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Legend

Taxpayer =

Issuer =

Group Contract =

Certificate =

Dear :

Taxpayer has requested several rulings regarding the application of certain provisions of the Internal Revenue Code to a contemplated transaction.

FACTS:

The Taxpayer represents that:

Issuer is a life insurance company within the meaning of § 816(a) of the Code, files its federal income tax return on a calendar year basis, and reports its income on an accrual method.

Issuer intends to issue Group Contract to an entity ("Sponsor") unrelated to Issuer that establishes and maintains certain investment account(s) ("Account") on behalf of an individual(s) ("Account Owner"). Issuer will offer Certificates under the Group Contract to eligible Account Owners. The Certificate will provide certain benefits,

primarily a benefit of a specified amount ("Annual Benefit") in the event the value of the Account is depleted before the Account Owner's demise.

The measuring life – the 'annuitant' – is generally the Account Owner; if the Certificate is owned by an entity,[1] the measuring life is a natural person who has a beneficial interest in the Account. Upon purchase of the Certificate, the Account Owner can elect to have the Annual Benefit payable for either the Account Owner's life or through the life of the second to die of the Account Owner and the Account Owner's spouse;[2] this election is a factor in the computation of factors applied to determine benefits and charges under the Certificate.

Issuer will offer a certificate for purchase by Account Owner who must:

a. be within a certain age range and establish an Account with Sponsor that falls within stated minimum and maximum values ("Account Value");
b. allocate the Account Value among "Permitted Investment Profiles" and otherwise invest the Account Value in accordance with general guidelines specified and conduct all trading activity through an approved broker-dealer;
c. provide Issuer the information necessary to administer the Group Contract; and,
d. pay a periodic fee ("Certificate Charge").

The Permitted Investment Profiles are designed by Issuer in conjunction with Sponsor to limit volatility and investment losses within the Account that would increase Issuer's obligation to provide benefits under the Certificate. Though some of the permitted investments may include mutual funds or exchange traded funds that an affiliate of Issuer manages, there will be no limitation or requirement that the available funds have any affiliation with Issuer; the objective criteria used to identify approved investments will not have the effect of limiting the universe of available investments to those that share an affiliation with Issuer.

The Sponsor must designate a fixed income mutual fund(s) to serve as the "Home Base Fund" within each Account. The Account, including this Home Base Fund, is not property of Issuer or Sponsor; assets in the Account are not treated as assets of Issuer for financial or regulatory accounting purposes, and do not secure any rights or claims of the Issuer or Sponsor against the Account Owner, or obligations of the Account Owner to the Issuer or Sponsor.

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[1] As allowed by § 72(u)(1).

[2] Taxpayer represents that any payout under the Certificate will be consistent with § 72(s).

The Account Owner is the legal owner of the assets in the Account, including those in the Home Base Fund, and can withdraw monies subject to the restrictions imposed by the Certificate.

The Account Owner must rebalance the Account at least quarterly. Issuer and Sponsor will monitor the performance of the profiles and the accounts subject to the Group Contract. Sponsor will correct any imbalance caused by market value fluctuations. Issuer will monitor the performance daily by measuring the Account against a quotient derived from a specified formula. If the measure of the Account exceeds this quotient, Issuer will direct Sponsor to liquidate a portion of the assets held in the Account and allocate the proceeds to the Home Base Fund. If the measure of the Account is inferior to this quotient, Issuer will direct Sponsor to liquidate a corresponding portion of the Account allocated to the Home Base Fund and invest it according to the Permitted Investment Profile.

The benefit provided by the Certificate is determined by reference to an "Annual Income Amount," which is the maximum amount the Account Owner may withdraw each year from the Account without certain consequences described below. The initial Annual Income Amount is determined at the time the first withdrawal is made after the issuance of the Certificate, by applying a "Withdrawal Factor" to the "Withdrawal Base" then in effect. The Withdrawal Base is determined each day, by reference to both market values and any applicable specified "Guaranteed Increase Rate" (expressed as an annual interest rate) or "Guaranteed Base Increase." The precise mechanics of this determination is different once there has been a withdrawal from the Account; additions to the Account (e.g., additional contributions) are included in determining the Withdrawal base provided they do not cause the Account Value to exceed a specified maximum limit.[3]

An amount withdrawn during the year that exceeds the Annual Income Amount is an "Excess Withdrawal." An Excess Withdrawal proportionately reduces both the Annual Income Amount and the Withdrawal Base. Except for adjustments resulting from Excess Withdrawals, the Annual Income Amount is not reduced. If the amount withdrawn from the Account during a year is less than the Annual Income Amount (e.g., if there were no withdrawal), the un-withdrawn Annual Income Amount does not increase the Annual Income Amount for subsequent years.

