Internal Revenue Service

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September 25, 2001

Legend

Parent =

IC1 =

IC2 =

State 1 =

State 2 =

Dear :

This is in response to your authorized representative's submission dated February 15, 2001, and subsequent submissions, on behalf of IC1 and IC2 (collectively, the "Companies"), requesting certain rulings under IRC § 72.

FACTS

IC1 is a stock life insurance company organized and operated under the laws of State 1. IC2 is a stock life insurance company organized and operated under the laws of State 2. Each of the Companies is licensed to engage in the life insurance and annuity business in certain jurisdictions.

Both of the Companies represent that they are life insurance companies within the meaning of § 816(a), and file federal income tax returns on a calendar year basis, and report their income on an accrual method. IC2 is a wholly owned subsidiary of IC1, which in turn is a wholly owned subsidiary of Parent. Parent, IC1, and IC2 all join in the filing of a consolidated federal income tax return.

As a part of their regular business activities, the Companies issue fixed and variable annuity contracts (the “Contracts”). The Contracts that are the subject of this request are what are commonly referred to as “non-qualified” deferred variable annuity contracts that are purchased with “after-tax” money, and therefore must comply with the distribution requirements of § 72(s), following the death of the owner of a Contract. Except as explained herein, the Contracts issued by IC1 are substantially identical in all respects material to this ruling request to the Contracts issued by IC2. Hereafter, all references to “Contracts” refer to both IC1 and IC2 Contracts.

Under the terms of the Contracts, premiums may be paid at any time prior to the annuity starting date (“ASD”). The Contract holder may allocate premiums and earnings thereon (“Contract Values”) among fixed investment options (the “Guaranteed Account Options”) and variable investment options (the “Portfolio Options”) available under the Contracts. Each Portfolio Option corresponds to a Portfolio of the IC1 Separate Account I or the IC2 Separate Account I, respectively (collectively referred to as the “Separate Account”). The Portfolios of the Separate Account, in turn, purchase shares of a corresponding series of a trust that is a “regulated investment company” for federal income tax purposes.

The Companies represent that each segregated asset account underlying any of the Contracts that is a “variable contract” within the meaning of § 817(d) will, at all relevant times, meet the asset diversification requirements of § 817(h) and § 1.817-5 of the Income Tax Regulations.

Contract Values allocated to a Portfolio are credited with “Accumulation Units” in that portfolio. The “Accumulation Unit Value” for each Portfolio will vary with the investment performance of the assets underlying the Portfolio. The “Separate Account Contract Value” is the sum of the value of all Accumulation Units credited under a Contract.

Each Guaranteed Account Option corresponds to a Guaranteed Account identified on the premium allocation page. Each Guaranteed Account earns a fixed rate of interest throughout a “Guaranteed Account Period,” which may differ from the duration of the Guaranteed Period of other Guaranteed Accounts. The “Guaranteed Account Contract Value” is subject to a market value adjustment (the “Interest Rate Adjustment”) set forth in the Contracts in the event that amounts are withdrawn, transferred or annuitized from the Guaranteed Account prior to the end of the Guarantee Period of the corresponding Guaranteed Account Option.

Before the ASD, the Contract Value of a Contract equals the sum of the Separate Account Contract Value and the Guaranteed Account Contract Value.

Settlement Provisions

The Contract holder is required to select an ASD and an “ASD Option.” The

Contract holder may change, subject to certain rules, the ASD and the ASD Option up to seven days before the ASD. The Contract holder may elect one of the following ASD Options:

(a) a life income annuity,
(b) a joint and survivor annuity,
(c) a life annuity with 120 or 240 monthly payments guaranteed,
(d) an income for a specified period (5 to 30 years),
(e) or any other ASD Options agreed to by the Companies.

On the ASD, the Contract holder may choose to receive payments from the Guaranteed Account, the Separate Account, or both.

