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The Taxation of Annuity Contracts

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This outline is a summary of issues pertaining to the federal income tax treatment of annuity contracts. The outline does not constitute tax advice. It is intended solely for general educational purposes. For complete information regarding the issues discussed herein, you should consult the applicable Internal Revenue Code provisions, Treasury regulations, rulings, cases and a qualified tax advisor.

I. OVERVIEW.

A. Scope of Outline.

This outline covers the federal income taxation of annuity contracts. Federal estate and gift taxes, as well as state and local taxes, are not covered.

B. Sources of Federal Tax Law.

1. *Internal Revenue Code (the "Code").* The Congressionally enacted statutes which govern federal taxation are contained in the Internal Revenue Code of 1986. 26 USC et seq. The Code has, of course, been amended many times since 1986. The Code is divided into "sections" which are in turn divided into subsections and further subdivisions, *e.g.*, paragraphs etc. For example, Code Section 72, which contains many of the income tax rules applicable to annuities, is divided into 22 subsections.

2. *Treasury Regulations.* The U.S. Treasury Department, in conjunction with the Internal Revenue Service (often referred to as the "IRS" or simply the "Service") issues regulations interpreting the Code. Courts generally view regulations as authoritative interpretations of the Code and hence binding on taxpayers. Treasury regulations are assigned a number corresponding to the Code Section which they interpret. Thus, for example, the income tax regulations interpreting Code Section 72 are identified as Treas. Reg. Sections 1.72 -1 etc.

3. *Revenue Rulings and Revenue Procedures.* Revenue rulings and revenue procedures are issued by the IRS after consultation with the Treasury Department. A revenue ruling typically represents the IRS's interpretation of the law. Revenue rulings are less authoritative than a regulation, but typically the

IRS will challenge a tax return position that is inconsistent with a revenue ruling. Revenue rulings are published in the Internal Revenue Bulletin and hence are sometimes referred to as "published rulings." Taxpayers can generally rely on the interpretations set forth in revenue rulings.

Revenue procedures generally set forth administrative procedures under the tax law. For example, the procedures for filing a request for a private letter ruling from the IRS are set forth in a revenue procedure.

4. *Private letter rulings.* Private letter rulings, or PLRs, are issued by the IRS to a specific taxpayer in response to a request from the taxpayer for an interpretation of the tax law to a particular set of facts. PLRs may not be cited as precedent and generally may not be relied upon by a taxpayer other than the taxpayer which received the PLR. However, PLRs are released to the public (without identifying the taxpayer) and are typically viewed as expressing the views of the IRS applicable to all taxpayers with the same issue.

C. "Non-Qualified" vs. "Qualified" Annuities.

1. The term "qualified" annuity is generally used to describe an annuity contract that is purchased in connection with a retirement plan that receives special tax treatment under the Code. An example would be a "section 403(b) annuity" used by a school teacher to defer a portion of his or her salary for retirement. The term "qualified annuity" is not actually used in the Code.

2. The term "non-qualified" annuity is generally used to describe an annuity contract that is *not* purchased in connection with a retirement plan that receives special tax treatment under the Code.

3. Key differences.

   a. The premiums used to purchase a "qualified" annuity are typically either deductible, or if paid by an employer, excludable, from the owner's income. The premiums used to purchase a non-qualified annuity are neither deductible nor excludable, *i.e.,* they are said to be "after-tax."

      The Code limits the amount of premiums that can be paid into a qualified annuity, but not into a non-qualified annuity.

   b. The time and manner in which benefits must be paid differ substantially between qualified and non-qualified annuities.

   c. There are a number of other tax differences between qualified and non-qualified annuities. For example, the Code generally prohibits transfer of the ownership of a qualified annuity, whereas ownership of a non-qualified annuity can be transferred (although a tax may be incurred).

II. FEDERAL TAX DEFINITION OF "ANNUITY."

A. Nature of the Tax Law's Annuity Definition.

1. Amounts under an annuity contract will obtain federal income tax deferral treatment, and premium deductions or exclusions applicable to qualified arrangements will be available, only if the contract is treated as an annuity for federal tax purposes. There is no comprehensive statutory definition of "annuity" or "annuity contract," but the defining characteristics may be discerned from regulations, case law, and certain statutory provisions.

2. According to the Income Tax Regulations, an "annuity contract" that is subject to the rules of Code Section 72 (governing the tax treatment of distributions from life insurance and annuity contracts) includes a contract that is recognizable as an annuity under the "customary" practices of life insurance companies. See Treas. Reg. Section 1.72-2(a)(1).

3. A variable annuity contract, to be treated as an annuity for federal tax purposes, must comply with the investment diversification requirements of Code Section 817(h) (and the regulations thereunder) and must not provide the policyholder with excessive "control" over the investments underlying the contract. (See II.D. below.)

B. Key Definitional Requirements of Case Law and IRS Rulings.

1. *Amortization of principal and earnings*. Under the regulations and applicable case law, a contract must provide for (at least annual) periodic payments in order to be considered an annuity. Further, such "annuity payments" — sometimes called an "annuitization" — must liquidate the principal applied to provide the payments along with the interest or earnings thereon. See Igleheart v. Comm'r., 174 F. 2d 605, 606-07 (7^{th} Cir. 1949), aff'g 10 T.C. 766 (1948).

    a. *Maximum annuity starting date*. In the past, most deferred annuity contracts provided for annuity payments to commence around the annuitant's age 70. For a contract used in a qualified arrangement, minimum distribution requirements generally impose a need to begin payments (which may or may not represent an annuitization) after the participant's age 70-1/2. However, many nonqualified contracts issued today permit the commencement of payments to be deferred until age 90 or even later. See PLR 200022003 (contract permitted deferral to as late as age 90). The income tax consequences of a late annuity starting date, if any, are uncertain. On the other hand, the IRS has suggested that such a contract may not be an annuity. See General Counsel Memorandum 38934 (1982) (arguing that such an arrangement was a taxable account). On the other hand, in 1983, Congress considered and rejected the idea that annuity payments under a non-qualified annuity should begin on a date certain. See Hearings on the Taxation of Life Insurance Before the Subcomm. on Select Revenue Measures of the House Ways and Means Comm., 98th Cong. 583, 904, (1983).

b. *Immediate annuities with surrender values*. The IRS has issued private letter rulings treating certain immediate annuities with cash surrender values as annuities for federal tax purposes. See PLR 20036021 (Jun. 7, 2000); PLR 9237030 (Jun. 16, 1992). Even so, the existence of such a surrender value presents the possibility that the principal and interest or earnings under the annuity are not being amortized. Immediate annuities providing surrender values represent a relatively new development and the manner in which Code Section 72 applies to such arrangements is not fully known.

2. *"Agreements to pay interest" distinguished*. If, in substance, the purported annuity payments distribute only interest, with the principal left intact for payment upon a commutation or to a death beneficiary, the entirety of the interest payments will be includible in gross income for tax purposes. See Code Section 72(j); Treas. Reg. Section 1.72-14(a); Meyer v. Comm'r., 139 F. 2d 256, 258-59 (6th Cir. 1943).

C. Section 72(s) – Distributions on Death of Owner.

1. *Required distributions.* An annuity contract issued after January 18, 1985, whether deferred or immediate, is not treated as an annuity for any purpose of the Code unless it satisfies *by its terms* the minimum distribution-at-death requirements of Code Section 72(s).

2. *Death before annuity starting date*. If the "holder" of the contract dies *before* the annuity starting date, the contract must provide that the entire value will be distributed within five years of death. See Code Section 72(s)(1)(B). There are exceptions:

   a. Any portion of the contract's value distributable over the life or over a period not exceeding the life expectancy of a designated beneficiary, distribution of which begins no later than one year from the date of death, is treated as distributed on the day that the distribution commences.

   b. If the designated beneficiary is the spouse of the holder, the spouse may "step into the shoes" of the decedent and continue the contract.

3. *Death after the annuity starting date.* If the holder dies *on or after* the annuity starting date, any remaining payments must be made at least as rapidly as they would have been made under the distribution method in effect prior to the holder's death. See Code Section 72(s)(1)(A).

4. *Non-natural owners.* If the holder is not a natural person (and Code Section 72(u) does not apply – see II.E. below), the "primary annuitant" under the contract – the individual whose life, age, etc., primarily affect the timing and amount of the payout under the contract – is treated as the holder. If such primary annuitant is changed, the contract must provide for its liquidation as if the holder had died. See Code Section 72(s)(6)-(7).

5. *Multiple owners.* If there is more than one holder (as in the case of joint owners), the death of *any* holder must trigger the above-described liquidation of the contract.

6. *Annuity starting date.* The annuity starting date is the first day of the first period for which an amount is received as an annuity under the contract. See Code Section 72(c)(4); Treas. Reg. Section 1.72-4(b).

7. *Structured settlements.* Structured settlement annuities and contracts used in qualified arrangements are exempted from the Code Section 72(s) requirements. See Code Section 72(s)(5).

D. Investor Control and Diversification Requirements.

1. *The Doctrine of "Investor Control" and Events Leading to the Enactment of Section 817(h).*

   a. *Ownership of assets*. Under the "traditional" variable life insurance or annuity contract, the insurance company (and not the policyholder) is considered the owner of the underlying separate account assets. Consistently with this, the policyholder is not currently taxed on the increase in the contract's cash value.

   b. *The "wraparound" issue.* In the mid-1970s, the IRS began to question the tax-deferred status of variable annuities which permitted varying degrees of policyholder control over the investment of the underlying assets.

      i. Subsequently, a series of rulings were issued indicating that, in certain circumstances, the policyholder would be deemed to "own" the assets for federal income tax purposes, with the annuity contract being characterized as a mere "wrapper."

      ii. As a result, the policyholder would be currently taxable on earnings from those assets, e.g., realized capital gains, dividends, and interest.

      iii. These "wraparound" or "investor control" rulings are said to be based on a general principal of tax law: that the substance of an arrangement, not merely its form, controls the taxation of the arrangement.

c. *Revenue Ruling 77-85.* In Rev. Rul. 77-85, 1977-1 C.B. 12, the IRS held that the bundle of rights given the policyholder in an "investment annuity" contract amounted to a direct investment in the underlying account assets. Thus, the policyholder would be treated as the owner of the assets and currently taxed on their earnings.

   i. The "bundle of rights" included the complete investment control of the underlying assets and the possession of voting rights with respect to the underlying securities.

   ii. The ruling was a reversal of earlier private letter rulings which had granted annuity tax treatment to policyholders under investment annuities.

   iii. In Investment Annuity, Inc. v. Blumenthal, 442 F. Supp. 681 (D.D.C. 1977), the court sustained the issuing company's action to void Rev. Rul. 77-85 and enjoin IRS enforcement. The case was reversed on procedural grounds, 609 F.2d 1 (D.C. Cir. 1979), cert. denied, 446 U.S. 981 (1980).

d. *Revenue Ruling 80-274.* In the "savings and loan annuity" contract, a policyholder's premiums were invested in certificates of deposit having a duration and rate selected by the policyholder and issued by a bank or savings and loan association of the policyholder's choice. In Rev. Rul. 80-274, 1980-2 C.B. 27, the IRS ruled that "the policyholder's position is substantially identical to what his position would have been" had the investment been made directly with the savings institution, so that the policyholder (and not the insurer) would be considered the owner of the assets underlying the contract.

e. *Revenue Ruling 81-225.* Rev. Rul. 81-225, 1981-2 C.B. 12, pertained to annuity contracts funded by insurance company unit investment trust separate account arrangements, where the insurance company purchased and sold shares of mutual funds which were also offered for sale directly to the public. The ruling held that the policyholders of certain variable annuity contracts, whose purchase payments were invested in publicly available mutual fund shares, would be treated as the owners of the mutual fund shares.

f. *Revenue Ruling 82-54.* In Rev. Rul. 82-54, 1982-1 C.B. 11, the IRS held that a policyholder's ability to choose among three broad, general investment strategies (stocks, bonds and money market instruments) would not constitute sufficient control over individual investment decisions so as to cause ownership of the private mutual fund shares to be attributable to the policyholder.

g. *Revenue Ruling 82-55.* In Rev. Rul. 82-55, 1982-1 C.B. 12, the IRS attempted to clarify various issues which had been left open under Rev. Rul. 81-225. In particular, the ruling stated that purchasers of annuity contracts whose funds were invested in a "closed" mutual fund (i.e., its shares were no longer available for purchase by the general public) would not be treated as the owners of those mutual fund shares.

h. *The "representations."* In 1982, the IRS began to issue letters detailing certain "representations" which would be required from an issuer of a variable annuity contract (and subsequently a variable life insurance contract) in order to receive a favorable private letter ruling. Changes to these "representations," which related to the nature and control of the assets in variable contract separate accounts, were made almost continuously after the initial letter ruling was issued.

i. *Christoffersen v. United States*.

   i. On October 15, 1981, taxpayers purchased a variable annuity contract which permitted them as policyholders to allocate premiums among sub-accounts of the issuing insurance company's separate account. The premiums allocated to a particular sub-account were invested in a specified mutual fund, the shares of which were also available for purchase (directly or indirectly) by the general public.

   ii. Pursuant to Rev. Rul. 81-225, the taxpayers included in their taxable income for 1981 income received by the insurance company on the mutual fund shares allocated to the contract at issue. The taxpayers then sued for a refund challenging the validity of Rev. Rul. 81-225.

   iii. The U.S. District Court for the Northern District of Iowa decided in favor of the taxpayers, holding that the "contract is an annuity pursuant to 26 U.S.C. 801(g) qualifying for deferred taxation under 26 U.S.C. 72." See 578 F. Supp. 398 (N.D. Ia. 1984).

   iv. On appeal by the Government, the U.S. Court of Appeals for the 8th Circuit overturned the district court's ruling and held that the taxpayers' variable annuity contract did not qualify for deferred tax treatment under Code Section 72, and thus that the policyholders were currently taxable on income from the contract. See 749 F.2d 513 (8th Cir. 1984)

      (a) The Court of Appeals characterized the contract as "an investment program which includes a contract for the purchase of an annuity."