If the Account Value is reduced to zero by other than an Excess Withdrawal, Issuer will commence payments of an "Annual Benefit."[4] Thus, an Annual Benefit under

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[3] The specified maximum limit is a restraint on contributions. There is no specified limit on the value of the Account resulting from the performance of the Permitted Investment Profile.

[4] The default modality of payment is annual.

the Certificate is payable if the value of the Account is reduced to zero solely by withdrawals of the Annual Income Amount, not as a result of losses incurred in the Account. The amount of the Annual Benefit is equal to the Annual Income Amount in effect as of the date the Account Value was reduced to zero for reasons other than Excess Withdrawals. In the year in which the Account Value is reduced to zero, the Annual Benefit equals the Annual Income Amount not yet withdrawn in that year. The Annual Benefit is payable until the demise of the measuring life under the Account.

The Certificate Fee is determined by applying a “Fee Factor” to the greater of the Withdrawal Base and the Account Value. The fee is charged until the earlier of the commencement of the Annual Benefit and termination of the Certificate.[5] Payment of the Certificate Fee from the Account is not treated as a withdrawal.

Prior to the commencement of the Annual Benefit, the Certificate terminates upon the happening of specified events:

1. the Account Owner elects to terminate the Certificate;
2. the Account Owner dies;
3. the Account Owner fails to timely pay the Certificate Fee;
4. the Account Owner depletes the Account because of an Excess Withdrawal;
5. the Account Owner or the Sponsor fails to adhere to the Permitted Investment Profile;
6. the Group Contract terminates before the annuity purchase guarantee is exercised or Annual Benefit payments have commenced; or,
7. the Account Owner closes the Account without exercising the annuity purchase guarantee.

Upon termination of the Certificate the portion of the Account Value allocated to the Home Base Fund will be liquidated.

The Group Contract can be terminated at the discretion of Issuer if:

1. Sponsor fails to comply with the provisions of the Group Contract (including violation of any applicable law);
2. Sponsor stops administering the Group Contract without arranging with Issuer for a successor administrator; or,
3. Issuer and Sponsor agree to terminate the Group Contract.

[5] With respect to any applicable Guaranteed Base Increase feature, the Certificate Fee will be increased to the current rate offered for new Certificates. At such time the Account Owner will have the opportunity to forfeit future applicable Guaranteed Base Increases instead.

If the Group Contract is terminated, Issuer will pay the Account Owner an amount that represents the excess of the fair market value of the Certificate over the current Account Value.[6]

If the Group Contract or Certificate is terminated after Issuer has begun paying the Annual Benefit, the Annual Benefit will not be affected and will continue.

The Certificate also entitles the Account Owner to apply the Account Value to purchase a stream of annuity payments ("Annuity Payments") at rates specified in the Certificate, for either life or life with a period certain. Part of the process of effecting this option is for the Account to be liquidated and the proceeds transferred to Issuer.

Sponsor may assign the Group Contract with Issuer's consent as permitted by applicable law but the Certificate may not be assigned.

Taxpayer is an individual taxable under the Internal Revenue who is contemplating becoming an Account Owner and purchasing a Certificate.

REQUESTED RULINGS

Taxpayer requests the following rulings:

1. The Group Contract and Certificate will constitute an annuity contract for purposes of § 72;

2. The Annual Benefit and Annuity Payments will be taxable as "amounts received as an annuity" using an "exclusion ratio" under § 72(b);

3. The Account will not cause the Group Contract or Certificate to have a "cash value" or "cash surrender value" for purposes of § 72, and will not otherwise be part of the Group Contract or Certificate for federal tax purposes;

4. For purposes of § 72(c)(1) and § 72(e)(6) (each defining "investment in the contract"), the "aggregate amount of premiums or other consideration paid" for the Certificate will equal the sum of all Certificate Fees paid under the Certificate plus any proceeds paid to Issuer upon liquidation of the Account in consideration for Annuity Payments;

5. Dividends that the Taxpayer receives from the assets in the Account will not fail to be treated as "qualified dividend income" within the meaning of § 1(h)(11)(B) merely because he also owns the Certificate;

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[6] That is, the present value of the projected future Annual Benefit over the current Account Value.

