Internal Revenue Service

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Person To Contact:
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March 10, 2014

Legend:

Taxpayer =

State =
Geographic Area =
Parent =

Age Range =
Age X =
Age Y =
A =
B =

Dear :

This is in response to the letter submitted by your authorized representative, requesting rulings on the application of certain sections of the Internal Revenue Code (the "Code") to an annuity product that Taxpayer intends to offer.

Taxpayer is a stock life insurance company organized and operated under the laws of State. Taxpayer represents that it qualifies as a life insurance company under section 816(a) of the Code and that it is licensed to engage in the life insurance business in Geographic Area.

Taxpayer joins in the filing of a consolidated federal income tax return with Parent, who is the common parent of the affiliated group that includes Taxpayer. The consolidated return is filed on a calendar year basis using an accrual accounting method.

Taxpayer intends to offer a new term certain annuity option with variable payments (the "New Annuity Option") with non-qualified deferred variable annuity contracts (the "Contracts").

The Contracts are variable contracts within the meaning of section 817(d) of the Code and are registered with the Securities and Exchange Commission ("SEC") under the Securities Act of 1933. Each Contract offers various investment options to which the owner may allocate net premiums and earnings thereon.

An Owner can elect any time prior to the Contract's maturity date to apply the Contract's account value to an annuity option. The New Annuity Option will be made available to Owners in addition to other annuity options offered by Taxpayer pursuant to the Contracts. An Owner can elect the New Annuity Option only if a minimum account value will be applied to the New Annuity Option. In addition, the account value must be greater than the investment in the contract.

In order to elect the New Annuity Option, the Owner must be in the Age Range on the business day on which Taxpayer receives an Owner's election of the New Annuity Option (i.e., the "Election Receipt Date" of the option). In the case of joint Owners, both Owners must meet the age requirement. If the Contract has one individual Owner or has a non-natural Owner with a single annuitant, the Owner can add an individual as a contingent Owner or joint annuitant to the Contract, provided that the individual meets the age requirements just described.

On the Election Receipt Date, the Owner will select the number of years in the term certain annuity (the "Annuity Term"). Owners may not select an Annuity Term that extends beyond the year in which the Owner attains Age X or, in the case of joint or contingent Owners, the year in which the younger Owner attains Age Y. The Owner can choose an Annuity Term that is shorter than the maximum Annuity Term. However, the Annuity Term must be at least A or B years, depending on the Contract. Once the Annuity Term is established, the duration of the Annuity Term cannot be changed (except that the Annuity Term can be reduced as a result of commutation, as discussed below).

After the Election Receipt Date, but on or before the date the first payment is made under the New Annuity Option (the "Starting Payment Date"), the Owner can revoke the election of the New Annuity Option and elect another annuity option. Absent a revocation, on or after the Election Receipt Date the Owner cannot assign or change ownership of the Contract and the Owner also cannot change the annuitants. Moreover, unless there is a revocation, on or after the Election Receipt Date, the duration of the Annuity Term cannot be changed (except that the Annuity Term can be reduced in certain circumstances as a result of commutation). Finally, the Owner may not pay additional premiums to the Contract on or after the Election Receipt Date, absent a revocation.

Taxpayer will determine the annual amount to be paid under the New Annuity Option (the “Yearly Payment Amount”) on the “Calculation Date.” The Calculation Date for the first Yearly Payment Amount is the Election Receipt Date. The Calculation Date for each subsequent Yearly Payment Amount is the day before the anniversary of the Election Receipt Date.

The Yearly Payment Amount for a year will be determined by dividing the Contract’s account value as of the Calculation Date for the year by a whole number. In the year the Owner elects the New Annuity Option, the divisor will be the number of years in the Annuity Term selected by the Owner. In each subsequent year the divisor will be the Annuity Term minus the number of years that have elapsed since the Election Receipt Date. The Contract’s account value on the Calculation Date will fluctuate from year to year due to the periodic payments that will be made from the account value, the investment gains and losses of the variable sub-account investments, and the crediting of interest above the minimum interest rate guarantee under the fixed account, if any.

Due to the annual changes in the account value and the remaining Annuity Term, the Yearly Payment Amount will also change annually. However, over the duration of the Annuity Term the account value will always decrease and in the final year of the Annuity Term the account value will be reduced to zero and the Contract will terminate.[*]

The Yearly Payment Amount can be paid annually or in monthly or quarterly installments (“Periodic Payments”), as elected by the Owner. The amount of each Periodic Payment in a year is equal to the Yearly Payment Amount for the year divided by the number of installment payments to be made each year. In other words, if the Owner elects to receive the Yearly Payment Amount in monthly installments, each Periodic Payment to be made in the year will equal the Yearly Payment Amount for the

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[*]

year divided by 12. As described above, the Yearly Payment Amount will vary from year to year, but the amount of each Periodic Payment within a year will be the same, except as discussed in the next paragraph.

