would have raised other issues. For example, there would be questions about the proper tax treatment of the distributions transferred to the escrow account, including whether such amounts need to be tax reported in order for the distributions to satisfy the life expectancy rule and to whom they should be reported. In addition, the tax treatment of the amounts held in the escrow account pending the resolution of Individual B's competing claim would be uncertain, including how to tax report the interest that would be paid on such account.

Contrasting the RMD rules. As noted above, the Treasury Department and the IRS have not published regulations interpreting the life expectancy rule under section 72(s). This is in contrast to the after-death distribution rules applicable to qualified arrangements, where the IRS and Treasury have published extensive regulations interpreting these requirements. In this regard, the five-year rule and life expectancy rule that apply under section 72(s) have their counterparts in section 401(a)(9)(B)(ii) and (iii), respectively.

In particular, section 401(a)(9)(B)(ii) (i.e., the RMD counterpart to the five-year rule) provides that if an employee dies before the required beginning date, any remaining interest must be distributed within five years after the employee's death. Section 401(a)(9)(B)(iii) (i.e., the RMD counterpart to the life expectancy rule) provides an exception to this five-year rule for qualified arrangements under which a portion of the employee's interest may be distributed over the life of a "designated beneficiary,"[14] or over a period not extending beyond the designated beneficiary's life expectancy, if "such distributions begin not later than 1 year after the date of the holder's death or such later date as the Secretary may by regulations prescribe." For ease of discussion, we will also refer to the RMD counterparts of these rules simply as the five-year rule and life expectancy rule.[15]

The RMD regulations have fairly comprehensive rules interpreting the after-death distribution requirements in section 401(a)(9), including rules relating to elections that may be made and default rules that apply in the absence of an election. For example, under Treas. Reg. section 1.401(a)(9)-3, Q&A-4, a qualified arrangement may permit the employee (or beneficiary) to elect whether the five-year rule or the life expectancy rule applies to distributions after the death of an employee who has a designated beneficiary. The regulations provide that the election must be made no later than the earlier of the end of the calendar year in which distribution would be required to commence in order to satisfy the requirements for the life expectancy rule or the end of the calendar year that contains the fifth anniversary of the date of death of the employee. As of the last date the election may be made, the election must be irrevocable with respect to the beneficiary (and all subsequent beneficiaries) and must apply to all subsequent calendar years. In addition, the plan may also specify a default method of distribution that applies if neither the employee nor the beneficiary makes the election. If neither the employee nor the beneficiary elects a method and the plan does not specify which method applies, distribution must be made in accordance with the life expectancy rule if there is a designated beneficiary and the five-year rule if there is no designated beneficiary.

The following discusses several private letter rulings in which the IRS considered whether the five-year rule or life expectan-

cy rule applies when distributions of a designated beneficiary's interest in a qualified arrangement do not actually commence within the year following the employee's death as required under the life expectancy rule for qualified arrangements. In making this determination, the IRS generally looked to see whether an election had been made or whether the terms of the qualified arrangement defaulted to the five-year rule or life expectancy rule. Where the life expectancy rule was the default distribution method, the IRS permitted distributions to be made under that rule, notwithstanding that such distributions did not actually begin within the one-year period required under that rule.

