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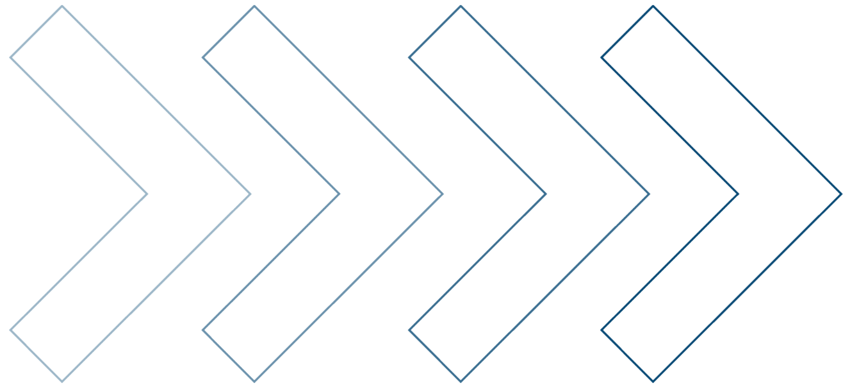

IRS Addresses Tax Treatment of Non-Qualified Annuities Issued to Trusts

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The Internal Revenue Service released a private letter ruling in July, PLR 202031008 ("the Ruling"), which considers how Internal Revenue Code sections 72(q) and (u) apply to an annuity contract issued to a trust.[1] In particular, the Ruling interprets the terms "taxpayer," "holder" and "held by" in those Code sections in situations where a non-qualified deferred annuity contract is issued to a grantor trust or a non-grantor trust. The Ruling's analysis and conclusions differ in some respects depending on which of these types of trusts is involved. In addition, although the Ruling does not address sections 72(s) or 72(e)(4)(C), the Ruling has potential implications under those provisions because they also use the term "holder" and "holds," respectively.

Facts of the Ruling

The Ruling was issued to a life insurance company ("Insurer") that regularly issues non-qualified deferred annuity contracts to trusts. The Insurer has certain information reporting obligations with respect to such contracts.[2] The Insurer collects information about the trust at the time a contract is issued, including whether or not the trust is treated as a grantor trust for federal income tax purposes. The Insurer requested the Ruling to help it determine how to satisfy its reporting obligations with respect to a factual scenario involving contracts issued to a grantor trust (the "Grantor Trust Scenario") and another scenario involving contracts issued to a non-grantor trust (the "Non-Grantor Trust Scenario").

In the Grantor Trust Scenario, the Insurer issues a non-qualified deferred annuity contract to a trust that is described in sections 671–79 (a "Grantor Trust").[3] The beneficiaries of the Grantor Trust are an individual and a charitable organization. For tax purposes, the individual who established the trust (the "Grantor") is considered the owner of the trust property. The annuity contract names the Grantor Trust as the owner and beneficiary of the contract and names the individual trust beneficiary as the sole annuitant. The Insurer represented that the sole annuitant is the "primary annuitant" within the meaning of Section 72(s)(6)(B).

In the Non-Grantor Trust Scenario, the Insurer issues a non-qualified deferred annuity contract to a trust that is not described in sections 671–79 (a "Non-Grantor Trust").[4] An individual ("Settlor") established the Non-Grantor Trust and named another individual as the beneficiary of the trust. There are no other trust beneficiaries and no contingent trust beneficiaries. For tax purposes, neither the Settlor nor the trust beneficiary is considered the owner of the Non-Grantor Trust property, and the Non-Grantor Trust itself is subject to tax under Section 641. The annuity contract names the Non-Grantor Trust as the owner and beneficiary of the contract and names the individual trust beneficiary as the sole annuitant. The Insurer represented that the sole annuitant is the "primary annuitant," as in the Grantor Trust Scenario.

Background: Applicable Law

Section 72 of the Code governs the tax treatment of annuity contracts, as well as certain distributions from life insurance and endowment contracts. Several of the rules in Section 72 apply differently depending on the identity of the contract owner, generally referred to as the "holder" of the contract. In addition, certain provisions rely on the identity of the "taxpayer" with respect to the contract, who may be different than the holder. In cases where the named owner of an annuity contract is a trust, but the beneficial owner of the contract is someone else, a

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question arises whether the trust's status as a grantor trust or non-grantor trust matters for purposes of these rules, which in turn could affect the annuity issuer's income tax reporting obligations.