      (b) The court observed, with respect to the contract, that the "investors" bore the entire investment risk, could withdraw any or all of the investment upon 7 days notice, and might never annuitize the contract. Further, the only difference between this "variable annuity" arrangement and that of a traditional brokerage account was the fact that the investor was limited to withdrawing cash.

(c) The court held that the taxpayers were in constructive receipt of the income generated by the account assets.

(d) The court did not analyze (or mention) the specific issue involved in the case and the essence of Rev. Rul. 81-225 — the public availability of the mutual funds upon which the contract was based. However, after describing the doctrine of constructive receipt, the court noted that "[t]his is the essence of Rev. Rul. 81-225, which we find persuasive."

v. The rationale of the Court of Appeals conceivably could be applied to alter the tax treatment of all variable annuity contracts (and variable life insurance contracts). However, the provisions of the Code at issue were substantially revised in 1982 and again in 1984 so as to place significant restrictions on nonqualified annuity contracts. In this connection, the court specifically noted that, because the case involved the 1981 tax year, it dealt only with the statute as it existed in 1981.

2. *Diversification Requirements Under Section 817(h).*

a. *Section 817(h).*

i. Section 817(h), containing the variable contract "investment diversification" rules, was enacted by section 211(a) of the Deficit Reduction Act of 1984 (Pub. L. 98-369) "in order to discourage the use of tax-preferred variable annuities and variable life insurance primarily as investment vehicles." S. Rep. No. 98-169, vol. 1, 98th Cong., 2nd Sess. 546 (1984).

ii. General rule of Code Section 817(h)(1). A variable contract is not treated as an annuity, endowment, or life insurance contract for life insurance company tax purposes or for purposes of Code Sections 72 and 7702 unless the investments made by the segregated asset account on which such contract is based are "adequately diversified" in accordance with regulations to be prescribed by the Secretary of the Treasury.

iii. Code Section 817(h) does not apply to pension plan contracts described in Code Section 818(a). Thus, variable annuities used as Code Section 403(b) "tax-sheltered annuities" and Code Section

408(b) individual retirement annuities do not need to be based on diversified accounts. See Code Section 817(h)(1).

iv. "Safe harbor" rules.

(a) Any fund will be deemed to be adequately diversified if it meets the diversification requirements of Code Section 851(b)(3) (relating to regulated investment companies) *and* not more than 55 percent of its total assets consist of cash, cash items, Government securities, and securities of "other regulated investment companies." See Code Section 817(h)(2).

(b) Funds underlying *variable life insurance contracts* are deemed adequately diversified even if such funds invest totally in U.S. Treasury securities. The statute does not provide a similar exception for variable annuity contracts. See Code Section 817(h)(3).

(c) An insurance company may use an independent investment advisor to manage the assets underlying its variable contracts. See Code Section 817(h)(5).

v. "Look-through rule." The insurer is allowed to look through to the assets of the underlying investment vehicle in determining compliance with investment diversification requirements, provided that all of the beneficial interests in the regulated investment company or trust used as the investment vehicle are held by one or more insurance companies in their general account or in segregated asset accounts or by fund managers (or affiliated companies) in connection with the creation or management of the regulated investment company or trust. See Code Section 817(h)(4).

vi. "Clone funds." According to the Conference Report on the 1984 law, the fact that a "similar fund" is available to the general public will not, in itself, cause a fund underlying a segregated asset account to be treated as publicly available. See H.R. Rep. 98-861, 98th Cong., 2nd Sess. 1055 (1984).

b. *Temporary and proposed regulations under Code Section 817(h)(1).*

i. Temporary and proposed regulations implementing Code Section 817(h) were issued in September, 1986.

ii. The preamble to the temporary and proposed regulations provided background information and a summary of the regulatory provisions. The preamble noted, in particular, that the temporary and proposed regulations did not provide guidance relating to the circumstances in which "investor control" of variable account investments may cause such investor, rather than the insurance company, to be treated as the owner of assets of such account." Rather, the preamble stated such guidance "will be provided in regulations or revenue rulings under Code Section 817(d), relating to the definition of a variable contract." (Such formal guidance has never been issued.)

iii. Numerous comments were filed by the life insurance industry on the proposed regulations, and a number of changes were made in the final regulations, issued in March, 1989.

c. *Final regulations (Treas. Reg. Section 1.817-5).*

i. Basic rule (Treas. Reg. Section 1.817-5(b)(1)): The assets of a "segregated asset account" will be treated as adequately diversified only if —

(a) No more than 55% of the value of the assets of the account is represented by any one investment;

(b) No more than 70% of the value of the assets of the account is represented by any two investments;

(c) No more than 80% of the value of the assets of the account is represented by any three investments; and

(d) No more than 90% of the value of the assets of the account is represented by any four investments.

ii. Safe harbor (Treas. Reg. Section 1.817-5(b)(2)): <u>See</u> II.D.2.a.iv.(a). above.

iii. Special rule for variable life contracts (Treas. Reg. Section 1.817-5(b)(3)). Under a formula set forth in the regulations, a segregated asset account supporting variable life insurance contracts is effectively allowed to invest entirely in Treasury securities — see II.D.2.a.iv.b. above.

iv. Aggregation of securities (Treas. Reg. Section 1.817-5(b)(1)(ii)). All securities of the same issuer generally are treated as a single investment. However, in the case of Government securities, each Government agency or instrumentality is treated as a separate issuer.

v. Period for which account must be adequately diversified (Treas. Reg. Section 1.817-5(c)):

(a) An account must be adequately diversified each calendar quarter. It is treated as adequately diversified for the quarter if it is diversified on the last day of a calendar quarter (i.e., March 31, June 30, Sept. 30, and Dec. 31) or within 30 days thereafter.

(b) There are special, more liberal rules for new and for liquidating accounts. See Treas. Reg. Section 1.817-5(c)(2) and (3).

(c) There is also a special rule to prevent market value fluctuations of assets from causing the percentage limitations to be violated. See Treas. Reg. Section 1.817-5(d).

vi. Definition of a "segregated asset account" (Treas. Reg. Section 1.817-5(e)): For purposes of the diversification regulations —

(a) "A segregated asset account shall consist of all assets the investment return and market value of each of which must be allocated in an identical manner to any variable contract invested in any of such assets."

(b) In the case of the typical variable contract, each sub-account or investment division is treated as a segregated asset account for diversification testing. However, this treatment presupposes that the owner of the contract has the right to allocate funds among the sub-accounts or investment options. See Treas. Reg. Section 1.817-5(g).

vii. Look-through rule (Treas. Reg. Section 1.817-5(f)):

(a) If certain conditions are satisfied, a segregated asset account is treated as owning a pro-rata portion of each asset of the entity in which the account invests, rather than an interest in the entity itself. The rule applies only to certain entities: regulated investment companies, real estate investment trusts, partnerships, and grantor trusts.

(b) General conditions to be satisfied: The look-through generally is available only if all the beneficial interests in the entity are held by one or more segregated asset accounts of one or more insurance companies, and public access to such entity is available exclusively through the purchase of a variable contract. (This has the effect of enforcing the holding of Rev. Rul. 81-225.)

(c) Exceptions: Application of the look-through rule is not prevented if beneficial interests in the entity are held —

(i) by the general account of the life company or certain related corporations, if certain conditions are satisfied;

(ii) by the manager, or certain related corporations, of the entity, but only if the holding of the interest is in connection with the creation of the entity and certain other conditions are satisfied;

(iii) by the trustee of a qualified retirement plan (See Rev. Rul. 94-62); or

(iv) in connection with certain grandfathered "wrap-around" annuity contracts.

(d) Non-registered partnerships. Until recently, the regulations also allowed look-through treatment with respect to a segregated asset account's interest in a partnership that was not registered under any federal or state law regulating the offering or sale of securities (a "non-registered partnership"). *see* former Treas. Reg. sec. 1.817-5(f)(2)(ii).

(i) Thus, look-through treatment applied to non-registered partnerships without regard to whether the "beneficial interest" and "public access" requirements were satisfied.

(ii) This special rule was repealed in 2005. Under a transition rule, a segregated asset account in existence before March 1, 2005 will be considered adequately diversified if as of March 1, 2005, the account was adequately diversified within the meaning of section 817(h) and the 817(h) regulations as in effect prior to that date (*i.e.*, complied with the special provisions then in existence relating to the application of the look-through rule in the case of non-registered partnerships), and (2) by December 31, 2005, the account is adequately diversified within the meaning of section 817(h) and the 817(h) regulations. See Treas. Reg. sec. 1.817-5(h)(10)(i)(2)(v).

(e) An issue that sometimes arises is whether a "double" look through is available in circumstances where one fund invests in another fund. The general answer is "yes," providing that the requirements of the look-through rule are satisfied by both funds. See Rev. Rul. 2005-7, 2005-1 C.B. 464. See also, e.g., PLR 200016008 (Jan. 18, 2000).

viii. Definitions of terms (Treas. Reg. sec. 1.817-5(h)): the regulations define a number of the terms that they use, including "government security" and "Treasury security." Terms that are undefined are to be given the same meaning as when used in section 851.

ix. Consequences of nondiversification (Treas. Reg. sec. 1.817-5(a)(1)):

(a) The regulations provide that for purposes of subchapter L, section 72, and section 7702(a), a variable contract which is based on one or more segregated asset accounts shall not be treated as an annuity or life insurance contract for (1) any calendar quarter for which the investments of *any* such account are not "adequately diversified," and (2) any subsequent period even if the investments are adequately diversified for such subsequent period.

(b) A contract is treated as based on a segregated asset account for a calendar quarter if *any* amounts under the contract are allocated to the account at *any* time during the quarter.

(c) If a contract is not treated as an annuity or life insurance contract as a result of the foregoing rule, the "income on the contract" within the meaning of section 7702(g) is treated as ordinary income received by the policyholder during the year.

x. Inadvertent failures to diversify (Treas. Reg. sec. 1.817-5(a)(2)): the investments of a nondiversified segregated asset account will be treated as adequately diversified if certain conditions are satisfied —

(a) The nondiversification must have been "inadvertent."

(b) The nondiversification must be cured within a "reasonable time after the discovery" of the nondiversification.

(c) Either the issuer of the contract or the holder must "agree to make such adjustments or pay such amounts as may be required by the Commissioner with respect to the period or periods during which the investments of the account [were not diversified.] The amount required by the Commissioner to be paid shall be an amount based upon the tax that would have been owed by the policyholders if they were treated as receiving the income on the contract [during the period of non-diversification]."

(d) Rev. Proc. 92-25, 1992–1 C.B. 741, sets forth the procedure to be followed and the computation of the sanction, or "toll charge," to be paid to obtain this relief. <u>See</u> <u>also</u> Notice 99-48, 1999-2 C.B. 429.

3. Status of Investor Control Doctrine Today.

   a. The investor control doctrine was not specifically addressed in the final regulations under section 817(h), although some have viewed the doctrine as being preempted by section 817(h) and the regulations thereunder. In this regard, in July 2003, the IRS released two revenue rulings addressing the investor control doctrine. These rulings represent the first formal guidance on the investor control doctrine since 1982.

   b. Revenue Ruling 2003-91, 2003-2 C.B. 347.

      i. Facts.

         (a) Revenue Ruling 2003-91 describes two situations involving the purchase of a variable contract within the meaning of section 817(d) from a life insurance company subject to tax under section 801 ("IC"). Under the first situation, an individual ("Holder") purchases a life insurance contract from IC, and under the second situation the Holder purchases an annuity contract from IC (collectively, the variable life and annuity contracts are called the "Contracts"). Otherwise, the situations are identical.

         (b) Assets supporting the Contracts are maintained by IC in a separate account ("Separate Account") that is divided into various sub-accounts ("Sub-Accounts").

            (i) Interests in the Sub-Accounts are available solely through the purchase of a Contract, <u>i.e.</u>, they are not otherwise available for sale to the public.

            (ii) IC engages an independent investment advisor ("Advisor") to manage the investments of each Sub-Account.

            (iii) Each Sub-Account at all times will meet the diversification requirements of section 817(h).

         (c) Twelve Sub-Accounts currently are available under the Contracts, according to the ruling, and IC may increase or decrease this number at any time, although there will never be more than 20 Sub-Accounts available under the Contracts. The Sub-Accounts (which, as identified in the ruling, actually numbered 13) consist of:

            (i) a bond fund,
            (ii) a large company stock fund,

(iii) an international stock fund,
(iv) a small company stock fund,
(v) a mortgage backed securities fund,
(vi) a health care industry fund,
(vii) an emerging markets fund,
(viii) a money market fund,
(ix) a telecommunication fund,
(x) a financial services industry fund,
(xi) a South American stock fund,
(xii) an energy fund, and
(xiii) an Asian markets fund.

(d) Holder specifies the allocation of premiums paid among the Sub-Accounts at issuance and thereafter may transfer amounts among the Sub-Accounts without limitation, subject to incurring fees for more than one transfer per 30 days.

(e) There is no prearrangement, plan, contract, or agreement between Holder and IC or between Holder and Advisor regarding the availability of a particular Sub-Account, the investment strategy of any Sub-Account, or the assets to be held by a particular Sub-Account.

(f) All investment decisions are made by IC or Advisor in their sole and absolute discretion. Holder cannot select or recommend particular investments or investment strategies, and cannot communicate directly or indirectly with any investment officer of IC or its affiliates or with Advisor regarding the selection, quality, or rate of return on any specific investment or group of investments held in a Sub-Account.

(g) Holder has only a contractual claim against IC to collect cash under the Contract in the form of death benefits or surrenders, and has no legal, equitable, direct, or indirect interest in any of the assets held by a Sub-Account.

(h) All decisions regarding the choice of Advisor or the choice of any of IC's investment officers that are involved in the investment activities of the Separate Account or any Sub-Account are made by IC in its sole and absolute discretion. Holder cannot communicate directly or indirectly with IC regarding these matters.

ii. Holdings and analysis.