If the Contract's account value is less than or equal to the Periodic Payment due, the remaining account value will be paid and the Contract will terminate. In the last year of the Annuity Term, the account value on the date of the last scheduled Periodic Payment could be more than the amount of the scheduled payment, because, for example, of positive investment performance since the previous Periodic Payment. In that event, the scheduled Periodic Payment will be increased to an amount equal to the remaining account value and the Contract will terminate.

Any time after the Starting Payment Date, the Owner can redeem part or all of the Contract's account value. If the Owner redeems only a portion of the account value, the amount of each subsequent Yearly Payment Amount, and thus, each Periodic Payment payable in subsequent years after the redemption, will be partially commuted because of the redemption. If the Owner redeems all of the remaining account value, the Periodic Payments will end and the Contract will terminate. Taxpayer will treat amounts received by Owner in connection with a complete commutation as includible in income to the extent that they exceed the remaining investment in the contract, and amounts received in connection with a partial commutation as fully includible in income.

If any Owner dies or, in the case of a Contract held by a non-natural Owner, the annuitant dies, on or after the Starting Payment Date, the surviving joint or contingent Owner (or surviving joint annuitant, if there is a non-natural Owner), if any, will be treated as the "beneficiary" and will continue the Periodic Payments for the remainder of the Annuity Term. If there is no surviving joint or contingent Owner (or in the case of a non-natural Owner, no surviving joint annuitant), the Periodic Payments will be made to the beneficiary (or beneficiaries) named under the Contract for the remainder of the Annuity Term. Periodic Payments will continue to be made at least as rapidly as before the death and the account value will be depleted by the end of the Annuity Term. A beneficiary, including a beneficiary that is any surviving joint or contingent Owner (or surviving joint annuitant, if there is a non-natural Owner), has the option to partially or fully commute the remaining Yearly Payment Amounts and thus, the future Periodic Payments.

If multiple beneficiaries are named under the Contract, the account value will be divided into shares for each beneficiary. The proportionate shares of the Periodic Payments will continue to be made to each beneficiary for the remaining Annuity Term; however, each beneficiary may partially or fully commute the beneficiary's share. The Election Receipt Date anniversary remains the same for each beneficiary electing to continue the New Annuity Option. Finally, Periodic Payments may continue to successive beneficiaries until the account value falls to zero, including through commutations.

ADDITIONAL REPRESENTATIONS

Taxpayer makes the following additional representations:

1. The Contracts are annuity contracts under the laws of the states and other jurisdictions in which they are issued.

2. The Contracts satisfy the requirements of section 72(s).

3. The segregated asset accounts in which the Contracts invest are adequately diversified within the meaning of section 817(h) and the regulations thereunder.

4. For federal tax purposes, Taxpayer is the owner of the assets held in the segregated asset accounts.

REQUESTED RULINGS

1. The portion of each Periodic Payment that does not exceed the amount allocable to the investment in the contract is treated as an amount received as an annuity and will be excludable from gross income. The excess (if any) of each Periodic Payment over such portion will be treated as an amount not received as an annuity on or after the annuity starting date and will be includible in gross income.

2. On and after the date an Owner elects the New Annuity Option, no amount will be includible in gross income before it is actually paid under the New Annuity Option.

LAW AND ANALYSIS

Requested Ruling 1

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

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

Section 72(b)(2) provides that the portion of any amount received as an annuity which is excluded from gross income under section 72(b)(1) shall not exceed the unrecovered investment in the contract immediately before the receipt of such amount.

Section 72(c)(4) provides, generally, for purposes of section 72, that the annuity starting date in the case of any contract is the first day of the first period for which an amount is received as an annuity under the contract.

Section 1.72-4(b)(1) of the Income Tax Regulations (the "Regulations") provides, generally, that the first day of the first period for which an amount is received as an annuity under the contract is the later of (i) the date upon which the obligations under the contract become fixed or (ii) the first day of the period which ends on the date of the first annuity payment.

Section 1.72-2(b)(2) provides that amounts subject to section 72 of the Code are considered "amounts received as an annuity" only in the event that all of the following tests are met:

(i) They must be received on or after the "annuity starting date" as that term is defined in Section 1.72-4(b) of the Regulations;

(ii) 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

(iii) Except as indicated in section 1.72-2(b)(3) of the Regulations, 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 the use of either mortality tables or compound interest computations, or both, in conjunction with such terms and in accordance with sound actuarial theory.