SECTION 72(Q): ADDITIONAL TAX

Section 72(q)(1) imposes a 10 percent additional tax on any "taxpayer" who receives a distribution from a non-qualified annuity contract, subject to certain exceptions. The Ruling focuses on four of those exceptions, found in Section 72(q)(2):

- Distributions made on or after the date the "taxpayer" attains age 59½ (the "Age Exception")[5]
- Distributions made on or after the death of the "holder" or, if the holder is not an individual, the death of the "primary annuitant" (the "Death Exception")[6]
- Distributions attributable to the "taxpayer's" becoming disabled (the "Disability Exception")[7]
- Distributions that are part of a series of substantially equal periodic payments ("SEPPs") made at least annually for the life (or life expectancy) of the "taxpayer" or the joint lives (or joint life expectancies) of the "taxpayer" and his or her designated beneficiary (the "SEPP Exception")[8]

SECTION 72(U): NON-NATURAL PERSON OWNERSHIP

Section 72(u)(1) generally provides that if a non-qualified annuity contract is "held by" a non-natural person, such as a trust, a corporation or other entity, the contract will not be treated as an annuity contract under subtitle A of the Code (except for purposes of subchapter L), and the income on the contract for any year of the policyholder will be currently taxable. However, the flush language of Section 72(u)(1) provides that "holding by a trust or other entity as an agent for a natural person shall not be taken into account" when applying Section 72(u)(1).[9]

IRS Analysis

The IRS analysis in the Ruling is summarized below.

SECTION 72(Q): THE AGE, DISABILITY AND SEPP EXCEPTIONS

As noted above, the Age Exception, Disability Exception and SEPP Exception to the 10 percent additional tax under Section 72(q) each reference the "taxpayer." The Ruling concludes that for purposes of these exceptions, the identity of the "taxpayer" differs depending on whether the trust is a Grantor Trust or a Non-Grantor Trust.

In the Grantor Trust Scenario, the Ruling concludes that by virtue of the rules governing Grantor Trusts under sections 671–79, the individual Grantor is treated as the owner of the Grantor Trust for federal income tax purposes. As a result, the Grantor must include all items of income, deduction and credits attributable to the Grantor Trust in computing the Grantor's own taxable income and credits, as though the Grantor Trust had not been in existence, including "any income arising from the receipt by the Grantor Trust of distributions under the Contract." This, in turn, causes the Grantor to be treated as the "taxpayer" with respect to the contract. Because the Grantor is the taxpayer, and because the Age, Disability and SEPP Exceptions each reference the "taxpayer," the Ruling concludes that those exceptions will apply based on the Grantor's age, disability and life or life expectancy, respectively.

In the Non-Grantor Trust Scenario, the grantor trust rules of sections 671–79 do not apply to treat the Grantor (or anyone other than the trust) as the owner of the trust property for federal income tax purposes. Rather, the Non-Grantor Trust is subject to tax under Section 641. In that regard, the Ruling focuses on the mechanics that apply to the taxation of Non-Grantor Trusts, stating that:

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> Unlike grantor trusts, a non-grantor trust is potentially subject to federal income tax. (Although the tax burden may be passed through to a non-grantor trust's beneficiaries, the non-grantor trust is initially subject to the tax and must claim a deduction to eliminate any income tax liability at the trust level.)

The Ruling observes that Section 7701(a)(14) defines "taxpayer" as any person "subject to any internal revenue tax." The Ruling then reasons that because the Non-Grantor Trust is "potentially" subject to tax, the Non-Grantor Trust is the "taxpayer" with respect to the annuity contract for purposes of the Age, Disability and SEPP Exceptions. The Ruling then concludes that because the Non-Grantor Trust is not an individual, and therefore cannot attain age 59½, become disabled or have a life expectancy, the Age, Disability and SEPP Exceptions are "not applicable to distributions under the Contract in the Non-Grantor Trust Scenario." As a result, none of those exceptions will apply in the Non-Grantor Trust Scenario, regardless of the age, disability or life expectancy of the two individuals involved in the arrangement, namely, the Settlor and the primary annuitant (who is also the trust beneficiary).

SECTION 72(Q): THE DEATH EXCEPTION

The Death Exception to the 10 percent additional tax under Section 72(q) applies upon the death of the contract "holder." If the holder is not an individual, however, the exception applies upon the death of the "primary annuitant," as defined in Section 72(s)(6)(B) (regarding the after-death distribution rules for non-qualified annuities).

