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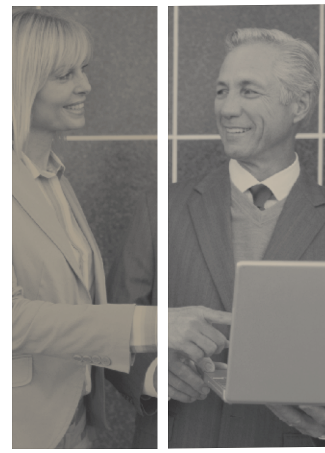

IRS Confirms Annuity Status of "Contingent Annuity Contracts"

By Bryan W. Keene and Joseph F. McKeever, III

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In recent months, the Internal Revenue Service (the "Service") has released three private letter rulings addressing the tax treatment of group insurance contracts providing guaranteed minimum withdrawal benefits linked to an investment account (the "Account") that the owner establishes with a financial institution unrelated to the contract issuer.[1] The new rulings are the first to address the recent innovation of "unbundled" annuity products that strip the annuity to its core insurance elements. Such contracts have sometimes been referred to colloquially as "stand alone withdrawal benefits" or "contingent annuity contracts." Two of the rulings were issued to individuals who proposed to purchase certificates under the contracts,[2] and one of the rulings was issued to a life insurance company as the proposed issuer of the contract.[3]

The new rulings address four specific federal income tax issues with respect to the contracts. First, all three rulings conclude that the contracts will be treated as annuity contracts under section 72.[4] In addition, the rulings issued to contract owners address three questions that are pertinent to the owners' (but not the insurers') tax returns. Specifically, they conclude that the contracts: 1) will not affect the owners' ability to deduct losses incurred in the Accounts; 2) will not affect the owners' ability to receive "qualified dividend income" from assets in the Accounts; and 3) will not constitute part of a "straddle" with the Accounts.

The contracts involved in these rulings represent a significant departure from the typical annuity contract available to consumers, and, with the Service confirming their favorable tax treatment, the products have the potential to change the annuity landscape as it has existed in recent years. Both the typical deferred variable annuity contract with a guaranteed lifetime

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withdrawal benefit ("GLWB") and the contracts addressed in the rulings offer annuitants the guarantee of a lifetime income in the event a pool of assets is depleted. However, the former provide the owner with the ability to defer taxes on increases in the cash surrender value, require the owner to cede control over the investments upon which the annuity payments depend to the insurer, and pay tax at ordinary income rates when gains in those assets are distributed from the contract. In contrast, according to the recent rulings, the new types of annuity contracts they address do not provide the benefit of tax deferral, but give the owner substantially more control over the assets upon which the annuity payments depend as well as access to capital gains tax rates with respect to sales and exchanges of those assets, which generally are lower than ordinary income tax rates.[5] These differences can provide valuable alternatives for consumers searching for effective ways to accumulate assets for retirement while also assuring themselves a guaranteed lifetime income. The new rulings, and the contracts they address, are summarized below.

FACTS OF THE RULINGS

The facts of the first two rulings, PLRs 200949036 and 200949007, which were released in December 2009, are identical, and the two rulings apparently involve the same contract. The facts of the third ruling, PLR 201001016, which was released in January of this year, are almost identical to those of the two earlier rulings. As a result, the rulings will be discussed together except where a difference between the 2009 rulings and the 2010 ruling is significant.

These differences can provide valuable alternatives for consumers searching for effective ways to accumulate assets for retirement while also assuring themselves a guaranteed lifetime income.

In the rulings, a life insurance company (the "Company") intends to issue a "Group Contract" to an unrelated financial institution (a "Sponsor"). The Group Contract will authorize the Sponsor to sell certificates (each, a "Certificate") to individuals who open an investment Account with the Sponsor. The life insurance company taxpayer intends to issue the Group Contract and Certificates, and the individual taxpayers intend to purchase a Certificate from the Company and establish an Account with a Sponsor.

Each Account can hold only shares of regulated investment companies (mutual funds) or other publicly-traded securities that the Company approves as being consistent with an investment strategy that the Company prescribes. The Company also specifies the maximum amount that an individual can invest in the Account. The Certificate has no cash surrender value. The Certificate involved in the 2009 rulings cannot be assigned or transferred, while the Certificate involved in the 2010 ruling can be assigned with the Company's consent.