Section 1.72-2(b)(3) provides, notwithstanding the requirement of section 1.72-2(b)(2)(iii), if amounts are to be received for a definite or determinable time (whether for a period certain or for a life or lives) under a contract which provides that the amount of the periodic payments may vary with investment experience, then each such payment received shall be considered as an amount received as an annuity only to the extent that it does not exceed the amount computed by dividing the investment in the contract, as adjusted for any refund feature, by the number of periodic payments anticipated during the time periodic payments are to be made. If payments are to be made more frequently than annually, the amount so computed shall be multiplied by the number of periodic payments to be made during the taxable year for the purpose of determining the total amount which may be considered received as an annuity during such year. To this extent, the payments received shall be considered to represent a return of premiums or other consideration paid and shall be excludable from gross income in the taxable year in which received. To the extent that the payments received under the contract during the taxable year exceed the total amount thus considered to be received as an annuity during such year, they shall be considered to be amounts not received as an annuity and shall be included in the gross income of the recipient.

Here, each Periodic Payment under the New Annuity Option will be made after the annuity starting date. Second, the Periodic Payments will be payable at regular intervals over a period of more than one full year from the annuity starting date. Third, the amounts payable will be determined in a way that complies with section 1.72-2(b)(3) of the Regulations.

Requested Ruling 2

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

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

An annuity contract consists of an accumulation phase and a phase subsequent to the annuity starting date, commonly referred to as annuitization. During the accumulation phase, all amounts received by the holder are "amounts not received as an annuity." During the annuitization phase, if the requirements of sections 1.72-2(b)(2) and (3) are met, amounts received by the holder may be characterized as "amounts received as an annuity." During the annuitization phase, amounts received by the holder may, in certain circumstances, be characterized as "amounts not received as an annuity." See section 72(e)(2)(A) of the Code section 1.72-2(b)(3)(i) of the Regulations. Regardless of the characterization of the payments made as "amounts received as an annuity" or "amounts not received as an annuity," no amount should be considered constructively received by an annuitant before its actual payment under the proposed distribution methods for several reasons.

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

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

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

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

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

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

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

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

Third, section 72(e)(4)(A), which provides generally that if an individual receives a loan under an annuity contract or pledges a portion of the value of such contract, the amount of the loan or the portion of the value pledged will be treated as an amount not received as an annuity, is inconsistent with applying the doctrine of constructive receipt to annuities. If the doctrine of constructive receipt applied, the increase in the annuity's cash value would be taxed once and would in many cases be subject to tax a second time as an amount not received as an annuity under section 72(e)(2), a result inconsistent with general income tax principles.

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

Fifth, neither does section 72(u) operate to require the designated beneficiary to include amounts in gross income prior to actual receipt. Section 72(u) only requires, prior to actual receipt, the recognition of the income on the contract, in certain cases in which the annuity contract is held by certain nonnatural persons. As defined in section 72(s)(4), for purposes of section 72(s), the term "designated beneficiary" means any individual designated a beneficiary by the holder of the contract.

HOLDINGS

1. Each Periodic Payment received under the New Annuity Option shall be considered as an "amount received as an annuity" within the meaning of section 72(b)(1) only to the extent that it does not exceed the amount computed by dividing the investment in the Contract by the number of Periodic Payments anticipated during the time that the Periodic Payments are to be made. To this extent, the Periodic Payments received shall be considered to represent a return of premiums or other consideration paid and shall be excludable from gross income in the taxable year in which received. To the extent that the Periodic Payments received under the New Annuity Option during the taxable year exceed the total amount thus considered to be received as an annuity during such year, they shall be considered to be amounts not received as an annuity and shall be included in the gross income of the recipient.

2. On and after the date an Owner elects the New Annuity Option, no amount will be includible in gross income before it is actually paid under the New Annuity Option.

CAVEATS

Taxpayer will have no mortality or morbidity risks associated with the New Annuity Option, so it will take no life insurance reserve to support any portion of a Contract that is applied to the New Annuity Option.

Except as expressly provided herein, no opinion is expressed concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. The rulings contained in this letter are based upon information and representations submitted by Taxpayer and accompanied by a penalties of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination. This ruling is directed only to the taxpayer who requested 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 representatives.

Sincerely,

SHERYL B. FLUM
Branch Chief, Branch 4
Office of the Associate Chief Counsel
(Financial Institutions & Products)

cc: