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Partial Annuitization Using a Deferred Income Annuity Rider

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In May, the Internal Revenue Service issued PLR 201632004,[1] which addresses the partial annuitization rules of section 72(a)(2) in the context of a deferred income annuity rider (the Rider).[2] The ruling is interesting in several respects. It is the first private letter ruling (PLR) to address section 72(a)(2) since Congress added those rules to the Code in 2010. It also is the first PLR to address the tax treatment of a deferred income annuity (DIA) rider that is issued with a deferred annuity contract. In doing so, the ruling favorably resolves an inherent circularity in the statutory language of section 72(a)(2). The ruling also favorably answers a variety of questions that are somewhat peculiar to the use of a DIA payout in a partial annuitization. The peculiarities arise because of two key characteristics of a DIA payout, namely, a potentially long delay between the irrevocable election of the payout option and the date the payments actually commence, and the lack of any cash value during that time period.

THE FACTS OF PLR 201632004

The taxpayer in PLR 201632004 is a life insurance company that intends to issue a non-qualified deferred variable annuity contract (the Contract) with the Rider.[3] During the accumulation period, the Contract provides various investment options, and the Accumulation Value and death benefit are based on the values held under those options. The owner can surrender the Contract or take withdrawals from the Accumulation Value, or apply the Accumulation Value to a payout option under the Contract.

The Rider will amend the Contract to provide the owner a DIA payout option. The payout option works like a typical DIA. That is, it provides life-contingent fixed annuity payments (the DIA Payments) that will commence on a specified date that is potentially several years in the future, with no withdrawal value or surrender right. The owner elects the DIA payout option by making one or more transfers of Accumulation Value from the Contract to the Rider. Each transfer entitles the owner to DIA Payments that are calculated at the time of the transfer using the company's then-current annuity purchase rates for DIAs and other relevant factors. Regardless of the timing or number of transfers, all DIA Payments under a Rider will commence on the same date and will be paid over the same duration with the same annuitant, payment frequency, and period certain (if any). The owner, annuitant, and beneficiary under the Rider are the same as under the Contract, and the annuitant and payout option cannot be changed after the first transfer to the Rider.

Transfers to the Rider are irrevocable in the sense that once an amount is transferred, it is no longer part of the Contract's Accumulation Value and therefore cannot be accessed via withdrawal or surrender or applied to any other payout option. If the owner or annuitant dies before DIA Payments start, a lump sum death benefit may become payable, calculated as the sum of all prior transfers to the Rider, with no interest or earnings thereon. The Rider's death benefit is added to the Contract's Accumulation Value at death and then is governed by the death benefit provisions in the Contract. If only a portion of the Accumulation Value is transferred to the Rider, all contractual benefits continue to apply to the remaining Accumulation Value, including the right to withdraw it, apply it to another payout option, or make another transfer to the Rider.

Under these facts, life annuity payments may commence from the Rider while the Contract otherwise remains in a deferred status. The issuing company requested and received several rulings on whether and how the partial annuitization rules of section 72(a)(2) will apply in such a situation. The IRS concluded that section 72(a)(2) will apply each time a partial transfer of Accumulation Value is made from the Contract to the Rider. The

IRS also concluded that, pursuant to section 72(a)(2), each such partial transfer will give rise to a separate contract for purposes of section 72, and that each of the resulting separate contracts (a) will be allocated a *pro rata* portion of the "investment in the contract" based on the percentage of Accumulation Value transferred, and (b) will have its own "annuity starting date."

APPLICABLE LAW

Section 72(a)(2) addresses partial annuitizations of annuity contracts. It applies "[i]f any amount is received as an annuity for a period of 10 years or more or during one or more lives under any portion of an annuity … contract." If section 72(a)(2) applies, (A) the portion of the contract under which the annuity payments are received is treated as a separate contract for purposes of section 72, (B) the investment in the contract is allocated *pro rata* between each annuitized and non-annuitized portion of the contract for certain purposes under section 72, and (C) a separate annuity starting date is determined under section 72(c)(4) for each annuitized portion of the contract.[4] Congress enacted these rules in 2010 after the IRS initially and informally expressed the view that the section 72 regulations precluded partial annuitizations.[5] The statutory amendments were meant to extend "exclusion ratio" treatment to annuity payments made for life or at least 10 years under part of a contract while another part of the contract remains in deferred status.[6]

The IRS explains in PLR 201632004 that when the owner makes an "irrevocable election" to allocate some, but not all, of the Accumulation Value to the Rider, the DIA Payments will be made under a portion of the Contract while the remaining portion is "administered according to the terms of the Contract."