Each Certificate obligates the Company to provide the owner with a series of periodic payments (the "Monthly Benefit") for the remainder of the owner's life if the Account balance is reduced to zero for any reason other than the Certificate owner withdrawing more than a prescribed annual amount (the "Annual Withdrawal") from the Account. Thus, the Certificate operates in much the same way that a guaranteed minimum withdrawal benefit operates under a deferred variable annuity contract, except that the assets that normally would comprise the "cash value" of the deferred annuity are held by the Sponsor, rather than the insurer, and the Certificate owner owns those assets for federal income tax purposes.

The Monthly Benefit and Annual Withdrawal amount are determined by reference to a "Benefit Base." On the Certificate date, the Benefit Base equals the Account value, and thereafter is increased for additional permitted cash investments in the Account. In the case of the 2009 rulings, depending on the terms of the individual's Certificate, the Benefit Base also may be adjusted upward on each Certificate anniversary to: 1) the Account value on that anniversary or a prior anniversary; 2) a minimum value specified in the Certificate; or 3) an amount determined by applying an annual cost of living adjustment to the Benefit Base. In other words, the Certificates described in those rulings offered both a "ratchet" and a "roll-up" benefit. In the case of PLR 201001016, the Certificate offered only a ratchet feature.

The Certificates involved in the 2009 rulings allow the owner to commence Annual Withdrawals from the Account at any time, while the Certificate involved in the 2010 ruling allows the owner to do so any time after a defined "Commencement Date." The amount of the permitted Annual Withdrawal is recalculated on each Certificate anniversary. This amount may increase, but will not decrease unless the owner takes withdrawals in excess of the then-applicable Annual Withdrawal amount ("Excess Withdrawals"). Such Excess Withdrawals will reduce the Benefit Base, the Annual Withdrawal amount and the Monthly Benefit. The Certificate will terminate upon the owner's death, a stated maturity date,[6] the failure to pay charges, the termination of the Account, any investment by the Account in unapproved instruments, or any Excess Withdrawal that reduces the Account value to zero. The Certificate also provides the owner with the right to apply the Account value to purchase a life annuity ("Annuitized Payments").[7]

In all three rulings, the taxpayers represented to the Service that: 1) the Company will not have direct or indirect control over investment decisions with respect to the Account, although it may require automatic rebalancing of the Account to bring it into accord with the prescribed investment strategy; 2) the Sponsor will not be related to the Company; 3) the Account's holdings will not be limited to mutual funds that the Company or its affiliates manage; 4) the Company will not impose any significant barriers to reallocations among eligible assets within the Account; and 5) the Company will not have access to any nonpublic information about mutual funds in which the Account may be invested. In PLR 200949036, the Company also represented that it will issue the Group Contract only in states that treat it as an annuity contract, and in PLRs 200949007 and 201001016 the individual taxpayers represented that they will purchase the Certificate only if the regulations of the taxpayer's state of residence treat it as an annuity contract.[8]

Finally, the taxpayers in all the rulings provided the Service with an actuarial analysis of the contract, which concluded that the arrangement is substantially more sensitive to the risk of the owner's longevity than to volatility in the securities markets, and that the predominant risk "insured" against is longevity risk, with incidental market risk protection.

ANALYSIS AND CONCLUSIONS OF THE RULINGS

The rulings address four specific federal income tax issues with respect to the Certificates. First, all three rulings conclude that the Certificates will be treated as annuity contracts under section 72. In addition, the two rulings issued to Certificate owners (PLRs 200949007 and 201001016) address three questions that are pertinent to the owners' (but not the insurers') tax returns. Specifically, they conclude that the Certificates: 1) will not affect the owners' ability to deduct losses incurred in the Accounts; 2) will not affect the owners' ability to receive "qualified dividend income" from assets in the Accounts; and 3) will not constitute part of a "straddle" with the Accounts.

