Internal Revenue Service

Number: **201001016**
Release Date: 1/8/2010

Index Number: 72.00-00, 165.03-00, 1.11-00, 1092.02-01

Department of the Treasury
Washington, DC 20224

Person To Contact:

Telephone Number:

Refer Reply To:
CC:FIP:B04 – PLR-131336-08

Date:
September 14, 2009

Taxpayer =
IC =
Sponsor =
Group Contract =

Certificate =

Dear :

This is in response to your request for various rulings regarding the application of the Internal Revenue Code to a transaction you contemplate undertaking.

FACTS

The following facts are represented:

Taxpayer is an individual. Taxpayer intends to establish an investment account (Account) with Sponsor, a financial institution that offers retail investment services. IC is a corporation taxable under part I of subchapter L of the Internal Revenue Code. IC issues Group Contract to Sponsor under which Sponsor can sell on IC's behalf Certificates to its customers (e.g., Taxpayer) who open or maintain an Account under its auspices. In exchange for a fee, the Certificate obligates IC to provide Taxpayer a guaranteed minimum benefit: if the value of the Account is reduced to zero within the parameters of the Certificate, IC will commence monthly payments as required by the Certificate of a specified amount to Taxpayer, the "annuitant"[1], for life (Monthly Benefit).

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[1] 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 obtain a Certificate, Taxpayer must have or invest a minimum amount in the Account; Taxpayer may make additional subsequent contributions. IC approval is required before a Certificate will be issued covering an Account with a value in excess of a specified amount. To keep the Certificate in-force, the entire value of the Account must be invested within the parameters specified in the Certificate and Taxpayer must periodically pay IC a Charge (which may change quarterly) which will be withdrawn from the Account.

Group Contract requires Sponsor to permit Taxpayer to invest the Account by selecting from investment strategies approved by IC. Sponsor will manage the Account and can change the specific instruments held by the Account. If a change is made inconsistent with the selected strategy, Sponsor must conform the holdings of the Account to the selected strategy within a specified time or the Certificate terminates. Similarly, if the holdings of the Account become inconsistent with the selected strategy (e.g., because certain securities are liquidated to fund a requested withdrawal), and such inconsistency is not corrected within a specified time, the Certificate terminates.[2]

The operation of the Certificate is keyed off of the "Benefit Base." The Benefit Base is the value of the Account on the date the Certificate becomes effective; typically this will be the amount of the initial contribution to the Account. The Benefit Base will increase by the amount of additional contributions. The Certificate allows Taxpayer to make an Annual Election for the Benefit Base to increase to the value of the Account. Making this election may result in an increased Charge.

The amount of the benefit provided by the Certificate will be affected by when Taxpayer accesses the value of the Account. The Certificate will specify the Commencement Date, which is the date when Annual Permitted Withdrawals may commence. If Taxpayer makes a withdrawal from the Account prior to the Commencement Date, the amount by which the Benefit Base will be reduced is determined by a formula.[3] If Taxpayer makes a withdrawal from the Account after the Commencement Date and the aggregate amount withdrawn during a calendar year is greater than the Annual Permitted Withdrawal, the excess over the Annual Permitted Withdrawal will reduce the Benefit Base by an amount determined by a formula.

The amount of the Annual Permitted Withdrawal[4] is determined by applying a factor to the Benefit Base and is recalculated each year. At the Commencement Date, Taxpayer can begin to make Annual Permitted Withdrawals.[5]

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[2] The Certificate will not terminate if the Account's holdings are inconsistent with the selected strategy because the value of the Account is insufficient to implement the selected strategy.
[3] Withdrawals to pay the Charge are not counted for this purpose.
[4] The amount of the Charge is not included in the amount of the Annual Permitted Withdrawal.

If the value of the Account decreases to zero within the parameters of the Certificate, IC will begin to pay the Monthly Benefit, the amount of which is determined by applying a factor to the Benefit Base. If this occurs prior to the Commencement Date, the Monthly Benefit will begin after the Commencement Date.

The Certificate terminates upon the occurrence of specified conditions, including cancelling the Certificate (withdrawing the value of the Account other than through an Annual Permitted Withdrawal is deemed a cancellation), withdrawals that reduce the Benefit Base to zero, Taxpayer's death, failing to conform to the investment strategy, assignment, or choosing to apply the value of the Account to purchase a life annuity.

