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Refer Reply To:
CC:FIP:4-PLR-126743-02
Date:
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Legend

Taxpayer =

Parent =

State X =

Form1 =

Form 2 =

Form X =

Form Y =

Dear :

This is in response to your submission dated May 10, 2002, and subsequent submissions, requesting rulings regarding the treatment, for Federal income tax purposes, of certain payments under certain annuity contracts issued by Taxpayer.

FACTS

Taxpayer represents that it is a life insurance company within the meaning of § 816(a) of the Internal Revenue Code, taxable as such under § 801.

PLR-126743-02

Taxpayer is a wholly owned subsidiary of Parent. Parent and its subsidiaries have elected, under § 1504(c)(2) of the Code, to file a life non-life consolidated Federal income tax return. As the common parent, Parent reports the group's income using the accrual method and files the consolidated return on a calendar year basis.

Taxpayer is a stock life insurance company organized under the laws of State X. It is licensed to conduct insurance business in all 50 states, the District of Columbia and Puerto Rico. Among other business activities, Taxpayer issues group annuity contracts with individual certificates. This request concerns certificates issued to individuals under Taxpayer's Form 1 and Form 2 labels.

The Form 1 contract is comprised of a group annuity contract (Form X), the Form 1 certificate, and Data Pages (Form Y). The Form 2 contract, which is substantially identical to the Form 1 contract, is comprised of the same group annuity contract and the Form 2 certificate and Data Pages. (Hereinafter the Form 1 and Form 2 contracts are referred to as the "Contracts").¹

The Contracts are the type of annuity contract commonly referred to as "non-qualified" deferred variable annuity contracts purchased with "after-tax" money. Premiums for the Contracts (called "contributions") may be paid at any time before the Annuity Commencement Date ("ACD").² The contractowner may allocate its contributions and earnings thereon among various variable investment options and fixed investment options available under the Contracts. Each variable investment option corresponds to an investment fund of a Taxpayer separate account. The sum of the amounts held for the contractowner in the investment options is called the "Annuity Account Value."

Taxpayer represents that each investment fund of each separate account underlying the Contracts will, at all relevant times, meet the asset diversification requirements of § 817(h) and Treas. Reg. § 1.817-5. Taxpayer further represents that it is the owner, for Federal income tax purposes, of the assets of the separate accounts underlying the Contracts.

Additional features of the Contracts are described further below.

¹ Differences between the Form 1 contract and the Form 2 contract relate primarily to the periods during which they have been marketed, the distribution channels used, some of the investment options, and a few of the product features. None of the differences are relevant to this request.

² The group annuity contract defines the ACD as the date on which annuity payments are to commence. Compare this to the definition of "annuity starting date" in § 72(c)(4) and Treas. Reg. § 1.72-4(b)(1). The two definitions are not identical.

PLR-126743-02

A. Settlement Provisions

At a Contract's ACD, the Annuity Account Value is applied to provide the "Normal Form of Annuity Benefit," which is an annuity payable for the life of the annuitant with 10 years certain. The purchase price of the annuity is determined from the annuity purchase rate schedule guaranteed under, and set forth in, the Contract. The owner may alternatively elect an annuity benefit in another form offered by Taxpayer, which include a life annuity, a life annuity with refund certain, and a period certain annuity. With the exception of the period certain annuity, the annuity payout options are available on a single life or joint and survivor life basis.

B. Withdrawals

At any time before a Contract's ACD, the contractowner may request a withdrawal from, or may surrender, the Contract. Such withdrawals and surrender benefits may be subject to withdrawal charges.

C. Death Benefits

In the event that the annuitant under a Contract dies before the ACD, a death benefit is paid as an annuity benefit or in a single sum, as selected by each primary beneficiary³ under the Contract. The amount of this death benefit is set forth on the Contract's Data Page. As a general rule, the death benefit is equal to the Annuity Account Value or, if greater, the "Guaranteed Minimum Death Benefit." The Guaranteed Minimum Death Benefit generally equals, depending on the contractholder's election upon issuance of the contract: (1) the net contributions accumulated at 5% interest to age 80,⁴ or (2) the highest Annuity Account Value on a preceding anniversary plus contributions since that date and less withdrawals since that date. The Guaranteed Minimum Death Benefit for annuitants age 80-90 at issue is equal to the total contributions paid for the contract less any withdrawals.⁵

Moreover, as nonqualified annuity contracts, the Contracts provide for distributions following the death of the owner of a Contract in accordance with the requirements of § 72(s). These provisions are contained in an endorsement attached to each Contract used in the nonqualified market. As relevant here, under the current endorsement, in the event of the death of the owner of a Contract who is also the annuitant, the beneficiary may elect to (i) continue the Contract if the beneficiary is the

³ While more than one individual may be named a primary beneficiary, the text will sometimes refer to "the beneficiary" of a Contract.

⁴ This guaranteed minimum death benefit is not available in State X.

⁵ Note that the Contracts are not issued to applicants over age 90, since the ACD is the processing date which follows the applicant's 90th birthday.

PLR-126743-02

owner's spouse or (ii) receive an annuity benefit. Otherwise the amount will be paid in a lump sum. The annuity benefit, if elected, will be paid out over the life of the beneficiary, or for a period not extending beyond the beneficiary's life expectancy, and payments must begin within one year after the owner's death. If the owner is not the annuitant, the named beneficiary must receive the entire Annuity Account Value within five years or over a period not longer than his/her life expectancy (with annuity payments beginning within one year after the owner's death). Taxpayer seeks rulings regarding proposed changes to these provisions of the endorsements, as described below.

D. Proposed Additional Distribution Methods Upon Death of the Owner

In order to market effectively the Contracts, Taxpayer believes that it must provide owners of the Contracts and beneficiaries of deceased owners with more flexible distribution options. In accordance with this goal of increasing the flexibility of the distribution methods available to the beneficiaries of deceased owners of Contracts, Taxpayer proposes to revise its endorsements for the Contracts. Among the changes, as relevant here, the revised endorsement would make available alternative distribution methods in cases where the owner dies and the named beneficiary is an individual who elects to receive payments over a period not extending beyond his/her life expectancy.

Specifically, in the event that the owner of the Contract dies before the ACD,⁶ a named beneficiary who is an individual may elect the "Beneficiary Continuation Option" ("the BCO").⁷ Under the BCO:

1. If the Annuity Account Value at the date of the owner's death is less than the Guaranteed Minimum Death Benefit, and the owner was the annuitant, the Annuity Account Value will be reset to equal the Guaranteed Minimum Death Benefit.
2. Only named beneficiaries who are individuals may elect the BCO. Each electing named beneficiary is called a "Continuation Beneficiary" with respect to his/her portion of the Annuity Account Value.

⁶ Taxpayer's ruling requests only concern situations where the owner of the contract dies before the ACD. Taxpayer represents that the requirements of § 72(s)(1)(A) are met if the owner dies on or after the ACD.

⁷ A named beneficiary for this purpose includes a successor owner in cases where the deceased owner is not the annuitant.

PLR-126743-02

3. A Continuation Beneficiary will become the distributee⁸ under the Contract with respect to that beneficiary's portion of the Annuity Account Value. Distributions of the Annuity Account Value will be made at least annually over a period not extending beyond the life expectancy of a Continuation Beneficiary, will be made over a period of more than one full year from the ACD, and the first payment will begin no later than one year after the death of the owner of the Contract. In this regard, a Continuation Beneficiary may irrevocably elect to receive its distributions in accordance with one of the three methods set forth in Q&A-12 of Notice 89-25, 1989-1 C.B. 662, 666, as modified by Rev. Rul. 2002-62, 2002-42 I.R.B. 710, as follows:

(a) The required minimum distribution method ("life expectancy fraction method"). For this purpose, a Continuation Beneficiary may elect that payments be determined based on his/her life expectancy or any period certain that does not exceed his/her life expectancy. Life expectancy will be determined in accordance with Treas. Reg. § 1.401(a)(9)-5, Q&A-6.

(b) The fixed amortization method ("amortization method"). For this purpose, a Continuation Beneficiary may also elect that payments be determined based on his/her life expectancy or any period certain that does not exceed his/her life expectancy. Life expectancy will be determined in accordance with Treas. Reg. § 1.401(a)(9)-5, Q&A-6, and the interest rate will be a chosen interest rate that complies with section 2.02(c) of Rev. Rul. 2002-62.

(c) The fixed annuitization method ("annuity factor method"). For this purpose, a Continuation Beneficiary may also elect that payment be determined based on his/her life expectancy or any period certain that does not exceed his/her life expectancy. The annuity factor will be derived using the Single Life Table in Treas. Reg. § 1.401(a)(9)-9, Q&A-1,⁹ and using a chosen interest rate that complies with section 2.02(c) of Rev. Rul. 2002-62.