The Certificates are Annuity Contracts

As indicated previously, all three rulings conclude that the Certificates will be treated as annuity contracts for purposes of section 72. This treatment is important to both the issuer and the purchaser of the Certificate. For the issuer, among other things, it clarifies the Company's reserve deductions and tax reporting and withholding obligations with respect to the Certificates. For the purchaser, it means that the Monthly Benefit and any Annuitized Payments will be eligible for "exclusion ratio" treatment under section 72(b).[9] In concluding that the Certificates will be annuity contracts, the rulings also state that the purchaser (rather than the Company) will own the Account assets for tax purposes—with the necessary implications that the Account will not be part of the Certificates for tax purposes and that the Certificate owner will be currently taxable at capital gains rates with respect to sales and exchanges of Account assets.

With respect to the conclusion that the Certificates will be annuity contracts, the rulings observe that the Code does not provide a comprehensive definition of an annuity. As a result, the rulings focus on the various requirements applicable to annuities under the Treasury Department (the "Treasury") regulations, as well as on descriptions of annuities set forth in the legislative history of section 72, case law and several secondary sources.

Regarding the Treasury regulations, the rulings first note that Treas. Reg. section 1.72-2(a)(1) provides that the types of contracts governed by section 72 include those "which are considered to be … annuity contracts in accordance with the customary practice of life insurance companies." Perhaps prompted by this reference to customary practices, the rulings then discuss a number of sources describing key characteristics of annuity contracts and assess whether the Certificates possess a sufficient number of those characteristics to be properly viewed as annuity contracts for tax purposes.

For example, the rulings state that the Certificates possess two of the key characteristics of annuity contracts described in the legislative history of section 72(e), in that each Certificate represents "a promise by the life insurance company to pay the beneficiary a given sum for a specified period" and is "used to provide long-term income security."[10] The rulings also conclude that the Certificates have a "determining characteristic" of annuities described in the American Jurisprudence treatise on annuities, in that "the annuitant has an interest only in the periodic payments and not in any principal fund or source

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The rulings are clear, however, that while the Certificates are annuity contracts, the assets held in the Account are not part of those annuity contracts, and instead are owned by the Certificate holder for federal income tax purposes.

from which they may be derived."[11] Citing the same source, the rulings state that the Certificate 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 multiple authorities indicate are not annuities.[12] Finally, the rulings conclude that the Certificates satisfy the requirements of the Treasury regulations applicable to annuity contracts and annuity payments,[13] and that the Certificates are not merely contracts to pay interest within the meaning of Treas. Reg. section 1.72-14(a).[14]

In considering the determining characteristics of annuity contracts, the rulings also downplay the importance of two features of the Certificates that are somewhat unusual in comparison to other deferred annuity contracts available in the marketplace today. Specifically, the rulings note that the Certificates: 1) do not provide a cash surrender value; and 2) condition the availability of periodic payments on the Account value being depleted. These features are atypical of deferred annuities sold today, which generally provide cash values (and, in fact, promote the deferral of income tax on such values as a key attribute) and allow the owner to annuitize those values at any time. (Of course, the preponderance of deferred variable annuities sold today contain a GLWB that operates in much the same manner as item 2), but with reference to the contract's cash value.) The Service ultimately concluded that these somewhat unusual features of the Certificates are not dispositive of their treatment as annuity contracts in light of the many other characteristics of annuities that they possess.

We understand that the tax implications of the first of the foregoing two Certificate features (lack of cash value) was the subject of much internal debate at the Service, with some individuals at the Service expressing the view that a contract cannot constitute an annuity contract for federal income tax purposes if it does not provide a cash surrender value. It is not clear why this concern arose, especially with respect to the Certificates involved in these rulings, since the interest and earnings that accrue in the Account are currently taxable—in contrast to the tax deferral otherwise afforded to the cash surrender value of a deferred annuity contract.[15] In any event, the Service appears to have gotten comfortable that the presence or lack of a cash value is not dispositive. The Service had reached a similar conclusion in another private letter ruling issued earlier in 2009, where it cited several sources describing the existence of deferred annuities without cash values in the first half of the 20th century as indicating that such products are within the "customary practice of life insurance companies."[16] Consistently with that earlier ruling, the three more recent rulings point to a leading insurance treatise as indicating that the availability of a cash value during the accumulation phase of a deferred annuity is a function of state law,[17] with the necessary implication that some states allow deferred annuities that lack cash values and therefore it is a customary practice. All of the foregoing contributed to the Service apparently placing little relevance on the presence or lack of a cash value, and the rulings ultimately conclude that, on balance, the Certificates possess the essential attributes of annuity contracts. The rulings are clear, however, that while the Certificates are annuity contracts, the assets held in the Account are not part of those annuity contracts, and instead are owned by the Certificate holder for federal income tax purposes.

The Certificates Will Not Affect the Owners' Ability to Deduct Losses in the Accounts

The two rulings issued to Certificate owners also address the owners' ability to claim tax deductions with respect to losses incurred in the Account. In that regard, the Code generally allows individuals to claim a deduction for losses incurred in any transaction entered into for profit.[18] Because the Certificate owners will purchase, sell, or exchange assets in the Accounts with the goal of making a profit, they generally will be entitled to deduct losses they incur in connection with such activity. The owner could experience such investment losses if he or she sells or exchanges Account assets at a price that is lower than the owner's adjusted basis in the assets.

The Code, however, also places certain restrictions on a taxpayer's ability to claim loss deductions. In particular, a loss is not deductible if the taxpayer receives compensation for the loss through "insurance or otherwise."[19] Thus, if the individual has a reasonable prospect of recovering the loss through a claim for reimbursement, he or she cannot deduct the loss until it can be ascertained with reasonable certainty whether or not the reimbursement will be received.[20] The two rulings issued to Certificate owners state that this determination is one of fact based on all the relevant facts and circumstances. They cite to a number of cases addressing whether losses sustained by a taxpayer were reimbursed by "insurance or otherwise," and ultimately conclude that the Certificates do not provide such protection against losses in the Account.[21]

In reaching this conclusion, the rulings state that the relationship between any individual market loss in the Account and any eventual periodic payments under the Certificate is too tenuous and too contingent on a number of factors for the periodic payments to be considered compensation for any given market loss. In this respect, the rulings state that "the fact, amount, and timing of the Monthly Benefit are contingent on a number of factors, including not only a particular market loss, but also other market losses, offsetting market gains, Taxpayer's withdrawal rate, and—most significantly—Taxpayer's life span." Although not specifically referenced in the rulings' analysis, the Service undoubtedly placed great emphasis on the findings of the actuarial analysis that the taxpayers submitted with their requests for rulings. As described above, that analysis concluded that the arrangement is substantially more sensitive to the risk of longevity than to the volatility of the securities markets, and that the predominant risk that the Certificates mitigate is longevity risk, with only incidental market risk protection. In other words, the taxpayers were able to demonstrate to the Service that the economics of the arrangements are more akin to a traditional annuity contract than protection against investment losses. As a result, the rulings conclude that the Certificate will not create a right to reimbursement for losses realized on Account assets for purposes of the rules governing loss deductions, and therefore will not prevent the owner from currently deducting such losses to the extent they are otherwise deductible.

In stating this, however, the Service cautioned that its conclusion was "based on and limited to the particular contract at issue, and the effect of that contract as represented by Taxpayer; it would not necessarily apply to a similar feature if the terms of the contract were significantly altered." This, too, suggests that the Service placed great weight on the taxpayers' actuarial analysis of the particular Certificates involved, as the Service went out of its way to add this caveat to the conclusion despite the fact that the law is clear that a private letter ruling will not apply to a transaction if the facts are materially altered.[22] Perhaps this caveat was the Service's way of ensuring that the taxpayers understood the actuarial analysis to be a material fact.

The Certificates Will Not Prevent Account Assets from Providing Qualified Dividend Income

The rulings issued to Certificate owners also address the treatment of certain dividends paid with respect to stock that the Account holds. Because the Certificate owners will own the Account assets for tax purposes, the owners will be currently taxable on any income that those assets generate—including any dividends paid by corporations that have issued stock that the Account holds. As a general matter, if a corporation pays a dividend out of its earnings and profits, the amount received by its shareholders is taxable, as either net capital gain or ordinary income. Capital gains rates apply only if the dividends constitute "qualified dividend income" ("QDI").[23]

QDI generally includes dividends received from domestic and, in some cases, foreign corporations.[24] To be eligible for capital gain treatment, the shareholder must hold the dividend-paying stock for a minimum time period (a "holding period"). The holding period is suspended—meaning that the taxpayer is treated as not holding the stock during the suspension—for any period in which the taxpayer has "diminished his risk of loss by holding 1 or more other positions with respect to substantially similar or related property."[25]

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The relevant rulings conclude that a Certificate does not diminish the owner's risk of loss on Account assets under the foregoing rules. This means that the Certificate will not affect the owner's ability to receive QDI with respect to stock held in the Account, and that capital gains rates will be available with respect to dividends that otherwise constitute QDI. In reaching this conclusion, the rulings note, among other things, that the Certificate is not "substantially similar or related property" to the Account because: 1) the fair market value ("FMV") 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; and 2) changes in the FMV of the Account are not reasonably expected to approximate, directly or inversely, changes in the FMV of the Certificate.[26] As further evidence that the Certificate and Account are not substantially similar or related property, the rulings point out that longevity risk is the predominant risk for which the Certificates provide protection. Here, too, the taxpayers' actuarial analysis of the types of risks mitigated by the Certificates apparently weighed heavily in the Service's analysis.

The Certificates Will Not Form Part of a Straddle with the Accounts

The final question addressed by the two rulings issued to Certificate owners is the treatment of the Certificate and the Account under the tax rules applicable to "straddles." The term straddle as used in the Code has a somewhat different meaning compared to its common usage in the financial markets. In the latter context, the term generally refers to an options strategy in which the investor holds a position in both a call and a put with the same strike price and expiration date, such that the two positions exactly offset each other. In tax parlance, a straddle is more broadly defined as "offsetting positions" in actively traded personal property, with offsetting positions encompassing more than those that exactly offset each other.[27]

Straddles have a variety of nontax uses, including to lock-in gain from an appreciated position or to protect against market losses. In the past, however, straddles also were widely used solely to manipulate the timing of gains and losses (including manufacturing tax losses where no real economic loss occurred), or to convert ordinary income or short-term capital gain to long-term capital gain. In light of these abuses, Congress enacted section 1092 and related measures that generally allow nontax-motivated uses of straddles while preventing their use to manipulate the tax laws.[28]

In that regard, section 1092 imposes special rules that effectively suspend losses with respect to investment positions that are held as part of a straddle. If investments comprise part of a straddle, a loss incurred with respect to one of the investments cannot be taken into account in computing the taxpayer's gross income until that loss exceeds any unrecognized gain in the offsetting position. Under these rules, positions are "offsetting" if they result in a substantial diminution of the taxpayer's risk of loss—even if the positions do not exactly offset one another. Applied to the Certificates described in the rulings, if the Account and the Certificate were found to be offsetting positions that formed a straddle, presumably the owner would be precluded from reflecting on his or her tax return any loss incurred on the sale or exchange of Account assets until such time that the loss exceeded the excess of the owner's tax basis in the Certificate over its FMV, determined at the close of the taxable year.[29]

The two rulings issued to Certificate owners conclude that section 1092 does not apply to the Certificate and the Account, *i.e.*, that they do not form a straddle. The rulings note that the Certificate is not an "offsetting position" with respect to the Account, but offer no reasoning for reaching this conclusion. Presumably, the same reasoning outlined above in connection with the QDI issue supports the conclusion that the rulings reach under the straddle rules. In other words, the relationship between any individual market loss in the Account and any eventual periodic payments under the Certificate is too tenuous and too contingent on a number of factors—most importantly the owner's longevity—for the periodic payments to be considered "offsetting" with respect to any given market loss. Again, the taxpayers' actuarial analysis of the Certificates may well have proved critical to the Service's conclusions here.