The Ruling concludes that the trust is the "holder" in both the Grantor Trust and the Non-Grantor Trust scenarios "because [the trust] is designated in the Contract as the owner of the Contract." Thus, the Ruling equates "holder" with the party named in the annuity contract as the owner of the contract. In other words, the "holder" is the *nominal* owner of the contract, even if different than the "tax owner" of the contract; otherwise, in the Grantor Trust Scenario, the IRS seemingly would have concluded that the Grantor (and not the Grantor Trust) is the "holder." This also necessarily means the IRS did not completely disregard the Grantor Trust when applying the Death Exception under Section 72(q)(2)(B).

Because the Ruling concludes that the trust is the "holder" in both the Grantor Trust Scenario and the Non-Grantor Trust Scenario, and because a trust is not an individual, the Death Exception applies in both scenarios upon the death of the primary annuitant. In this respect, the Ruling appears to be the first IRS guidance to conclude that when an annuity contract is issued to a grantor trust, the trust (and not the grantor) is the "holder" of the contract for purposes of the Death Exception to Section 72(q), so that the exception applies upon the primary annuitant's death and not upon the grantor's death.

SECTION 72(U): CONTRACTS HELD BY NON-NATURAL PERSONS

As discussed above, Section 72(u)(1) generally provides that an annuity contract is not treated as such for federal income tax purposes (other than subchapter L) if held by a non-natural person. The flush language of Section 72(u)(1) states, however, that "holding by a trust or other entity as an agent for a natural person" is not taken into account when applying Section 72(u).

The Ruling concludes that, in both the Grantor Trust and the Non-Grantor Trust scenarios, the contract is treated as "held by" the trust for purposes of Section 72(u)(1). The Ruling uses the same reasoning it used when determining the "holder" of the contract for purposes of the Death Exception to the 10 percent additional tax under Section 72(q). Namely, the trust is the "holder" of the contract for purposes of Section 72(u)(1) "because it is designated in the Contract as the owner of the Contract." Thus, the IRS again equates "holder" with the *nominal* owner of the contract, even in the Grantor Trust Scenario where the Grantor (and not the Grantor Trust) is, according to the Ruling, the "tax owner" of the contract.

Having concluded that the contract is "held by" the trust in both scenarios, the Ruling proceeds to consider whether the contract is held "by a trust or other entity as an agent for a natural person" within the meaning of the flush

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language of Section 72(u)(1). In that regard, the Ruling discusses whether an actual agency relationship under general principles of agency law must exist in order for the flush language to apply when a trust is the nominal owner of the contract. The ruling concludes that such agency principles have no bearing, and that instead the analysis for trust-owned contracts looks to the beneficial owner of the contract.[10] This conclusion rejects the reasoning in several earlier PLRs that had looked to agency principles when interpreting the flush language of Section 72(u)(1).[11]

The Ruling next considers whether the contract is held for a natural person in the two scenarios described therein. The Ruling's analysis of this question differs between the scenarios.

In the Grantor Trust Scenario, the Ruling concludes that because the grantor trust rules treat the Grantor as owning the contract for federal income tax purposes, the "Grantor Trust is holding the Contract for the Contract's tax owner, the Grantor." Because the Grantor is a natural person, the flush language of Section 72(u)(1) applies. The Ruling's analysis does not look to the trust beneficiaries when applying Section 72(u)(1) in the Grantor Trust Scenario. That is, even though the Grantor Trust's beneficiaries include a charitable organization, the Ruling concludes that the Grantor Trust is still treated as holding the contract "for a natural person," the Grantor.[12]

In the Non-Grantor Trust Scenario, the Ruling applies a somewhat different analysis. Because the grantor trust rules do not apply to treat an individual as owning the contract for tax purposes, the Ruling looks to the trust beneficiary to determine if the trust holds the contract "for a natural person." Under the facts presented, the sole beneficiary of the Non-Grantor Trust is an individual; there are no non-natural beneficiaries (such as a charity) and no contingent beneficiaries under the trust. Accordingly, the Ruling concludes that the Non-Grantor Trust is holding the contract for a natural person, and the flush language of Section 72(u)(1) applies.