6. The taxpayer's ownership of the Certificate and the Account will not be treated as a straddle under § 1092; and,

7. The Annual Benefit will not constitute insurance or other compensation for any prior deductible losses in the Account for purposes of § 165 and the "investment in the contract" portion of each Annual Benefit will not be includible in the Taxpayer's gross income by virtue of the 'tax benefit rule.'

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 Certificate possess the essential attributes of an annuity. It is true that the Certificate may not, "at the election of the [Account Owner], 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 for the Annual Benefit is contingent upon the value of the Account being exhausted while Account Owner is alive, it is not the case that "if [Account Owner] 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 Group Contract and Certificate and the amounts paid under the Group Contract and 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 Group Contract and 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 Account Owner 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 Group Contract and Certificate is not a contract to pay interest. See § 1.72-14(a).

Accordingly, the Group Contract and Certificate will constitute an annuity contract for purposes of § 72.

Requested Ruling #2

Section 72(a) provides that 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 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 annuity starting date) bears to the expected return under the contract (as of such date).

Section 72(c)(4) defines “annuity starting date” as the first day of the first period for which an amount is received as an annuity under the contract.

Section 1.72-2(b)(2) defines “amounts received as an annuity” as only those amounts that meet all of the following tests:

a. they must be received on or after the ‘annuity starting date’ as that term is defined in § 1.72-4(b);
b. they must be payable in periodic installments at regular intervals (whether annually, semiannually, quarterly, monthly, weekly, or otherwise) over a period of more than one full year from the annuity starting date; and
c. except as indicated in § 1.72-2(b)(3), the total of the amounts payable must be determinable at the annuity starting date either directly from the terms of the contract or indirectly by use of either mortality tables or compound interest computations, or both, in conjunction with such terms and in accordance with sound actuarial theory.

Section 1.72-4(b) defines “annuity starting date” as 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 whichever of the following is the later:

a. the date upon which the obligations under the contract became fixed, or

b. the first day of the period (year, half-year, quarter, month, or otherwise, depending on whether payments are to be made annually, semiannually, quarterly, monthly, or otherwise) which ends on the date of the first annuity payment.

Here, with respect to the Annual Benefit, when the Annual Benefit becomes payable the obligations under the Certificate become fixed: no additional Certificate Charges are due and the benefit obligation of Taxpayer is fixed at paying the Annual Benefit until the annuitant(s)' demise. Hence, the Annual Benefit will be received on or after the annuity starting date.

Second, the Annual Benefit will be paid periodically at regular intervals over a period of more than one full year from the annuity starting date (unless death occurs).

Third, the total amount payable is determinable from the Certificate using mortality tables and sound actuarial theory.

Accordingly, the Annual Benefit will be an "amount received as an annuity."

With respect to the Annuity Payment, if the Account Owner exercises that option the obligations under the Certificate become fixed: no additional Certificate Charges are due and the benefit obligation of Taxpayer is to pay the annuity settlement option consistent with the rate guarantee. Hence, the Annuity Payments will be received on or after the annuity starting date.

Second, the Annuity Payments will be paid periodically at regular intervals over a period of more than one full year from the annuity starting date, consistent with the annuity settlement option.

Third, the total amount payable is determinable from the Certificate's rate guarantee using mortality tables and sound actuarial theory.

Accordingly, the Annuity Payment will be "an amount received as an annuity."

Either the Annual Benefit or the Annuity Payment[7] will be taxable under § 72(a) as an amount received as an annuity, subject to the exclusion of the amount allocable to the investment in the contract determined under § 72(b).

Requested Ruling #3

[7] The Account Owner cannot receive both.

Section 72 does not define the terms “cash value” or “cash surrender value” with regard to an annuity contract. With regard to a life insurance contract, § 7702(f)(2)(A) defines “cash surrender value” as “cash value determined without regard to any surrender charge, policy loan, or reasonable termination dividend.” Section 1.7702-2(h)(2) of the Proposed Income Tax Regulations defines “cash surrender value” of a life insurance contract as generally equaling its “cash value”, which in turn is defined by proposed § 1.7702-2(b)(1) as “the maximum amount payable under the contract (determined without regard to any surrender charge or policy loan); or the maximum amount that the policyholder can borrow under the contract.”[8] See also H.R. Rep. No. 98-432 at 1444.

The common definition of “cash surrender value” is “the amount made available, contractually, to a withdrawing policyowner who is terminating his or her prortection.” Kenneth Black, Jr. & Harold D. Skipper, Jr., LIFE & HEALTH INSURANCE 46 (13th ed. 2000); see also John H. Magee, LIFE INSURANCE 599 (3d ed. 1958) (“The cash value represents the amount available to the policyholder upon the surrender of the life insurance contract.”)