OBSERVATIONS

As indicated earlier, the new rulings are the first to address the recent innovation of "unbundled" annuity products that strip the annuity to its core insurance elements. Such products intentionally disavow the benefit of tax-deferred inside build-up in exchange for access to more favorable capital gains tax rates while retaining the key longevity insurance protection that annuities traditionally provide. The rulings address the primary tax issues raised by this new product innovation and provide taxpayers with clear guidance as to their tax treatment. As with all private letter rulings, however, only the taxpayers to whom they were issued can rely upon them.[30] Moreover, the weight that the Service appears to have placed on the taxpayers' actuarial analysis of the Certificates—demonstrating that the arrangements were "substantially more sensitive to the risk of longevity than [to] volatility in the securities markets"—strongly suggests that the Service might reach different conclusions if the facts were materially altered. As a result, perhaps more than usual, taxpayers who are contemplating similar products may wish to seek their own private letter rulings from the Service.

In addition, while the rulings clarify the primary tax issues relating to the Certificates, there are two related aspects of the rulings that leave the authors somewhat confused as to the Service's analysis of the Certificates' tax treatment. First, the rulings correctly note that the Certificate owners are treated as the owners of the Account assets for tax purposes, but in doing so they cite two examples from the Service's line of "investor control" revenue rulings as requiring that result.[31] In our view, the investor control doctrine is a specific application of the more general judicial principal of "substance over form."[32] In that regard, the doctrine has been applied to annuity products that, in form, place legal title of the underlying assets in the issuing life insurance company, but in substance give the policyholder so much command over those assets that he or she is properly deemed to own (and be currently taxed on) them for tax purposes.

The application of this doctrine to the arrangements described in the recent private letter rulings seems misplaced and unnecessary. Presumably, legal title in the Account assets resides with the Certificate owner, not the issuing life insurance company, so the form of the arrangement is already consistent with treating the individual as owning the Account assets for tax purposes. That form need not be disregarded using a substance over form analysis in order to reach the conclusion that the individual owns the assets. Moreover, the investor control doctrine is generally directed at disallowing the tax benefits normally afforded to annuity contracts (namely, tax-deferred inside buildup) in situations where the Service believes that the individual is more appropriately treated as directly owning the underlying assets. Again, such a goal is moot in the context of the Certificates addressed in the recent private letter rulings, as the taxpayers have already structured the arrangement so that the individual will be currently taxable on any income or gains generated in the Account.

A similarly confusing aspect of the recent rulings is the importance they appear to place on the lack of any corporate affiliation between the issuer of the Certificates and the Sponsor of the Accounts. Among the representations the Service appears to have required of the taxpayers were: 1) the Sponsor will not be related to the issuing Company; 2) the universe of investments that the Account will be permitted to hold will not be limited to regulated investment companies ("RICs") managed by the Company or its affiliates; and 3) the Company will not have any nonpublic information about the RICs in which the Account may be invested.

While not discussed in the analysis set forth in the rulings, these representations give the impression that the Service was struggling with whether the arrangements should be treated as annuity contracts in their entirety, with the assets in the Accounts being deemed to be owned by the Certificate issuer and therefore benefitting from the tax deferral that assets underlying deferred annuities otherwise enjoy. If that were the case, however, then surely the degree of the Certificate owner's control over those assets would result in the investor control doctrine applying to undo what the Service had just done, thereby redeeming the assets as being owned by the individual, and not the carrier, for tax purposes. This apparent circularity in the analysis—where the form of the arrangement is disregarded twice—seems unnecessary to the ultimate conclusions that the rulings reach. As a result, we question whether the conclusions that the rulings reach would really differ if the representations described above were lacking, *e.g.*, if the issuing Company and the Sponsor were affiliated.

As a result, perhaps more than usual, taxpayers who are contemplating similar products may wish to seek their own private letter rulings from the Service.

Despite the foregoing uncertainties regarding the rulings' analysis, the conclusions the rulings reach are sound. More generally, the rulings demonstrate that the Service is willing to give thoughtful consideration to the tax issues raised by new innovations in financial products, and to reach favorable conclusions that facilitate such products in appropriate cases. It is not always easy to apply tax rules that have been in place for decades to new product innovations that challenge the conventional understanding of how those rules apply. For those efforts, the Service should be commended. (See END NOTES on page 12).

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END NOTES

1 PLR 200949007 (July 30, 2009); PLR 200949036 (July 30, 2009); and PLR 201001016 (Sept. 14, 2010).

2 PLRs 200949007 and 201001016.

3 PLR 200949036.

4 Unless otherwise indicated, each reference herein to a "section" is to a section of the Internal Revenue Code of 1986, as amended (the "Code").