Observations and Implications

Although the Ruling itself is generally straightforward, its analysis and conclusions have some interesting potential implications.

ISSUES ARISING UNDER SECTION 72(Q)

The Ruling appears to be the first IRS guidance to conclude that the Age, Disability and SEPP Exceptions to the 10 percent additional tax under Section 72(q) are not available with respect to annuity contracts issued to non-grantor trusts. Beyond that, the Ruling's conclusions that (1) the Age, Disability and SEPP Exceptions are not available to non-grantor trusts, and (2) the primary annuitant rule under the Death Exception applies to grantor trusts and non-grantor trusts alike lead to some interesting and perhaps unexpected results. This is particularly true in situations where the death of the trust grantor causes the trust to change from a grantor trust to a non-grantor trust.

Consider the following examples, all of which assume that (1) a non-disabled individual establishes a grantor trust, (2) the trust purchases a deferred, non-qualified annuity, and (3) the trust becomes a non-grantor trust upon the grantor's death:

- Example 1. The grantor is over age 59½ and his granddaughter is the primary annuitant. Withdrawals that the trust receives from the contract during the grantor's life will qualify for the Age Exception because the grantor is the "taxpayer" and is over age 59½. After his death, however, the Age Exception is not available because the trust is a non-grantor trust. In addition, neither the SEPP Exception nor the Disability Exception is available to a non-grantor trust. Finally, the Death Exception is not available because the granddaughter is the primary annuitant and is still alive. As a result, it appears from the Ruling that any withdrawals from

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the contract which the trust receives after the grantor's death will be subject to the 10 percent additional tax, even though withdrawals prior to his death were not.

- **Example 2.** Assume the same facts as in Example 1, except that while the grantor is alive, the trust annuitizes the contract over the granddaughter's life. As in the example above, the Age Exception will apply to the annuity payments during the grantor's life. But the Ruling suggest that after his death, the Age, SEPP and Disability Exceptions will all be unavailable to the non-grantor trust. Likewise, the Ruling suggests that the Death Exception will not apply because the primary annuitant (granddaughter) is still alive. As a result, the annuity payments that the trust receives after the grantor's death will be subject to the 10 percent additional tax, even though the annuity payments made before his death were not.
- **Example 3.** Assume the grantor is age 50 when the trust annuitizes the contract to provide fixed payments over the granddaughter's life. The grantor then dies at age 58. For the payments made during the grantor's life (1) the Age Exception is not available because the grantor is younger than age 59½, (2) the SEPP Exception is not available because the payments are made over the granddaughter's life (and not the grantor's life), and (3) the Disability Exception is not available because the grantor is not disabled. For the payments made after the grantor's death, it appears that none of those exceptions is available because the trust becomes a non-grantor trust. In addition, the Death Exception is not available because the primary annuitant is still alive. As a result, the Ruling suggests that all of the annuity payments made during and after the grantor's life are subject to the 10 percent additional tax.
- **Example 4.** Assume the same facts as in Example 3, except the contract is annuitized over the life of the grantor, rather than the granddaughter, with a certain period equal to the grantor's life expectancy. The SEPP Exception would seem to apply to the annuity payments during the grantor's life. After the grantor's death, when the trust becomes a non-grantor trust, the Ruling suggests that the SEPP Exception is not available. But query whether this is true, given that the annuity payments originally commenced over the life of the "taxpayer" (grantor). In other words, is the determination of the "taxpayer" for purposes of the SEPP Exception made solely when the SEPPs commence, or must the taxpayer be re-determined later if the taxpayer changes by virtue of the trust becoming a non-grantor trust? The Ruling does not address this. (This question would not seem to arise where an individual is named as the contract owner. In such case, the individual would be the "taxpayer" so the SEPP Exception would apply during her life, and the individual also would be the holder so the Death Exception would apply after her death.)

ISSUES ARISING UNDER SECTION 72(S)

Section 72(s) generally provides that a contract will not be treated as an annuity contract for federal income tax purposes unless the contract provides for certain distributions upon the death of any "holder." For this purpose, Section 72(s)(6)(A) provides that if the holder is not an individual, the "primary annuitant" is treated as the holder. Section 72(s)(7), in turn, provides that in cases where the holder is not an individual, a change in the primary annuitant is treated as the death of the holder. Accordingly, in cases where the holder of a non-qualified annuity contract is not an individual, Section 72(s) requires the contract to provide that certain distributions will be made upon the death of, or a change to, the primary annuitant.