- In PLR 201417027 (Jan. 30, 2014) the IRS addressed the failure of distributions to commence within one year of an employee's death. The case involved two daughters of a deceased participant of a profit sharing plan (Plan D) where the participant died prior to the required beginning date.[16] As permitted under the RMD regulations, the terms of Plan D provide that the life expectancy rule applies as the default rule if no election is made between the life expectancy rule and the five-year rule.[17] Due to circumstances beyond the daughters' control, the executor of the deceased participant's estate failed to notify them that they were beneficiaries under the plan by the end of the calendar year following the year of the employee's death. Accordingly, the daughters did not timely elect a distribution method, and thus the life expectancy rule applied by default. As a result, the deceased parent's interest in Plan D will be distributed to the daughters in accordance with the life expectancy rule over the life expectancy of the older daughter.[18] In addition, the IRS concluded that the daughters were liable for the 50 percent excise tax under section 4974 on the missed distributions under the life expectancy rule, subject to a possible waiver of the excise tax under section 4974(d).
- Similarly, PLR 200811028 (Dec. 21, 2007) involved an individual (Taxpayer A) who was the sole beneficiary under two IRAs held by Decedent B who died in 2002 prior to his required beginning date. Under the terms of the IRAs, the life expectancy rule was the default rule, subject to the designated beneficiary's ability to elect to receive distributions under the five-year rule. Taxpayer A made no election for the five-year rule to apply with respect to either IRA. For reasons not explained in the ruling, Taxpayer A failed to take distributions under the life expectancy rule for 2003 and 2004. The RMDs for 2003, 2004 and 2005 were taken in the aggregate in 2005. Taxpayer A later paid the 50 percent excise tax under section 4974 for failing to timely receive the RMDs determined under the life expectancy rule for 2003 and 2004. The IRS concluded that the life expectancy rule applied to distributions from both IRAs.
- In contrast, PLR 9812034 (Dec. 22, 1997) involved an IRA owner who died prior to her required beginning date. For almost four years after her death, her brother (Taxpayer A) was unaware that he was the designated beneficiary of the IRA. Taxpayer A requested relief to receive his interest in the IRA under the life expectancy rule in section 401(a)(9). The IRS reasoned that the time a non-spouse beneficiary, like Taxpayer A, must begin to receive a distribution "is expressly fixed by the terms of the IRA." Under the IRA in this case, distributions would be made under the five-year rule unless the designated beneficiary elected, by Dec. 31 of the year following the year of the owner's death, to apply the life expectancy rule. The IRS concluded that since Taxpayer A failed to timely elect the life expectancy rule, the entire remaining interest in the IRA was required to be distributed under the five-year rule.

It is interesting to note that in PLR 201417027 and PLR 9812034, discussed above, the IRS refused to extend the time by which distributions must begin under the life expectancy rule beyond the one-year period expressed in the rule. The taxpayers requested that the IRS extend this one-year period under the IRS' authority in Treas. Reg. section 301.9100-1 to grant a taxpayer a reasonable extension of the time fixed by a regulation, revenue ruling, revenue procedure, notice or announcement published in the Internal Revenue Bulletin for the making of certain elections or applications for relief. The IRS explained that although a designated beneficiary may elect to determine whether to apply the five-year rule or life expectancy rule, the date by which distributions must commence under the life expectancy rule is fixed by the Code and may not be extended by operation of Treas. Reg. section 301.9100-1. Hence, even where the IRS concluded in PLR 201417027 that the life expectancy rule applied, the distributions were required to begin within one year of the employee's death and thus the 50 percent excise tax (unless waived) applied to the missed payments.

As noted above, the after-death distribution rules set forth in section 72(s) are intended to conform to the similar after-death distribution requirements set forth in the RMD rules for qualified arrangements. However, because Treasury and IRS have not published regulations interpreting section 72(s), it is not clear whether a taxpayer could rely on the regulations under section 401(a)(9) when interpreting how section 72(s) should apply to distributions to beneficiaries from annuity contracts. In order for Taxpayer to get a different result under the Ruling, the IRS would have had to respect Taxpayer's request as a valid election notwithstanding the fact that distributions did not timely begin.