(a) When regulations were first proposed under section 817(h) in

1986, the IRS indicated that the particular facts relating to a variable contract owner's ability to allocate premiums and contract values among sub-accounts could give rise to an investor control issue. However, prior to Revenue Ruling 2003-91, the IRS had never published further guidance on these points.

(b) Based on the facts summarized above, the IRS concludes in Revenue Ruling 2003-91 that in both situations described in the ruling Holder will not be considered the owner, for federal income tax purposes, of the assets funding the Contracts. In so concluding, the IRS states that the determination of whether Holder possesses sufficient incidents of ownership over Sub-Account assets to be deemed the owner of those assets for tax purposes depends upon all the relevant facts and circumstances.

(c) In this regard, the IRS notes that Holder may not select or direct particular investments to be made by either the Separate Account or the Sub-Accounts, that Holder may not sell, purchase, or exchange assets in the Separate Account or Sub-Accounts, and that investment in the Sub-Accounts is available solely through the purchase of a Contract.

(d) The IRS also notes that Holder's ability to transfer Contract values among Sub-Accounts does not, in itself, indicate that Holder has control over those assets for tax purposes. In so stating, however, the IRS observes that the investment strategies of the Sub-Accounts (i.e., the funds listed above) are "sufficiently broad" to prevent Holder from making particular investment decisions through investment in a Sub-Account.

iii. *Point of interest regarding the ruling.* Prior to Revenue Ruling 2003-91, the only published guidance from the IRS addressing the number of investment options available under a variable contract in the context of the investor control doctrine was Revenue Ruling 82-54. As described above, in that ruling the IRS concluded a variable contract owner's "ability to choose among broad, general investment strategies such as stocks, bonds or money market instruments" did not cause an investor control problem. Revenue Ruling 2003-91 suggests that investment strategies that are more specific than the fundamental "stock, bond, and money market" asset classes (such as the 13 strategies listed in the ruling) can be viewed as "broad, general investment strategies" for purposes of the investor control doctrine.

c. Revenue Ruling 2003-92, 2003-2 C.B. 350.

i. Facts.

(a) Revenue Ruling 2003-92 describes three situations involving the purchase of a variable annuity contract and/or variable life insurance contract from a life insurance company ("IC"). In each situation, the variable contract is not registered under federal securities laws, and is sold only to "qualified purchasers" that are "accredited investors" or to no more than 100 accredited investors (i.e., the variable contract is sold only through "private placement" offerings).

(b) In the first situation, an individual who is a qualified purchaser and accredited investor ("Holder") purchases an annuity. The assets supporting the annuity are held in a segregated asset account that is divided into 10 sub-accounts ("Sub-Accounts").

(i) Each Sub-Account at all times will meet the asset diversification requirements of section 817(h).

(ii) Holder specifies how premiums are to be allocated among the Sub-Accounts at issuance of the annuity, and may change the allocation of subsequent premiums at any time.

(c) Also in the first situation, each Sub-Account invests in interests in a partnership ("Partnership").

(i) No Partnership is a publicly traded partnership within the meaning of section 7704, and each Partnership is exempt from registration under federal securities laws.

(ii) Interests in the Partnerships are available to qualified purchasers and accredited investors without purchasing an annuity.

(iii) Each Partnership has an investment manager that selects the Partnership's investments.

(iv) Holder may not act as investment manager or independently own any interest in any Partnership offered under the annuity.

(v) Holder will have no voting rights with respect to any Partnership.

(d) The second situation described in the ruling is identical to the first, except that Holder purchases a life insurance contract rather than an annuity.

(e) In the third situation, Holder purchases both an annuity and a life insurance contract, but interests in the Partnerships are available for purchase only through the purchase of a variable contract.

ii. Holdings and analysis.

(a) Based on the foregoing facts, the IRS concludes that "the holder of a variable annuity or life insurance contract will be considered to be the owner, for federal income tax purposes, of the partnership interests that fund the variable contract if interests in the partnerships are available for purchase by the general public," i.e., other than through the purchase of a variable contract.

(b) Thus, the IRS states that because in the first two situations the Partnership interests are available other than to purchasers of a variable contract from an insurance company, Holder is the owner of the interests in the Partnerships for tax purposes. However, because in the third situation the Partnership interests are available for purchase only by a purchaser of a variable contract, IC is the owner of the Partnership interests for federal income tax purposes.

iii. *Point of interest regarding ruling.* Revenue Ruling 2003-92 marks the first time that the IRS has published guidance on investor control issues in the context of a private placement life insurance or annuity contract. Likewise, it is noteworthy that the guidance reaches a favorable conclusion under the third situation described in the ruling.

(a) With regard to the unfavorable conclusion reached in the first two situations, the holding of Revenue Ruling 2003-92 is essentially the same as the conclusion the IRS reached in a private letter ruling issued last year (PLR 200244001 (May 2, 2002)).

(b). Significantly, Revenue Ruling 2003-92 does not refer to the non-registered partnership look-through rule in Treas. Reg. sec. 1.817-5(f)(2)(ii), which the taxpayer in PLR 200244001 argued was inconsistent with the IRS's holding in that ruling (and now, the holding in Revenue Ruling 2003-92).

d. Other guidance on investor control.

i. "Dedicated" separate accounts are accounts used for one or a small number of similarly situated policyholders. In PLR 9433030, the IRS concluded that a single policyholder's separate account did not run afoul of the investor control doctrine. The IRS based its conclusion on Rev. Rul. 77-85, Rev. Rul. 80-274, Rev. Rul. 81-225, and the Christoffersen case. The status of this private letter ruling has been questioned in light of Rev. Rul. 2003-91 and Rev. Rul. 2003-92.

ii. Indirect funding with public mutual funds:

(a) PLR 9839034 involved a regulated investment company (the "Closed Fund") that proposed to invest in nine funds. Each of the nine funds was a regulated investment company which offered its shares to the Closed Fund as well as to members of the public (the "Public Funds").

(b) Shares of the Closed Fund were offered only to insurance company segregated asset accounts and others allowed under Treas. Reg. sec. 1.817-5(f)(3)(i) and (ii). Purchasers of the variable contracts based on the Closed Fund had no power to alter the allocation of the Closed Fund assets among the Public Funds. That power was held by the sponsor of the Closed Fund.

(c) The IRS held that the shares of the Closed Funds would be treated as held by the insurance company and not the variable contract owners. See also PLR 9851044 (Sept. 22, 1998).

(d) The IRS has issued a number of rulings on investor control in recent years where insurance-dedicated funds could invest their assets completely (PLR 200420017 (May 14, 2004)) or partially (PLR 200025037 (Mar. 24, 2000) and PLR 200601006 (Sept. 30, 2005)) in publicly available funds.

iii. Direct funding with public mutual funds:

(a) In Rev. Rul. 81-225, the Service held that contracts based on public mutual funds were "not annuity contracts described in section 403(a) or (b) or section 408(b) of the Code."

(b) In 1984, when Congress enacted section 817(h), Congress expressly excepted from the diversification requirements all qualified retirement plan contracts, including those just listed.

(c) As a result, some taxpayers requested the IRS to rule that variable contracts used to fund qualified retirement plans can be based on publicly available mutual funds. The IRS has issued such a ruling in the case of variable annuity plan contracts issued to section 401(a) plans. See PLR 9723032 (Mar. 10, 1997).

(d) The IRS issued Rev. Proc. 99-44, 1999-2 C.B. 598, in response to this request. Under Rev. Proc. 99-44, a section 403(b) annuity, a section 408(b) IRA annuity, and a section 403(a) annuity can invest in public mutual funds and still be treated as annuities if certain conditions are satisfied.

(e) Rev. Proc. 99-44 reaffirmed the Service's position that the investor control doctrine retains vitality independent from the diversification requirements of section 817(h) and the regulations thereunder.

4. Open issues.

a. Permissible number of fund options — how many is too many? Rev. Rul. 2003-91, supra, states that the contract will provide up to 20 investment options, but the IRS' analysis makes no reference to that figure as a limitation on the permissible number of investment options. Instead, the IRS concludes that the investment strategies identified in the facts are "sufficiently broad" to avoid an investor control problem.

b. Permissible number of transfer/exchanges among funding options — are there any limits? Rev. Rul. 2003-91, supra, states that the contract allows unlimited transfers among investment options, subject to fees for more than one transfer per 30 days.

c. Clone funds – in PLR 9437027, the IRS modified an earlier set of private rulings to delete references in the earlier rulings that could have been viewed as "blessing" clone funds. What is a clone fund? Do clone funds create an investor control problem?

d. Narrowly focused funds – how broad must the focus or permitted investments of a fund be? Rev. Rul. 2003-91, supra, suggests that investment strategies that are more specific than the fundamental "stock, bond, and money market" asset classes (such as the 13 strategies listed in that ruling) can be viewed as "broad, general investment strategies" for purposes of the investor control doctrine.

E. Section 72(u) – Non-Natural Owners.

An annuity contract owned by a non-natural person is not treated as an annuity for federal income tax purposes (other than for insurance company taxation), and so the contract's inside buildup is currently taxed, pursuant to Code Section 72(u). Of course, some exceptions apply.

1. Included in gross income for any taxable year is the "income on the contract" for the year, defined as the excess of (1) the contract's net surrender value at year-end plus all distributions under the contract to date, over (2) the premiums paid for the contract (net of dividends) plus all distributions includible in income to date. See Code Section 72(u)(2).

2. The inside buildup taxation applies with respect to contributions to annuity contracts after February 28, 1986.

3. A significant exception to this current taxation treatment is provided under Code Section 72(u)(1) where the annuity contract is held "by a trust or other entity as an agent for a natural person."

   a. The trust/agent exception does not apply to all trust-held annuities. For example, this exception does not apply to the extent that beneficial ownership of the trust resides in a non-natural person or to an annuity held by a charitable remainder unitrust. PLR 9115032 (Jan. 14, 1991); PLR 9009047 (Dec. 5, 1989).

   b. According to the legislative history of Code Section 72(u)(1) and recent IRS rulings on this subject, an annuity is generally viewed as being held by a natural person within the meaning of the statute where beneficial ownership of the annuity resides with a natural person. See H.R. Rep. No. 99-426, 99th Cong., 1st Sess 704 (1985); S. Rep. No. 99-313, 99th Cong., 2d Sess. 567 (1986); PLR 200449011 (Dec. 3, 2004).

4. Additional exceptions to this current taxation treatment are made in Code Section 72(u)(3) for:

   a. An "immediate annuity," defined in Code Section 72(u)(4) as an annuity purchased with a single premium and providing for a payout of substantially equal periodic amounts beginning no later than one year from purchase and continuing over the annuity period;

   b. A contract acquired by a decedent's estate by reason of the decedent's death;

   c. A structured settlement annuity; and

   d. A contract held in one of the enumerated qualified arrangements.

F. Consequences of Noncompliance with the "Annuity" Definition.

1. A contract that does not provide for the systematic liquidation of principal and interest or earnings, but rather provides solely for the payment of interest or earnings on the principal amount of an invested fund with the principal remaining intact, is not treated as an annuity contract for federal income tax purposes. See Code Section 72(j); Treas. Reg. Section 1.72-14(a); Meyer v. Comm'r., supra.

    a. If such a contract is non-variable, it will be considered an "agreement to pay interest," and the owner of the contract will be currently taxable on the interest accruing on the account values.

    b. If it is a variable contract, it will most likely be considered a mutual fund for tax purposes, and the owner will be taxed accordingly. However, there is no guidance on this issue.

2. A contract that does not meet the requirements for distributions upon death of the holder under Code Section 72(s) will not be considered an annuity contract for federal tax purposes.

    a. Interest or earnings accruing on the account values under such a contract will be currently taxable to the contract's owner, although there is no published guidance on the specifics of the calculation. The insurer that issued the contract also has tax reporting obligations with respect to such income, and potentially incurs penalties for failure to observe such obligations.

    b. There likewise is no published guidance regarding the procedure for an annuity issuer to correct contracts that fail to meet the distribution rules of Code Section 72(s).

3. Failure to satisfy the investment diversification rules of Code Section 817(h) will result in treatment of the related variable contract as other than an annuity contract for federal income tax purposes.

    a. The owner of the contract will be currently taxable on earnings accruing on the account values. Additionally, the issuer of the contract has withholding and reporting obligations with respect to such income, and may incur penalties for failure to observe such obligations. See Treas. Reg. Section 1.817-5(a)(1); Rev. Rul. 91-17, 1991-1 C.B. 190 (diversification failure).

    b. Once a separate account underlying a variable contract fails to comply with the diversification requirements, the contract cannot automatically regain its status as an annuity contract even after the account is brought back into compliance. See Treas. Reg. Section 1.817-5(a)(1); Rev. Proc. 92-25, 1992-

1 C.B. 741. However, a failure to meet diversification requirements can be excused by the IRS via the procedure set forth in Rev. Proc. 92-25 if:

i. the failure was inadvertent,

ii. it is corrected within a reasonable time after the failure is discovered, and

iii. the issuer of the contract (or the holder) agrees to make adjustments or pay the amount determined by the IRS to be due for the period of nondiversification (i.e., the tax due as if the contract's owner were receiving income on the contract for that period). See Treas. Reg. Section 1.817-5(a)(2); Rev. Proc. 92-25, supra.

4. A contract that fails the investor control requirements is said to be a wrap-around annuity (since the owner is trying to "wrap" annuity deferral rules around an otherwise taxable arrangement). The owner of such a contract will be currently taxable as if the owner held the underlying separate account assets (or mutual fund shares) directly. See Rev. Rul. 81-225, 1981-2 C.B. 12.

III. DISTRIBUTIONS FROM ANNUITY CONTRACTS.

A. Key Concepts. The tax treatment of distributions from annuity contracts is governed by Code Section 72. As already discussed, since this provision states that income is included in gross income when received, the effect is to permit the "inside buildup" of the annuity contract to grow on a tax-deferred basis. Under Code Section 72, the tax treatment of a distribution depends on whether the distribution is in the form of an annuity (*i.e.*, periodic payments after the "annuity starting date") or a lump sum amount. In addition, certain distributions may be subject to penalty taxes.