The Certificate will have no cash value. Taxpayer may not assign his interest in the Certificate without IC's approval.

Under applicable state regulations, the Group Contract will be an annuity contract. Taxpayer will purchase Certificate only if the regulation of his state of residence treats the Group Contract as an annuity contract.

An actuarial analysis of the premise underlying the Group Contract 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 mitigated is longevity risk with incidental market risk protection.

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

<u>REQUESTED RULINGS</u>

1. That the Certificate will be treated as an annuity contract within the meaning of § 72 of the Internal Revenue Code.

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[5] If the Certificate is purchased in connection with a qualified account, the Annual Permitted Withdrawal amount will be not less than the required minimum distribution, even if that amount is greater than what would be the amount permitted by the Certificate.

2. That the Certificate will not create a right to reimbursement for losses realized on Account assets for purposes of § 165(a) and thus will not prevent Taxpayer from currently deducting such losses.

3. That the Certificate will not be treated as diminishing Taxpayer's risk of loss on Account assets for purposes of applying the holding period requirements of § 1(h)(11).

4. That the Certificate and Account assets will not, either at the time of issuance of the Certificate or subsequently, be viewed as components of a straddle within the meaning of § 1092.

LAW and ANALYSIS

Requested Ruling #1

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 Taxpayer is alive, it is not the case that “if [Taxpayer] 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 Certificate Holder 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)[6].

Accordingly, the Certificate will be treated as an annuity contract within the meaning of § 72.[7]

Requested Ruling #2

Section 165(a) allows as a deduction any loss not compensated for by insurance or otherwise.

Section 1.165-1(d)(2)(i) provides that if a casualty or other event occurs which may result in a loss, and in that year there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained until it can be ascertained with reasonable certainty whether or not the reimbursement will be received. Whether a reasonable prospect of recovery exists with respect to a claim for reimbursement of a loss is a question of fact to be determined upon an examination of all facts and circumstances.

In Dunne v. Commissioner, 29 B.T.A. 1109 (1934), aff'd, 75 F.2d 255 (2d Cir. 1935), the taxpayer and two others were the beneficial owners of three brokerage accounts that were opened at the recommendation of a wealthy friend who, desiring to assist them in making money on the stock market, guaranteed the accounts. The court held that the taxpayer's subsequent losses were not deductible because of the guarantee.

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[6] 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).

[7] Taxpayer 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.

In Boston Elevated Rwy v. Commissioner, 16 T.C. 1084, 1111-1112 (1951), aff'd on another issue, 196 F.2d 923 (1st Cir. 1952), the Service argued that loss resulting from the abandonment of an elevated railway structure was compensated for by legislation (the Public Control Act) guaranteeing the taxpayer operating profits sufficient to pay dividends. The court disagreed, stating that "regardless of the amounts of any possible losses sustained by petitioner, no payments would be forthcoming to it if its income were sufficiently high, after absorbing the losses and other charges, to pay the required dividends." 16 T.C. at 1112.

Johnson v. Commissioner, 66 T.C. 897 (1976), aff'd, 574 F.2d 189 (4th Cir. 1978), involved a business partnership formed by the taxpayer and an associate. The taxpayer purchased an insurance policy on his partner's life. After his partner's accidental death, the taxpayer and his partner's widow were unsuccessful in continuing the business and terminated the partnership. The court upheld the disallowance of a loss on the termination because the taxpayer was compensated by the proceeds of the insurance policy. The court pointed out that the amount of the policy was approximately equal to the taxpayer's investment in the partnership. Thus, although it was not the partnership interest itself that was insured, the life insurance acted to compensate the loss of the partnership interest.

In Forward Communications Corp. v. United States, 608 F.2d 485, 221 Ct. Cl. 582 (Ct. Cl. 1979), aff'g 1978 US Ct. Cl. LEXIS 766, 42 AFTR.2d (RIA) 5334, 78-2 USTC (CCH) ¶ 9542 (Ct. Cl. Trial Div. 1978), the taxpayer, a local television station, claimed a loss based on termination of its affiliation agreement with CBS, the television network. The trial judge upheld disallowance of the deduction on the theory that increased revenues from affiliation with ABC, another television network, compensated taxpayer for loss of the CBS affiliation. Reversing this finding, the Court of Claims stated, "[t]he statute does not bar a deduction for a loss actually incurred merely because the taxpayer is able to effect an offsetting gain on a different although contemporaneous transaction." 608 F.2d at 611-12.