IRS CONCLUSIONS AND ANALYSIS

The IRS explains in PLR 201632004 that when the owner makes an "irrevocable election" to allocate some, but not all, of the Accumulation Value to the Rider, the DIA Payments will be made under a portion of the Contract while the remaining portion is "administered according to the terms of the Contract." The IRS then concludes that "the election to allocate a portion of the Accumulation Value to the Rider will be a transaction to which [section] 72(a)(2) applies." This, in turn, led the IRS to conclude that, at the time of each partial transfer of Accumulation Value to the Rider:

(A) Pursuant to section 72(a)(2)(A), a separate contract will be treated as arising for purposes of section 72,

(B) Pursuant to section 72(a)(2)(B), for purposes of applying section 72(b) (regarding the exclusion ratio), section 72(c) (defining investment in the contract and other terms in section 72), and section 72(e) (regarding withdrawals and other non-annuity payments), a *pro rata* portion of the investment in the contract will be apportioned between the Contract and the separate contract that is treated as having arisen by virtue of the transfer, with the *pro rata* allocation determined as of the transfer date based on the percentage of the Accumulation Value transferred, and

(C) Pursuant to section 72(a)(2)(C), a separate annuity starting date will be determined with respect to each separate contract that is treated as having arisen by virtue of a transfer from the Contract to the Rider.

The IRS also elaborated on the foregoing conclusions by addressing the treatment of withdrawals from the Contract and multiple transfers to the Rider. With respect to withdrawals, the IRS stated that if an owner transfers a portion of the Accumulation Value to the Rider and then takes a withdrawal from the remaining Accumulation Value in the Contract, "the withdrawal will be taxable under [section] 72(e) without regard to the investment in the contract that was allocated to the Rider, *i.e.*, to the separate contract that [section] 72(a)(2)(A) treated as arising when such transfer was made."

With respect to multiple transfers, the IRS stated that if an owner makes additional transfers of a portion of the Accumulation Value after the first transfer, each subsequent transfer will give rise to a new, separate contract for purposes of section 72, and the conclusions listed above will apply to each of the separate contracts that is treated as arising from each partial transfer. Thus, for example, if the owner makes the first transfer on Date 1, new contract #1 will arise, and if the owner makes a second transfer on Date 2, new contract #2 will arise, and so forth.

RESOLVING THE CIRCULARITY IN THE STATUTE

The new ruling is the first PLR involving section 72(a)(2) and the first addressing a DIA rider attached to a deferred annuity. The ruling also implicitly addresses and favorably resolves a circularity in the statutory language of section 72(a)(2). The

circularity arises by virtue of the statute's reference to an amount "received as an annuity." Section 72(a)(2) states, in relevant part, that "if any amount is received as an annuity" under a portion of a contract, that portion will be treated as a separate contract with its own annuity starting date. This is circular in the sense that, without the separate contract and separate annuity starting date rules, an amount presumably could not be "received as an annuity" in the first place.

In that regard, the Code does not define the phrase "amount received as an annuity." The regulations under section 72, however, provide a comprehensive definition of the phrase. In relevant part, the regulations state that an amount is considered "received as an annuity" only if it is received on or after the "annuity starting date."[7] For this purpose, the regulations define "annuity starting date" as the later of (i) the date upon which the obligations under the contract became fixed, or (ii) the first day of the period (year, half-year, quarter, month, or otherwise, depending on whether payments are to be made annually, semiannually, quarterly, monthly, or otherwise) which ends on the date of the first annuity payment.[8]

Before Congress added section 72(a)(2) to the Code, there was considerable uncertainty about whether a partial annuitization could technically occur under the Code and regulations. This uncertainty was attributable to a view that an annuity contract can have only a single "annuity starting date" as defined above, apparently because the definition refers to the obligations under "the" contract becoming fixed.[9] If a contract can have only one annuity starting date, and an amount cannot be received as an annuity until on or after that date,[10] no such amount could be received until all values in the contract had been annuitized. In this respect, the view and the uncertainty it entailed effectively precluded partial annuitizations.

Congress resolved this uncertainty, with the Treasury Department's support,[11] by adding the "separate contract" and "separate annuity starting date" rules in section 72(a)(2)(A) and (C), respectively. Without those rules, a partial annuitization arguably cannot give rise to an "amount received as an annuity." It would seem incongruous, then, to interpret the statute as applying only when an amount is actually "received as an annuity" in the technical sense, since it is necessary for the special rules in the statute to apply before an amount can be received as an annuity in the first place.[12] In short, section 72(a)(2) cannot operate as intended if the statutory language were interpreted to require that an amount must first be "received as an annuity" before the statute will apply.