1. *"Investment in the contract."* A key concept that affects the portion of a distribution that is taxable is the "investment in the contract." Before the annuity starting date, the "investment in the contract" is the aggregate amount of premiums or other consideration paid for the contract before such date, minus the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income. Code Section 72(e)(6).

2. *Actual receipt and constructive receipt.* Generally, the gain present in an annuity contract is not taxable until received.

a. Actual receipt. Amounts may be actually received, such as where an insurer sends a check for cash payment to a policyholder.

b. Constructive receipt. It is also possible for amounts to be constructively received, such as where an amount is payable to a policyholder and receipt of such amount is not subject to substantial limitations or restrictions. (Having to forego valuable rights, such as those provided by annuity purchase rate guarantees, may provide such a substantial limitation or restriction.)

c. Constructive receipt of lump sum payments. Section 72(h) generally provides that if a contract provides for payment of a lump sum and the option to receive such amount is exercised within 60 days after the day on which such lump sum first became payable, then no part of such lump sum will be considered as includible in gross income at the time the lump sum first became payable.

d. Deemed receipt. As discussed below, there are other instances in which amounts are deemed to be received, *e.g.*, loans, assignments, and pledges, and certain charges assessed against a contract's cash value.

3. *Amounts received as an annuity and the "annuity starting date."* The tax treatment of payments from an annuity contact depends on whether or not they are received before the "annuity starting date." Treas. Reg. Section 1.72-4(b)(1) provides that a contract's "annuity starting date" generally is the "first day of the first period for which an amount is received as an annuity ... The first day of the first period for which an amount is received as an annuity shall be whichever of the following is the later: (i) The date upon which the obligations under the contract became fixed; or (ii) The first day of the period ... which ends on the date of the first annuity payment."

4. *Amounts not received as an annuity*. The rules for taxation of any amount not received as an annuity before the annuity starting date (including partial withdrawals and surrenders) are described below. Any non-annuity amounts received on or after the annuity starting date are automatically treated as gross income. Code Section 72(e)(2)(A).

5. *Who bears the tax – owner, annuitant, or beneficiary*. The person entitled to payments generally will be taxable on such payments, even if they are made to a third party. Thus, for example:

a. Prior to the annuity starting date, an owner typically has the right to partially or fully surrender a contract. If the owner directs that such a payment be made to another person, the owner will nonetheless be taxed on it.

b. Annuity contracts differ regarding the person who is entitled to receive annuity payments. Some contracts grant the owner the right to receive payments, while others grant the annuitant this right. Again, the person entitled to the payments under the terms of the contract will be taxable on them. If the annuitant is entitled to receive payments, is the transfer of rights on the annuity starting date treated as a gratuitous transfer that will trigger tax to the owner? Has there been a "transfer?"

c. Where a beneficiary is entitled to receive a death benefit, such amounts generally will be taxable to the beneficiary as paid.

B. Actual Distributions. The tax treatment of payments from an annuity contact depends on whether or not they are received before the "annuity starting date." Any non-annuity amounts received *on or after* the annuity starting date are automatically treated as gross income. Code Section 72(e)(2)(A). Amounts received *before* the annuity starting date may be characterized as either a payment of income or as a return of the policyholder's investment in the contract under the rules described below. However, policyholder dividends (or similar amounts) that are retained by the insurance company as premiums are not treated as distributions from the contract. Code Section 72(e)(4)(B).

1. *Distributions before the "annuity starting date."* Distributions prior to the annuity starting date are (1) included in income in accordance with a "gain first" or "LIFO" rule, and (2) may be subjected to a penalty tax.

a. Under the LIFO rule, amounts are includible in income to the extent that the contract's "cash value" immediately before the distribution — unreduced by any surrender charges — exceeds the investment in the contract (as defined above). See Code Section 72(e)(3) and (6).

b. Distributions subject to these rules are surrenders, partial surrenders or withdrawals, policy loans — including those used to pay premiums or to cover interest due on prior loans — and assignments for value. See Code Section 72(e)(4) and (10).

c. A loss incurred upon the surrender of an annuity contract is deductible as an ordinary loss, assuming that the contract was entered into for profit. See Rev. Rul. 61-201, 1961-2 C.B. 46; *George M. Cohan,* 39 F.2d 540 (2nd Cir. 1930).

2. *Aggregation rules.* For purposes of determining the "gain" or "income on the contract," Code Section 72(e)(11) requires the "aggregation" of all annuity contracts sold to the same policyholder within the same calendar year by the same insurer (or its affiliates). Excluded from this aggregation rule are immediate annuities and annuities used in qualified plan arrangements. Also excluded are so-called "split-funded" annuities (though these may be subject to other aggregation treatment).

3. *Penalty tax and exceptions.*

a. Applicable to premature distributions. To encourage taxpayers to use annuity contracts for retirement purposes rather than as short-term investments, Code Section 72(q)(1) imposes a 10% tax penalty on premature distributions. The amount of the penalty is 10% of the amount of the distribution that is includible in income.

b. Exceptions. The penalty tax does not apply to the following:

i. Distributions received on or after the taxpayer reaches age 59½. Code Section 72(q)(2)(A).

ii. Distributions made on or after the death of the contract holder or, where the holder is not an individual, the death of the "primary annuitant." Code Section 72(q)(2)(B).

iii. Distributions attributable to the taxpayer becoming disabled. Code Section 72(q)(2)(C).

iv. Distributions that are part of a series of substantially equal periodic payments (made at least annually) for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of the taxpayer and a designated beneficiary. Code Section 72(q)(2)(D).

v. Certain distributions made in connection with certain qualified retirement plans. Code Section 72(q)(2)(E), (H) and (J).

vi. Distributions allocable to investment in the contract prior to August 14, 1982 (including earnings thereon). Code Section 72(q)(2)(F).

vii. Distributions under a qualified funding asset (within the meaning of Code Section 130(d)), whether or not there is a qualified assignment. Code Section 72(q)(2)(G).

viii. Distributions made under an immediate annuity contract. Code Section 72(q)(2)(l). (The IRS has ruled that this exception will not apply upon the exchange of a deferred annuity for an immediate annuity since the issue date of the deferred annuity will carry over to the new contract. *See* Rev. Rul. 92-95, 1992-2 C.B. 43.)

4. *Death benefits.* Amounts payable under an annuity contract (whether or not it has been annuitized) to a beneficiary after the death of the contract owner or annuitant are taxable to the beneficiary, when received, under the normal Code Section 72 rules.

a. There is no Code Section 101 exclusion or Code Section 1014 "step-up" in basis. *See* Rev. Rul. 55-313, 1955-1 C.B. 219; Rev. Rul. 79-335, 1979-2 C.B. 292 (involving variable annuities).

b. A variable annuity contract may provide an "enhanced" death benefit, *i.e.*, an amount that exceeds the greater of the premiums paid or the cash surrender value of a contract, and for which a separate charge is imposed. Assuming the benefit is not treated as life insurance under state law, which is typically the case, the death benefit is taxable as discussed above. If the death benefit were treated as a separate contract of life insurance under state law, different tax consequences would ensue.

C. Deemed Distributions.

1. *Loans and assignments.* If an individual receives (directly or indirectly) any amount as a loan under an annuity contract, or assigns or pledges (or agrees to assign or pledge) any portion of the value of the contract, such amount or portion shall be treated as received under the contract as an amount not received as an annuity. Code Section 72(e)(4)(A). The investment in the contract is increased by any such amount included in gross income, although it is not otherwise affected by the above rule. Thus, the repayment of the loan, or the release of an assignment does not affect the investment in the contract.

2. *Gifts and other gratuitous transfers*. The gratuitous transfer of an annuity contract is effectively treated as a surrender of the contract, pursuant to Code Section 72(e)(4)(C), unless the transfer is to a spouse or to a former spouse incident to a divorce. As a result, the owner is taxable on the excess of the policy's cash value over his or her investment in the contract. The donee's investment in the contract is increased by the amount of this income. <u>See</u> Code Section 72(e)(4)(C)(i).

3. *Charges to pay for other benefits.* Various charges have traditionally been made against the cash value of an annuity contract, *e.g.*, to compensate the insurer for risks assumed with respect to annuity purchase rate guarantees or to cover administrative costs relating to the annuity contract. However, if a charge is assessed against the annuity contract's cash value to fund a benefit that is not considered part of the annuity contract, such charge may be treated as a distribution from the contract.

D. Annuitized Payments.

1. *General.* If the entire value of an annuity contract is applied to provide a stream of periodic payments, each of those payments will be partly includible in income and (because of nondeductible premium payments) partly excludable as a return of capital, pursuant to an "exclusion ratio." <u>See</u> Code Section 72(b)(1). Specifically, each payment is included in income to the extent it exceeds an excluded amount.

2. *Fixed annuity payments.* In the case of fixed annuity payments, the excluded amount is determined by multiplying the payment by a fraction (which is the exclusion ratio): the investment in the contract divided by the "expected return" under the contract. The expected return is determined under tables of life expectancies and interest rates prescribed in regulations, and an adjustment is made for any refund feature. <u>See</u> Code Section 72(c); Treas. Reg. Sections 1.72-4 through 1.72-7.

3. *Variable annuity payments.* In the case of variable annuity payments, the excluded amount is determined by dividing the investment in the contract by the expected number of payments. See Treas. Reg. Sections 1.72-2(b)(3).

4. *Recovery of investment.* Once the investment in the contract is fully recovered, the entirety of each succeeding annuity payment is includible in income. Conversely, if the death of the annuitant causes payments to cease without full recovery of the investment, the unrecovered portion is deductible by the annuitant in his or her final tax return. See Code Section 72(b)(2)-(4).

5. *Commutation features*. The IRS has issued private letter rulings holding that an immediate annuity with a cash surrender value would be treated as an annuity for federal tax purposes. See PLR 20036021 (Jun. 7, 2000); PLR 9237030 (June 16, 1992).

6. *Guaranteed periods and amounts.* As noted above, the expected return under a fixed annuity contract is adjusted to reflect any guarantee period or amount.

7. *Partial annuitizations.* Is it possible to partially annuitize a contract, so that the annuitized part of the contract will be subject to the rules for annuity payments (where each payment returns a portion of the investment in the contract), and the non-annuitized part of the contract is subject to the rules that generally apply prior to the annuity starting date (LIFO treatment)? The IRS is considering this issue.

IV. TAX-FREE EXCHANGES OF ANNUITY CONTRACTS UNDER CODE SECTION 1035.

A. Code Section 1035 in General.

1. Code Section 1001(a) sets forth a general rule that the entire amount of the gain or loss on the sale or exchange of property is recognized, and thus includible in gross income.

2. Code Section 1035(a) sets forth an exception to this general rule under which no gain or loss is recognized on the exchange of (1) a life insurance contract for another life insurance contract, endowment contract, or annuity contract, (2) an endowment contract for another endowment contract or annuity contract, or (3) an annuity contract for another annuity contract.

3. Application of Code Section 1035 to “qualified” and “non-qualified” contracts

   a. For purposes of this discussion, references to a *non-qualified annuity contract* are to an annuity contract that is *not* issued in connection with a pension, profit sharing, or tax-qualified retirement arrangement. References to a *qualified annuity contract* are to an annuity contract issued to fund a qualified plan (*e.g.*, under Code Sections 401 and 403(a)), a Code Section

403(b) arrangement, an individual retirement arrangement under Code Sections 408 or 408A, or a deferred compensation plan under Code Section 457.

b. There is nothing in Code Section 1035 that limits its application to non-qualified annuity contacts, and Courts have applied it to exchanges involving qualified contracts (*e.g.*, of Code Section 403(b) annuities). See Greene v Commissioner, 85 TC 1024 (1985). Of course, any such exchange must be permissible under the Code provisions governing the particular type of qualified plan or arrangement. The IRS takes the position generally that those conditions, in effect, make Code Section 1035 inapplicable to qualified annuity contracts. See, e.g., PLR 9241007 (Jul. 2, 1992), 9233054 (May 22, 1992), see also GCM 39882 (May 27, 1992). In addition, special rollover and transfer rules apply to qualified arrangements.

B. Actual and Deemed "Exchanges."

1. An exchange gives rise to realized gain or loss for federal income tax purposes only if there is an "exchange of property for property differing materially either in kind or in extent." Treas Reg § 1.1001-1(a).

2. In Cottage Savings Ass'n v. Commissioner, 499 US 554 (1991), the United States Supreme Court held that an "exchange of property gives rise to a realization event when the exchanged properties are 'materially different,' that is, when they embody legally distinct entitlements."

3. An exchange of contracts commonly involves the assignment of a contract to an insurer for the issuance of a new contract.

    a. However, it is possible for changes to a contract to rise to the level of an "exchange" for this purpose. Any change in the terms of an annuity contract, including the change of the annuitant's identity, can amount to a constructive exchange of the contract for a new contract under Code Section 1001.

    b. Also, as discussed further below, an "exchange" can involve only a portion of a contract.

4. The exchange must be a "like kind" transfer of one contract for another contract, so that the exchange proceeds are transferred directly between the issuers of the old and new contracts.

    a. In the case of a nonqualified annuity contract, if proceeds are received in cash by the contract owner and then transferred to the issuer of the new contract, the transaction will be treated as a taxable surrender of the existing contract, followed by the purchase of a new contract. Rev. Rul. 2007-24, 2007-21 I.R.B. 1282.

b. Assuming Code Section 1035 applies to qualified annuity contracts, tax-free treatment under Code Section 1035 of an exchange of a qualified annuity contract is not necessarily defeated if the proceeds are received by the contract owner and then transferred to the issuer of the new contract. In Greene v. Commissioner, 85 TC 1024 (1985), the Tax Court held in the case of a Code Section 403(b) annuity contract that the distribution of cash to the contract owner followed by a transfer by the contract owner to another Code Section 403(b) annuity contract constituted a tax-free exchange under Code Section 1035. The IRS acquiesced in that result. See 1986-1 CB 1. The stated basis for such a distinction has been that the Code Section 401(g) prohibition on transferability with respect to qualified retirement savings arrangements would prohibit direct transfers initiated by contract owners in the qualified area. See AOD No. 1986-044. (However, as stated above, currently, the IRS takes the position generally that Code Section 1035 is inapplicable to qualified annuity contracts.)

