Article from

Taxing Times

October 2016
Volume 12 Issue 3

Possible Opportunities for Product Design: the IRS Advises on a Notice That Does *Not* Apply to Non-Qualified Annuities

By John T. Adney and Mark Griffin

Two companion pieces of guidance published by the IRS last June may have created opportunities for life insurers to develop income options under non-qualified annuity contracts that provide flexibility for contract owners while also according section 72(b) "exclusion ratio" treatment to the income payments, concepts not previously viewed as coexisting peaceably.[1] Interestingly, this came about in official guidance that was issued to clarify that the tax treatment announced for certain qualified defined benefit plan distributions do *not* apply to non-qualified annuities.

In Notice 2016-39, the IRS and the Treasury Department provide guidance apparently directed at the Civil Service and Federal Employees Retirement Systems. The Notice advised on the treatment of payments made under a defined benefit plan during "phased retirement," denying them treatment as "amounts received as an annuity" under section 72. Simultaneously, the IRS and Treasury released Revenue Procedure 2016-36 to provide assurance that the manner in which the terms "annuity starting date" and "amounts received as an annuity" are applied in Notice 2016-39, which results in denial of annuitization treatment of the phased retirement payments, does not apply to non-qualified annuities. In doing so, the new revenue procedure also describes two product features that "generally will not affect the determination of whether payments are amounts received as an annuity" in the case of non-qualified annuities. In particular, the guidance in Rev. Proc. 2016-36 seems to allow periodic payments under non-qualified annuities to qualify for exclusion ratio treatment in circumstances where otherwise the payments would be characterized as "amounts *not* received as an annuity," subject to taxation on an income-first basis.

While the exact meaning of the guidance in Rev. Proc. 2016-36 remains to be seen, understanding its teaching (and that of Notice 2016-39) as well as its possible implications requires some explanation.

A BRIEF TUTORIAL ON SECTION 72 (IN RELEVANT PART)

An amount received under an annuity contract, whether the amount is paid under a non-qualified contract issued by an insurer or under an employer's qualified defined benefit plan, is includible in gross income except to the extent that it represents a recovery of the "investment in the contract," *i.e.*, generally the after-tax premiums or contributions under a contract or plan. The portion of the amount so received that is includible in gross income is determined differently depending on (1) whether the amount constitutes an "amount received as an annuity" or an "amount not received as an annuity" as those phrases are used in section 72, and (2) whether it is received before the "annuity starting date" or on or after that date.

Amounts received as an annuity: Treas. Reg. § 1.72-2(b)(2) provides that payments under an annuity contract are considered "amounts received as an annuity" only if they satisfy three conditions:

1 The amount must be received on or after the "annuity starting date." Section 72(c)(4) defines the annuity starting date as "the first day of the first period for which an amount is received as an annuity under the contract." Treas. Reg. § 1.72-4(b)(1) explains that the first day of the first period for which an amount is received as an annuity is the later of (1) the date upon which the obligations under the contract become "fixed," and (2) the first day of the period (year, half-year, quarter, month or otherwise) which ends on the date of the first annuity payment.

2 The amount must be "payable in periodic installments at regular intervals (whether annually, semi-annually, quarterly, monthly, weekly, or otherwise) over a period of more than one full year from the annuity starting date."

3 Except in the case of variable payments, the total amounts payable must be determinable at the annuity starting date either directly from the terms of the contract or indirectly by the use of either mortality tables or compound interest computations, or both, in conjunction with such terms and in accordance with sound actuarial theory. In the case of variable periodic payments, this third requirement is satisfied if the amounts are to be received for a "definite or determinable time," whether for a period certain or for a life or lives.[2]

Taxation of amounts received as an annuity: If payments qualify as amounts received as an annuity, the manner in which the investment in the contract is recovered differs somewhat between a non-qualified annuity (or an IRA annuity) and a qualified employer retirement plan, including a defined benefit plan. In the case of a non-qualified annuity (or an IRA), section 72(b)(1) excludes from gross income an amount equal to the periodic payment multiplied by an exclusion ratio. The exclusion ratio is the ratio of the investment in the contract as of the annuity starting date (adjusted for the value of any refund feature) to the expected return under the contract. (The calculation for variable annuity payments is somewhat different but yields a similar result.) In the case of a qualified employer plan, on the other hand, section 72(d) provides that the investment in the contract is recovered using a "simplified method." This simplified method excludes from income the portion of a monthly payment that does not exceed the amount obtained by dividing the investment in the contract as of the annuity starting date by the number of anticipated payments determined under a table set out in section 72(d)(1)(B)(iii) or (iv).

In substance, Notice 2016-39 provides that a defined benefit plan participant who enters phased retirement (as defined in the Notice) and begins receiving a portion of his benefit payments will be taxed on those payments as "amounts not received as an annuity."

