Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:FIP:4-PLR-125242
Date:
October 24, 2002

Legend:

Taxpayer =

State A =
Company B =
Contract C =
Formula D =
Number 1 =
Form Number 2 =
Number 3 =
Phase I =
Phase IIA =
Phase II =

Dear :

This is in reply to your letter of May 1, 2002, requesting certain rulings under § 72 of the Internal Revenue Code.

FACTS

Taxpayer is a stock life insurance company incorporated under the laws of State A. It files a consolidated tax return with Company B on a calendar year basis using the accrual method of accounting. Taxpayer is a life insurance company as defined by § 816(a) and is licensed to conduct business in, among other places, Number 1 states.

Taxpayer presently markets for sale an individual, non-qualified, flexible premium deferred variable contract known as Contract C (hereafter "Contract"). The Contract is deemed an annuity under the laws of each jurisdiction in which it is issued and qualifies for treatment as an annuity under § 72. The assets supporting the Contract are maintained in a segregated asset account(s) and in Taxpayer's general account. The segregated asset account(s) complies with § 817(h) and § 1.817-5 of the Income Tax Regulations. The assets in the account(s) are owned by Taxpayer. The premiums paid into the Contract, as well as any additional allowed "purchase payments", can be allocated between sub-accounts in the segregated asset account(s) or the general account.

Taxpayer proposes to offer a "rider" (hereafter "Rider") to the Contract, provided the Contract is non-qualified and has at least a specified value. Taxpayer will use its Form Number 2 for the Rider. The Rider will supercede any contrary provision in the Contract and will provide for a stream of periodic income payments over the lifetime of one or two annuitants based on the investment experience of the amounts paid in on the Contract and, where appropriate, a credit when the Contract has been in force for a stated number of years. The periodic income payments will be made in two segments: Phase I and Phase II.

Phase I will be no less than Number 3 years and no more than the maximum length specified by Taxpayer. Its initial length will be established when the Rider is issued. During Phase I, periodic payments will be made to the designated recipient, and during Phase I the owner of the Contract ("Owner") can elect to access the surrender value of the Contract by surrendering or making a withdrawal(s) from the Contract, including the Rider; the Rider alone cannot be surrendered. The value that can be accessed is the value of the Contract as of the date of access less the applicable charge(s). A surrender will result in termination of the Contract and Rider and all periodic payments; a withdrawal will result in a pro tanto reduction in the periodic payments. The Owner cannot make any additional purchase premium payments during Phase I.

The Owner can change the length of Phase I not more than once per contract year before Phase I ends. An effect of such a change will be an adjustment to the amount of the periodic payments; lengthening the period will generally reduce the amount of the payments while shortening it will increase the amount.

Upon the expiration of Phase I, Phase II will commence, and will continue until the death of the annuitant(s). The Owner can specify that a minimum number of periodic payments is to be made at the beginning of Phase II, regardless whether the annuitant(s) survives; such a period of guaranteed payments is known as Phase IIA. The Owner can change the length of Phase IIA during Phase I; such a change will result in a corresponding change in the amount of the periodic payments. Once Phase IIA is completed, the periodic payments will continue until the death of the annuitant(s). During Phase IIA and Phase II, the Owner cannot surrender the Contract or make a withdrawal against the surrender value.

Changing the length of Phase I or Phase IIA does not change the overall duration of periodic payment to be made under the Rider; the payments will continue to be made over the lifetime of the annuitant(s).

The Rider provides for a death benefit, the amount of which depends on the phase of the Rider during which the death occurred[1]; if the death occurs during Phase II, the Contract will terminate without the payment of a death benefit. If the death occurs before the commencement of Phase I, the amount of the death benefit will be distributed as provided in the Contract, without the Rider. The death benefits were designed to comply with § 72(s).

In order to effect the Rider, the Owner must make three selections: 1)the assumed interest rate for purposes of determining the amount of payments; 2)the frequency of payments[2]; 3)the length of Phase I, and (if any) of Phase IIA. A commencement date on which the amount of the initial periodic payment will be calculated is specified in the Rider, and within 14 days after that date, Taxpayer will begin making payments to the designated recipient at the selected frequency.

As a general rule, the amount of each payment will vary with the investment performance of the segregated asset account(s). However, the amount of the payments will be level if the performance of the accounts equals the assumed rate, no withdrawals are made, and the lengths of Phase I and Phase IIA are not changed.

The initial payment will be a Phase I payment and the amount will be determined by applying Formula D to the value[3] of the Contract on the commencement date. The amount of subsequent Phase I payments will be determined in one of two ways as chosen by the Owner. The Owner can elect to have the amount of subsequent payments determined annually or at the same frequency as the periodic payments; a revised Formula D will be applied to the value of the contract at the appropriate time. The formulas used to compute the amount of the periodic payments are designed to deplete the value of the Rider by the expiration of the maximum allowed duration of Phase I (assuming no Phase IIA is chosen).