The IRS resolved this circularity problem in PLR 201632004 by concluding that section 72(a)(2) will apply each time Accumulation Value is transferred to the Rider, even though the "annuity starting date" with respect to the resulting DIA Payments may not occur until much later. This conclusion essentially treats each transfer to the Rider as an annuitization that triggers section 72(a)(2). This makes perfect sense in the context of a DIA. Under a DIA, annuity payments are "locked in" with each premium payment (or, in this case, with each transfer to the Rider). In this sense, the act of paying a premium under a DIA is the equivalent of (or closely resembles) a more traditional annuitization, such as one involving an immediate annuity where the payments likewise are locked in once the premium is paid. In that regard, the IRS seems to have based its conclusion in part on the fact that a transfer to the Rider is an "irrevocable election" of DIA Payments.

FACILITATING THE PROPER TREATMENT OF WITHDRAWALS

The conclusion in PLR 201632004 that section 72(a)(2) applies each time part of the Accumulation Value is transferred to the Rider also facilitates the proper treatment of subsequent withdrawals from the Contract. If section 72(a)(2) did not apply at that time, the separate contract rule of subparagraph (A) and the *pro rata* basis allocation rule of subparagraph (B) would not apply then, either. This could mean that a transfer of Accumulation Value to the Rider would reduce the cash value of the Contract but not the "investment in the contract," thereby depressing the "income on the contract" for purposes of applying section 72(e) to subsequent withdrawals.[13] The conclusions in PLR 201632004 avoid this result by triggering the separate contract and *pro rata* basis allocation rules at the time of each transfer, thereby ensuring that when the transfer reduces the Contract's cash value both the gain and basis are reduced in appropriate amounts.

The IRS resolved this circularity problem in PLR 201632004 by concluding that section 72(a)(2) will apply each time Accumulation Value is transferred to the Rider, even though the "annuity starting date" with respect to the resulting DIA Payments may not occur until much later.

AGGREGATION RULE

The conclusions in PLR 201632004 also implicitly confirm that the aggregation rule of section 72(e)(12) does not apply under the facts presented. Section 72(e)(12) provides that all annuity contracts issued to the same policyholder by the same company in the same calendar year shall be treated as a single annuity contract when applying section 72(e) to withdrawals from any of those contracts. Thus, a withdrawal from any one of the aggregated contracts is taxable under section 72(e) to the extent that the sum of all the contracts' cash values exceeds the sum of their "investment in the contract." Because the IRS concluded in PLR 201632004 that the Contract and Rider would be treated as separate contracts when the partial annuitization rule of section 72(a)(2)(A) applies, a question might arise regarding whether those separate contracts nonetheless are treated as a single contract pursuant to the aggregation rule.

PLR 201632004 implicitly confirms this is not the case. The IRS specifically concluded that "if the Contract owner takes a withdrawal from the Contract following an election to allocate Accumulation Value to the Rider, the withdrawal will be taxable under [section] 72(e) without regard to the investment in the contract that was allocated to the Rider." If section 72(e) will apply without regard to the transferred investment in the contract, which is treated as held under an entirely separate contract, then section 72(e)(12) must not be operating to aggregate those contracts for purposes of section 72(e). The PLR does not specifically discuss this, but the point follows from the foregoing IRS conclusion.

NON-TAXABLE TRANSFERS TO THE RIDER

It also is inherent in PLR 201632004 that the transfer of Accumulation Value from the Contract to the Rider is not a taxable distribution. For example, the ruling does not suggest that a deemed exchange will occur when an amount is transferred to the Rider, such that section 1035 would need to be available to make the transfer non-taxable.[14] Rather, each transfer gives rise to an entirely new contract for purposes of section 72, pursuant solely to the statutory language of section 72(a)(2)(A). This also would seem to render the IRS guidance on partial exchanges irrelevant to the transaction.[15]

MULTIPLE VS. SINGLE EXCLUSION RATIO(S)

A further implication of PLR 201632004 is that a separate exclusion ratio will be calculated with respect to each of the separate contracts that section 72(a)(2)(A) treats as arising with each transfer of Accumulation Value to the Rider. Thus, for example, if the owner made two transfers of Accumulation Value to the Rider, two new contracts would be deemed to arise, and an exclusion ratio would be calculated for each of those new contracts. However, because all of the DIA Payments under any given Rider will commence on the same date and have the same payment terms based on the same annuitant, it is likely that a single exclusion ratio could be calculated for all of the DIA Payments resulting from multiple transfers to the Rider and produce the same result as calculating separate exclusion ratios for each stream of DIA Payments.