Rev. Rul. 77-85, 1977-1 C.B. 12, addressed an arrangement involving an ‘investment annuity policy’ that has some features similar to Taxpayer’s proposed arrangement. In the ruling,

> [t]he policyholder may not receive any amount directly from the account and may not receive a distribution of assets in kind. At any time prior to the annuity starting date, however, the policyholder may make a full or partial surrender of the policy to the insurance company. If such a surrender is made, the custodian is directed by the agreement to sell all or part of the assets as appropriate and to pay over the necessary proceeds to the insurance company. The insurance company in turn will make the full or partial cash surrender payment to the policyholder in an amount equal to the proceeds received by the insurance company from the account, less any cash surrender charges.

The ruling does not address whether the underlying account created any “cash value” or “cash surrender value” for the investment annuity policy. Nonetheless, it illustrates the contrast in the mechanics of the Certificate. The Certificate cannot be

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[8] Cf. § 1.7702-2(b)(2), which provides certain exclusions from cash value, none of which are relevant to this discussion.

monetized at the discretion of Account Owner[9] other than through receipt of Annual Benefit or exercise of the option to receive Annuity Payments. It cannot be assigned or surrendered in whole or part in exchange for cash. The connection to the Account is unlike that in the ruling – the Account Value is used to only pay the Certificate Fee or to purchase the Annuity Payments if that option is exercised. The Account Owner can access the Account Value without operation of the Certificate, though with consequences if, for example, such access produces an Excess Withdrawal or investments outside the Permitted Investment Profile.

Although the Certificate has utility only in conjunction with an eligible Account under the auspices of Sponsor, 'controls' the Account Owner's activities with regard to that Account, and cannot be alienated or otherwise monetized, the Account is not so intertwined with Certificate as to be effectively part of the Certificate. Cf. Rev. Rul. 77-85; Rev. Rul. 2003-97, 2003-2 C.B. 380.

Requested Ruling #4

Section 72(c)(1) provides that, for purposes of the exclusion ratio under § 72(b), the "investment in the contract" as of the annuity starting date is the aggregate amount of premiums or other consideration paid for the contract, minus the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income. Under § 72(c)(2), this amount is then reduced by the value of the refund feature, if any.

Section 72(e)(6) provides that for purposes of § 72(e), the "investment in the contract" as of any date is the aggregate amount of premiums or other consideration paid for the contract before such date, minus the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income.

As mentioned, Rev. Rul. 77-85 addressed an arrangement with some similar features. That ruling held that the issuer should include in its premium income only the premiums and charges paid each year.

Accordingly, with regard to the Annual Benefit, the Certificate Fee should be taken into account in the determination of an Account Owner's "investment in the contract" for the Certificate under § 72; with regard to Annuity Payments, both the Certificate Fee and the amount remitted to Taxpayer upon exercise of the option to

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[9] If the Group Contract is terminated before either the Annual Benefit commences or the option to receive Annuity Payments is exercised, Taxpayer will pay the termination amount described above. This amount is not available at the discretion of the Account Owner hence is not the monetization contemplated by "cash value" or "cash surrender value."

receive Annuity Payments should be taken into account in the determination of Account Owner's "investment in the contract" for the Certificate under § 72.

Requested Ruling #5

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."

The purchase of the Certificate will not cause Taxpayer to have an option to sell, to be under a contractual obligation to sell, or to have made (and not 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 #6

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

Requested Ruling #7

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.

In Boston Elevated Railway Co. 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 (Ct. Cl. 1979), 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 Annual Benefit may appear to be "structured to replace what was lost," in that the Annual Benefit takes effect upon the reduction of the overall value of the Account to zero, and may reflect a percentage of the highest prior net value of the Account. 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.

In this case, however, the relationship between any individual market loss on the Account and any eventual payment of the Annual Benefit 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, the Account Owner may die before the Account is depleted, in which case the Annual Benefit will never take effect. Even if the recipient of the Annual Benefit (the Account Owner or, if elected upon purchase, the second to die of the Account Owner or the Account Owner's spouse) begins receiving the Annual Benefit, the recipient is entitled to the Annual Benefit only while he or she is alive and, thus, there is no certainty that the recipient will live long enough to be fully compensated for market losses on the Account before recovering associated Certificate Fees.