These provisions of Section 72(s) reflect statutory language that is almost identical to the language in the Death Exception to Section 72(q), as set forth in Section 72(q)(2)(B). Both refer to a "holder" that is not an "individual." Both refer to the death of the "primary annuitant" in such situations. Both use the same definition of "primary annuitant." As a result, it is possible (and perhaps likely) the IRS would apply the same analysis to Section 72(s) that it did in the Ruling when addressing Section 72(q)(2)(B).

This would not seem to have any implications under Section 72(s) for contracts issued to non-grantor trusts, since it was already clear in those cases that the "primary annuitant" rule applies. It has been less clear, however, whether the primary annuitant rule applies in cases involving grantor trusts. The question has been whether (as the Ruling suggests) the "holder" of a contract issued to a grantor trust is the trust, as the nominal owner of the contract, or

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whether the Code's treatment of grantor trusts means that the trust is disregarded and instead the grantor, as the "tax owner" of the contract, is the "holder" for Section 72(s) purposes. Some companies may have avoided this legal uncertainty by (1) requiring the grantor of a grantor trust to be the primary annuitant under the contract, and (2) prohibiting any change in the primary annuitant under the terms of the contract. With this practice, whether the grantor or the primary annuitant is treated as the holder does not matter because it is the same person and that person's death will trigger the required distributions under the contract.

In cases where the grantor and primary annuitant are different, however, the question described above persists, and the analysis in the Ruling suggests the IRS would take the position that the grantor trust is the holder so the primary annuitant rule applies. Nonetheless, an argument could still be made that the grantor is the holder by virtue of the grantor trust rules, which provide that the grantor is taxable on all trust income as if "the trust [had] not been in existence" and which do not treat the trust as a taxpayer separate from the grantor.[13] Moreover, the Ruling does not directly address Section 72(s) and is only a private letter ruling, which is not binding on other taxpayers and cannot be used or cited as precedent.[14]

ISSUES ARISING UNDER SECTION 72(E)(4)(C)

Section 72(e)(2)(B) generally provides that if any amount is received under an annuity contract that is *not* an amount received as an annuity (that is, the amount is not an annuitized payment under the contract), and such amount is received before the annuity starting date, then the amount is "included in gross income to the extent allocable to income on the contract. …" This means, in short, that if an amount is received from an annuity contract before the annuity starting date, such amount is included in gross income to the extent of any (essentially deferred) income on the contract.

Section 72(e)(4) provides several "special rules" that apply when an amount is received prior to the annuity starting date. One of these special rules, found in Section 72(e)(4)(C), provides that

> [i]f an individual who holds an annuity contract transfers it without full and adequate consideration, such individual shall be treated as receiving an amount equal to the excess of (I) the cash surrender value of such contract at the time of the transfer, over (II) the investment in such contract at such time, under the contract as an amount not received as an annuity.

The purpose of this rule, as explained in the legislative history, is to "implement fully the forced distribution rules adopted under the [Deficit Reduction Act of 1984], which were intended to terminate deferral allowed in annuity contracts when such contracts were no longer required as a retirement vehicle for the contractholder. …"[15] Congress reasoned that if no rule addressing gratuitous transfers of annuity contracts were in place, "the required distribution rules adopted in the 1984 Act could be avoided easily because they would allow taxpayers to continue tax deferral beyond the life of an individual taxpayer."[16]

As explained in the discussion of Section 72(s), the Ruling does not directly address Section 72(e)(4)(C). However, Section 72(e)(4)(C) applies by its terms when an "individual … holds" the annuity contract. The word "holds" is almost identical to the words "holder" and "held by" used in Section 72(q)(2)(B) and Section 72(u)(1), respectively, which the Ruling did address.

If the word "holds" in Section 72(e)(4)(C) has the same meaning that the Ruling ascribes to the words "holder" and "held by" in Section 72(q)(2)(B) and Section 72(u)(1), then the following results could ensue in cases where an annuity contract is issued to a trust. The trust, whether a grantor or a non-grantor trust, would be the person who "holds an annuity contract" for purposes of Section 72(e)(4)(C). Because that section, by its terms, applies only if an "individual" who holds the contracts transfers it, Section 72(e)(4)(C) would not apply to any transfer of the contract by the trust. This, coupled with the potential implications under Section 72(s) described previously, could lead to some interesting situations, such as those described in the following examples.