C. "Annuity Contract."

1. *"Annuity Contract" Defined.* For purposes of Code Section 1035, the term "annuity contract" is defined by reference to an endowment contract. Specifically, an "endowment contract" is defined for this purpose in Code Section 1035(b)(1) as "a contract with an insurance company *which depends in part on the life expectancy of the insured*, but which may be payable in full in a single payment during his life" (emphasis added). An "annuity contract" is defined as a contract to which Code Section 1035(b)(1) applies "but which may be payable during the life of the annuitant only in installments." See Code Section 1035(b)(2).

2. *Life-Contingent vs. Term Certain Annuity Contracts.* The IRS has taken the position in the past that, for purposes of Code Section 1035, an annuity contract must depend in part on the life expectancy of the annuitant. See PLR 7934023 (May 22, 1979) (stating that Code Section 1035 treatment "is only accorded annuity contracts that are payable over the life of the annuitant" and thus denying such treatment to the conversion of a life annuity to a term certain annuity). The IRS's current position, however, appears to be that Code Section 1035 applies to exchanges involving term certain annuities. See Rev Rul 92-95, 1992-2 CB 43 (involving a term certain annuity contract received in an exchange under Code Section 1035).

3. *Group Annuity Contracts.* The IRS has taken the position that an exchange of an individual contract for an interest (i.e., a certificate) under a group contract can qualify for non-recognition treatment under Code Section 1035. See PLR 7004136890A (Apr. 13, 1970) (permitting transfer of individual annuity contract to new group annuity contract); PLR 9017062 (Jan. 31, 1990) (permitting exchange of life contracts for separate participating interests in group life insurance contract).

4. *Fixed and Variable Contracts.* The exchange of a fixed annuity contract for a variable annuity contract (or vice versa) can qualify for tax-free treatment under Code Section 1035. See Rev Rul 68-235, 1968-1 CB 360.

5. *Annuity Contract With a Life Insurance Rider.* In PLR 200022033 (Dec. 9, 1999), the IRS addressed the treatment under Code Section 1035 of an exchange of an existing deferred annuity contract for a new deferred annuity contract with two riders. One of the riders provided term life insurance, the charges for which were paid from the new contract's values each year. This term life insurance rider qualified as a life insurance contract for federal tax purposes. The other rider provided for acceleration of the death benefits under the new contract and the term life insurance rider if the insured became terminally ill. The IRS held that the exchange of the existing contract for the new contract qualified as a tax-free exchange of annuity contracts under Code Section 1035(a)(3). The IRS reasoned that the presence of the two riders to the new contract did not preclude or in any way alter this treatment where the riders were acquired for a portion of the new contract, and not for any portion of the exchanged contract.

D. The Same "Obligee" Requirement.

1. The income tax regulations under Code Section 1035 state that the exchange of an annuity contract for another annuity contract under Code Section 1035 is limited to cases where "the same person or persons must be the obligee or obligees under the contract received in the exchange as under the original contract." Treas. Reg Section 1.1035-1.

2. Although the term *obligee* is not defined in Code Section 1035 and its related regulations, an obligee under a contract is considered generally to be the person to whom an obligation is owed (in this case, by the insurer).

3. The identity of the obligee(s) under a contract will depend on the facts and circumstances, including the terms of the contract and the rights of the parties thereunder, and may change over the life of a contract. For instance, in the case of a deferred annuity contract, the contract owner typically is the person to whom an existing obligation is owed during the deferral stage, whereas no obligation is owed to the annuitant (or to the payee of the annuity payments, if a different person). In contrast, once a contract is annuitized, the identity of the annuitant becomes fixed, and the annuitant may be the party to whom the annuity payments are made under the contract's terms, *i.e.*, an "obligee."

E. The Same "Insured" Requirement.

1. The income tax regulations under Code Section 1035, covering exchanges of life insurance and endowment contracts as well as annuity contracts, state that "section 1035 does not apply to such exchanges if the policies exchanged do not relate to the same insured." Treas Reg Section 1.1035-1.

2. It is unclear whether (and if so, how) this "same insured" requirement applies to an exchange involving an annuity contract.

F. Exchanges of a Partial Interest in an Annuity Contract.

1. In some circumstances, the IRS will recognize the exchange of part of an existing non-qualified annuity for another new annuity contract (a "partial exchange") as an exchange that is tax free under Code Section 1035. In Conway v. Commissioner, 111 TC 350 (1998), the Tax Court held that a partial exchange qualified under Code Section 1035. In that case, the taxpayer who owned an annuity contract asked the issuer to transfer part of the contract value to another issuer for the purchase of a new annuity contract. The issuer of the first contract, after deducting a surrender charge, transferred the requested amount to the issuer of the second contract. The taxpayer expressly indicated that the partial withdrawal from the first annuity contract and the transfer to the second annuity contract should be processed as a Code Section 1035 exchange. The IRS concluded that the taxpayer received unreported taxable income on the transaction equal to the total amount of the gain in the first annuity contract. In addition, the IRS asserted the Code Section 72(q) penalty tax against the taxpayer for taking a "premature" distribution from her annuity contract.

2. The Tax Court held in favor of the taxpayer, declaring that nothing in Code Section 1035 or the regulations thereunder expressly or implicitly conditions non-recognition treatment on the exchange of an *entire* annuity contract. The Tax Court noted that the taxpayer's "funds… remain invested in a similar annuity contract, and [the taxpayer] has not personally received use or benefit of these funds since they were originally invested" in the first annuity contract. In addition, the Tax Court noted that the legislative history of Code Section 1035 explained that the purpose of the statute was to provide non-recognition treatment to taxpayers "who have merely exchanged one insurance policy for another better suited to their needs and who have not actually realized gain." In the court's view, the taxpayer was in essentially the same position that she was before the exchange, with the same funds invested (less the surrender charge), except for the fact that the taxpayer then owned two annuity contracts.

3. In November 1999, the IRS released an Action on Decision (AOD) announcing that it had acquiesced in the Tax Court's Conway decision. See 1999-47 I.R.B. Such acquiescence signifies that the IRS accepts the Tax Court's holding and will follow it in disposing of cases with the same controlling facts. The IRS specifically described its acquiescence as "relating to whether a taxpayer's partial surrender of an annuity contract and direct transfer of the resulting proceeds for the purchase of a new annuity qualifies as a nontaxable exchange under I.R.C. section 1035." Furthermore, the IRS noted its agreement with the Tax Court that "as long as all of the funds in the original contract, less any surrender fee, remain invested in annuity contracts after the transaction, and, as long as the proceeds at

all times during the transaction remained invested in annuity contracts, the transaction was within the parameters of section 1035."

4. The IRS seems to be of the view that the exchange of part of an annuity contract for another contract may be accomplished tax free under Code Section 1035 *if* all of the amounts held under the original contract remain in *some* annuity contract. The IRS noted that it will continue to challenge transactions in cases where taxpayers enter into a series of partial exchanges and annuitizations as part of a design to avoid application of the Code Section 72(q) ten percent penalty, or any other limitation imposed by Code Section 72. In such cases, the IRS will rely upon all available legal remedies to treat the original and new annuity contracts as one contract.

5. Rev. Rul. 2003-76 and Notice 2003-51. In Rev. Rul. 2003-76, 2003-2 C.B. 355, the IRS addressed the direct transfer of a portion of the cash surrender value of an existing annuity contract issued by one life insurance company for a new annuity contract issued by a second life insurance company. The Revenue Ruling holds that the transfer qualifies as a tax-free exchange under Code Section 1035. However, Rev. Rul 2003-76 directs taxpayers to Notice 2003-51, 2003-2 C.B. 361, which was issued at the same time. The Notice warns that the IRS will apply general tax law principles to determine whether a partial exchange followed by a partial withdrawal from, or complete surrender of, either annuity should be treated "as an integrated transaction, and thus whether the two contracts should be treated as a single contract to determine the tax treatment" of the surrender or withdrawal. The IRS is currently considering further guidance on such transactions, including the treatment of partial exchanges into a single premium immediate annuity (or "SPIA").

G. Exchanges Involving Multiple Contracts and Consolidations.

1. The Code Section 1035(a)(3) specifically provides that no gain or loss is recognized on the exchange of "an annuity contract for an annuity contract." For many years, there was little guidance on whether non-recognition treatment applied where one contract is exchanged for two or more contracts, apart from the view taken by the IRS in PLR 8741052 (July 15, 1987) that only one-for-one exchanges qualified for such treatment.

2. The IRS has since taken the position that non-recognition treatment applies to multi-contract exchanges, at least in certain situations.

   a. In PLR 9644016 (July 18, 1996), the IRS concluded that the exchange of one single premium deferred annuity contract for a single premium deferred annuity contract and a flexible premium deferred annuity contract qualified for non-recognition treatment where the contracts received in the exchange were to be issued by the same insurance company.

b. In PLR 9708016 (Nov. 20, 1996), the IRS granted non-recognition treatment to the exchange of two life insurance contracts for one deferred annuity contract.

3. In Rev. Rul. 2002-75, 2002 C.B. 812, the IRS held that the direct transfer of an entire annuity contract into another preexisting annuity contract qualified as a tax-free exchange under Code Section 1035. This reversed an earlier position of the IRS. See PLR 8810010 (Oct. 29, 1987).

H. Exchanges Involving Contracts Issued by Foreign Insurers.

1. The exchange of a non-qualified annuity contract issued by a domestic insurer for an annuity issued by a foreign insurer can qualify for non-recognition treatment under Code Section 1035. See PLR 9319024 (Feb. 10, 1993).

2. It should be noted, however, that the Secretary of the Treasury has authority under Code Section 1035(c) to issue regulations denying such treatment to "any exchange having the effect of transferring property to any person other than a United States person."

I. Treatment of "Boot" Received in an Exchange.

1. If an exchange of non-qualified annuity contracts would qualify for non-recognition treatment under Code Section 1035 but for the fact that the property received in the exchange consists not only of an annuity contract but also of other property or money (commonly referred to as "boot"), a special rule applies. In such a case:

   a. the exchange of the property permitted under Code Section 1035 remains eligible for non-recognition treatment;

   b. gain, if any, will be recognized to the extent of the boot; and

   c. no loss will be recognized.

   See Code Sections 1035(d)(1), 1031(b), 1031(c); Treas Reg Section 1.1031(b)-1(a).

2. The IRS has applied its boot rules by integrating several transactions occurring contemporaneously with an exchange and treating them as part of the exchange. In PLR 9141025 (July 11, 1991), the IRS treated a partial surrender of a contract and the exchange of the remaining contract for a new contract as an exchange with boot equal to the partial surrender amount. In TAM 8905004 (Oct. 17, 1988), the IRS concluded that the withdrawal from an annuity contract of an amount equal to the original premium for the purchase of a life insurance contract and the concurrent exchange of the remaining interest in the contract for a new

annuity contract should be treated as a tax-free exchange under Code Section 1035 with boot equal to the fair market value of the life insurance contract.

J. Carryover Attributes in an Exchange.

A. *Basis.* A contract received in an exchange under Code Section 1035 will have the same basis as the exchanged contract. However, this carryover basis is (1) decreased by the amount of any money received in the exchange, (2) increased by the amount of any gain recognized on the exchange (i.e., in the case of "boot"), and (3) decreased by the amount of any loss recognized on the exchange. See Code Section 1031(d).

B *"Grandfather" Treatment.* When the income tax rules applicable to annuity contracts are changed, Congress usually provides that the rules in existence before any change will continue to apply to existing contracts if certain conditions are met. That practice is referred to as "grandfathering" the existing contracts. Whether the grandfathered status of a contract given up in an exchange carries over to the contract acquired in the exchange depends on the specific grandfather provision involved. For instance, when the rules of Code Section 72(e) were substantially revised in 1982, Congress provided that *amounts* grandfathered under the prior statutory rules should carry that status over in a Section 1035 exchange. See Staff of the Joint Comm on Taxation, 97th Cong, 2d Sess, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, at 365 (Joint Comm Print 1982); Rev Rul 85-159, 1985-2 CB 29. In the absence of a special rule, if a non-qualified annuity contract that is grandfathered under a provision effective for contracts issued on or after a specified date is exchanged on or after that date, the contract received in the exchange is likely to be treated as not being grandfathered. See, e.g., PLRs 9442030 (July 26, 1994), 9346002 (July 26, 1993), 9245035 (Aug. 11, 1992), 8824046 (Mar. 22, 1988).

C. *Purchase date.* As mentioned above, Code Section 72(q)(2)(I) sets forth an exception to the 10 percent penalty tax on premature distributions from a non-qualified annuity for distributions under an immediate annuity contract (i.e., a contract under Code Section 72(u)(4) that provides annuity payments commencing within one year of the purchase date). For this purpose, the IRS held in Rev. Rul. 92-95, 1992-2 C.B. 43, that where a deferred annuity contract is exchanged for an immediate annuity contract, the purchase date of the new contract is considered to be the purchase date of the exchanged contract. Since the annuity payments under the annuity contract received in the exchange did not commence within one year of the exchanged contract's purchase date, the annuity payments did not qualify for this exception to the penalty tax.

K. Treatment of "Failed" Exchanges.

1. Unless otherwise provided in the Code, if an exchange of a non-qualified annuity contract fails to qualify for non-recognition treatment under Code Section 1035,

the "gain" in the contract exchanged will be included in gross income pursuant to Code Section 1001. That gain will not qualify for treatment as capital gain. Such gain will be measured as the excess of the cash surrender value of the contract over the unrecovered investment in the contract.

2. If there is loss on the transaction, that is, if the proceeds are less than the unrecovered investment in the contract given up, a loss deduction might be available in certain circumstances where the original contract was acquired with a profit motive.

3. An exchange that fails to qualify for non-recognition treatment under Code Section 1035 nevertheless may qualify for such treatment under another section of the Code. For example, if the "failed" exchange results in a transfer of property between spouses or to a former spouse incident to divorce, no gain or loss will be recognized on the transfer under Code Section 1041.