There is no close correlation between any given loss and any eventual payments that Taxpayer may make. Once determined at the time of the initial withdrawal from the Account, the Annual Income Amount, which the Annual Benefit is based on, may be increased but may not be decreased except for Excess Withdrawals. Withdrawals from the Account, and not just investment 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 the Permitted Investment Profile(s) is intended to minimize the effect of excessive volatility and market risk. Should the recipient live long enough and

if the withdrawals from the Account do not constitute Excess Withdrawals, the Annual Benefit could become payable even if no losses were sustained.

Thus, the facts are similar to those considered in Boston Elevated Railway Co., where the court noted 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 … ." 16 T.C. at 1112. The fact, amount, and timing of the Annual Benefit are contingent on a number of factors, including not only a particular market loss, but also other market losses, offsetting market gains, the Account Owner's withdrawal rate, Excess Withdrawals, and – most significantly – the Account Owner'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. The Certificate is not structured to replace or reimburse either individual or overall market losses on the Account. 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 in the Account for purposes of § 165(a) and thus will not prevent the Account Owner from currently deducting such losses, assuming the Account Owner's losses otherwise meet the requirements of § 165.

Section 61(a) provides that, except as otherwise provided, gross income means all income from whatever source derived.

Section 111(a) provides that gross income does not include income attributable to the recovery during the taxable year of any amount deducted in a prior taxable year to the extent that amount did not reduce the amount of tax imposed by chapter 1 of the Code.

The tax benefit rule allays some of the inflexibilities of the annual accounting system under specific circumstances. Generally, the tax benefit rule requires a taxpayer who received a tax benefit from a deduction in an earlier year to recognize income in a later year if there occurs an event that is fundamentally inconsistent with the premise on which the deduction was initially based. See Hillsboro National Bank v. Commissioner, 460 U.S. 370, 377 (1983). The tax benefit rule will "cancel out" an earlier deduction when the later event is fundamentally inconsistent with the premise on which the deduction was initially based, even if there is no actual recovery of funds. 460 U.S. at 381-383.

To the extent that the Annual Benefits are treated as "amounts received as an annuity" as requested in Ruling Request #2 above, the Taxpayer will use an "exclusion ratio" under § 72(b) to determine the taxable portion of each Annual Benefit. A portion

of the Annual Benefit payment representing premiums or other consideration paid in for the contract will then be treated as non-taxable "investment in the contract" for purposes of § 72(c)(1) and §72(e)(6). The return of investment in contract might be recharacterized as taxable income under the tax benefit rule if it were viewed as an event that is fundamentally inconsistent with the premise on which an earlier loss deduction was based. We conclude, however, that for the same reasons that the Annual Benefits will not be considered compensation for losses incurred in the Account for purposes of § 165, their receipt will not be fundamentally inconsistent with the premise of the § 165 deduction, for purposes of the tax benefit rule.

RULINGS

Based on the foregoing,

1. The Group Contract and Certificate will constitute an annuity contract for purposes of § 72.

2. The Annual Benefit and Annuity Payments will be taxable as "amounts received as an annuity" using an "exclusion ratio" under § 72(b).

3. The Account will not case the Group Contract or Certificate to have a "cash value" or "cash surrender value" for purposes of § 72, and will not otherwise be part of the Group Contract or Certificate for federal tax purposes.

4. For purposes of § 72(c)(1) and § 72(e)(6) (each defining "investment in the contract"), the "aggregate amount of premiums or other consideration paid" for the Certificate will equal the sum of the Certificate Fees paid under the Certificate plus any proceeds paid to Issuer upon liquidation of the Account in consideration of Annuity Payments.

5. Dividends that the Taxpayer receives from the assets in the Account will not fail to be treated as "qualified dividend income" within the meaning of § 1(h)(11)(B) merely because he also owns the Certificate;

6. The Taxpayer's ownership of the Certificate and the Account will not be treated as a straddle under § 1092; and,

7. The Annual Benefit will not constitute insurance or other compensation for any prior deductible losses in the Account for purposes of § 165 and the "investment in the contract" portion of each Annual Benefit will not be includible in the Taxpayer's gross income by virtue of the 'tax benefit rule.'

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 upon 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, including but not limited to including but not limited to issues under Subchapter D (§ 401 et seq.), the computation of the exclusion ratio under § 72(b), or the treatment of any transaction within or between the Account and the Home Base Fund.

This ruling is directed only to the taxpayer requesting it. 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
Branch Chief, Branch 4
(Financial Institutions & Products)