Internal Revenue Service

Number: **200949036**
Release Date: 12/4/2009
Index Number: 72.00-00

Department of the Treasury
Washington, DC 20224

Person To Contact:

Telephone Number:

Refer Reply To:
CC:FIP:B04 – PLR-149119-07
Date:
July 30, 2009

Taxpayer =
Group Contract =
Certificate =

Dear :

This is in response to the request for a letter ruling, as supplemented, regarding the application of the Internal Revenue Code to a transaction you contemplate undertaking.

FACTS

The following is represented:

Taxpayer is a corporation taxable under part I of subchapter L of the Internal Revenue Code. Taxpayer intends to enter into an arrangement with a financial institution that offers retail investment services (Sponsor). Some of Sponsor's customers are individuals[1] (Customer) who open an investment account (Account) under Sponsor's auspices. Under this arrangement, Taxpayer will issue Group Contract to Sponsor under which Sponsor can sell Certificates to its Customers. Customer will invest money in the Account. The amount that Customer can invest is limited by the Certificate; Customer can invest more only with Taxpayer's prior approval. In exchange for a fee, the Certificate obligates Taxpayer to provide Customer a guaranteed minimum benefit: if through a series of prescribed annual withdrawals by Customer the value of the Account is exhausted, Taxpayer will commence monthly payments of a specified amount to Customer, the "annuitant"[2] for life (Monthly Benefit).

[1] Consistent with § 72(u).
[2] Under the Group Contract and Certificate, the annuitant must be an individual who is the owner of, or has a beneficial interest in, the Account.

To keep the Certificate in-force, Customer must manage the Account within the parameters specified in the Certificate and must periodically pay Taxpayer a Charge (which may change once each ‘certificate year’, or, if constrained by the terms of the Certificate, at specified anniversaries).

Customer can allocate the Account to only those specified regulated investment companies or other publicly traded securities that are approved by Taxpayer (because they are consistent with Taxpayer’s prescribed investment strategy) and Sponsor will periodically advise Taxpayer of Customer’s transactions in the Account. The Monthly Benefit is determined by reference to a Benefit Base. At the time of issuance of the Certificate, the Benefit Base is the value of the Account. The Benefit Base is increased by additional cash investments, subject to the limit on the amount invested imposed by the Certificate. Terms of some Certificates provide that the Benefit Base will be adjusted on each anniversary of the Certificate’s effective date to be the greatest of 1) the value of the Account on the anniversary, 2) the maximum value of the Account on a prior anniversary, or 3) a minimum value (if specified) in the Certificate.

Customer’s ability to access the value of the Account is controlled by the Certificate. Customer can commence Annual Withdrawals from the Account at Customer’s discretion. The amount of such withdrawals is determined under a formula specified in the Certificate consistent with the Benefit Base and the annuitant’s (i.e., Customer’s) life expectancy; the amount is recalculated (but cannot decrease) on each certificate anniversary. Once begun, Annual Withdrawals must continue; no portion of an Annual Withdrawal can be reserved for a subsequent year. Customer may elect to apply the value of the Account to purchase a lifetime fixed immediate annuity contract at guaranteed purchase rates specified in the Certificate. Withdrawals in excess of the Annual Permitted Withdrawal Amount (Excess Withdrawals) will reduce (including to the point of eliminating) the Benefit Base. The Benefit Base may increase but will not decrease except for a decrease due to an Excess Withdrawal.[3]

The Certificate terminates upon the occurrence of specified conditions, including maturity, Customer’s death, failure to pay the Charge, ceasing to own the Account, investing any portion of the Account in unapproved instruments, or making an Excess Withdrawal that reduces the value of the Account to zero.

If the value of the Account is reduced to zero for any reason other than a withdrawal that includes an Excess Withdrawal, and the annuitant (i.e., Customer) is still alive, the Certificate obligates Taxpayer to pay the Monthly Benefit, which is determined

---

[3] Some Certificates will allow the Customer to elect at issuance a cost-of-living-adjustment feature by which the Benefit Base will increase by a stated percentage per annum.

by reference to the Benefit Base and the last determination of the permitted Annual Withdrawal amount.

