Part I

Section 691.—Recipients of Income in Respect of Decedents

26 CFR 1.691(a)-1: Income in respect of a decedent.
(Also §§ 72, 1014.)

Rev. Rul. 2005-30

ISSUE

If the owner-annuitant of a deferred annuity contract dies before the annuity starting date, and the beneficiary receives a death benefit under the annuity contract (either in a lump sum or as periodic payments), is the amount received by the beneficiary in excess of the owner-annuitant's investment in the contract includible in the beneficiary's gross income as income in respect of a decedent (IRD) within the meaning of § 691 of the Internal Revenue Code?

FACTS

*A* purchased a deferred annuity contract providing for annuity payments to *A* beginning as of a date specified in the annuity contract. *A* named *B* as beneficiary of the contract. The contract provides that *A* may surrender the contract during *A*'s life for its account value as determined by the formula provided under the contract. The contract further provides that if *A* dies before the annuity starting date, *B* will receive a death benefit equal to the account value as determined by the formula provided under the contract. At *B*'s election, the death benefit will be paid either in a lump sum or as periodic payments consistent with the provisions of § 72(s).

*A* dies before the annuity starting date and *B* receives the death benefit under the contract, which exceeds *A*'s investment in the contract.

LAW AND ANALYSIS

Section 72(a) provides that gross income includes any amount received as an annuity. Sections 72(b) through (d) provide rules for determining what portion of an annuity payment represents a non-taxable return of investment. Section 72(e) provides rules for amounts received under an annuity contract, but not received as an annuity (and therefore not described in § 72(b) through (d)). Specifically, amounts received before the annuity starting date are generally includible in gross income to the extent allocable to the income on the annuity contract. Section 72(s) provides rules regarding the period in which an interest in an annuity contract must be distributed after the holder's death in order for the contract to qualify as an annuity contract within the meaning of § 72.

Section 691(a)(1) provides that the amount of all items of gross IRD that are not properly includible in respect of the taxable period in which falls the date of the decedent's death or a prior period (including the amount of all items of gross income in respect of a prior decedent, if the right to receive the amount was acquired by reason of the death of the prior decedent or by bequest, devise, or inheritance from the prior decedent) is included in the gross income, for the taxable year when received, of: (A) the estate of the decedent, if the right to receive the amount is acquired by the decedent’s estate from the decedent; (B) the person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent’s estate from the decedent; or (C) the person who acquires from the decedent the right to receive the amount by bequest, devise, or inheritance, if the amount is received after a distribution by the decedent’s estate of the right.

Section 691(c)(1) provides that a person who includes an amount of IRD in gross income under § 691(a) is allowed as a deduction, for the same taxable year, a portion of the estate tax paid by reason of the inclusion of that IRD in the decedent’s gross estate. Generally, the amount of the deduction is calculated using estate tax values, and is the amount that bears the same ratio to the estate tax attributable to the net value of all IRD items included in the decedent’s gross estate as the value of the IRD included in that person’s gross income for that taxable year bears to the value of all IRD items included in the decedent’s gross estate.

Section 1014(a)(1) provides that the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent generally is the fair market value of the property at the date of the decedent’s death. This rule does not apply if the property is sold, exchanged, or otherwise disposed of before the decedent’s death by the person.

Section 1014(b)(9) provides that, for purposes of § 1014(a), property acquired from the decedent by reason of death, form of ownership, or other conditions if by reason thereof the property is required to be included in determining the value of the decedent's gross estate for estate tax purposes, is considered to have been acquired from, or to have passed from, the decedent.

Section 1014(b)(9)(A) provides that § 1014(b)(9) does not apply to annuities described in § 72.

Section 1014(c) provides that § 1014 does not apply to property that constitutes a right to receive an item of IRD under § 691.

Rev. Rul. 79-335, 1979-2 C.B. 292, addresses a situation in which the owner-annuitant purchases a deferred variable annuity contract that provides that if the owner dies prior to the annuity starting date, the named beneficiary may elect to receive the present accumulated value of the contract either in the form of an annuity or a lump-sum payment. Rev. Rul. 79-335 concludes that, for purposes of § 1014, the contract is an annuity described in § 72 (as then in effect), and therefore receives no basis adjustment by reason of the owner's death because it is governed by the annuity exception of § 1014(b)(9)(A). If the beneficiary elects a lump-sum payment, the excess of the amount received over the amount of consideration paid by the decedent is includable in the beneficiary's gross income. Rev. Rul. 79-335 prospectively revokes Rev. Rul. 70-143, 1970-1 C.B. 167, which had concluded on substantially identical facts that such a contract, if surrendered by the beneficiary prior to the annuity starting date, is not an annuity described in § 72 and therefore is not governed by the rule of § 1014(b)(9)(A), and that the beneficiary receives the date of death value as the basis in the contract.

Although Rev. Rul. 79-335 concludes that the annuity exception in § 1014(b)(9)(A) applies to the contract described in that ruling, it does not specifically address whether amounts received by a beneficiary under a deferred annuity contract in excess of the owner-annuitant's investment in the contract would be subject to §§ 691 and 1014(c). However, had the owner-annuitant surrendered the contract and received the amounts in excess of the owner-annuitant's investment in the contract, those amounts would have been income to the owner-annuitant under § 72(e). Because those amounts would have been income to the owner-annuitant if the contract had been surrendered during life, those amounts are IRD under § 691.

Likewise, in the present case, had *A* surrendered the contract and received the amounts at issue, those amounts would have been income to *A* under § 72(e) to the extent they exceeded *A*'s investment in the contract. Accordingly, amounts that *B* receives that exceed *A*'s investment in the contract are IRD under § 691(a). As provided in Rev. Rul. 79-335, those amounts are includible in *B*'s gross income and *B* does not receive a basis adjustment in the contract. However, *B* will be entitled to a deduction under § 691(c) if estate tax was due by reason of *A*'s death. The result would be the same whether *B* receives the death benefit in a lump sum or as periodic payments.

HOLDING

If the owner-annuitant of a deferred annuity contract dies before the annuity starting date, and the beneficiary receives a death benefit under the annuity contract, the amount received by the beneficiary in a lump sum in excess of the owner-annuitant's investment in the contract is includible in the beneficiary's gross income as IRD within the meaning of § 691. If the death benefit is instead received in the form of a series of periodic payments in accordance with § 72(s), the amounts received are likewise includible in the beneficiary's gross income (in an amount determined under § 72) as IRD within the meaning of § 691.

## EFFECT ON OTHER DOCUMENTS

Rev. Rul. 79-335 is modified and superseded for deferred annuity contracts purchased on or after October 21, 1979. The holding of Rev. Rul. 70-143 (which was revoked by Rev. Rul. 79-335) will continue to apply for deferred annuity contracts purchased before October 21, 1979, including any contributions applied to those contracts pursuant to a binding commitment entered into before that date.

## DRAFTING INFORMATION

The principal author of this revenue ruling is Bradford R. Poston of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this revenue ruling, contact Bradford R. Poston at (202) 622-3060 (not a toll-free call).