Withdrawals

Prior to the ASD, the Contract holder may withdraw all or a portion of the Contract Value of the Contract. Withdrawals and any applicable surrender charges will be deducted from the Contract Value in proportion to their allocation among the Portfolios and Guaranteed Account Options.

A “surrender charge” may apply to certain withdrawals. The surrender charge will vary in amount depending upon the “Contribution Year” of the premium at the time of withdrawal. For purposes of determining the surrender charge, withdrawals will be allocated first to earnings, if any (which may be withdrawn free of a surrender charge), and then to premiums on a first-in, first-out basis so that all withdrawals are allocated to premiums to which the lowest surrender charge applies.

Death Benefits

If a Contract Holder dies before the ASD, a “Death Benefit” will be paid to the Beneficiaries designated by the Contract holder. The Contracts offer a standard Death Benefit which is equal to the greater of (1) the Contract Value at the end of the “Valuation Period;” or (2) the total Premiums paid prior to the death of the Contract holder, less the total withdrawals, Withdrawal Charges, and premium taxes incurred.[1]

[1] The Contracts offered by IC2 provide that the Death Benefit is the greater of (1) and (2) as listed above and (3) the greatest “Anniversary Value” until the Contract holder’s 86th birthday. The Anniversary Value is the Contract Value on the first day of each Contract Year, less any withdrawals and Withdrawal Charges, plus any additional premium since that anniversary.

An Enhanced Death Benefit is also offered where permitted by state law.[2] The Enhanced Death Benefit is the greater of:

(1) the standard Death Benefit recomputed by accumulating the total premiums paid (minus the sum of total withdrawals, any surrender charges assessed, and premium taxes incurred) annually at five percent[3] to the date of death; and

(2) the Contract Value at the seventh Contract Year, plus any premiums paid since that time and prior to death, minus the sum of total withdrawals, and any surrender charges assessed since the seventh Contract Year, and premium taxes incurred since the seventh Contract Year, accumulated annually at five percent[4] to the date of death.[5]

The Proposed Distribution Options

The Companies represent that in order to effectively market the Contracts, they must provide holders of Contracts and beneficiaries of deceased holders with flexible distribution options. In accordance with this goal of increasing the flexibility of the distribution options available to the beneficiaries of deceased holders of Contracts, the Companies have developed an optional distribution procedure that they propose to make available to any individual who is a “designated beneficiary,” within the meaning of § 72(s)(4), of a deceased holder of a Contract.

More specifically, Taxpayers represent that under the terms of the Contracts the optional distribution procedure will only be available where each of the following requirements is satisfied:

(i) The Contract Holder dies before the ASD;

(ii) The Contract Holder has named an individual who is a “designated beneficiary,” within the meaning of § 72(s)(4), of the deceased holder of the Contract to receive the payments that are due under the Contract; and

(iii) Within one year of the death of the Contract Holder, either:

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[2] An Enhanced Death Benefit is not permitted under State 2 law and thus is not an option under the IC2 Contracts.

[3] Four percent if the Contract holder was age 70 or older on the Issue Date.

[4] Four percent if the Contract holder was age 70 or older on the Issue Date.

[5] This amount is deemed $0 if the Contract holder dies prior to the seventh Contract Year.

(a) the designated beneficiary makes an irrevocable election to receive the entire balance payable to the designated beneficiary under the Contract in accordance with the systematic withdrawal procedure described in the first method set forth in Q & A 12 of Notice 89-25, 1989-1 C.B. 662, 666 (referred to herein as “the life expectancy fraction method”) and actually receives the first such payment within one year of the death of the Contract Holder; or

(b) the designated beneficiary makes an irrevocable election to receive a portion of the balance payable under the Contract to the beneficiary under the life expectancy fraction method and actually receives the first such payment within one year of the death of the Contract Holder, with the entire remaining balance distributed to the beneficiary within five years of the date of death.