Constructive receipt. Another potential argument that could be made is that, based on the facts and circumstances, a beneficiary is in constructive receipt of the missed payments under the life expectancy rule and thus distributions could continue to be made under that rule. For example, assume the designated beneficiary elects to receive distributions under the life expectancy rule and the issuer accepts the election but inadvertently fails to commence making those distributions within one year of the contract holder's death. The issuer's acceptance of the election arguably gives rise to a right of the designated beneficiary under the terms of the contract, including the terms of the election, to receive the elected distributions in accordance with the life expectancy rule. If under the facts and circumstances the designated beneficiary is treated for federal income tax purposes as being in constructive receipt of the elected distributions, this treatment could support the view that distributions were deemed to have begun within one year of the holder's death, and thus that the life expectancy rule applies even though the distributions did not actually begin within that time.[19]

It appears that the IRS has applied the constructive receipt doctrine in the context of section 72(s) in another set of identical rulings, i.e., PLRs 201302015 and 201302016 (July 13, 2012).[20] Those rulings addressed whether an after-death distribution option (the "new distribution option") to be offered to beneficiaries under nonqualified annuity contracts with guaranteed withdrawal benefit riders will satisfy section 72(s). The new distribution option would allow a beneficiary who is not the spouse of a deceased owner of the annuity (*i.e.*, a "non-spouse beneficiary") to continue the annuity contract and the guaranteed withdrawal benefit rider after the owner's death without any withdrawals from the contract. However, the insurance company will notify the non-spouse beneficiary who wishes to elect the option that she will be required to include in gross income the amount that would be includible in gross income if she instead chose to immediately receive the death benefit proceeds in a lump sum. In addition, the insurance company will send the non-spouse beneficiary a Form 1099-R reporting the amount she will be treated as receiving for tax purposes and the amount that will be taxable. The rulings conclude that the option will satisfy the requirements of section 72(s) based on the premise that the purpose of section 72(s) is to prevent additional tax deferral once the owner of an annuity contract has died.

In these rulings, the IRS seems to reason that as long as the deferral ends (within the time frame required by section 72(s)), the requirements of section 72(s) are met irrespective of whether any amount is *actually* distributed from the contract. The rulings view tax deferral as ending because the death benefit will be included in the non-spouse beneficiary's income. The rulings seem to say that the reason the death benefit is includible in the non-spouse beneficiary's income is because, based on the facts and circumstances involving the election of the distribution option, the non-spouse beneficiary is in constructive receipt of the death benefit proceeds. Thus, treating the amounts as distributed and reportable on a Form 1099-R would be appropriate.

Without knowing the additional facts in the Ruling, it does not seem likely that Taxpayer would have been in constructive receipt of the payments simply by requesting the life expectancy rule because the companies did not honor the request in light of Individual B's competing claim. In this regard, a mere election to include an amount in income would not be consistent with the constructive receipt requirements in section 451(a) and the regulations thereunder.[21] However, if other facts and circumstances are present that would cause a taxpayer to be viewed in constructive receipt of the missed distribution payments, arguably the life expectancy rule could still apply. In this regard, constructive receipt would require the taxpayer to include the missed distribution amounts in income and, thus, would end the tax deferral associated with those payments.

CONCLUSION

The IRS strictly applied the requirement in section 72(s) that distributions must begin within one year of the holder's death for the life expectancy rule to apply. Based on the limited facts described in the Ruling, it is hard to disagree with that result. However, there could be additional facts or theories that could be considered, which might produce a different result. It is unclear whether the IRS would be receptive to these theories because no regulations or other published guidance exists interpreting these issues under section 72(s). In fact, as noted above, the Ruling appears to be the first pronouncement of any kind from the IRS addressing the consequences of failing to begin distributions from a nonqualified deferred annuity contract under the life expectancy rule within one year after the holder's death. ■

The views expressed herein are those of the authors and do not necessarily reflect the view of Davis & Harman LLP.

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END NOTES

[1] Unless otherwise indicated, the term "section" refers to a section of the Internal Revenue Code of 1986, as amended ("Code").

[2] While private letter rulings neither constitute precedent, *see* section 6110(k)(3), nor may be relied upon by taxpayers other than the taxpayer receiving the ruling, they are widely accepted as indicating the views of the IRS National Office at the time of issuance.