Upon the expiration of Phase I, Phase II will commence. Phase II includes the duration of Phase IIA, if any. If the Phase I and Phase IIA payments did not deplete the value of the Rider, the remaining value will be used in computing the amount of the Phase II periodic payments. Formula D will be separately applied to portions of

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[1]Another effect of changing the length of Phase I or Phase IIA is to change the period of eligibility for the death benefit.

[2]The Rider provides alternative frequencies of monthly, quarterly, semi-annually, or annually.

[3]The Contract's value is the sum of Contract's allocable share of the values of the segregated and general accounts, less applicable premium taxes.

segregated account(s) and the general account allocable to the Contract to arrive at the amount of the initial Phase II periodic payment; as with the Phase I periodic payments this amount can be adjusted either annually or at the same frequency as the periodic payments. If there is no value remaining to the Rider at the end of Phase IIA, the amount of the payments will be the minimum amount specified in the Rider. During Phase II the Owner cannot access the surrender value, if any.

Taxpayer represents that the Contract will be issued to or for the benefit of only natural persons.

LAW AND ANALYSIS

Requested Ruling #1

Requested Ruling #1 concerns whether the payments made under the Rider will be treated as made on or after the annuity starting date. Section 72(c)(4) defines the annuity starting date for any contract as “the first day of the first period for which an amount is received as an annuity under the contract”. Section 1.72-4(b)(1) provides that the first day of the first period for which an amount is received as an annuity is the later of 1) the date upon which the obligations under the contract become fixed, or 2) the first day of the period which ends on the date of the first annuity payment. Here, the obligations under the Rider will become fixed no later than the commencement date. The first annuity payment is due within 14 days thereafter. Accordingly, the payments made under the Rider will be treated as made on or after the annuity starting date.

Requested Ruling #2

Requested Ruling #2 regards the tax treatment of amounts received as an annuity and amounts not received as an annuity. Section 72(b)(1) provides that gross income does not include the portion of the amount received as an annuity which bears the same ratio as the investment in the contract does to the expected return under the contract. See also §§ 1.72-1(c)(1), 1.72-3, 1.72-2(b)(3)(i). This exclusion ratio is computed as provided in § 1.72-4. See § 1.72-1(c)(1). The application of the exclusion ratio to variable annuities, such as the Contract with the Rider, is described in § 1.72-4(d)(3). Under § 1.72-4(d)(3)(i), an exclusion ratio of 100% is applied to the amount received as an annuity under a variable contract. The amount received as an annuity under a variable contract is the portion of the investment in the contract allocable to the tax year. Id. Section 72(b)(2) provides that the amount that can be excluded from gross income as an amount received as an annuity shall not exceed the unrecovered investment in the contract immediately before the payment.

An amount received under a variable contract during a taxable year exceeding the amount which was received as an annuity is treated as an amount not received as an annuity and is fully includible in the gross income of the recipient. § 1.72-11(b)(2); § 72(e)(2)(A).

Accordingly, the appropriate treatment of the periodic payments made under the Contract and Rider is that the amount of each periodic payment equal to the portion of the investment in the Contract allocable to the tax year involved and hence the amount received as an annuity under the Contract and Rider is subject to the 100% exclusion ratio of § 1.72-4(d)(3). Any excess amount paid is an amount not received as an annuity under the Contract and Rider and is fully includible in gross income pursuant to § 1.72-11(b)(2). See also § 1.72-2(b)(3)(i).

Requested Ruling #3

Requested Ruling #3 concerns the computation of the amount of each payment that will be considered the portion received as an annuity. Taxpayer proposes to compute the
portion received as an annuity by dividing the investment in the contract, adjusted for the Rider's refund feature, by the number of anticipated payments. In making this computation, Taxpayer proposes to aggregate Phase I and Phase IIA for the purpose of determining the value of the refund feature, and the number used to represent the anticipated payments will be chosen by reference to the tables in § 1.72-9, as adjusted in accordance with § 1.72-5.

Section 72(b)(1) provides that "[g]ross income does not include that part of any amount received as an annuity...which bears the same ratio to such amount as the investment in the contract...bears to the expected return under the contract", limited to the amount of the investment in the contract. § 72(b)(2). The amount excluded from gross income is computed by applying an exclusion ratio as described in § 1.72-4 to the amount received as an annuity.

Under § 1.72-4(d)(3), an exclusion ratio of 100% is applied to the amount received as an annuity under a variable contract described by § 1.72-2(b)(3). Under § 1.72-2(b)(3)(i), the amount received as an annuity under a variable annuity contract such as the Rider can be no more than "the portion of the investment in the contract which is properly allocable to that year and hence excludable from gross income as a return of premiums or other consideration paid for the contract." The "investment in the contract" is defined by § 72(c)(1) as the amount, as of the annuity starting date of the aggregate consideration paid for the contract less any amount received prior to the annuity starting date which was excludable from gross income. See also, § 1.72-6.