Under the optional distribution procedure, any beneficiary also has the right to receive additional payments from the (portion of the) balance held under the Contract that is being paid under the life expectancy fraction method. Under this procedure, however, no such additional payments made to any beneficiary will reduce any future payments to such beneficiary under the life expectancy fraction method (except, of course, to the extent that the reduction in the balance held under the Contract is reduced and thus, as a consequence, there is a reduction in the future payments to the beneficiary).

REQUESTED RULINGS

1. The distribution of the entire balance payable to a beneficiary under a Contract in accordance with the life expectancy fraction method will satisfy the requirements of § 72(s)(2).

2. The distribution of a portion of the balance payable to a beneficiary under a Contract in accordance with the life expectancy fraction method, with the entire remaining balance distributed to the beneficiary within five years of the date of death, will satisfy the requirements of § 72(s)(2).

3. The answers under 1 and 2 will not be affected by the fact that the beneficiary has the right to receive additional payments from the (portion of the) balance that is being paid under the life expectancy fraction method where such additional payments do not reduce any future payment (except, of course, to the extent that the reduction in the balance held under the Contract is reduced and thus, as a consequence, there is a reduction in the future payments to the beneficiary).

4. Where payments are made to the beneficiary under the procedures

described in 1, 2, and 3, above, no amount will be constructively received by the beneficiary prior to its actual payment under the specified payment procedure.

LAW AND ANALYSIS

Section 72(a) provides that except as otherwise provided in chapter 1 of the Code, gross income includes any amount received as an annuity (whether for a period certain or during one or more lives) under an annuity, endowment, or life insurance contract.

Section 72(b)(1) provides, in general, that gross income does not include that part of any amount received as an annuity under an annuity, endowment, or life insurance contract which bears the same ratio to such amount as the investment in the contract (as of the ASD) bears to the expected return under the contract (as of such date).

Section 72(e)(1)(A) provides, in general, that § 72(e) shall apply to any amount that is received under an annuity contract and is not received as an annuity if no provision of the income tax law (other than § 72(e)) applies with respect to such amount.

Section 72(e)(2)(B) provides, as a general rule, that any amount to which § 72(e) applies if received before the ASD –

(i) shall be included in gross income to the extent allocable to income on the contract, and

(ii) shall not be included in gross income to the extent allocable to the investment on the contract.

Section 72(s)(1)(B) provides that a contract will not be treated as an annuity contract for purposes of the Code unless it provides that if any holder of such contract dies before the ASD, the entire interest in such contract will be distributed within 5 years after the death of such holder.[6]

Section 72(s)(2) provides an exception for certain amounts payable over the life of a designated beneficiary. Specifically, § 72(s)(2) provides that if:

(A) any portion of the holder's interest is payable to (or for the benefit of) a designated beneficiary,

[6]Section 72(s) is not applicable to "qualified" annuity contracts. See § 72(s)(5).

(B) such portion will be distributed (in accordance with regulations) over the life of such designated beneficiary (or over a period not extending beyond the life expectancy of such beneficiary), and

(C) 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,

then, for purposes of § 72(s)(1), the portion referred to in § 72(s)(A) shall be treated as distributed on the day on which such distributions begin.

Section 1.451-1(a) of the Income Tax Regulations provides that gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting.

Section 1.451-2(a) of the Income Tax Regulations provides that income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year that it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, the regulation provides that income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

Ruling Requests 1 and 2

Section 72(t) provides for a 10-percent "penalty tax" for early distributions from certain "qualified" plans. Section 72(t)(2)(A)(iv), an exception to § 72(t), provides that the penalty tax will not apply to any payment that is "part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of such employee and his designated beneficiary."

Section 401(a)(9)(A)(ii), which sets forth certain distribution requirements for various "qualified" plan benefits, refers to payments which "will be distributed . . . over the life of such employee or over the lives of such employee and a designated beneficiary (or over a period not extending beyond the life expectancy of such employee or the life expectancy of such employee and a designated beneficiary)."