V. QUALIFIED ANNUITY CONTRACTS.

A. Overview and Types of Qualified Annuities.

1. *In General.*

   a. Annuities may be used to fund the following types of tax-favored retirement plans:

      i. qualified pension, profit-sharing, and stock bonus plans under Code Section 401(a) ("qualified plans");

      ii. qualified annuity plans under Code Section 403(a);

      iii. tax-sheltered annuities under Code Section 403(b) and custodial accounts under Code Section 403(b)(7) (collectively referred to as "Code Section 403(b) arrangements");

      iv individual retirement accounts under Code Section 408(a) and individual retirement annuities under Code Section 408(b) (collectively referred to as "IRAs"), and the several types of IRAs (discussed below); and

      v. deferred compensation plans of state and local governments and tax-exempt organizations under Code Section 457.

   b. Earnings under annuities used to fund these types of tax-favored retirement plans are not taxed while they remain in the arrangement. Depending on the type of plan, contributions may or may not be deductible or excludable from gross income, and distributions may or may not be excludable from gross income.

c. A non-refundable tax credit is available under Code Section 25(b) with respect to contributions to tax-favored retirement plans. The maximum annual contribution eligible for the credit is $2,000, and the amount of the credit available depends on the individual's income and filing status. The credit is available with respect to elective contributions to a Code Section 401(k) plan, Code Section 403(b) arrangement, or governmental 457(b) plan, SIMPLE, or SEP, contributions to a traditional or Roth IRA, and voluntary after-tax employee contributions to a qualified retirement plan. See Code Section 25B.

d. Depending on the type of tax-favored retirement plan, an annuity contract used with a plan may be issued to and held under the plan for the benefit of an individual participant, or issued directly to the participant.

i. For example, it is common for an annuity contract used in connection with a qualified plan to be held under the plan for the benefit of an individual participant. Such annuity contract might be distributed from the plan to the participant at some point, e.g., upon the participant's retirement.

ii. In contrast, Code Section 403(b) annuity contracts and IRA annuity contracts are issued typically to the individuals for whose benefit they are purchased.

iii. Typically, an annuity contract held by the individual participant issued must be amended by an endorsement or rider to reflect the federal income tax requirements of such a plan and, if necessary, to conform to the terms of the plan.

2. *IRA Annuities (in their many forms).*

a. In General.

i. As discussed further below, there are several types of IRA annuities, including (1) traditional IRA annuities under Code Section 408(b), (2) Simplified Employee Pensions under Code Section 408(k) ("SEP" IRAs), (3) SIMPLE IRAs under Code Section 408(p), and (4) Roth IRAs under Code Section 408A.

ii. In order for an annuity contract to qualify as an IRA (1) the form of the contract must comply with the federal income requirements of the particular type of IRA being issued, and (2) the contract must be operated and administered in accordance with those requirements.

With respect to the form of the contract, IRS "prototype" approval of a traditional IRA, SEP IRA, SIMPLE IRA, or Roth IRA annuity contract may be obtained by requesting an opinion letter from the IRS that the form of the contract complies with the applicable requirements of the Code. The IRS might require some modifications to the contract or accompanying endorsement as a condition to issuing such an opinion letter. In the case of a Roth IRA, an annuity contract issued with the IRS's model endorsement for Roth IRAs (Form 5305-RB) will be treated as an IRS-approved prototype Roth IRA without applying to the IRS for such approval. It should be noted that IRS prototype approval is not required for an annuity contract to qualify as an IRA.

b. Traditional IRAs.

i. An IRA annuity is an annuity contract issued by an insurance company which meets the requirements under Code Section 408(b), including (but not limited to) the following:

(a) The annual premium on behalf of any individual will not exceed the lesser of the individual's compensation for the year, and the maximum annual contribution under Code Section 219(b)(1)(A).

- The maximum annual contribution is $4,000 for 2007, and $5,000 for 2008 and thereafter (subject to cost-of-living increases after 2008).
- For individuals who have attained age 50, the maximum annual contribution may be increased to allow an additional "catch-up" contribution of $1,000.
- Special rules apply for purposes of making contributions to the IRA of a spouse, including a non-working spouse.

For 2007 through 2009, eligible individuals affected by an employer's bankruptcy are permitted to make additional contributions up to $3,000.

(b) The minimum distribution requirements under Code Section 401(a)(9), and the incidental death benefit requirement under Code Section 401(a), apply to the distribution of the entire interest of the owner.

ii. An individual is not permitted to contribute to his or her traditional IRA for the year in which the individual attains age 70½ and thereafter.

iii. Contributions to an IRA may consist of deductible (<u>i.e.</u>, "pre-tax") amounts and non-deductible (<u>i.e.</u>, "after-tax") amounts. If the owner or the owner's spouse is covered by an employer retirement plan, the extent to which contributions are deductible phases out depending on the owner's filing status and income. Also, the owner's deduction may be reduced by Social Security benefits the owner receives.

iv. If an amount is borrowed under an IRA annuity contract, it ceases to qualify as an IRA as of the first day of the year in which the loan is taken, and the owner must include in gross income the fair market value of the IRA determined as of that first day. See Code Section 408(e)(3).

v. An owner who has attained age 70½ may exclude from income qualified charitable distributions up to $100,000 that are made directly by the IRA trustee or custodian to a charitable organization and that would otherwise be tax deductible (without regard to otherwise applicable income limits).

vi. The income tax regulations require generally that each prospective purchaser of an IRA must be provided with a disclosure statement setting forth an explanation of the rules applicable to the particular type of IRA involved, the time and procedures for revoking the IRA, whether the IRA has received IRS prototype approval, certain financial information and illustrations, and where the prospective purchaser can obtain additional information. See Treas Reg Section 1.408-6(d)(4). Much of this information for the various types of IRAs is set forth in the IRS's Publication 590, *Individual Retirement Arrangements (IRAs)*.

c. SEP IRA Annuities.

i. A simplified employee pension (or "SEP") under Code Section 408(k) is a written arrangement or plan that allows an employee to make deductible contributions to IRAs set up for employees participating in the plan. Contributions must be based on a written allocation formula that does not discriminate in favor of highly compensated employees.

ii. An employer may contribute to each participating employee's SEP IRA up to the lesser of (1) 25 percent of the employee's compensation (or 20 percent of earnings from self employment), or (2) $45,000 for 2007. For 2007, only the first $225,000 of compensation is usually considered for this purpose.

iii. Employer contributions to a SEP IRA are excluded from the employee's income (rather than deducted from income by the employee).

iv. An employee can make contributions to a SEP IRA independent of employer contributions. Such employee contributions are deductible to the same extent as contributions to a traditional IRA, discussed above. It should be noted, however, that the deductibility of employee contributions will be subject to phase out limits applicable to individuals covered under employer retirement plans.

d. SIMPLE IRA Annuities.

i. A SIMPLE plan is a tax-favored retirement plan that certain small employers (including self-employed individuals) can establish for the benefit of their employees. A SIMPLE plan is a written salary reduction agreement between an employee and the employer that allows an eligible employee to choose to (1) reduce compensation by a certain percentage each pay period, and (2) have the employer contribute these salary reduction contributions to a SIMPLE IRA on the employee's behalf.

(a) Salary reduction contributions are limited to $10,500 for 2007, increased (by $2,500 for 2005) to permit additional "catch-up" contributions for individuals who have attained age 50.

(b) If the employee is a participant in another employer retirement plan and has elective salary reductions or deferred compensation under that plan, the salary reduction contributions under the SIMPLE plan are included in the annual limit on exclusions of salary reductions and other elective deferrals.

ii. In addition to salary reduction contributions, the employer must make either (1) certain matching contributions (that may vary between 1 percent and 3 percent of compensation), or (2) non-elective contributions (of 2 percent of compensation).

iii. An eligible employee generally is one who (1) receives at least $5,000 in compensation from the employer during any 2 prior years, and (2) is reasonably expected to receive at least $5,000 in compensation during the calendar year for which contributions are made.

e. Roth IRA Annuities.

i. A Roth IRA is an IRA that is designated as a "Roth IRA" when it is established and is treated in the same manner as a traditional IRA except as provided in Code Section 408A.

ii. With respect to contributions to a Roth IRA:

(a) Unlike with traditional IRAs, Roth IRA contributions are permitted after the owner attains age 70½. <u>See</u> Code Section 408A(c)(3).

(b) No deduction is allowed for any contribution to a Roth IRA. <u>See</u> Code Section 408A(c)(1).

(c) An individual can rollover (or "convert") amounts in a traditional IRA, SEP IRA, or SIMPLE IRA to a Roth IRA. Beginning 2010, amounts in a qualified plan, qualified annuity plan, Code Section 403(b) arrangement, or governmental Code Section 457(b) plan also can be converted to a Roth IRA. The conversion amounts are includible in the owner's gross income, and thus are taxable, for the year of the conversion. However, prior to 2010, such a conversion is not permitted if the owner's adjusted gross income exceeds $100,000, or the owner is married filing separately. See Code Section 408A(c)(3)(B). Special rules allow the owner to re-convert the money in certain circumstances.

iii. With respect to distributions from a Roth IRA:

(a) "Qualified distributions" from a Roth IRA are excluded from gross income. See Code Section 408A(d). A distribution will be treated generally as a qualified distribution for this purpose if:

(i) the distribution is made after the 5-taxable year period beginning with the first taxable year in which the owner or the owner's spouse contributed to any Roth IRA established for the owner, and

(ii) the distribution is:

- made after the owner attains age 59½;
- made after the owner's death;
- attributable to the owner's becoming disabled; or
- a qualified first-time homebuyer distributions.

(b) As discussed further below, the minimum distribution requirements under Code Section 401(a)(9) do not apply during the Roth IRA owner's life, but do apply after the owner's death. Also, the incidental death benefit requirements under Code Section 401(a), do not apply to Roth IRAs. See Code Section 408A(c)(5).

3. *Code Section 403(b) Annuities.*

a. A Code Section 403(b) annuity contract is an annuity contract purchased for:

i. an employee by an employer which is an organization described under Code Section 501(c)(3) and exempt from tax under Code Section 501(a);

ii. an employee of an educational organization described in Code Section 160(b)(1)(A)(ii) by an employer which is a state, political subdivision of a state, or an agency or instrumentality of a state or political subdivision thereof (i.e., a public school or university); or

iii. a minister described in Code Section 414(e)(5)(A) by the minister or by an employer.

b. Contributions to a Section 403(b) annuity may consist of salary reduction contributions, non-salary reduction contributions, and after-tax employee contributions.

c. Detailed contribution limits apply, including the contribution limit under Code Section 415 for defined contribution plans, and the limit on elective deferrals under Code Section 402(g).

d. A Code Section 403(b) arrangement must limit annual pre-tax contributions (to $15,500 for 2007), which limit can be increased to allow certain "catch-up" contributions to individuals over age 50.

e. Designated Roth accounts.

A Code section 403(b) arrangement may permit a participant to designate all or a portion of his or her elective deferral contributions as Roth contributions that are maintained in a separate "designated Roth account" under the arrangement. Contributions so designated are not excluded from gross income. However, qualified distributions from the designated Roth account are excluded from gross income.

It is unclear how the requirement that Roth contributions must be maintained in a separate account is satisfied in the case of an annuity contract that has combined guarantees that apply to the designated Roth account and the non-Roth account. The IRS has authority to issue published guidance addressing this issue.

Designated Roth accounts also are permitted under qualified plans.

f. Certain withdrawal restrictions apply to Code Section 403(b) arrangements. In general, amounts under Code Section 403(b) annuity contract may be distributed only in the case of hardship, certain "qualified reservist distributions," or if the employee attains age 59½, has a severance from employment, dies, or becomes disabled. (Similar rules apply to salary reduction amounts under a Code Section 403(b)(7) custodial account.)

g. Proposed regulations.

Proposed regulations under Code section 403(b) were issued in November 2004 and contain a number of significant provisions, including the following:

i. A Code Section 403(b) arrangement would need to be maintained pursuant to a "written plan," which, in both form and operation, satisfies the requirements of section 403(b) and the regulations.

ii. New restrictions would be imposed on tax-free transfers between section 403(b) contracts.

iii. There would be a prohibition against investing in life insurance under a Code Section 403(b) arrangement, subject to certain grandfathering rules.

iv. New withdrawal restrictions would be imposed on employer contributions, and new non-discrimination testing rules would apply, with respect to Code Section 403(b) annuity contracts.

These proposed regulations cannot be relied on until finalized. Final regulations are expected to be issued on or before June 30, 2007.

4. *Qualified Plans Under Code Section 401(a).*

a. A qualified plan must satisfy the numerous requirements of Code Section 401(a).

b. An annuity contract may be (1) held by a trust for a qualified plan, or (2) used to establish and fund a "non-trusteed" qualified plan.

c. In general, a qualified annuity must satisfy the same requirements as any other qualified plan. In addition, any refund of premiums must be applied to reduce employer contributions for the year of the premium payment or for the immediately following year. <u>See</u> Code Section 404(a)(2); Treas Reg Section 1.404(a)-8.

d. The terms and administration of the annuity contract must comply with the terms of the qualified plan. In order to accomplish this, it might be necessary for the contract to contain an endorsement or rider.

e. The limits on contributions and benefits under qualified plans are based on whether the plan is a defined contribution plan, like a qualified plan under Code Section 401(k) (applicable generally to annuity contracts issued to fund qualified plans) or a defined benefit plan.

i. Under a defined contribution plan, the qualification rules limit the annual additions to the plan with respect to each plan participant to the lesser of (1) $45,000 (for 2007), indexed for inflation, and (2) 100 percent of compensation, subject to certain limits. Annual additions are the sum of employer contributions, employee contributions, and certain other amounts.

ii. The maximum annual deferrals that an individual may make to a qualified cash or deferred arrangement under Code Section 401(k) plan is equal to $15,500 in 2007.

e. Designated Roth accounts.