Partial annuitization: Section 72(a)(2) provides a rule allowing the partial annuitization of a deferred annuity contract. (Although sometimes thought of as applicable only to non-qualified annuity contracts, in fact this provision is not limited to non-qualified contracts.) Under this rule, payments under a portion of an annuity contract for a period of 10 years or more, or for one or more lives, can qualify for treatment as "amounts received as an annuity." Specifically, the statute treats the portion of the account value applied to the partial annuitization as a separate contract with its own annuity starting date and exclusion ratio, and it provides for a pro rata allocation of the investment in the contract between the annuitized and non-annuitized portions of the contract.

Taxation of amounts not received as an annuity: If payments do not qualify as "amounts received as an annuity"—*i.e.*, they are classified by section 72 as "amounts not received as an annuity"—there is a dramatic difference in the treatment of the payments as between qualified and non-qualified annuities. In the case of a non-qualified annuity, the payments are taxed on an income-first basis pursuant to section 72(e)(2) and (3), whereas section 72(e)(8) accords a more favorable pro rata recovery of investment in the contract to the payments when made from qualified retirement plans and IRAs, with the determination of the excludable amount made at the time of the distribution or at a time provided by the IRS. Hence, if periodic payments fail to qualify as amounts received as an annuity, the federal income tax impact is much more significant for non-qualified annuities than for qualified retirement plans and IRAs.

PHASED RETIREMENT GUIDANCE: NOTICE 2016-39

Notice 2016-39 addresses the taxation under section 72 of defined benefit plan payments made during phased retirement. The Notice defines phased retirement as "an arrangement under which a participant in a qualified defined benefit plan commences the distribution of a portion of his or her retirement benefits from the plan while continuing to work on a part-time basis." From a financial perspective, the phased retirement arrangement described in the Notice is similar to the partial annuitization of a deferred annuity contract, *i.e.*, a portion of the employee's retirement benefit begins to be paid in the form of regular periodic payments while the remainder of the benefit is deferred to a future date. Indeed, the similarity of the two seems to have prompted the further guidance that appeared in the form of the new revenue procedure, as noted below.

> . . . Rev. Proc. 2016-36 might be read as potentially expanding the circumstances in which periodic payments from a non-qualified annuity can qualify as "amounts received as an annuity". . .

In substance, Notice 2016-39 provides that a defined benefit plan participant who enters phased retirement (as defined in the Notice) and begins receiving a portion of his benefit payments will be taxed on those payments as "amounts not received as an annuity." As a result, the phased retirement payments will be subject to the pro rata recovery rules of section 72(e)(8), rather than the simplified exclusion ratio rules that apply to amounts received as an annuity under section 72(d). The Notice reaches this conclusion by reasoning that the plan's obligations are not "fixed within the meaning of § 1.72-4(b)(1) during the participant's continued part-time employment," which is to say that the payments are not made after the annuity starting date. To this end, the Notice points to several aspects of the phased retirement arrangement, including the unknown duration of the phased retirement period (which is within the control of the employee), the accrual of additional benefits before the full benefits begin, and the indeterminate form of the phased retirement benefit.

The arrangement described in the Notice appears to parallel the phased retirement program that the Federal government introduced in 2014 for the Civil Service Retirement System and the Basic Benefit Plan of the Federal Employees Retirement System. The guidance might also apply to state and local government defined benefit plans and some church defined benefit plans with after-tax contributions, but not to most private sector plans (which are subject to the section 401(a)(11) qualified joint and survivor and preretirement survivor annuity requirements).

NON-QUALIFIED ANNUITY GUIDANCE: REV. PROC. 2016-36

While the IRS and Treasury thought it necessary to issue guidance on the treatment of payments received from qualified defined benefit plans during phased retirement, the precise rule addressed in Notice 2016-39—the application of section 72(e)(8) rather than section 72(d) —on its face has no bearing on the treatment of non-qualified annuities. So, what motivated the issuance of the companion revenue procedure, speaking to non-qualified products? It appears there were concerns within the government that taxpayers (and particularly life insurers) could view the conclusion of Notice 2016-39 (*i.e.*, that the initial stream of periodic payments are taxed as amounts not received as an annuity) and the reasoning behind that conclusion (*i.e.*, that until the employee's full retirement benefit begins the plan's obligations were not fixed) as producing an inappropriate result in the case of non-qualified annuities. For example, the analysis in the Notice might be viewed as inconsistent with the partial annuitization rules of section 72(a)(2). To avoid this possibility, the Notice expressly provides that it does not apply to amounts received from non-qualified contracts, and that Rev. Proc. 2016-36 "provides guidance regarding the application of Treas. Reg. §§ 1.72-2(b)(2) and 1.72-4(b)(1) to non-qualified contracts."