5 Subject to certain exceptions, capital gains rates range between 0% and 15% for 2009 and 2010, whereas ordinary income tax rates range from 10 percent to 35 percent. *See* sections 1(h)(1) and 1(i). Capital gains rates are available only with respect to long-term capital gains, *i.e.,* gains from the sale or exchange of a capital asset that the taxpayer held for more than a year. *See* section 1222(11) (defining "net capital gain" for purposes of section 1(h)(1) as excluding net short-term capital gains).

6 PLRs 200949007 and 200949036 reference a maturity date, but PLR 201001016 does not.

7 PLR 200949007 states that the Certificate owner "may elect to apply the value of the Account to purchase a lifetime fixed immediate annuity contract at guaranteed purchase rates specified in the Certificate." In contrast, PLR 201001016 describes this right more generally, without any reference to guaranteed purchase rates being specified in the Certificate. It is unclear whether this was a factual difference between the rulings, or simply a matter of how the rulings were written.

8 This representation suggests that some states may not view the Certificates as annuity contracts for state law purposes. Indeed, prior to the Service issuing the three rulings, the New York State Insurance Department pronounced that a "contingent annuity contract" sharing many of the characteristics of the contracts described in the recent rulings is not permissible under New York insurance law because it constitutes a disallowed form of financial guaranty insurance. *See* OGC Op. No. 09-06-11 (June 25, 2009).

9 In simple terms, exclusion ratio treatment allows the owner to recover his or her after-tax "investment in the contract" *pro rata* over the term of the periodic payments. The rulings do not address how the investment in the contract would be determined for this purpose.

10 S. REP. NO. 97-494, at 349-50 (1982) (the "TEFRA Senate Report") (discussing the amendments made to section 72(e) by the Tax Equity and Fiscal Responsibility Act of 1982, which implemented an "income-first" ordering rule with respect to nonannuitized distributions from annuity contracts).

11 4 Am. Jur. 2d Annuities, §1.

12 For example, the rulings cite the TEFRA Senate Report for the proposition that annuity contracts involve "the systematic liquidation of an amount consisting of principal (the policyholder's investment in the contract) and income." TEFRA Senate Report, *supra* note 10 at 349. *See also* section 72(j) (providing that if any amount is held under an agreement to pay interest, the interest payments are currently includible in gross income irrespective of any other provisions of section 72); Igleheart v. Comm'r, 174 F.2d 605, 606-07 (7th Cir. 1949) (referring to the "firmly accepted notion that an annuity has as its basic function the systematic liquidation of the principal"); Meyer v. Comm'r, 139 F.2d 256, 258-59 (6th Cir. 1943) (similar).

13 Specifically, the rulings state that the contracts and the amounts payable thereunder meet the requirements of Treas. Reg. section 1.72-1(b) and (c) (regarding the treatment of amounts received as an annuity); Treas. Reg. section 1.72-2(a)(1) (regarding the customary practice of life insurance companies); Treas. Reg. section 1.72-2(b)(3) (regarding variable annuity payments); and Treas. Reg. section 1.72-4(b)(1) (regarding the annuity starting date). We note that the reference to the variable annuity rules of Treas. Reg. section 1.72-2(b)(3) seems somewhat misplaced, as the Monthly Benefit and the Annuitized Payments would appear to be fixed in amount, rather than varying with investment performance or similar criteria.

14 Treas. Reg. section 1.72-14(a) states that an amount is considered held under an agreement to pay interest (in contrast to under an annuity contract) if the amount payable after the specified term is substantially equal to or larger than the aggregate amount of premiums.

15 While it is not clear why the lack of a cash value became an issue within the Service, possible reasons might include (1) general concern over potential collateral consequences for products that artificially depress an otherwise available cash value in order to circumvent tax rules based on that value (*see, e.g.,* 70 Fed. Reg. 48,868 (Aug. 22, 2005) (describing concern over such practices in the context of Roth individual retirement annuity conversions)), or (2) a general desire not to facilitate a perceived expansion of the types of arrangements that qualify as annuity contracts for tax purposes. These possibilities are purely the speculation of the authors, as the rulings themselves do not provide any insight on the discussions that occurred within the Service on this question.