A qualified plan may permit a participant to designate all or a portion of his or her elective deferral contributions as Roth contributions that are maintained in a separate "designated Roth account" under the plan. Contributions so designated are not excluded from gross income. However, qualified distributions from the designated Roth account are excluded from gross income.

As mentioned above, it is unclear how the requirement that Roth contributions must be maintained in a separate account is satisfied in the case of an annuity contract that has combined guarantees that apply to the designated Roth account and the non-Roth account. The IRS has authority to issue published guidance addressing this issue.

Also as mentioned above, designated Roth accounts also are permitted under Code Section 403(b) arrangements.

5 *Qualified Annuities Under Code Section 403(a).*

a. A Code Section 403(a) annuity plan is a type of qualified plan, except that it does not involve a trust. Stated differently, a Code Section 403(a) annuity plan is a qualified plan that is not held by, or funded through, a trust.

b. A Code Section 403(a) annuity plan is required generally to meet all the requirements that apply to a qualified trusteed plan described in Code Section 401(a). <u>See</u> Code Section 404(a)(2). In addition, any premium refunds must be applied, in the current year or next succeeding taxable year, toward the payment of premiums (e.g., in lieu of employer contributions).

6. *Deferred Compensation Plans Under Code Section 457(b).*

a. Code Section 457(a) provides that in the case of a participant in an "eligible deferred compensation plan," any amount of compensation deferred under the plan, and any income attributable to such amounts, shall be includible in gross income only for the taxable year in which such compensation or other income is paid or otherwise made available to the participant or other beneficiary.

b. An eligible deferred compensation plan is described in Code Section 457(b) as a plan established and maintained by an "eligible employer" that meets certain additional requirements. An eligible employer is defined generally as (1) a state, political subdivision of a state, and any agency or instrumentality of a state or political subdivision thereof (i.e., generally a state or local government), or (2) any other tax-exempt organization.

c. A governmental 457 plan generally must satisfy the same requirements as a Code Section 457 plan of a tax-exempt organization. In addition, all deferred compensation under a governmental 457 plan, along with the plan assets and income, must be held in a trust, annuity contract, or custodial account for the exclusive benefit of participants and their beneficiaries. See Code Section 457(g).

d. The dollar limit on elective deferrals under a Code Section 457 plan is $15,500 for 2007. The limit is twice the otherwise applicable dollar limit in the three years prior to retirement. See Code Section 457(b).

e. Special distribution requirements apply to plans under Code Section 457. A plan is treated as meeting these requirements if it satisfies the minimum distribution requirements under Code Section 401(a)(9), discussed below. See Code Section 457(d).

f. Special rules under Code Section 457(f) apply in the case of an eligible employer providing a deferred compensation plan that is not an "eligible" deferred compensation plan.

B. Incidental Death Benefit Requirements.

1. Tax-favored retirement plans are required generally to satisfy certain "incidental benefit," or "incidental death benefit," rules. See Code Sections 401(a), 408(a)(6) and (b)(3), 403(b)(10), 457(d)(2).

2. The incidental death benefit requirements have two components:

a. One component, referred to as the "pre-retirement incidental benefit requirement," applies to limit pre-retirement distribution in the form of non-retirement benefits, such as life, accident, or health insurance.

b. The other component, the "minimum distribution incidental benefit" (or "MDIB") rule, applies to insure that funds are accumulated primarily for distribution to the owner or employee participants, whichever is applicable, and that other payments to their beneficiary are merely "incidental."

C. Required Minimum Distributions (or "RMDs").

1. *In General.*

a. Code Section 401(a)(9) sets forth minimum distribution requirements that apply to qualified plans, qualified annuities under Code Section 403(a), Code Section 403(b) arrangements, IRAs, and deferred compensation plans of state and local governments and tax-exempt organizations under Code Section 457.

b. Any distribution required under the incidental death benefit requirements is treated as a distribution required under Code Section 401(a)(9).

c. The failure to satisfy the RMD requirements could result in disqualification of the arrangement as a qualified plan, qualified annuity, Code Section 403(b) arrangements, IRA, or deferred compensation plan. However, such failure may be corrected through the Employee Plans Compliance Resolution System (or "ECPRS"), discussed below. Unfortunately, EPCRS does not apply to IRAs.

Also, the failure to satisfy the RMD requirements can result in an excise tax equal to 50 percent of the excess of the RMD over the amount actually distributed, and the excise tax applies each year for as long as the excess remains undistributed. See Code Section 4974. The IRS may waive this excise tax if it is established that the failure is due to reasonable cause and reasonable steps are being taken to remedy the failure. See Prop. Treas. Reg. Section 54.4974-2, Q&A-8(a).

d. If an individual owns more than one IRA, the RMD for a year must be calculated separately for each IRA, but the total may be taken from any one or more IRA. Similar rules apply to an individual who is the beneficiary under more than one IRA, or is the owner of more than one Code Section 403(b) arrangement. See Treas. Reg. Section 1.403(b)-2, Q&A-4; Treas. Reg. Section 1.408-8, Q&A-9.

e. Required minimum distributions from annuity contracts

i. The interval between payments for an annuity must be uniform over the entire distribution period and must not exceed one year.

ii. Once annuity payments have commenced over a period, the period may not be changed, subject to certain exceptions set forth in regulations.

iii. All annuity payments must be non-increasing, subject to certain exceptions set forth in regulations.

iv. Prior to the date that an annuity contract is "annuitized," the entire interest to which the Code Section 401(a)(9) minimum distribution requirements apply is "the dollar amount credited to the employee or beneficiary under the contract plus the actuarial present value of any additional benefits (such as survivor benefits in excess of the dollar amount credited to the employee or beneficiary) that will be provided under the contract." Treas. Reg. Section 1.401(a)(9)-6, Q&A-12.

2. *Lifetime Distribution Requirements.*

a. The entire interest of the individual for whose benefit the arrangement is established (referred to as the "owner" for this purpose) must (1) be distributed no later than the "required beginning date," or (2) commence to be distributed no later than that date over the life of the owner or joint lives of the owner and a "designated beneficiary" (or over a period not extending beyond the life expectancy of the owner or the joint life expectancy of the owner and a designated beneficiary).

b. The "required beginning date" generally is April 1 of the calendar year following the later of (1) the calendar year in which the owner attains age 70½, and (2) the calendar year in which the owner retires. However, in the case of an IRA, the required beginning date is April 1 of the calendar year following the calendar year in which the owner attains age 70½. Code Section 401(a)(9). Special rules apply with respect to 5-percent owners under Code Section 416, a governmental plan under Code Section 414(d), and a plan maintained by a church within the meaning of Code Section 3121(w).

c. In general, a "designated beneficiary" is an individual who is entitled to a portion of the owner's interest, contingent on the owner's death or another specified event. Prop. Treas. Reg. Section 1.401(a)(9)-4, Q&A-1.

i. The designated beneficiary within the meaning of Code Section 401(a)(9) is not necessarily the individual or entity designated by the employee as the beneficiary under the arrangement. For example, where the owner's interest is being distributed under an annuity option providing payments for the joint lives of the owner and a joint annuitant, if the owner predeceases the joint annuitant, payments will continue to the joint annuitant. Hence, the joint annuitant, and not the beneficiary named under the arrangement, would be the designated beneficiary.

ii. If after the employee's death, the interest is payable to other than an individual, the RMD rules are applied generally as if there was no designated beneficiary (subject to a special rule for certain trusts).

iii. In the case of multiple beneficiaries, special rules apply for purposes of determining the required minimum distribution where separate accounts are established for the beneficiaries. See Treas Reg. Section 1.401(a)(9)-8, Q&A-2.

d. These lifetime distribution requirements do not apply to Roth IRAs. Code Section 408A(c)(5).

3. *After-Death Distribution Requirements.*

a. If the owner dies after distribution of his or her interest has begun, the remaining portion of such interest must be distributed at least as rapidly as under the method of distributions being used as of the date of the owner's death. Code Section 401(a)(9)(B)(i).

b. If the owner dies before distribution of his or her interest has begun, the entire remaining interest must be distributed by December 31 of the calendar year containing the fifth anniversary of the owner's death, except that:

i. The entire interest may be distributed over the life of the designated beneficiary (or over a period not exceeding the designated beneficiary's life expectancy) commencing no later than December 31 of the calendar year immediately following the calendar year in which the owner died.

ii. If the designated beneficiary is the owner's surviving spouse, the date distributions are required to begin in accordance in the preceding sentence shall not be earlier than the later of (1) December 31 of the calendar year immediately following the calendar year in which the owner died, and (2) December 31 of the calendar year in which the owner would have attained age 70½ .

See Code Sections 401(a)(9)(B)(ii) – (iv). Also, a special rule applies if the owner's surviving spouse is the designated beneficiary and dies after the owner but before distributions have begun to the surviving spouse. See Prop. Treas. Reg. Section 1.401(a)(9)-3, Q&A-5.

c. Distributions are considered to have begun for this purpose if (1) distributions are made on account of the owner reaching the required beginning date, or (2) if prior to that date annuity distributions irrevocably commence over a period permitted and in a form acceptable under regulations. See Treas. Reg. Section 1.401(a)(9)-2, Q&A-6; Treas. Reg. Section 1.401(a)(9)-6, Q&A-10.

d. Under special rules applicable generally to IRAs (including Roth IRAs), a designated beneficiary who is the owner's surviving spouse may elect (or be deemed to have elected, in certain circumstances) to treat the IRA as his or her own. If such election is made (or deemed to be made), the IRA would be subject to the RMD requirements (including lifetime distribution requirements) as applied to the surviving spouse, rather than the after-death distribution rules as applied with respect to the deceased owner. See Treas. Reg. Section 1.408-8, Q&A-5.

D. Taxation of Distributions.

1. The taxation of distributions from a tax-favored retirement plan are governed generally by Code Section 72(d). See, e.g., Code Sections 402(a), 403(b)(1), 408(d)(1).

    a. If there are only pre-tax amounts under the arrangement, all distribution are includible in income.

    b. If there are after-tax amounts under the arrangement, distributions are not taxable to the extent allocable to such amounts.

        i. Code Section 72(d) sets forth rules that determining (generally on a pro rata basis) the portion of a distribution allocable to after-tax amounts.

        ii. It should be noted that the rules apply differently in certain respects depending on whether the distributions are received in the form of an annuity.

        iii. A special, simplified method applies for purposes of determining the portion of distributions from an IRA and Code Section 403(b) arrangements allocable to after-tax amounts.

    c. As mentioned above, "qualified distributions" from a Roth IRA are not includible in gross income.

2. In the case of an annuity contract that is held under a tax-favored plan (rather than issued directly to the plan participant), the distribution of the annuity contract to the participant generally is not a taxable event. See Treas. Reg. Section 1.402(a)-1(a)(2); Treas. Reg. Section 1.401(a)(9)-8, Q&A-10. Rather, amounts are taxed as they are distributed from the contract.

3. Code Section 72(t)(1) sets forth a general rule under which a distribution from a tax-favored retirement plan is subject to a penalty tax equal to 10 percent of the portion of the distribution which is includible in gross income.

    a. The amount of the penalty tax is increased to 25 percent of amounts includible in gross income with respect to certain SIMPLE IRA distributions. See Code Section 72(t)(6).

b. Code Section 72(t)(2) sets forth exceptions to this general rule under which the penalty tax generally will not apply with respect to:

   i. distributions after the employee attains age 59½, dies, becomes disabled, or (except in the case of an IRA) separates from service after age 55;

   ii. distributions that are part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancy) of the employee and his designated beneficiary, subject to a special rule to recapture the penalty tax in certain cases where the series of payments is modified (see Rev. Rul. 2002-62, 2002-42 I.R.B. 710);

   iii. dividends paid with respect to stock of a corporation which are described in Code Section 404(k);

   iv. distributions made on account of an IRS levy under Code Section 6331 on the plan;

   v. certain medical expenses;

   vi. certain payments (other than from an IRA) to an alternate payee pursuant to a qualified domestic relations order under Code Section 414(p)(1);

   vii. certain distributions from an IRA to cover (1) health insurance premiums of an unemployed individual, (2) qualified higher education expenses, or (3) qualified first-time homebuyer distributions; and

   viii. certain qualified reservist distributions from an IRA under Code Section 72(t)(2)(G) (which can be later "recontributed" to an IRA in certain circumstances).

E. Loans.

1. Loans may be made generally under a tax-favored retirement plan. Loans may not be taken under an IRA (including a Roth IRA).

2. To the extent that loans are permitted, they are subject to the provisions of Code Section 72(p), which sets forth the limits on the amount of loans and the time and manner in which loans must be repaid. Failure to satisfy these requirements could trigger tax and jeopardize the tax-qualification of the plan.

F. Rollovers and Transfers of Qualified Annuity Contracts.

1. *In General.* As discussed below, an individual can direct the trustee of a tax-favored retirement plan to transfer amounts thereunder tax-free directly to the trustee of certain other arrangements. Alternatively, an individual can roll over (directly or indirectly) certain distributions tax-free from one arrangement to certain other arrangements. It is important to note that for federal income tax purposes, rollovers (whether direct or indirect) are treated as distributions, and trustee-to-trustee transfers are not treated as distributions.

2. *Trustee-To-Trustee Transfers.*

    a. The IRS generally permits tax-free direct transfers of funds as long as the same type of plan is involved. Such "trustee-to-trustee" transfers are not treated as distributions from the particular plan. Hence, for example, amounts under a Code Section 403(b) arrangement that are subject to withdrawal restrictions (mentioned above), and thus may not be distributed, nevertheless may transferred to another Code Section 403(b) arrangement in a trustee-to-trustee transfer.

    b. The IRS permits such trustee-to-trustee transfers between the following:

        i. qualified plans. See Rev. Rul. 67-213, 1967-2 CB 149.

        ii. Code Section 403(b) arrangements, as long as the funds are subject to the same or more restrictive in-service distribution limitations. See Rev. Rul. 90-24, 1990-1 CB 97.

        iii. IRAs. See Rev. Rul. 78-406, 1978-2 CB 157.

    c. Code Section 457(e)(10) also permits direct transfers of funds between eligible deferred compensation plan under Code Section 457(b).