4. A Continuation Beneficiary receiving periodic payments under one of these three distribution methods will have the right to transfer amounts among the investment options with respect to his/her share of the Annuity Account Value while receiving payments.

5. A Continuation Beneficiary may irrevocably elect, at the time one of the three distribution methods is elected, one of two withdrawal options. Under "Withdrawal

⁸ Taxpayer's submission uses the term "annuitant" instead of "distributee." However, one of the issues in this ruling letter is whether a Continuation Beneficiary is receiving amounts as an annuity under one of the proposed alternative methods of distribution.

⁹ This table is printed as Appendix B to Rev. Rul. 2002-62.

PLR-126743-02

Option 1," a Continuation Beneficiary may withdraw the entire remaining Annuity Account Value apportioned to such Continuation Beneficiary at any time, with the result that all other payments will cease. Under "Withdrawal Option 2," a Continuation Beneficiary may make additional withdrawals at any time. The exercise of Withdrawal Option 2 may reduce future payments to the beneficiary because of its effect on the Annuity Account Value.

6. A Continuation Beneficiary cannot make additional contributions to the Contract or assign his/her interest under the Contract. Upon a Continuation Beneficiary's death, his/her remaining Annuity Account Value will be paid in a lump sum unless the person designated by such deceased Continuation Beneficiary elects to continue the payment method over any remaining portion of the period initially selected by such Continuation Beneficiary.

RULINGS REQUESTED

1. The distribution of the Annuity Account Value payable to a Continuation Beneficiary under a Contract in accordance with the life expectancy fraction method will satisfy the requirements of § 72(s)(2).

2. The distribution of the Annuity Account Value payable to a Continuation Beneficiary under a Contract in accordance with the amortization method will satisfy the requirements of § 72(s)(2).

3. The distribution of the Annuity Account Value to a Continuation Beneficiary under a Contract in accordance with the annuity factor method will satisfy the requirements of § 72(s)(2).

4. The answers under 1-3 will not be affected by the fact that a Continuation Beneficiary has the right, under Withdrawal Option 1 or Withdrawal Option 2, as applicable, to receive additional payments from the Annuity Account Value where such additional payments do not reduce any future payment (except to the extent that the Annuity Account Value under the Contract is reduced and thus, as a consequence, there is a reduction in the future payments to the beneficiary).

5. Where payments are made to a Continuation Beneficiary under the distribution methods described in 1-4 above, no amount will be constructively received by such Continuation Beneficiary before its actual payment under the specified distribution method.

6. Where a Continuation Beneficiary has irrevocably elected Withdrawal Option 1, each periodic payment made to such Continuation Beneficiary under the life expectancy fraction method, the amortization method, and the annuity factor method shall be considered an amount received as an annuity to the extent that it does not

PLR-126743-02

exceed the amount computed by dividing the investment in the Contract at the date of death of the owner by the number of periodic payments selected by such Continuation Beneficiary, which period cannot exceed the life expectancy of such Continuation Beneficiary. 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 excludable from gross income in the taxable year in which received. To the extent that the periodic payments received under the Contract during the taxable year exceeds the amount thus considered to be received as an annuity during such year, they shall be considered to be an amount not received as an annuity and shall be included in the gross income of such Continuation Beneficiary.

7. Where a Continuation Beneficiary has irrevocably elected Withdrawal Option 1 and subsequently exercises such option, the complete surrender of the Contract will be treated as an amount not received as an annuity. The amount received shall be includible in the gross income of such Continuation Beneficiary to the extent it exceeds the remaining investment in the Contract.

LAW AND ANALYSIS

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 ("ASD")) 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 § 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 § 72, that the ASD 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.

Treas. Reg. § 1.72-4(b)(1) 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.

PLR-126743-02

Treas. Reg. § 1.72-2(b)(2) provides that amounts subject to § 72 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 Treas. Reg. § 1.72-4(b);

(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 ASD; and

(iii) Except as indicated in Treas. Reg. § 1.72-2(b)(3), the total of the amounts payable must be determinable at the ASD 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.

Treas. Reg. § 1.72-2(b)(3) provides, notwithstanding the requirement of Treas. Reg. § 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.

Section 72(e)(1)(A) provides, in general, that § 72(e) shall apply to any amount that is received under an annuity contract and is not received as an annuity if no provision of the income tax law (other than § 72(e)) applies with respect to such amount.

Section 72(e)(2)(A) provides that any amount to which § 72(e) applies, if received on or after the ASD, shall be included in gross income.