The investment in the contract has to be adjusted if there is a "refund feature". A refund feature exists under a contract if the expected return on the contract depends at least in part on the life expectancy of one or more individuals and the contract provides for payments to be made to a beneficiary (or to the estate of an annuitant) on or after the death of the annuitant(s) which are in the nature of a refund of the consideration for the contract. § 72(c)(2). The regulations specify that payments will be considered to be required to be made on or after the death of the annuitant if a specified amount or a stated number of payments has not been paid prior to death. § 1.72-7(a)(1). Additionally, in describing what payments are in the nature of a refund of the consideration paid, the regulation refers to § 1.72-11(c)(1), which describes a refund of the consideration paid for a contract as including amounts paid after the death of the annuitant(s) where the contract called for a "minimum period of payments certain or with a minimum amount which must be paid in any event". The amount of the adjustment to the investment in the contract for the refund feature is computed as directed in § 1.72-7(d).

Here, the expected return depends at least in part on the life expectancy of the annuitant(s). The Rider provides for payments on or after the death of the annuitant(s): a death benefit (Phase I), and, if a Phase IIA period has been chosen, continued periodic payments (or an equivalent lump sum). The payment after death will be in a minimum amount or, if a Phase IIA period was chosen, in a minimum period of payments. Accordingly, the Rider may have a refund feature.

Under § 1.72-2(b)(3)(i), an amount received from a variable contract shall be considered as an amount received as an annuity only to the extent that it does not exceed the amount computed by dividing the investment in the contract, as adjusted for any refund feature, by the number of periodic payments anticipated during the time that the periodic payments are to be made. Section 1.72-2(b)(3)(ii) provides that if the payments are to be made for the life of an annuitant(s), the number of periodic payments to be made shall be determined by use of the appropriate tables contained in § 1.72-9, as adjusted in accordance with the table in § 1.72-5(a)(2). <u>See also</u> § 1.72-4(d)(3)(i) (providing that the portion of the investment in the contract allocable to any tax year shall be determined by reference to § 1.72-5, hence by using the tables contained in § 1.72-9 adjusted as appropriate under § 1.72-5(a)(2)).

<u>Requested Ruling #4</u>

Requested Ruling #4 involves the Contract and Rider's exclusion ratio. Under the terms of the Rider, changing the length of Phase I or Phase IIA will result in a corresponding change in the amount of the periodic payments. The amount will be increased if the phase(s) is shortened and decreased if the phase(s) is lengthened. Moreover, changing the length of the phase(s) changes the period in which the death benefit applies.

If a contract provides for variable payments to be made to a taxpayer, such as under the Contract and Rider, the investment in the contract shall be considered to be equal to the expected return under such contract and the resulting exclusion ratio (100%) shall be applied to all amounts received as an annuity under such contract. § 1.72-4(d)(3)(i). The amount excluded is treated as an amount received as an annuity. § 1.72-2(b)(3)(i). For any taxable year, payments received under such a contract shall be considered to be amounts received as an annuity only to the extent that they do not exceed the amount computed by dividing the investment in the contract, as adjusted for any refund feature, by the applicable multiple (whether for a term certain, life, or lives). §§ 1.72-2(b)(3)(i) and 1.72-4(d)(3)(i).

Where the periodic payments increase in amount after the annuity starting date in a manner not provided by the terms of the contract at such date, the portion of such payments representing the increase is not an amount received as an annuity. § 1.72-4(a)(3). (Similarly, § 1.72-11(b)(2) provides that amounts received in excess of the portion of the investment in the contract allocable to each taxable year is fully includible in gross income.) The regulations also provide that if the total amount of payments that a taxpayer receives under a variable contract in a taxable year is less than the total amount excludable for such year, the taxpayer may elect in a succeeding year to redetermine the amounts to be received as an annuity. § 1.72-4(d)(3)(ii). After an exclusion ratio has been determined for a particular contract, it shall be applied to any amounts received as an annuity unless or until, with two other exceptions not relevant here, the contract is exchanged (or is considered to have been exchanged) in a manner described in § 1.72-11(e). § 1.72-4(a)(4)(iii). For the treatment of amounts not received as an annuity, we would examine § 72(e) and § 1.72-11.