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For these examples, assume that an individual (Grantor) is the owner of a non-qualified deferred annuity contract. The contract names Grantor's daughter (Daughter) as the annuitant and the beneficiary of the contract. At the advice of his estate planning attorney, Grantor creates a revocable grantor trust for estate planning purposes. Grantor transfers ownership of the annuity contract to the trust. Grantor takes the position that this "transfer" is not treated as a transfer of property for federal income tax purposes because, pursuant to the rules governing grantor trusts, the Grantor is treated as the owner of the contract for federal income tax purposes before and after the "transfer."[17] As a result, Grantor does not treat the transfer of the contract to the trust as implicating Section 72(e)(4)(C), even though he is an "individual who holds" the contract when the transfer occurs. Grantor then changes the beneficiary of the annuity contract to be the revocable trust, but Daughter remains the annuitant.

- **Example 1.** Some years after Grantor transferred ownership of the annuity contract to the revocable trust, Grantor's estate planning attorney suggests that Grantor transfer ownership of the annuity outright to Daughter. Although Grantor is treated as the owner of the contract for federal income tax purposes, Grantor arguably is not the person who "holds" the contract for purposes of Section 72(e)(4)(C), at least if the analysis in the Ruling applies. Instead, if that analysis applies, the grantor trust would be treated as the person that "holds" the contract for such purposes.
  If the grantor trust is the holder, then it would appear that the transfer of the contract from the trust to Daughter is not subject to the rule of Section 72(e)(4)(C), which, by its terms, applies only when an individual who holds an annuity contract transfers it gratuitously.18 If this is correct, the transfer to Daughter would not trigger income tax recognition to Grantor or the grantor trust, and Daughter would own the deferred annuity contract outright without having implicated any forced distribution or income recognition rules.
- **Example 2.** Daughter meets with the estate planning attorney, who advises her to transfer ownership of the annuity contract to Daughter's own revocable trust for estate planning purposes. Prior to transferring ownership of the contract, Daughter contacts the issuing annuity company and names her daughter (Granddaughter) as the annuitant under the contract. This change occurs while Daughter is the owner and "holder" of the contract. As a result, Daughter and the issuing company take the position that changing the annuitant does not implicate the rule in Section 72(s)(7), which otherwise would trigger a distribution requirement under Section 72(s)(1) if the "holder" were not an individual.
  After the change of annuitant, Daughter transfers ownership of the annuity contract to her revocable trust. As was the case when Grantor completed a similar estate planning transfer, Daughter takes the position that this "transfer" does not implicate Section 72(e)(4)(C) because she is treated as owning the contract for tax purposes both before and after the "transfer," and therefore no property has been transferred for tax purposes. A few years later, Daughter passes away.
  The issuing company determines that Daughter's death does not trigger the after-death distribution rules of Section 72(s), since the "holder" of the contract at Daughter's death was her revocable trust, which is not an "individual." The company instead applies the primary annuitant rule of Section 72(s)(6)(A), and since the primary annuitant, Granddaughter, is still alive, the company determines that no after-death distributions are required as the result of Daughter's death.
- **Example 3.** After Daughter's death, Granddaughter meets with the estate planning attorney to discuss the administration of her mother's trust. The attorney recommends that the trust distribute ownership of the annuity contract, which is still in deferred status, to Granddaughter directly. Granddaughter agrees, and the trust distributes the annuity contract to her as a part of her beneficial interest in the trust.
  Granddaughter and the annuity issuer take the view that the transfer of the annuity contract from the trust to Granddaughter is not subject to the rule of Section 72(e)(4)(C) because the trust, which is the transferor, is not an "individual who holds" the annuity contract. Under this view, the transfer to Granddaughter does not trigger income tax recognition. As a result of this, Granddaughter owns the deferred annuity contract outright without having implicated any forced distribution or income recognition rules.

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The end result of the series of transfers described in these examples appears to be that Granddaughter becomes the owner of a non-qualified deferred annuity contract that was originally purchased by her grandfather. If correct, the contract effectively would have been passed down two generations without any application of the after-death distribution rules or the gratuitous transfer rules. However, such a result would seem inconsistent with the intent of Section 72(s) and the purpose of Section 72(e)(4)(C).