Section 72(e)(5)(E) provides that this rule shall not apply, however, to (i) any amount received, whether in a single sum or otherwise under a contract in full discharge of the obligation under the contract which is in the nature of a refund of the

PLR-126743-02

consideration paid for the contract; and (ii) any amount received under a contract on its complete surrender, redemption, or maturity. In these circumstances, the amount received shall be included in gross income, but only to the extent it exceeds the investment in the contract.

Section 72(e)(2)(B) provides, as a general rule, that any amount to which § 72(e) applies if received before the ASD –

- (i) shall be included in gross income to the extent allocable to income on the contract, and
- (ii) shall not be included in gross income to the extent allocable to the investment on the contract.

Section 72(s)(1)(B) provides, generally, that a contract will not be treated as an annuity contract for purposes of the Code unless it provides that if any holder of such contract dies before the ASD, the entire interest in such contract will be distributed within 5 years after the death of such holder.¹⁰

Section 72(s)(2) provides an exception for certain amounts payable over the life of a designated beneficiary. Specifically, § 72(s)(2) provides that if:

- (A) any portion of the holder's interest is payable to (or for the benefit of) a designated beneficiary,
- (B) such portion will be distributed (in accordance with regulations) over the life of such designated beneficiary (or over a period not extending beyond the life expectancy of such beneficiary), and
- (C) such distributions begin not later than 1 year after the date of the holder's death or such later date as the Secretary may by regulations prescribe,

then, for purposes of § 72(s)(1), the portion referred to in § 72(s)(2)(A) shall be treated as distributed on the day on which such distributions begin.

Treas. Reg. § 1.451-1(a) 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.

¹⁰ Section 72(s) is not applicable to "qualified" annuity contracts. See § 72(s)(5).

PLR-126743-02

Treas. Reg. § 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.

Ruling Requests 1-3

At the outset, we note that Taxpayer's ruling request concerns situations where the owner dies before the ACD. The definition of the ACD in the Contract is not identical to the definition of the ASD in § 72(c)(4) and Treas. Reg. § 1.72-4(b). However, all deaths occurring before the ACD will necessarily also occur before the ASD.¹¹

Ruling Requests 1-3 ask us to conclude that the Taxpayer's three proposed distribution methods satisfy § 72(s)(2). Section 72(s)(2)(A) and (C) are factual requirements that are satisfied by Taxpayer's representations.

Section 72(s)(2)(B) provides that the portion qualifying for the exception under § 72(s)(2) must be distributed (in accordance with regulations) over the life of such designated beneficiary (or over a period not extending beyond the life expectancy of such beneficiary). We conclude that the Taxpayer's three proposed distribution methods, the life expectancy fraction method, the amortization method, and the annuity factor method satisfy § 72(s)(2).

Requested Ruling 4

Under the Taxpayer's proposed distribution methods, a Continuation Beneficiary has the right, under Withdrawal Option 1, to withdraw his/her entire remaining share of the Annuity Account Value at any time. Additionally, as described above, under Withdrawal Option 2, a Continuation Beneficiary has the right to receive additional payments from his/her remaining share of the Annuity Account Value.

Examination of the text and purpose of § 72(s) indicates an intent that tax-deferred balances held under nonqualified annuity contracts be distributed within certain periods following the death of the holder (or, where the holder is not a natural

¹¹ The ACD under the Contract, does not occur until an annuity benefit has been paid. The ASD is generally the first day of the first period for which an amount is received as an annuity. If no amount is received as an annuity benefit, then the ASD will not have been reached.

PLR-126743-02

person, the death of the specified annuitant). We see no indication that § 72(s) prevents the designated beneficiary of a nonqualified annuity contract holder from receiving payments under the contract more rapidly than is required.

We conclude that as long as any “excess” payments result in the permanent acceleration of the payout stream, such “excess” payments are permitted under § 72(s)(B)(2). Therefore, Rulings 1-3 will not be affected by the fact that a Continuation Beneficiary has the right, under Withdrawal Option 1 or Withdrawal Option 2, to receive additional payments from the Annuity Account Value.

Requested Ruling 5

An annuity contract consists of an accumulation phase and a phase subsequent to the ASD 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 Treas. Reg. § 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 § 72(e)(2)(A) and Treas. Reg. § 1.72-2(b)(3)(i). Regardless of the characterization of the payments made to a Continuation Beneficiary as “amounts received as an annuity” or “amounts not received as an annuity,” no amount should be considered constructively received by a Continuation Beneficiary before its actual payment under the proposed distribution methods for several reasons.