16 PLR 200939018 (June 18, 2009). *See* also Joseph F. McKeever, III & Michelle A. Garcia, *IRS Rules Longevity Contract is Annuity under Section 72,* Vol. 6, Issue 1, *TAXING TIMES,* February 2010, at 14 (discussing PLR 200939018).

17 Appleman on Insurance § 182:05[B][7] and [8] (2d ed. 2008).

18 Section 165(c)(2).

19 Section 165(a).

20 Treas. Reg. section 1.165-1(d)(2)(i).

21 Specifically, the rulings cite to Estate of Bryan v. Comm'r, 74 T.C. 725 (1980); Forward Commc'ns Corp. v. United States, 608 F.2d 485 (1979); Johnson v. Comm'r, 66 T.C. 897 (1976), *aff'd,* 574 F.2d 189 (4th Cir. 1978); Shanahan v. Comm'r, 63 T.C. 21 (1974); Boston Elevated Rwy v. Comm'r, 16 T.C. 1084 (1951), *aff'd on another issue,* 196 F.2d 923 (1st Cir. 1952); and Dunne v. Comm'r, 29 BTA 1109 (1934), *aff'd,* 75 F.2d 255 (2d Cir. 1935).

22 *See* section 11.05 of Rev. Proc. 2010-1, 2010-1 I.R.B. 1, 50 (stating that the Service will revoke or modify a private letter ruling retroactively if (1) there has been a misstatement or omission of controlling facts; (2) the facts at the time of the transaction are materially different from the controlling facts on which the letter ruling was based; or (3) the transaction involves a continuing action or series of actions and the controlling facts change during the course of the transaction).

23 Absent additional legislation, capital gains treatment for QDI will not apply after 2010. *See* section 303 of the Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, as amended by section 102 of the Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222.

24 Section 1(h)(11).

25 Section 246(c)(4)(C).

26 *See* Treas. Reg. section 1.246-5(b)(1) (defining "substantially similar or related property").

27 *See* section 1092(c).

28 *See* STAFF OF THE J. COMM. ON TAX'N, 97TH CONG., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY ACT OF 1981, at 282-283 (Comm. Print 1981); H.R. CONF. REP. NO. 97-176 (1981); S. REP. NO. 97-144 (1981); H.R. REP. NO. 97-201 (1981).

29 *See* section 1092(a)(3)(A)(i) (stating that unrecognized gain means, "in the case of any position held by the taxpayer as of the close of the taxable year, the amount of gain which would be taken into account with respect to such position if such position were sold on the last business day of such taxable year at its fair market value.").

30 *See* section 6110(k)(3).

31 In particular, the rulings cite Rev. Rul. 2003-92, 2003-2 C.B. 350, and Rev. Rul. 81-225, 1981-2 C.B. 12. The following rulings also describe the investor control doctrine: Rev. Rul. 2003-91, 2003-2 C.B. 347; Rev. Proc. 99-44, 1999-2 C.B. 598; Rev. Rul. 82-55, 1982-1 C.B. 12; Rev. Rul. 82-54, 1982-1 C.B. 11; Rev. Rul. 80-274, 1980-2 C.B. 27; and Rev. Rul. 77-85, 1977-1 C.B. 12. *See also Christoffersen v. United States,* 749 F.2d 513 (8th Cir. 1984), *cert. denied,* 473 U.S. 905 (1985).

32 Under the investor control doctrine, the party who directs the selection, management, and disposition of the separate account assets supporting a variable contract will be considered the owner of those assets for federal income tax purposes. The relevant rulings state that this view is based on the judicial notion that "taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed…." *See, e.g.,* Rev. Rul. 2003-91 (quoting Corliss v. Bowers, 281 U.S. 376 (1930)). This notion, in turn, is a specific application of the long-standing judicial doctrine that the substance of an arrangement, rather than its form, controls its characterization for federal tax purposes. *See, e.g., Gregory v. Helvering,* 293 U.S. 465 (1935).

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