In Shanahan v. Commissioner, 63 T.C. 21 (1974), which involved federal disaster relief payments, the Tax Court, interpreting the words "insurance or otherwise" in § 165, determined that the general term "or otherwise" must be construed consistently with the specific term "insurance." The court stated that the general purpose of insurance is to spread the risk of loss from any peril among a large number of those who are exposed to a similar peril.

In Estate of Bryan v. Commissioner, 74 T.C. 725 (1980), the court, citing Shanahan, determined that the phrase "insurance or otherwise" in an analogous provision, § 2054, contemplates that the type of compensation received must be such

that it was "structured to replace what was lost." 74 T.C. at 727. The court held that a disbursement from a trust fund established by a state bar association, in compensation for losses incurred due to an attorney's unethical behavior, was in the nature of insurance.

Rev. Rul. 87-117, 1987-2 CB 61, involves a regulated public utility that abandons a partially-completed nuclear plant; the ratemaking authority allows a rate increase that takes into account the cost of the abandoned plant. The ruling holds that the rate increase does not reduce the taxpayer's abandonment-loss deduction because the rate increase was structured to serve the utilities' customers at a fair charge and ensure a reasonable return to investors, not to reimburse the loss.

In the present situation, the Certificate may appear to be "structured to replace what was lost," in that the Monthly Benefit takes effect upon the reduction of the overall value of the assets in the Account to zero, and is based on the highest prior net value of those assets. Similarly, as a case like Johnson illustrates, it is possible for a contractual arrangement to be treated as compensation for § 165 purposes even though it compensates for a loss indirectly, not directly. However, in this case the relationship between any individual market loss in the Account and any eventual periodic payments under the Certificate is too tenuous and too contingent on a number of factors for the payments to be considered compensation for any given market loss. For example, Taxpayer may die before the Account is depleted, in which case the Monthly Benefit will never take effect. The assets in the investment portfolio are subject to specified investment strategies that are intended to minimize the effect of excessive volatility and market risk. There is no close correlation between any given loss and any eventual payments that Taxpayer may receive. Moreover, the fact, amount, and timing of the Monthly Benefit depends on market gains as well as losses; similarly, in Boston Elevated Rwy, "regardless of the amounts of any possible losses sustained by petitioner, no payments would be forthcoming to it if its income were sufficiently high, after absorbing the losses … ." 16 T.C at 1112. Withdrawals of principal, not just losses, will contribute significantly to depletion of the Account; in fact, the arrangement is structured primarily to insure against longevity risk, not market risk, and, should Taxpayer live long enough, even with moderate market gains he would eventually begin to receive the Monthly Benefit whether or not losses were sustained. Finally, the amount of compensation Taxpayer may receive under the Certificate depends on how long he lives, and is not tied to the amount of the losses. Thus, the fact, amount, and timing of the Monthly Benefit are contingent on a number of factors, including not only a particular market loss, but also other market losses, offsetting market gains, Taxpayer's withdrawal rate, and – most significantly --Taxpayer's life span. The contract is structured, not as reimbursement for market losses, but rather as a contingent, deferred annuity that begins to pay benefits on the occurrence of an event the timing of which may be influenced by market performance. We conclude that the Monthly Benefit

feature of the Certificate is not structured to replace or reimburse either individual or overall market losses in the Account portfolio. Cases such as Dunne and Johnson are distinguishable because the nexus between the losses and the compensation for the losses was more direct than is the case here.

Therefore, the Certificate will not create a right to reimbursement for losses realized on Account assets for purposes of § 165(a) and thus will not prevent Taxpayer from currently deducting such losses, assuming Taxpayer's losses otherwise meet the requirements of § 165.

This holding is based on and limited to the particular contract at issue, and the effect of that contract as represented by Taxpayer; it would not necessarily apply to a similar feature if the terms of the contract were significantly altered.