[3] The "annuity starting date" is defined generally as the later of (1) the date the annuity obligations under the contract become fixed, and (2) the first day of the first annuity payment interval which ends on the date of the first annuity payment. Section 72(c)(4); Treas. Reg. section 1.72-4(b)(1).

[4] Section 72(s)(1)(A).

[5] For purposes of section 72(s), the term "designated beneficiary" is defined to mean "any individual designated a beneficiary by the holder of the contract." Section 72(s)(4).

[6] Section 72(s)(3). A similar spousal continuation rule applies to IRAs (*see* section 408(d)(3) and Treas. Reg. section 1.408-8, Q&A-5) but not to other types of qualified arrangements.

[7] The term "primary annuitant" is defined in section 72(s)(6)(B) to mean "the individual, the events in the life of whom are of primary importance in affecting the timing or amount of the payout under the contract."

[8] Pub. L. No. 98-369 § 222(b) (1984) ("DEFRA"). A discussion regarding the "inside buildup" of nonqualified annuity contracts appears in this issue of *Taxing Times*. See John T. Adney, "In the Beginning… How Are Nonqualified Annuities Taxed?" page 8.

[9] STAFF OF THE J. COMM. ON TAX'N, DESCRIPTION OF PROVISIONS OF S. 1992 RELATING TO LIFE INSURANCE PRODUCTS AND POLICYHOLDERS, at 19 (Comm. Print 1984).

[10] *See* H.R. 4170, 98th Cong. § 222 (as passed by Senate, May 17, 1984); S. COMM. ON FINANCE, EXPLANATION OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984, at 580-81 (Comm. Print 1984).

[11] Testimony at the Senate hearings held on the version of section 72(s) included in the House bill indicate that the life insurance industry urged the Senate to reject the House approach because of objections to shifting the tax on the deferred gain in the decedent's annuity from the beneficiary to the decedent. *See, e.g.*, *Tax Treatment of Life Insurance Products and Policyholders: Hearing Before S. Comm. on Fin. on S. 1992*, 98th Cong. 162.

[12] H.R. REP. NO. 98-861, at 1077 (1984) (Conf. Rep.).

[13] STAFF OF THE J. COMM. ON TAX'N, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 659 (Comm. Print 1984).

[14] The term "designated beneficiary" is defined for purposes of section 401(a)(9) in the same manner as that term is defined for purposes of section 72(s), *i.e.,* to mean "any individual designated a beneficiary by the holder of the contract." Section 401(a)(9)(E). The regulations under section 401(a)(9) expand on who is considered a designated beneficiary for purposes of that section. *See* Treas. Reg. section 1.401(a)(9)-4.

[15] Treas. Reg. section 1.401(a)(9)-3, Q&A-3. It should be noted that unlike distributions under the life expectancy rule in section 72(s)(2), distributions under the RMD counterpart of the life expectancy rule are permitted under the section 401(a)(9) regulations to commence by the end of the calendar year following the calendar year in which the employee died.

[16] PLR 201417027 also involved the deceased parent's interest in a money purchase pension plan (Plan E). Because the document provided with respect to this plan would require a factual determination concerning plan qualification matters under section 401, the IRS declined to rule with respect to the daughters' interest in Plan E.

[17] *See* Treas. Reg. section 1.401(a)(9)-3, Q&A-4.

[18] *See* Treas. Reg. section 1.401(a)(9)-5, Q&A-7(a).

[19] *See* Treas. Reg. section 1.451-2(a) (income not actually received generally is constructively received by a taxpayer if it's credited to his account, set apart for him, or otherwise made available and the taxpayer's control of its receipt is not subject to substantial limitations or restrictions).

[20] These rulings were discussed in more detail in a prior *Taxing Times* article. *See* Alison R. Peak, Bryan W. Keene, and Joseph F. McKeever, "Applying Section 72(s) to Joint-Life GLWBs Covering Non-Spouses," *Taxing Times*, May 2013, Vol. 9, No. 2.

[21] *See* Treas. Reg. section 1.451-1(a).