The Certificate will have no cash value and Customer cannot assign or transfer any ownership rights, including the right to the Monthly Benefit or to purchase a fixed annuity.

Taxpayer will issue the Group Contract only in those states which treat it as an annuity contract.

An actuarial analysis on which the concept underlying the Group Contract is premised concludes that the arrangement is substantially more sensitive to the risk of longevity than in volatility of the securities markets, and that the predominant risk "insured" against is longevity risk with incidental market risk protection.

With respect to the structure of the arrangement, it is represented that Taxpayer will not have direct or indirect control over investment decisions with respect to the Account covered by the Certificate. Sponsor will not be related to Taxpayer within the meaning of § 1563(a) of the Internal Revenue Code. The universe of investments that the Account will be permitted to hold will not be limited to regulated investment companies, within the meaning of § 851, managed by Taxpayer or any of its affiliates. Taxpayer will not impose any significant barriers to reallocations between and among eligible assets within the Account. Taxpayer may require automatic rebalancing of the Account to bring it into accord with the asset allocation strategy for the account. Taxpayer will not have access to any non-public information about RICs in which the Account may be invested.

REQUESTED RULING

Taxpayer requests a ruling that the Certificate will be treated as an annuity contract within the meaning of § 72 of the Internal Revenue Code.

LAW and ANALYSIS

Section 72(a) provides that except as otherwise provided, 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. The Code does not otherwise define an annuity contract or "any amount received as an annuity."

Section 1.72-2(a)(1) of the Income Tax Regulations provides that the contracts under which amounts paid will be subject to the provisions of § 72 include contracts which are considered to be life insurance, endowment, and annuity contracts in accordance with the customary practice of life insurance companies. Under §§ 1.72-1(b) and (c), as a general matter "amounts received as an annuity" are amounts which are payable at regular intervals over a period of more than one full year from the date on which they are deemed to begin, provided the total of the amounts so payable or the period for which they are to be paid can be determined as of that date, a proportionate part of which is considered to represent a return of premiums or other consideration paid. Under § 1.72-2(b), amounts are considered as "amounts received as an annuity" only if all of the following tests are met: 1) the amounts must be received on or after the annuity starting date, 2) the amounts must be payable in periodic installments at regular intervals over a period of more than one full year from the annuity starting date, and 3) the amounts payable must be determinable either directly from the terms of the contract or indirectly from the use of either mortality tables or compound interest computations, or both (if the contract is a variable contract, § 1.72-2(b)(3) provides an alternative formulation of this requirement). Under § 1.72-4(b)(1), the annuity starting date is the first day of the first period for which an amount is received as an annuity; the first day of the first period for which an amount is received as an annuity shall be the later of 1) the date upon which the obligations under the contract became fixed or 2) the first day of the period which ends on the date of the first annuity payment.

Explaining imposition of an "income-out-first" rule under §72(e) for withdrawals prior to the annuity starting date, the Senate report described a commercial annuity as

> a promise by a life insurance company to pay the beneficiary a given sum for a specified period, which period may terminate at death. Annuity contracts permit the systematic liquidation of an amount consisting of principal (the policyholder's investment in the contract) and income….An individual may purchase an annuity by payment of a single premium or by making periodic payments. A deferred annuity contract may, at the election of the individual, be surrendered before annuity payments begin, in exchange for the cash value of the contract….The committee believes that the use of deferred annuity contracts to meet long-term investment goals, such as income security, is still a worthy ideal.

S. Rep. No. 97-494 at 349-50 (1982)(footnote omitted). The report also explains § 72's utilization of an exclusion ratio regime: "[a] portion of each amount paid to a policyholder as an annuity generally is taxed as ordinary income under an 'exclusion ratio' (§ 72(b)) computed to reflect the projected nontaxable return of investment in the contract and the taxable growth on the investment." Id. As described in Samuel v. Commissioner, 306 F.2d 682, 687 (1st Cir. 1962), aff'g Archibishop Samuel Trust v. Commissioner, 36 T.C. 641 (1961), acq., 1964-2 C.B. 3

> [i]nherent in the concept of an annuity is a transfer of cash or property from one party to another in return for a promise to pay a specific periodic sum for a stipulated time interval….Again, in the normal annuity situation, once the annuitant has transferred the cash or property to the obligor and has received his contractual right to periodic payments, he is unconcerned with the ultimate disposition of the property transferred once it is in the obligor's hands.