3. *Rollovers Of Distributions.*

    a. Rollovers From IRAs.

        i. Under Code Section 408(d)(3), all or part of a distribution from an IRA (other than an IRA inherited from someone other than a spouse) may be rolled over tax-free within 60 days to a traditional IRA, qualified plan, qualified annuity, Code Section 403(b) arrangement, or governmental 457(b). However, any after-tax amounts in an IRA can be rolled-over only to another IRA.

        ii. A rollover from one IRA may be made only once in a 12-month period. See Code Section 408(d)(3)(B). The IRS applies this rule separately to each IRA an individual owns. Since trustee-to-trustee transfers are not treated as distributions, as mentioned above, an IRA owner may avoid this 12-month rule by making a direct trustee-to-trustee transfer to another IRA.

iii. A distribution from an individual's SIMPLE IRA may be rolled over only to another SIMPLE IRA during the 2-year period beginning on the date the individual first participated in his or her employer's SIMPLE plan.

iii. A distribution from a Roth IRA may be rolled over tax-free within 60 days to another Roth IRA. See Code Section 408A(e).

iv. Special rules apply permitting an individual to (1) rollover (or "convert") amounts in a traditional IRA, SEP IRA, or SIMPLE IRA to a Roth IRA, as mentioned above, and (2) to re-convert (or "re-characterize") rollover contributions between IRAs.

v. Special rules apply permitting amounts to be transferred from an IRA (other than a SEP IRA or a SIMPLE IRA) in a direct trustee-to-trustee transfer to a nontaxable Health Savings Account maintained in connection with a high deductible health plan.

b. Rollovers From Other Tax-Favored Retirement Plans.

i. In General.

(a) An "eligible rollover distribution" from a qualified plan, qualified annuity, Code Section 403(b) arrangement, or governmental 457(b) plan may be rolled over tax-free to an "eligible retirement plan." There are two ways to roll over an eligible rollover distribution:

(i) it can be transferred directly to another eligible retirement plan that accepts such amounts (i.e., in a "direct" rollover), or

(ii) it can be distributed to the employee for whose benefit the arrangement is established, and rolled over within 60 days to another eligible retirement plan that accepts such amounts (i.e., in an "indirect" rollover).

(b) Since an eligible rollover distribution is treated as a distribution for federal income tax purposes, amounts under a Code Section 403(b) arrangement that are subject to withdrawal restrictions may not be distributed and rolled over as eligible rollover distribution as long as the restrictions apply. However, as discussed above, such amounts nevertheless may be transferred to another Code Section 403(b) arrangement in a trustee-to-trustee transfer, to the extent otherwise permitted by law.

ii. An "eligible retirement plan" is defined in Code Section 402(c)(8)(B) to include (1) a traditional IRA, (2) a qualified plan under Code Section 401(a), (3) a qualified annuity under Code Section 403(a), (4) a governmental 457(b) plan, and (5) a Code Section 403(b) arrangement.

iii. An "eligible rollover distribution" is defined in Code Section 402(c)(4) as any distribution to an employee of all or any portion of the balance to the credit of the employee in the arrangement. However, the following are not eligible rollover distributions, and thus cannot be rolled over:

(a) any distribution which is one of a series of substantially equal periodic payment made at least once a year for:
- the employee's life or life expectancy, or the joint lives or joint life expectancy of the employee and a designated beneficiary, or
- a period of 10 years or more;

(b) any RMD under Code Section 401(a)(9);

(c) any distribution which is made upon hardship of the employee.

Special rules apply that generally prohibit the rollover of (1) cash dividends paid to you on employer stock held in an employee stock ownership plan, (2) a distribution made to correct a failed nondiscrimination test or because legal limits on certain contributions were exceeded, (3) the amount of a plan loan that becomes a taxable deemed distribution because of a default cannot be rolled over.

iv. Rollovers of After-Tax Amounts.

In general, any after-tax amounts may be (1) rolled over to a traditional IRA, or (2) transferred in a direct roll over to another eligible retirement plan, provided that the after-tax amounts are separately accounted for under transferee plan.

v. Rollovers from designated Roth accounts

A distribution from a designated Roth account under a qualified plan or Code Section 403(b) arrangement may be rolled over tax-free within 60 days to another designated Roth account or to a Roth IRA.

vi. Direct Rollovers

A direct rollover is a direct payment of an eligible rollover distribution to an eligible retirement plan that will accept it. An employee can choose a direct rollover of all or any portion of an eligible rollover distribution. The employee is not taxed on any taxable portion of the distribution directly rolled over, and no portion of the amount is withheld.

vii. Indirect Rollovers.

If any portion of an eligible rollover distribution is not directly rolled over to an eligible retirement plan, the distributing plan is required by law to withhold 20 percent of the taxable amount of the distribution (i.e., the employee cannot elect out of this withholding requirement). This amount is sent to the IRS as federal income tax withholding.

The 80 percent balance of the distribution is taxable for the year it is received by the employee unless it is rolled over within 60 days to an eligible retirement plan that accepts rollovers. Any portion of this amount that is not rolled over is subject to 10 percent withholding, unless the employee elects not to have withholding apply (i.e., the 20 percent mandatory withholding rules do not apply to these amounts).

If the employee wants to roll over 100 percent of the eligible rollover distribution, the employee must find other money to replace the 20 percent withheld. If the employee rolls over only the 80 percent received, the employee will be taxed on the 20 percent that was withheld and that is not rolled over.

In addition, the 10 percent penalty tax under Code Section 72(t), and state tax withholding, may apply to the portion of a distribution not rolled over.

Example: The taxable portion of an eligible rollover distribution is $10,000, and the employee chooses to receive the distribution, rather than have it directly rolled over to an eligible retirement plan. The employee will receive $8,000, and $2,000 will be sent to the IRS as mandatory income tax withholding.

- Within 60 days after receiving the $8,000, the employee may roll over the entire $10,000 to an eligible retirement plan. To do this, the employee must roll over the $8,000 received from the plan, and must find $2,000 from other sources (savings, a loan, etc.). In such case, the entire $10,000 is not taxed until the employee takes it out of the eligible retirement plan. If the entire $10,000 is rolled over, the employee may get a refund of part or all of the $2,000 withheld when filing his or her federal income tax return.

- If, on the other hand, the employee rolls over only $8,000, the $2,000 not rolled over is taxed in the year it was withheld. When the employee files a federal income tax return, he or she may get a refund of part of the $2,000 withheld. (However, any refund is likely to be larger if the entire $10,000 is rolled over.)

Special rules apply if (1) the employee was born before January 1, 1936, (2) the eligible rollover distribution includes employer stock (or other employer securities), or (3) employment ends and the employee has an outstanding loan from the plan.

viii. Surviving Spouses, Alternate Payees, and Other Beneficiaries.

In general, the rules summarized above that apply to payments to employees also apply to payments to the surviving spouse of an employee and to the spouse or former spouse who is an "alternate payee." An individual is an alternate payee if his or her interest in the plan results from a "qualified domestic relations order," which is an order issued by a court, usually in connection with a divorce or legal separation.

If permitted by the plan, a non-spouse beneficiary can transfer tax-free a portion of a distribution from an eligible retirement plan of a deceased employee in a direct trustee-to-trustee transfer to an "inherited" IRA that is established for the benefit of a non-spouse beneficiary and that makes distributions satisfying the after-death minimum distribution requirements under Code section 401(a)(9)(B). See Code Section 402(c)(11); Section V of Notice 2007-7, 2007-5 I.R.B. 395.

A payment to a surviving spouse, alternate payee, or other beneficiary generally is not subject to the 10 penalty tax, described above, even if they are younger than age 59½.

ix. Notice Requirements.

Code Section 402(f) and the regulations thereunder require generally that within a reasonable period of time before making an eligible rollover distribution the plan administrator must provide a written explanation to the recipient of the eligible rollover distribution rules, including the 20 percent mandatory withholding requirement. This written notice must be provided generally at least 30 days, and no more than 90 days, prior to the eligible rollover distribution.

x. In general, amounts rolled over into a particular type of eligible retirement plan are subject to the tax rules governing that plan. One exception to this general rule is that amounts rolled over into a governmental 457(b) plan must be tracked for purposes of applying the10 percent penalty tax on premature distributions under Code Section 72(t) to such amounts.

G. Failure to Qualify as a Tax-Favored Retirement Plan.

1. The IRS has developed the Employee Plans Compliance Resolution System ("EPCRS") under which qualified plan sponsors can correct failures to satisfy the tax requirements of tax-favored retirement plans, and thus continue to provide retirement benefits with the intended tax-favored treatment. See Rev. Proc. 2006-27, 2006-22 I.R.B. 945.

2. EPCRS does not apply to IRAs. It is unclear whether the IRS would extend to "failed" IRAs relief similar to that under EPCRS.

H. Application of ERISA.

1. Whether a tax-favored retirement plan is subject to the requirements of the Employee Retirement Income Security Act of 1974 ("ERISA") is determined independently of the type of asset or investment that funds plan benefits. Governmental and church plans are exempt from ERISA. Also, certain employee-pay-all IRAs and salary-reduction-only Code Section 403(b) arrangements may be exempt from ERISA.

2. A plan is subject to ERISA if it:

   a. is established or maintained by an employer and/or by an employee organization, and

   b. either (a) provides retirement income to employees, or (b) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond.

   Since a Code Section 403(b) arrangement generally provides retirement income, the level of employer or employee organization involvement typically determines whether the arrangement is established and maintained by an employer or employee organization, and thus subject to ERISA.

3. Arrangements covered by ERISA are subject generally to additional rules, such as (1) plan documentation, reporting and disclosure requirements, (2) substantive plan requirements relating to certain matters such as minimum age and service rules, minimum funding rules, minimum vesting standards, involuntary cash-out restrictions, "anti-cutback" rules, and certain survivor annuity rules, and (3) special fiduciary responsibility and prohibited transactions rules.

VI. SPECIAL USES OF ANNUITIES.

A. Structured Settlements - What Are They?

1. A structured settlement annuity is an annuity contract that is used to provide payments to an injured party in connection with a lawsuit. Often, an injured party has continuing financial needs, such as medical care and rehabilitation, that can continue over a number of years. Those needs may vary in amount at different times, such as higher education expenses for a minor who has been injured. A structured settlement annuity is purchased by the defendant (or the defendant's insurer) to provide for those ongoing financial needs.

2. The basic form of a structured settlement annuity is typically an immediate annuity payable over the life of the injured party, but the annuity will often have term certain guarantees and pay differing amounts at various periods. Structured settlement annuities are subject to a variety of special rules under the Code Section 130; if those rules are satisfied, there are significant tax benefits to the injured party as well as the defendant (or its insurer) who purchases the annuity.

3. In a basic structured settlement arrangement, the defendant (and/or the defendant's insurer) and the injured person agree that the defendant (and/or the defendant's insurer) will assign the defendant's liability to make periodic payments as damages to a third party (the "assignee") in exchange for the payment to the assignee of a lump sum. If the structured settlement arrangement conforms to the rules described below, the parties to the arrangement can achieve significant benefits.

B. Structured Settlements - How Are They Taxed?

1. If the assignment is a "qualified assignment," the assignee will not be required to include the lump sum in income to the extent that the payment does not exceed the cost of any "qualified funding assets" (for example, any structured settlement annuities). <u>See</u> Code Section 130. Likewise, the injured party will be able to exclude from income under Code Section 104(a)(3) all the payments he or she receives as a result of the settlement, while having the security that the payments will be made pursuant to an annuity contract issued by a commercial insurer.

2. A *qualified assignment* is the assignment of a liability to make periodic payments as damages (whether by suit or agreement), or as compensation under any workers' compensation act, on account of personal injury or sickness in a case involving physical injury or physical sickness that meets the following requirements:

    a. The assignee must assume the liability from a person who is a party to the suit, agreement, or workers' compensation claim;

b. The periodic payments must be fixed and determinable as to amount and time of payment;

c. The periodic payments cannot be accelerated, deferred, increased, or decreased by the recipient of such payments;

d. The assignee's obligation cannot be greater than the obligation of the person that assigned the liability; and

e. The periodic payments must be excludable from the gross income of the recipient under Code Section 104(a)(1) or (2).

See Code Section 130(c).

3. With respect to the requirement that the periodic payments under a qualified assignment must be "fixed and determinable," the IRS has ruled that, at least in certain circumstances, variable annuity payments are "fixed and determinable." (See PLRs 199942001 (Nov 10, 1998), 199943002 (Nov 10, 1998).)

4. A *qualified funding asset* is any annuity contract issued by a company licensed to do business as an insurance company under the laws of any state, or any obligation of the United States, that meets the following conditions:

   a. The annuity contract or obligation must be used by the assignee to fund the periodic payments under the qualified assignment;

   b. The periods of payments under the annuity contract or obligation must be reasonably related to the periodic payments under the qualified assignment, and the amount of the payments under the contract or obligation must not exceed the periodic payment to which it relates;

   c. The assignee must designate the annuity contract or obligation as being taken into account under Code Section 130 with respect to the qualified assignment; and

   d. The annuity contract or obligation must be purchased by the assignee not more than 60 days before or 60 days after the date of the assignment.

5. Generally, Code Section 104(a)(2) excludes from a person's gross income any amount of damages (other than punitive damages) received on account of personal injury or physical sickness. These amounts can be received by suit or by agreement and as lump sums or periodic payments. Code Section 130(c) provides that the determination of when the recipient of periodic payments is treated as having received any payment with respect to which there has been a qualified assignment is made without regard to any provision of the assignment that gives the recipient rights as a creditor greater than those of a general creditor. This rule has been interpreted by the IRS to mean that an injured party receiving periodic

payments pursuant to a qualified assignment will not be treated as in constructive receipt of a structured settlement annuity merely because the injured party possesses the annuity solely to perfect a state law security interest in the contract. (See PLRs 199942001 (Nov 10, 1998), 9605003 (Nov 12, 1995), 9253045 (Oct 6, 1992).)

C. Charitable Remainder Trusts. Such entities are governed by Code section 664.