Section 72(s)(2)(B), § 72(t)(2)(A)(iv), and § 401(a)(9)(A)(ii), all require that payments from a fund or account be made to an individual,[7] either over the individual's life or over the period of the individual's life expectancy. Section 72(t)(2)(A)(iv),

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[7]Sections 72(t)(2)(A)(iv) and 401(a)(9)(A)(ii) also allow the life expectancy of a second individual to be taken into account, but that is not permitted under § 72(s)(2)(B).

§ 401(a)(9)(A)(ii), and IRC § 72(s)(2)(B) all require that the rate of the distributions to the individual be calculated to exhaust the fund over the life or life expectancy of the individual (or in the case of § 72(t)(2)(A)(iv) and 401(a)(9)(A)(ii) the individual and a beneficiary). Section 72(t)(2)(A)(iv) is more stringent than § 401(a)(9)(A)(ii) as it requires the amounts of the payments to be "substantially equal." Under § 72(t) and § 401(a)(9), the Service has allowed the use of the life expectancy fraction method.

With respect to § 72(t)(2)(A)(iv), Q & A 12 of Notice 89-25, 1989-1 C.B. 662, 666, states that:

> Payments shall be treated as satisfying section 72(t)(2)(A)(iv) if the annual payment is determined using a method that would be acceptable for purposes of calculating the minimum distribution required under section 401(a)(9). For this purpose, the payment may be determined based on the life expectancy of the employee or the joint life and last survivor expectancy of the employee and beneficiary.

Prop. Reg. § 1.401(a)(9)-1, F-1 (1987)[8] establishes an "account-based" test under which an individual account plan may satisfy the minimum distribution requirements of IRC § 401(a)(9). Under this test, a participant must receive an amount each year equal to the product of (i) the account value as determined for that year, and (ii) a fraction, the numerator of which is 1 and the denominator of which is the remaining life expectancy of the participant or of the participant and a beneficiary. Aside from IRC § 401(a)(9)(A)(ii) allowing the life or life expectancy of a named beneficiary to be taken into account and § 401(a)(9)(D) allowing the life expectancy of the participant and spouse to be redetermined, the "account-based" test prescribed by Prop. Reg. § 1.401(a)(9)-1, F-1 (1987) is the same as the life expectancy fraction method that is the subject of this ruling request.[9]

We conclude that under the facts of this ruling request, the requirements of § 72(s)(2) are met if the entire balance is paid to the designated beneficiary under the life expectancy fraction method.

Under Requested Ruling 2, the distribution of a portion of the holder's balance at death is to be made under the life expectancy fraction method, with the entire remaining balance distributed to the beneficiary within five years of the date of death. Given the use of the word "portion" in § 72(s)(2) (<u>see</u> <u>supra</u>), the requirements of § 72(s)(2) will be

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[8]According to the proposed regulations' preamble, taxpayers may rely on the proposed regulations for guidance pending the issuance of final regulations. <u>See</u> 1987-2 C.B. 881, 884.

[9] New proposed required minimum distribution regulations were issued on January 17, 2001. However, the change made in the 2001 proposed regulations is not relevant to the application of Notice 89-25, Q & A 12, to the taxpayer's proposed distribution method.

satisfied under the circumstances presented by Requested Ruling 2.

Requested Ruling 3

In this requested ruling, the designated beneficiary has the right to receive additional payments from the (portion of the) balance that is being paid under the life expectancy fraction method when the additional payments do not reduce any future payment (except, of course, to the extent that the reduction in the balance held under the Contract is reduced, and thus, as a consequence there is a reduction in the future payments to the beneficiary.)

Examination of the text and purpose of § 72(s) indicates an intent that tax-deferred balances held under nonqualified annuity contracts be distributed within certain periods following the death of the holder (or, where the holder is not a natural person, the death of the specified annuitant). We see no indication that § 72(s) prevents the designated beneficiary of a nonqualified annuity contract holder from receiving payments under the contract more rapidly than is required.