First, § 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 § 72(a) and (e) literally require that amounts be “received” by the holder before they are included in gross income. The statute is silent whether amounts that are only “constructively received,” within the meaning of Treas. Reg. § 1.451-2(a), are “received” under § 72 and includible in gross income in accordance with the provisions of § 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 ASD 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:

PLR-126743-02

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, 1982,¹² 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 § 72 do not indicate that Congress intended to change prior law, which did not apply the doctrine of constructive receipt to annuity contracts.

Third, § 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 § 72(e)(2), a result inconsistent with general income tax principles.

Fourth, the provisions of § 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, § 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

¹² Note that the Conference Committee changed the effective date for the new provisions to August 13, 1982. (Footnote added.)

PLR-126743-02

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 § 264 to correct.

Fifth, neither does § 72(u) operate to require the designated beneficiary to include amounts in gross income prior to actual receipt under the procedures set forth in Requested Rulings 1, 2, 3, and 4. 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 § 72(s)(4), for purposes of § 72(s), the term “designated beneficiary” means any individual designated a beneficiary by the holder of the contract.

Thus, we conclude that where payments are made to a Continuation Beneficiary under the distribution methods set forth in Requested Rulings 1, 2, 3, and 4, no amount will be constructively received by such Continuation Beneficiary before its actual payment under the specified distribution method.

Requested Ruling 6

We note first that this requested ruling only pertains to the case where a Continuation Beneficiary has irrevocably chosen Withdrawal Option 1.

There are three tests that an amount received that is subject to § 72 must meet to be considered “an amount received as an annuity.” In the case of a variable annuity, such as the one in this case, these requirements are found in (a) Treas. Reg. § 1.72-2(b)(2)(i), (b) Treas. Reg. § 1.72-2(b)(2)(ii), and (c) Treas. Reg. 1.72-2(b)(3)(i) by means of reference from Treas. Reg. § 1.72-2(b)(2)(iii).

We look at satisfaction of the third requirement first. The third requirement, Treas. Reg. § 1.72-2(b)(3)(i), requires that amounts be received for a “definite or determinable time (whether for a period certain or for a life or lives).” Under all three proposed distribution methods, the periodic payments will be made over a period measured by the life expectancy of a Continuation Beneficiary or over a fixed number of years that does not extend beyond the life expectancy of a Continuation Beneficiary. Clearly, if a Continuation Beneficiary does not have a withdrawal option, the periodic payments will be received for a determinable time.

Now consider Withdrawal Option 1, which allows the recipient to make a complete withdrawal of any remaining Annuity Account Value. This withdrawal option should not change the fact that the recipient receives amounts for a definite or a determinable time, since the Code expressly contemplates the occurrence of this situation after the ASD. Section 72(e)(5)(E) deals with the complete surrender of an annuity. Specifically, § 72(e)(5)(E) provides that § 72(e)(2)(A), under which amounts not received as an annuity after the ASD shall be included in gross income, does not

PLR-126743-02

apply if § 72(e)(5)(E) applies. The clear implication here is that there can be a complete surrender of an annuity contract after the ASD.

The remaining two requirements for amounts received by a Continuation Beneficiary to be received as an annuity will be met if a Continuation Beneficiary receives amounts in accordance with one of the three distribution methods.

Under the Contract, the ACD will be the date distributions begin under the method of distribution chosen by such Continuation Beneficiary. Under Treas. Reg. § 1.72-4(b)(1), the ASD will generally be the first day of the period which ends on the date of the first annuity payment. This will always be no later than the ACD. Thus, Treas. Reg. § 1.72-2(b)(2)(i), the first requirement for an amount subject to § 72 to be considered an amount received as an annuity, is satisfied.

Treas. Reg. § 1.72-2(b)(2)(ii) is also satisfied. Taxpayer has represented that periodic payments to a Continuation Beneficiary will be made over a period of more than one full year from the ACD. Since the ASD will never be later than the ACD, the second element of the definition of amount received as an annuity is satisfied.

