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IRS Rules Increasing Annuity Payments Subject to Penalty Tax

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In this article, Griffin examines LTR 201120011 involving the 10 percent penalty tax under section 72(q)(1) that applies to premature distributions from annuity contracts, subject to some exceptions. The IRS ruled in LTR 201120011 that annuity payments that increase annually by a constant stated 1, 2, 3, or 4 percent do not satisfy the exception to this penalty tax for some "substantially equal periodic payments" (SEPPs) under section 72(q)(2)(D). Griffin asserts that this holding conflicts with prior private letter rulings, is inconsistent with the legislative history of the penalty tax exception, and leaves no published guidance addressing the treatment of annuity payments as SEPPs.

A. Introduction

The IRS recently issued LTR 201120011[1] to two affiliated life insurance companies addressing whether fixed lifetime annuity payments under non-qualified annuity contracts[2] that increase annually by a constant stated 1, 2, 3, or 4 percent are subject to the 10 percent penalty tax on premature distributions under section 72(q) — that is, distributions made before the taxpayer reaches age 59½. The annual increases are available under an option designed to give the annuity contract owner the ability to address legitimate inflation concerns associated with life annuities. The design reflects an increased focus on encouraging the use of lifetime annuity streams in non-qualified arrangements, as well as in qualified retirement plans, to address individuals' long-term retirement needs.[3]

The taxpayers asked the IRS to rule that the increasing annuity payments satisfy the percent penalty tax exception under section 72(q)(2)(D) for distributions from a non-qualified annuity contract that are part of a series of "substantially equal periodic payments" (SEPPs) made not less frequently than annually for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of the taxpayer and his designated beneficiary. This exception is based on the virtually identical exception in section 72(t)(2)(A)(iv) to the 10 percent penalty tax on premature distributions from qualified retirement plans. The exceptions under section 72(q)(2)(D) and 72(t)(2)(A)(iv) are referred to herein as the SEPP exceptions.

LTR 201120011 involved the application of Rev. Rul. 2002-62[4] and related IRS pronouncements addressing the SEPP exception to the increasing annuity payments under the annuity contracts. The taxpayers requesting the ruling essentially wanted the IRS to extend its position in other private letter rulings that treated annuity payments increasing annually by 3 percent as satisfying the SEPP exception.

Unfortunately, the IRS reached the troubling conclusion in LTR 201120011 that the increasing annuity payments are not SEPPs within the meaning of the section 72(q)(2)(D) SEPP exception. The IRS adopted a narrow interpretation of the SEPP exception and employed a rationale that effectively means annuity payments would not be treated as SEPPs under any current published guidance. This position unnecessarily limits the availability of annuity products before age 59½ that provide annuity payments reflecting reasonably expected long-term cost of living increases.

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[1] *Doc 2011-10935*, *2011 TNT 99-28*.

[2] References to "non-qualified" annuity contracts are to annuity contracts that are issued apart from a qualified retirement plan within the meaning of section 4974(c).

[3] *See*, *e.g.*, Labor and Treasury departments, "Request for Information Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans" (Feb. 1, 2010) (requesting public comment on how to better facilitate and promote annuitization in qualified retirement plans), *Doc 2010-2305*, *2010 TNT 21-57*.

[4] 2002-2 C.B. 710, *Doc 2002-22476*, *2002 TNT 193-7*.

B. The Contracts and Increasing Annuity Option

The contracts are non-qualified single premium immediate annuity contracts. They are all life-contingent annuities that are available in several different forms, including a straight life annuity (under which payments stop as soon as the annuitant dies), a life annuity with a guarantee period (under which payments continue for the longer of the annuitant's life or 10 years), and a life annuity with various types of refund features. The contracts can be payable for a single life or for joint lives (as long as either one of two annuitants is alive), and include both a feature permitting cash withdrawals and a feature permitting the acceleration of payments. Neither the cash withdrawal feature nor the acceleration feature can be exercised by the contract owner if he is under age 59½.

Unless the contract owner elects the increasing annuity payment option, the annuity payments under a contract are fixed, level, periodic payments. The taxpayers represented that the annuity payments made under the contracts when the option is not elected constitute SEPPs within the meaning of section 72(q)(2)(D).