The proposed regulations under § 1.401(a)-9 also implicitly support the conclusion that payments may be received under a Contract more rapidly than required under section 72(s). When section 72(s) was added to the Code, the Conference Committee stated:

> The conference agreement follows generally the Senate amendment, but with some modifications to the rules for the treatment of annuity contracts in the event of the contractholder's death. These modified rules generally conform to those applicable to qualified pension plans and IRAs.

H.R. Conf. Rep. No. 861, 96th Cong., 2d Sess. 1077 (1984). In the case of qualified annuities, the express rule of Prop. Reg. § 1.401(a)(9)-5, Q&A -2 (2001), is that no "credit" will be given for "excess" payments in one year against the minimum required payments in any subsequent year. Implicitly this rule permits "excess" payments in any year.

We conclude that as long as any "excess" payments result in the permanent acceleration of the payout stream, such "excess" payments are permitted under § 72(s)(B)(2).

Requested Ruling 4

The Companies have requested a ruling that where payments are made to a designated beneficiary under the procedures set forth in Requested Rulings 1, 2, and 3, no amount will be constructively received by the beneficiary prior to its actual payment under the specified payment procedure.

An annuity contract consists of an accumulation phase and a phase subsequent to the ASD commonly referred to as annuitization. During the accumulation phase, all amounts received by the holder are "amounts not received as an annuity." During the annuitization phase, if the requirements of Treas. Reg. § 1.72-2(b)(2) and (3) are met, amounts received by the holder may be characterized as "amounts received as an annuity." During the annuitization phase, amounts received by the holder may, in certain circumstances, be characterized as "amounts not received as an annuity." See § 72(e)(1)(A)(ii) and (e)(2)(A). This ruling expresses no opinion on whether amounts paid to the designated beneficiary under the procedures set forth in Requested Rulings 1, 2, and 3, are "amounts received as an annuity" or "amounts not received as an annuity." See Caveat 3. Nevertheless, under either conclusion, no amount will be constructively received by the beneficiary prior to its actual payment under the specified payment procedure.

Section 72 provides a comprehensive scheme for the taxation of life insurance, endowment, and annuity contracts. Section 72(a) and (b) provide, in general, for the taxation of "amounts received as an annuity." Section 72(e), in general, taxes amounts received under life, endowment, and annuity contracts that are "not received as annuities."

Both § 72(a) and (e) literally require that amounts be "received" by the holder before they are included in gross income. The statute is silent whether amounts that are only "constructively received," within the meaning of Treas. Reg. § 1.451-2(a), are "received" under § 72 and includible in gross income in accordance with the provisions of § 72.

Prior to the enactment of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), 1982-2 C.B. 462, "amounts not received as annuity" that were paid out before the ASD were includible in the holder's gross income only after the holder recovered the holder's investment in the contract. The Conference Committee Report to TEFRA explained the law prior to the statutory changes as follows:

> Under present law, taxation of interest or other current earnings on a policyholder's investment in an annuity contract generally is deferred until annuity payments are received or amounts characterized as income are withdrawn. Amounts paid out before the annuity starting date are first a return of capital and are taxable (as ordinary income) only after the investment in the contract is recovered.

H.R. Conf. Rep. No. 760, 97th Cong., 2d Sess. 646-47 (1982), 1982-2 C.B. 600, 685.

The Conference Committee generally followed the Senate amendment, which it described in the following terms:

> The Senate amendment provides that amounts received before the

> annuity starting date will be treated first as withdrawals of income earned on investments to the extent of such income, the remainder being treated as a return of capital. Likewise, loans under the contract, or amounts received upon assignment or pledging of the contract, will be treated as amounts received under the contract. These provisions apply as of July 1, 1982,[10] but do not apply to amounts allocable to investments made before July 2, 1982, to endowment or life insurance contracts (except to the extent prescribed in regulations), or to contracts purchased under qualified plans.

H.R. Conf. Rep. No. 760 at 647, 1982-2 C.B. at 685. Thus, the TEFRA changes to § 72 do not indicate that Congress intended to change prior law, which did not apply the doctrine of constructive receipt to annuity contracts.