As described above, Congress enacted Section 72(e)(4)(C) to "implement fully the forced distribution rules [under Section 72(s)], which were intended to terminate deferral allowed in annuity contracts when such contracts were no longer required as a retirement vehicle for the contractholder …" and to prevent "tax deferral beyond the life of an individual taxpayer."[19] The results suggested in the examples above would seem to facilitate the type of end around Section 72(s) that Congress meant to preclude. This, in turn, suggests that the IRS might not follow the reasoning in the Ruling when considering how Section 72(e)(4)(C) applies to grantor trusts.

In that regard, as discussed in the context of Section 72(s), an argument could be made here that the grantor of a grantor trust, rather than the trust itself, is the person who "holds an annuity contract" for purposes of Section 72(e)(4)(C). Such an argument could cite to the grantor trust rules, which provide that the grantor is taxable on all trust income as if "the trust [had] not been in existence" and which do not treat the trust as a taxpayer separate from the grantor.[20] Moreover, as discussed above, the Ruling does not directly address Section 72(e)(4)(C) and is only a private letter ruling, which is not binding on other taxpayers and cannot be used or cited as precedent. As a result, it would be prudent for taxpayers to proceed with caution and consider the intent of the underlying rules before extending the Ruling's reasoning to situations the Ruling does not address.

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Endnotes

[1] As used herein, "section" means a section of the Internal Revenue Code of 1986, as amended (the "Code").
[2] Pursuant to Section 6047(d)(1), an issuer of a non-qualified annuity contract generally must report designated distributions from the contract by filing Form 1099-R with the IRS and providing a copy of the form to the "participant or beneficiary." The issuer generally is required to indicate in Box 7 of Form 1099-R whether an exception to the Section 72(q) additional tax is available with respect to a reportable distribution. Specifically, the company must enter: (1) Code 1 for "Early distribution, no known exception" if the "participant" has not reached age 59½ and the company does not know if any other exception applies, (2) Code 2 for "Early distribution, exception applies" if the "participant" has not reached age 59½ and the company knows the distribution is one to which an exception to Section 72(q)(1) applies, (3) Code 3 for "Disability," (4) Code 4 for "Death" regardless of the age of the "participant," including payments to an "estate or trust," or (5) Code 7 for "Normal distribution" if no other code applies. In addition to the foregoing reporting requirements, annuity issuers also have corresponding federal income withholding obligations with respect to designated distributions from the annuity contracts they issue. *See generally* Section 3405.
[3] In general, a grantor trust is a trust under which a person other than the trust (usually the settlor) is treated as the owner of the trust assets pursuant to sections 671–79. In calculating his or her personal federal income tax obligations, the "grantor" of a grantor trust takes into account all items of trust income, deduction and credit, to which he or she would have been entitled "had the trust not been in existence during the period that the grantor is treated as the owner." Treas. Reg. Section 1.671-3(a). *See also* Rev. Rul. 57-390, 1957-2 C.B. 326 (providing that, in the case of a grantor trust, "the gross income from the trust properties must be determined by the [grantor] as if the trust had not been created"). The IRS has concluded that where a person is treated as owning all or part of the assets of a trust pursuant to the grantor trust rules, he or she is treated as the owner of such assets for all federal tax purposes and the trust is not treated as a separate taxpayer that is capable of entering into sales transactions with the grantor. Rev. Rul. 85-13, 1985-1 C.B. 184.
[4] A non-grantor trust is a trust that is not described in sections 671–79, and instead is subject to tax under Section 641. A non-grantor trust can be a simple trust or a complex trust. A **simple** trust is required by its terms to distribute all income currently and pays no tax at the trust level if certain requirements are met, whereas a **complex** trust generally is allowed by its terms to accumulate income and distribute corpus, and is subject to tax at the trust level. *See generally* sections 651 (simple trusts) and 661 (complex trusts). Section 652(b) for simple trusts and Section 662(b) for complex trusts provide that in both cases, the character of income received by the trust is passed through to the trust beneficiaries. Section 641(b) provides that "[t]he taxable income of an estate or trust shall be computed in the same manner as in the case of an individual." Regardless of whether a trust is a simple trust or a complex trust, the trust generally must file a federal income tax return each year, on which it can claim a deduction for trust income it distributes (or is deemed to have distributed) to the trust beneficiaries.
[5] Section 72(q)(2)(A).
[6] Section 72(q)(2)(B). For this purpose, "primary annuitant" is defined in Section 72(s)(6)(B), which sets forth the after-death distribution rules that apply to non-qualified annuities.
[7] Section 72(q)(2)(C).
[8] Section 72(q)(2)(D).
[9] The legislative history of Section 72(u)(1) describes the flush language of that provision as applying when the "nominal owner" of a contract is not "a natural person (e.g., a corporation or a trust)," but the "beneficial owner" is a natural person. H.R. Rep. No. 99-426, at 704–705 (1986); S. Rep. No. 99-313, at 568 (1986). Congress enacted Section 72(u) generally to deny tax deferral for non-qualified annuities that are used in the employment context to provide deferred compensation for employees, since such uses could circumvent various restrictions that apply to qualified retirement plans.
[10] The Ruling concludes that because a trustee generally has fiduciary obligations under the trust documents and governing law which are inconsistent with the trustee acting on behalf of the trust beneficiaries as an agent, the reference to "as an agent" in the flush language cannot pertain to trusts. Rather, that reference modifies only the phrase "other entity," and not the word "trust," in the flush language. In effect, this means the flush language will