In Life & Health Insurance, Black and Skipper state that "[i]n the broadest sense, an annuity is simply a series of periodic payments" and while "[l]ife insurance has as its principal mission the creation of a fund [, t]he annuity, on the contrary, has as its basic function the systematic liquidation of a fund." Accordingly,

> [e]ach payment under an annuity may be considered to represent a combination of principal and interest income and a survivorship element. Although not completely accurate, one can view the operation of an annuity as follows: If a person exactly lives out his or her life expectancy, he or she would have neither gained nor lost through utilizing the annuity contract.

Kenneth Black, Jr. and Harold D. Skipper, Jr., Life & Health Insurance 161-62 (13th ed. 2000).

Elsewhere an annuity has been described as "a right to receive fixed, periodic payments, for a specified period of time" and an annuity contract as

> a contract under which, in exchange for the payment of a premium or premiums, the recipient thereof is bound to make future payments, typically at regular intervals, in amounts, to payees, and conditions specified in the parties' agreement. The determining characteristic of an annuity is that the annuitant has an interest only in the periodic payments and not in any principal fund or source from which they may be derived. Although an individual who purchases an annuity remains the technical owner of the asset, he or she does not retain total control over that asset and does not

> have unfettered access to the full amount of his or her own "property".

4 Am. Jur. 2d Annuities, § 1 (2008). Moreover, "[t]he purchaser of an annuity surrenders all rights to the money paid, and therefore installment payments of a debt, or payments of interest on a debt, do not constitute an annuity." Id., § 2.

Whether an annuity contract allows the owner to access the value of the contract through other than periodic ("annuity") payments is a product of state statute, Appleman on Insurance § 182:05[B][7] and [8] (2d ed. 2008).

Here, on balance the Group Contract (and hence the Certificate) possess the essential attributes of an annuity. It is true that the Certificate may not, "at the election of the [holder], be surrendered before annuity payments begin, in exchange for the cash value of the contract", S. Rep. No. 97-464 at 349. It is also true that because the annuity starting date is contingent upon the value of the Account being exhausted while Customer is alive, it is not the case that "if [Customer] exactly lives out his or her life expectancy, he or she would have neither gained nor lost through utilizing the annuity contract", Life & Health Insurance, at 162, but these conditions are not dispositive.

The Certificate and the amounts paid under the Certificate meet the requirements of §§ 1.72-1(b) and (c), 1.72-2(a)(1) and (b)(3), and 1.72-4(b)(1) as annuity contracts and annuity payments. Additionally, the Certificate is purchased "by making periodic payments" of premium for "a promise by a life insurance company to pay the beneficiary a given sum for a specified period, which period may terminate at death", and is "used to provide long-term income security." S. Rep. No. 97-464 at 349. Moreover, it has "the determining characteristic … that the annuitant has an interest only in the periodic payments and not in any principal fund or source from which they may be derived." 4 Am. Jur. 2d Annuities, §1. The Customer will have "surrender[ed] all rights to the money paid", thereby distinguishing the Certificate from "installment payments of a debt, or payments of interest on a debt", which are not annuities. Id.

The Certificate is not a contract to pay interest. See § 1.72-14(a)[4].

Accordingly, the Certificate will be treated as an annuity contract within the meaning of § 72.[5]

---

[4] The Certificate is not a debt instrument because it is issued by an insurance company subject to tax under subchapter L in a transaction in which there is no consideration other than cash. Section 1275(a)(1)(B)(ii).

[5] Customer is considered the owner of the Account. Rev. Rul. 2003-92, 2003-2 C.B. 350; Rev. Rul. 81-225, 1981-2 C.B. 12.

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

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 Taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.

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

Sincerely,

/S/

Sheryl B. Flum
Chief, Branch 4
Office of the Associate Chief Counsel
Financial Institutions & Products