The provisions of § 264(a) disallowing deductions on indebtedness to purchase or carry certain annuities further support our conclusion that the doctrine of constructive receipt does not apply to annuities. In fact, § 264(a)(3) generally disallows a deduction for any amount paid or accrued on indebtedness incurred or continued to purchase an annuity contract pursuant to a plan of purchase, contemplating the systematic borrowing of part or all of the increases in cash value of the contract. If such increases in cash value were taxable under the doctrine of constructive receipt there would be no abuse for § 264 to correct.

Neither does § 72(u) operate to require the designated beneficiary to include amounts in gross income prior to actual receipt under the procedures set forth in Requested Rulings 1, 2 , and 3. Section 72(u) only requires, prior to actual receipt, the recognition of the income on the contract, in certain cases in which the annuity contract is held by certain nonnatural persons. As defined in § 72(s)(4), for purposes of § 72(s), the term "designated beneficiary" means any individual designated a beneficiary by the holder of the contract.

Thus we conclude that where payments are made to a designated beneficiary under the procedures set forth in Requested Rulings 1, 2, and 3, no amount will be constructively received by the beneficiary prior to its actual payment under the specified payment procedure.

CONCLUSIONS

1. Under the facts of this case, the distribution of the entire balance payable to a beneficiary under a Contract in accordance with the life expectancy fraction method will satisfy the requirements of § 72(s)(2).

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[10]Note that the Conference Committee changed the effective date for the new provisions to August 13, 1982. (Footnote added.)

2. Under the facts of this case, the distribution of a portion of the balance payable to a beneficiary under a Contract in accordance with the life expectancy fraction method, with the entire remaining balance distributed to the beneficiary within five years of the date of death, will satisfy the requirements of § 72(s)(2).

3. The answers under Requested Rulings 1 and 2 will not be affected by the fact that the beneficiary has the right to receive additional payments from the (portion of the) balance that is being paid under the life expectancy fraction method where such additional payments do not reduce any future payment (except, of course, to the extent that the reduction in the balance held under the Contract is reduced and thus, as a consequence, there is a reduction in the future payments to the beneficiary).

4. Where payments are made to the beneficiary under the procedures described in Requested Rulings 1, 2, and 3, above, no amount will be constructively received by the beneficiary prior to its actual payment under the specified payment procedure.

CAVEATS

1. Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

2. Specifically, no opinion is expressed or implied as to whether the Contracts satisfy the provisions of § 817(h) of the Code or the regulations thereunder.

3. Specifically, no opinion is expressed on whether payments made to the designated beneficiary under the procedures described in Requested Rulings 1, 2, and 3, above (the optional distribution procedures), are “amounts received as an annuity,” taxable under § 72(a) and (b), or “amounts not received as annuity” taxable under § 72(e).

4. Specifically, no opinion is expressed regarding the application of the investor control rules set forth in Christoffersen v. United States, 749 F.2d 513 (8th Cir. 1984), cert. denied, 473 U.S. 905 (1985); Rev. Rul. 81-225, 1981-2 C.B. 12, as modified by Rev. Proc. 99-44, 1999-2 C.B. 598; Rev. Rul. 80-274, 1980-2 C.B. 27; Rev. Rul. 77-85, 1977-1 C.B. 12.

5. Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling will be modified or revoked by the adoption of temporary or final regulations, to the extent the regulations are inconsistent with any conclusion in the letter ruling. See section 12.04(4) of Rev. Proc. 2001-1, 2001-1 I.R.B. 1, 47. However, when the criteria in section 12.05 of Rev. Proc. 2001-1, 2000-1 I.R.B. at 47, are satisfied, a ruling is not revoked or modified retroactively except in rare or unusual circumstances.

6. This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

A copy of this letter must be attached to any income tax return to which it is relevant.

Sinccerely yours,
MARK S. SMITH
Chief, Branch 4
Office of Associate Chief Counsel
(Financial Institutions & Products)