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apply if a contract is (1) held by a trust for a natural person, or (2) held by an entity other than a trust as an agent for a natural person.
[11] *See* PLR 9810015 (Dec. 4, 1997); PLR 9639057 (June 24, 1996). This view was inconsistent with the legislative history of Section 72(u)(1), which states that "[i]n the case of a contract the nominal owner of which is a person who is not a natural person (e.g., a corporation or a trust), but the beneficial owner of which is a natural person, the contract is treated as held by a natural person." H.R. Rep. No. 99-426, at 704–705 (1986); S. Rep. No. 99-313, at 568 (1986). Later PLRs backed away from this analysis, focusing instead on beneficial ownership rather than an agency relationship. *See* PLR 201124008 (March 16, 2011); PLR 200626034 (March 22, 2006). Nonetheless, the earlier PLRs cast some doubt on whether a true agency relationship was necessary for the flush language of Section 72(u)(1) to apply. The new Ruling explicitly rejects this reasoning, concluding that the reference to "as an agent" modifies only the phrase "other entity," and not the word "trust" in the flush language of Section 72(u)(1). As a result, the Ruling confirms that general principles of agency law have no bearing on whether the flush language applies to an annuity contract issued to a trust, and that instead the analysis for trust-owned contracts looks to the beneficial owner of the contract, consistently with the legislative history quoted above. On the other hand, the analysis in the Ruling suggests that general agency principles may be relevant when applying the flush language to annuity contracts issued to entities other than trusts. This too, however, would seem inconsistent with the legislative history quoted above.
[12] This conclusion also is consistent with earlier private letter rulings pertaining to grantor trusts where the grantor was a natural person. In those rulings, the IRS concluded that because the trust was a grantor trust (and so the trust assets would be treated as owned by the grantor), the trust was holding the contract for the grantor, a natural person. *See* PLR 9120024 (Feb. 20, 1991); PLR 9316018 (Jan. 22, 1993); PLR 9322011 (March 5, 1993); PLR 9810015 (Dec. 4, 1997).
[13] *See* Treas. Reg. Section 1.671-3(a); Rev. Rul. 57-390; Rev. Rul. 85-13.
[14] Section 6110(k)(3).
[15] H.R. Rep. No. 99-426, at 971.
[16] *Ibid*.
[17] *See*, *e.g.*, Rev. Rul. 2007-13, 2007-1 C.B. 684 (concluding that no "transfer" occurred for purposes of Section 101(a)(2) when an individual transferred a life insurance policy to his grantor trust); Rev. Rul. 85-13, 1985-1 C.B. 184 (similar).
[18] *Compare* PLR 201124008 (March 16, 2011) (focusing on the purpose of Section 72(e)(4)(C) to prevent avoidance of Section 72(s), rather than focusing on the phrase "individual who holds an annuity contract," when concluding that a transfer of an annuity contract from a trust to a trust beneficiary did not implicate Section 72(e)(4)(C) because the annuitant had not been changed in the transfer).
[19] H.R. Rep. No. 99-426, at 971.
[20] *See* Treas. Reg. Section 1.671-3(a); Rev. Rul. 57-390; Rev. Rul. 85-13.

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