In the case of a variable annuity, even though the requirements of Treas. Reg. § 1.72-2(b)(2)(i), Treas. Reg. § 1.72-2(b)(2)(ii), and the “definite or determinable time requirement” of Treas. Reg. § 1.72-2(b)(3)(i) are met, the amount of the distribution that is considered received as an annuity is limited. Under Treas. Reg. § 1.72-2(b)(3)(i) each periodic payment made to a Continuation Beneficiary under one of the three distribution methods shall be considered as an amount received as an annuity only to the extent 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 selected by such Continuation Beneficiary, which period cannot exceed the life expectancy of such Continuation Beneficiary. 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, payments received shall be excludable from gross income in the taxable year in which received. To the extent that the periodic payments received under the Contract during the taxable year exceeds the amount thus considered to be received as an annuity during such year, they shall be considered to be an amount not received as an annuity and shall be included in the gross income of such Continuation Beneficiary.

Requested Ruling 7

This requested ruling also only pertains to the case where a Continuation Beneficiary has irrevocably chosen Withdrawal Option 1.

PLR-126743-02

The exercise of Withdrawal Option 1 by a Continuation Beneficiary results in the complete surrender of the Contract. Since amounts received upon the complete surrender of the Contract are not periodic payments, they are not amounts received as an annuity. See Treas. Reg. § 1.72-2(b)(2)(ii).

Amounts received upon the complete surrender of an annuity are subject to § 72(e)(5). See § 72(e)(5)(E)(ii). Further, upon the complete surrender of an annuity, the rule of § 72(e)(2)(A) does not apply and the amount received is includible in gross income to the extent it exceeds the remaining investment in the Contract. See § 72(e)(5)(A)&(E).

CONCLUSIONS

1. The distribution of the Annuity Account Value payable to a Continuation Beneficiary under a Contract in accordance with the life expectancy fraction method satisfies the requirements of § 72(s)(2).
2. The distribution of the Annuity Account Value payable to a Continuation Beneficiary under a Contract in accordance with the amortization method satisfies the requirements of § 72(s)(2).
3. The distribution of the Annuity Account Value to a Continuation Beneficiary under a Contract in accordance with the annuity factor method satisfies the requirements of § 72(s)(2).
4. The answers under 1-3 will not be affected by the fact that a Continuation Beneficiary has the right, under Withdrawal Option 1 or Withdrawal Option 2, as applicable, to receive additional payments from the Annuity Account Value where such additional payments do not reduce any future payment (except to the extent that the Annuity Account Value under the Contract is reduced and thus, as a consequence, there is a reduction in the future payments to the beneficiary).
5. Where payments are made to a Continuation Beneficiary under the distribution methods described in 1-4 above, no amount will be constructively received by such Continuation Beneficiary before its actual payment under the specified distribution method.
6. Where a Continuation Beneficiary has irrevocably elected Withdrawal Option 1, each periodic payment made to such Continuation Beneficiary under the life expectancy fraction method, the amortization method, and the annuity factor method shall be considered an amount received as an annuity to the extent that it does not exceed the amount computed by dividing the investment in the Contract at the date of death of the owner by the number of periodic payments selected by such Continuation Beneficiary, which period cannot exceed the life expectancy of such Continuation

PLR-126743-02

Beneficiary. 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 excludable from gross income in the taxable year in which received. To the extent that the periodic payments received under the Contract during the taxable year exceeds the amount thus considered to be received as an annuity during such year, they shall be considered to be an amount not received as an annuity and shall be included in the gross income of such Continuation Beneficiary.

7. Where a Continuation Beneficiary has irrevocably elected Withdrawal Option 1 and subsequently exercises such option, the complete surrender of the Contract will be treated as an amount not received as an annuity. The amount received shall be includible in the gross income of such Continuation Beneficiary to the extent it exceeds the remaining investment in the Contract.

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, if Withdrawal Option 2 is irrevocably chosen by a Continuation Beneficiary, no opinion is expressed concerning the taxation of any periodic payments received by such Continuation Beneficiary or concerning the taxation of amounts received by such Continuation Beneficiary upon the exercise of Withdrawal Option 2.

Specifically, no opinion is expressed regarding the application of the investor control rules set forth in Christoffersen v. United States, 749 F.2d 513 (8th Cir. 1984), cert. denied, 473 U.S. 905 (1985); Rev. Rul. 81-225, 1981-2 C.B. 12, as modified by Rev. Proc. 99-44, 1999-2 C.B. 598; Rev. Rul. 80-274, 1980-2 C.B. 27; Rev. Rul. 77-85, 1977-1 C.B. 12.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant.

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

PLR-126743-02

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty 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.

Sincerely,

/S/

MARK S. SMITH

Chief, Branch 4

Office of Associate Chief Counsel

(Financial Institutions & Products)