Requested Ruling #3

Under § 1(h)(11)(A), for purposes of § 1(h), the term "net capital gain" means net capital gain (determined without regard to § 1(h)(11)) increased by qualified dividend income. In defining qualified dividend income, § 1(h)(11)(B)(iii) provides that the term shall not include any dividend on any share of stock with respect to which the holding period requirements of § 246(c) are not met, determined by substituting in § 246(c) "60 days" for "45 days" each place it appears and by substituting "121-day period" for "91-day period".

Section 246 provides rules applicable to deductions for dividends received, among them a required holding period. See, § 246(c). Under § 246(c)(4), this holding period is reduced for any period (during such periods) in which (A) the taxpayer has an option to sell, is under a contractual obligation to sell, or has made (and not closed) a short sale of, substantially identical stock or securities, (B) the taxpayer is the grantor of an option to buy substantially identical stock or securities, or (C) under regulations a taxpayer has diminished his risk of loss by holding 1 or more other positions with respect to substantially similar or related property.

The applicable regulation is § 1.246-5, which provides that property is substantially similar or related to stock when (i) the fair market value of the stock and the property reflect the performance of (A) a single firm or enterprise; (B) the same industry or industries; or (C) the same economic factor or factors such as (but not limited to) interest rates, commodity prices, or foreign-currency exchange rates; and (ii) changes in the fair market value of the stock are reasonably expected to approximate, directly or inversely, changes in the fair market value of the property, a fraction of the fair market value of the property, or a multiple of the fair market value of the property. Sec. 1.246-5(b)(1). A position is an interest (including a futures or forward contract or

an option) in property or any contractual right to a payment, whether or not severable from stock or other property, § 1.246-5(b)(3). Moreover, a taxpayer has diminished its risk of loss on stock by holding a position in substantially similar or related property if the taxpayer is the beneficiary of a guarantee, surety agreement, or similar arrangement and the guarantee, surety agreement, or similar arrangement provides for payments that will substantially offset decreases in the fair market value of the stock. § 1.246-5(c)(4).

The Conference Report to the Deficit Reduction Act of 1984, H. Rep. No. 98-861, at 818, 1984-3 C.B. (Vol. 2) 1, 72, indicates that "[t]he substantially similar standard is not satisfied merely because the taxpayer … is an investor with diversified holdings and acquires a [regulated futures contract] or option on a stock index to hedge general market risks."

Here, by purchasing the Certificate, Taxpayer has not entered into an option to sell, is not under a contractual obligation to sell, or has not made (nor closed) a short sale of, substantially identical stock or securities. The Certificate is not substantially similar or related property because the fair market value of the Account and the Certificate do not reflect the performance of a single firm or enterprise, the same industry or industries, or the same economic factors; because the predominant risk the Certificate protects against is longevity risk (i.e., the benefit under the Certificate is contingent upon Taxpayer's survival), and because the changes in the fair market value of the Account are not reasonably expected to approximate, directly or inversely, changes in the fair market value of the Certificate, a fraction or multiple thereof. Finally, the benefits that may be ultimately paid under the Certificate are not closely correlated with, and do not substantially offset, decreases in the fair market value of the Account. Thus, we conclude that the Certificate does not diminish Taxpayer's risk of loss on Account assets for purposes of applying the holding period requirements of § 1(h)(11).

Requested Ruling #4

Section 1092 imposes special rules that effectively suspend losses with respect to positions that are held as part of a straddle.

A straddle is defined in § 1092(c)(1) as "offsetting positions with respect to personal property." A taxpayer holds "offsetting positions with respect to personal property" if there is a substantial diminution of the taxpayer's risk of loss from holding any position by reason of his holding one or more other positions with respect to personal property (whether or not of the same kind). See § 1092(c)(2)(A). Section 1092(d) provides that the term "personal property" means any personal property of a type which is actively traded and that the term "position" means an interest in personal property. The Certificate, however, is not an "offsetting position" with respect to

Taxpayer's interest in the Account. See also § 1092(d)(3). Accordingly, § 1092 does not apply.

The rulings 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; specifically, no opinion is expressed or implied concerning the proper tax treatment of the Group Contract/Certificate by IC or Sponsor.

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