Section 1.72-11 deals with amounts not received as an annuity. More specifically, the regulation section applies to annuity payments[4] received that differ either in amount, duration, or both, from those originally provided under the contract. § 1.72-11(a)(1)(ii). The payments referred to include all annuity payments which are paid as the result of a modification or an exchange of the annuity obligations originally provided under a contract for different annuity obligations (whether or not such modification or exchange is accompanied by the payment of an amount which is not treated as an amount received as an annuity). If the duration of the new annuity obligations differs from the duration of the old annuity obligations, then § 1.72-11(e) applies to the new annuity obligations and other rules apply to any lump sum payments received. Under § 1.72-11(e), § 72(e) and paragraphs (b), (c), (d), and (f) of the regulation do not apply for the purpose of determining the includibility of such payments and a new exclusion ratio is calculated. Changing the length of Phase I or Phase IIA changes the period for which guaranteed periodic payments will be made. Such change does not change the duration of the Rider, which is the life of the annuitant(s). Because § 1.72-11(e) only applies if the duration of payments is changed, § 1.72-11(e) does not apply when a phase is changed. Compare § 1.72-11(f) (where a lump sum payment is made on the annuity thereby reducing the amount - but not the duration - of the annuity obligations).

Accordingly, any change in the Rider's Phase I, Phase IIA, or both, will not result in a change in the Contract's exclusion ratio as determined under § 1.72-4(a) except as provided under § 1.72-4(d)(3)(ii).

Requested Ruling #5

Requested Ruling #5 concerns whether the existence of the surrender value under the Contract and Rider will not, by itself, cause any person to be treated as

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[4]The term "annuity payment" is synonymous with the term "amount received as an annuity". § 1.72- 1(c)(1); Inglehart v. Commissioner, 174 F.2d 605, 607 (7th Cir. 1949).

having income with respect to any amounts held under the Contract and Rider.

Section 72 taxes only amounts actually received. Section 451(a) provides that any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer. In explaining the application of § 451, § 1.451-1(a) states that amounts are to be included in gross income in the "year in which they are actually or constructively received". Section 1.451-2(a) points out that income is constructively received if it is "otherwise made available so that [the taxpayer] can draw upon it at any time" but that the income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. In Rev. Rul. 68-342, 1968-2 C.B. 186, the Service held that the cash value of a qualified annuity contract was not made available to the holder by a surrender feature. Further, the Service observed that the taxpayer's control of the receipt of income through the surrender feature was subject to substantial limitations because in order to access the cash value the holder had to forfeit his rights under the contract and would incur charges that would reduce the value of the contract below that needed to purchase a comparable annuity.

Accordingly, the existence of the surrender value under the Contract and Rider will not, by itself, cause any person to be treated as having income with respect to any amounts held under the Contract and Rider.

HOLDINGS

Based on the facts submitted and the representations made, we hold as follows:

1. Each periodic payment under the Contract and Rider will be treated as made on or after the annuity starting date (within the meaning of § 72(c)(4) and § 1.72-4(b)).

2. The portion of each payment that will be treated as an amount received as an annuity will be excludable from gross income pursuant to § 72(b)(1) and §§ 1.72-2(b)(3) and 1.72-3, subject to the limitation imposed by § 72(b)(2), and the excess (if any) of each payment over such portion will be treated as an amount not received as an annuity on or after the annuity starting date and will be includible in gross income as provided in § 72(e)(2)(A) and §§ 1.72-1(d), 1.72-4(a)(3) and (d)(3), and 1.72-11(b)(2).

3. The portion of each payment that will be treated as an amount received as an annuity will be calculated pursuant to § 72(b)(1) and §§ 1.72-2(b)(3) and 1.72-4(d)(3) by dividing the investment in the contract (within the meaning of § 72(c)(1) and § 1.72-6), adjusted for the refund feature under the Rider as provided in § 72(c)(2) and § 1.72-7(d), by the number of payments anticipated during the time that such payments are to be made under the Rider. For this purpose:

(a) the value of the refund feature will be determined by treating the term of Phase I combined with Phase IIA (if one is chose) as the “guarantee period” (within the meaning of § 1.72-7(d)(1)), and

(b) the number of payments anticipated during the time that such payments are to be made, i.e., over the lives of the annuitant(s) under the Rider, will be determined by applying the appropriate table under § 1.72-9 as adjusted in accordance with the table in § 1.72-5(a)(2).

4. Any change in the Rider’s Phase I, Phase IIA, or both, will not result in a change in the Contract’s exclusion ratio as determined under § 1.72-4(a) except as provided under § 1.72-4(d)(3)(ii).

5. The existence of the Surrender Value under the Contract and Rider will not, by itself, cause any person to be treated as having income with respect to any amounts held under the Contract and Rider.

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. This ruling is directed only to the taxpayer requesting it.

Similarly, no opinion is expressed or implied concerning whether a given modification of the Contract and Rider will constitute an exchange under § 1035.

Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. A copy of this letter must be attached to any income tax return to which it is relevant.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the Taxpayer.

Sincerely,

/S/

DONALD J. DREES, JR.
Senior Technician Reviewer, Branch 4
Office of Associate Chief Counsel
(Financial Institutions & Products)