CONCLUSION

PLR 201632004 is the first ruling to address section 72(a)(2) or the treatment of a DIA rider to a deferred annuity. In the ruling, the IRS took a reasonable approach to resolving an inherent circularity in the statutory language of section 72(a)(2) that otherwise could have prevented the statute from applying to any partial annuitization. The IRS also interpreted and applied the statute in a way that favorably addresses some of the peculiar issues that arise by virtue of a partial annuitization occurring through a DIA payout option. The conclusions reached in the PLR facilitate the product design and ensure its proper tax treatment under section 72. ■

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ENDNOTES

[1] May 3, 2016.

[2] Unless otherwise indicated, each reference to a "section" means a section of the Internal Revenue Code of 1986, as amended (the Code).

[3] "Non-qualified" means the contract is not part of a tax-qualified retirement plan described in section 4974(c).

[4] *See* section 72(a)(2)(A)-(C).

[5] *See* The Small Business Jobs Act of 2010, Pub. L. No. 111-240 § 2113. The provision was effective for tax years beginning after December 31, 2010. The legislative history largely repeats the statutory language without elaborating on its meaning. *See* Staff of the Jt. Comm. on Tax'n, *Technical Explanation of the Tax Provisions in Senate Amendment 4594 to H.R. 5297, The "Small Business Jobs Act of 2010," Scheduled for Consideration by the Senate on September 16, 2010*, at 44 (Jt. Comm. Print 2010).

[6] "Exclusion ratio treatment" means the periodic payments will be taxable under the *pro rata* rule in section 72(b), which generally provides that a portion of each annuity payment will treated as a tax-free return of basis and a portion will be taxable income. In contrast, distributions from an annuity contract that are not entitled to exclusion ratio treatment are either fully taxable or taxable under an "income first" ordering rule. *See* section 72(e)(2)(A) and (B).

[7] Treas. Reg. section 1.72-2(b)(2)(i). The other requirements for an amount to be treated as "received as an annuity" are (1) the amount must be payable in periodic installments at regular intervals over a period of more than one full year from the annuity starting date, and (2) except in the case of variable annuity payments, the total of the 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. Treas. Reg. section 1.72-2(b)(2)(ii) and (iii).

[8] Treas. Reg. section 1.72-4(b)(1).

[9] *See*, *e.g.*, section 5.02 of Rev. Proc. 2008-3, 2008-1 C.B. 110 (listing partial annuitizations as an area under study on which the IRS would not issue rulings). We understand that the Service's prior no rule position was attributable largely to the view described in the text above.

[10] *See* Treas. Reg. section 1.72-2(b)(2)(i) (providing that an amount is received as an annuity only if, *inter alia*, it is received on or after the "annuity starting date").

[11] *See* Department of the Treasury, General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals, at 74 (Feb. 2010) (proposing legislation to clarify the treatment of partial annuitizations so as to encourage such transactions).

[12] In addition, section 72(a)(2) refers to an amount being received as an annuity "for a period of 10 years or more or during one or more lives …" This reference necessarily contemplates the *future* receipt of an "amount received as an annuity."

[13] A withdrawal from the Contract would be an amount that is "not received as an annuity" within the meaning of section 72(e)(1)(A)(ii) and would be received before the "annuity starting date" for the Contract. In such case, section 72(e)(2) provides that a withdrawal from the Contract will be included in gross income to the extent allocable to "income on the contract." Section 72(e)(3) provides that an amount is allocable to "income on the contract" to the extent that such amount does not exceed the excess (if any) of (i) the cash value of the contract (determined without regard to surrender charges) immediately before the amount is received, over (ii) the "investment in the contract" at that time. As indicated in the text above, the Contract's Accumulation Value is reduced dollar-for-dollar by amounts transferred to the Rider. Assuming that the Accumulation Value is the Contract's "cash value" within the meaning of the foregoing rules, which seems likely but was not addressed in the ruling, a transfer to the Rider thus reduces the Contract's cash value. If the "investment in the contract" were not also reduced, the result would be a reduction in the excess of the cash value over the investment in the contract, making it less likely that any withdrawal proceeds would be "allocable to income on the contract" for purposes of section 72(e)(3).

[14] Section 1035 provides a nonrecognition rule for the exchange of an annuity contract for another.

[15] *See* Rev. Proc. 2011-38, 2011-30 I.R.B. 66 (providing that (1) the IRS will treat a partial exchange of annuity contracts as a nonrecognition event under section 1035 if, *inter alia*, no amount, other than an amount received as an annuity for a period of 10 years or more or during one or more lives, is received under either contract within 180 days following the transfer, and (2) in other cases the IRS will characterize a transaction "in a manner consistent with its substance, based on general tax principles and all the facts and circumstances.").