Picking up where the Notice left off, Rev. Proc. 2016-36 begins by reciting the facts and conclusion of Notice 2016-39 and proceeds to discuss the differences between how annuity and non-annuity payments are taxed depending on whether they originate from a qualified plan or a non-qualified contract. Then, importantly, the revenue procedure states in section 3.06:

> The Internal Revenue Service will not apply Notice 2016-39 to amounts received from a non-qualified contract. Accordingly, in applying §§ 1.72-2(b)(2) and 1.72-4(b)(1) to a non-qualified contract, the possibility of further contributions to the contract or a subsequent election under the contract to receive the benefit payable under the contract in a different manner generally will not affect the determination of whether payments are amounts received as an annuity.

The revenue procedure concludes (in section 4) that it applies to taxable years beginning on or after Jan. 1, 2016, while expressly permitting taxpayers to apply it to taxable years beginning before that date.

Of potential interest to annuity taxpayers generally and annuity product designers in particular, section 3.06 of Rev. Proc. 2016-36 might be read as potentially expanding the circumstances in which periodic payments from a non-qualified annuity can qualify as "amounts received as an annuity" in two significant respects. First, that section seems to suggest that the ability of an annuitized contract's owner to change to a different form of annuity benefit would not prevent the obligations under the contracts from becoming "fixed"—the first condition noted above for amounts received as an annuity—and thus would not affect the eligibility of the payments to receive exclusion ratio treatment. The law in this area has been uncertain, with some prior rulings involving non-qualified annuities suggesting that exclusion ratio treatment applied partly because the policyholder lacked such a right. *See*, *e.g.*, PLR 201424014 (March 10, 2014). On the other hand, Treas. Reg. § 1.72-11(e) describes the treatment under section 72 of a situation where "the terms of the contract are modified or the annuity obligations are exchanged" to provide a different payment term and states that a new exclusion ratio is calculated in such circumstances. The latter arguably contemplates that the modification can occur as a result of the contract owner having the right to make the change.

Second, section 3.06 indicates that the payment of additional premiums after a payment stream begins will not in itself impair the ability to receive exclusion ratio treatment for the payments. However, the section 72 regulations require that the investment in the contract used to calculate an exclusion ratio be determined as of the later of the annuity starting date or the date on which an amount is first received as an annuity. *See* Treas. Reg. § 1.72-6(a)(1). If an exclusion ratio is calculated using the investment in the contract at that time, but a subsequent premium can be paid, this leaves one wondering about the effect of the subsequent premium on the previously calculated ratio. More generally, the retention of the right to pay an additional premium (or change to a different form of annuity benefit) raises questions about what it means for the obligations under an annuity contract to be "fixed." Although it is unclear, perhaps the partial annuitization rules can apply where additional premiums can be paid under the contract, with the payment stream being treated as a separate contract with a separate exclusion ratio, at least where the payment stream is made in accordance with those rules for a period of 10 years or more, or for one or more lives.

The guidance provided in the revenue procedure also could affect the application of section 72(s) in some circumstances. This section states that a contract will not be treated as an annuity contract for tax purposes unless it provides certain distribution requirements that apply after the death of any "holder"

of a non-qualified annuity contract. These after-death distribution requirements differ depending on whether the holder dies before the annuity starting date or thereafter. Hence, to the extent that the ability to pay additional premiums after periodic payments have commenced, or change the manner in which periodic payments are made, affects whether the payments constitute amounts received as an annuity on or after the annuity starting date, these features also will affect how section 72(s) applies to the contract.

A PARABLE AND A CONCLUSION

Some years ago, a taxpayer named Donna Elizabeth Conway brought a case in the Tax Court that challenged a long-held view by many in the IRS and the tax bar, *i.e.*, that one could not partially exchange an annuity contract and claim the benefit of tax-free treatment for the transaction under section 1035. The Tax Court disagreed with that long-held view and supported the taxpayer,[3] the IRS concluded that the Tax Court had a point, and thus began a series of revenue procedures explaining what would and would not qualify as a tax-free partial exchange.[4] So much for the conventional wisdom of the tax bar.

With publication of Rev. Proc. 2016-36, history may be repeating itself. The revenue procedure indicates that section 72(b) exclusion ratio treatment (*i.e.*, treatment of payments as amounts received as an annuity) may be available where the contract owner retains the right to alter the payments in mid-stream or to enhance the future payments via additional contributions after the payments have begun. While the guidance in Rev. Proc. 2016-39 presents a few important operational questions and its exact meaning remains to be seen, it may overturn conventional wisdom and provide annuity owners and product designers with some welcome flexibility. ■

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

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*.

ENDNOTES

1 Unless otherwise indicated, references to “section” are to sections of the Internal Revenue Code of 1986, as amended.

2 Treas. Reg. § 1.72-2(b)(3)(i).

3 *Conway v. Comm’r,* 111 T.C. 350, 355 (1998), *acq. in result* 1999-2 C.B. xvi.

4 *Action on dec*., 1999-016 (Nov. 26, 1999); Rev. Proc. 2011-38, 2011-30 I.R.B. 66, modfying and superseding Rev. Proc. 2008-24, 2008-1 C.B. 684.