The owner can select the increasing annuity payment option when a contract is issued — electing to have the fixed annuity payment increase annually for the life of the contract by a constant 1, 2, 3, or 4 percent. If the owner makes an election, the percentage chosen cannot be changed. The amount of the single premium paid for a contract is unaffected by whether the owner chooses the option. If the option is elected, the initial payments made under the contract will be lower than if the option is not elected. The taxpayers represented that if the option is elected, the increasing annuity payments will satisfy the minimum distribution requirements of section 401(a)(9) and reg. section 1.401(a)(9)-6. Those minimum distribution requirements apply to specific retirement plans, including qualified plans under section 401(a), tax-sheltered annuity contracts under section 403(b), and individual retirement arrangements under section 408.

C. The SEPP Exceptions

1. Section 72(q)(2)(D) for non-qualified annuity contracts. The federal income tax treatment of non-qualified annuity contracts is largely governed by section 72. Section 72(q)(1) provides generally that if a taxpayer receives any amount under an annuity contract in a tax year, his federal income tax for the year is increased by 10 percent of that amount includable in gross income. Section 72(q)(2) sets forth exceptions to that 10 percent penalty tax, including exceptions for distributions that are (1) made on or after the date on which the taxpayer reaches age 59½,[5] (2) on or after the death of the holder of the contract,[6] or (3) attributable to the taxpayer's becoming disabled.[7]

Section 72(q)(2)(D) provides another exception to the 10 percent penalty tax for any distribution that ''is a part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of such taxpayer and his designated beneficiary.'' If the stream of SEPPs under that exception is modified (other than by reason of death or disability) within five years or before the owner attains age 59½, the penalty tax that was avoided on the prior payments is recaptured under section 72(q)(3). Under this recapture rule, the taxpayer's tax for the first tax year in which the modification occurs is increased by an amount equal to the tax that (but for the SEPP exception) would have been imposed, plus interest.

The legislative history indicates that this SEPP exception is based on the SEPP exception in section 72(t)(2)(A)(iv) attributable to premature distributions from qualified retirement plans.[8] Also, the IRS has acknowledged that the SEPP exceptions under these two sections were enacted and designed for the same purpose.[9] Much of the information on the application of the section 72(q)(2)(D) SEPP exception and related recapture rule under section 72(q) is drawn from the guidance applying the counterparts to these provisions under section 72(t).

2. Section 72(t)(2)(A)(iv) for qualified retirement plans. Section 72(t)(1) provides that if a taxpayer receives any amount from a qualified retirement plan (including a qualified plan under section 401(a), a tax-sheltered annuity contract under section 403(b), and an IRA under section 408) in a tax year, the taxpayer's federal income tax for the year is increased by 10 percent of the amount includable in gross income. Section 72(t)(2) sets forth exceptions to this 10 percent penalty tax, including exceptions (like those under section 72(q)(2)) for distributions that are (1) made on or after the employee reaches age 59½,[10] (2) on or after the

[5]Section 72(q)(2)(A).

[6]Section 72(q)(2)(B).

[7]Section 72(q)(2)(C).

[8]H.R. Rep. No. 99-426, at 704 (1985); S. Rep. No. 99-313, at 567 (1986); H.R. Rep. No. 99-841 (Vol. II), at 403 (1986); Joint Committee on Taxation, ''General Explanation of the Tax Reform Act of 1986,'' JCS-10-87 (May 4, 1987), at 658 (TRA 1986 blue book).

[9]Notice 2004-15, 2004-1 C.B. 526, 527, *Doc 2004-4147*, *2004 TNT 40-11*.

[10]Section 72(t)(2)(A)(i).

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death of the employee,[11] or (3) attributable to the employee's being disabled.[12]

Section 72(t)(2)(A)(iv) sets out a SEPP exception (like the SEPP exception in section 72(q)(2)(D)) for any distribution that is part of a series of SEPPs (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and his designated beneficiary. In the case of a qualified plan under section 401(a), this SEPP exception is available only if the series of payments begins after the employee separates from service.[13] Section 72(t)(4) sets forth a recapture rule similar to the recapture rule under section 72(q)(3) for non-qualified annuity contracts.

3. Rev. Rul. 2002-62 and related IRS pronouncements. In 1989 the IRS released Notice 89-25,[14] Q&A-12, providing that payments would be considered SEPPs within the meaning of the section 72(t)(2)(A)(iv) SEPP exception if they are made according to one of three methods: the required minimum distribution method, amortization method, and annuitization method. The IRS later concluded that those methods of determining SEPPs from qualified retirement plans under section 72(t)(2)(A)(iv) also applied for purposes of determining SEPPs from non-qualified annuity contracts under section 72(q)(2)(D).[15]

Commonly, the amount of the SEPP payments under the amortization and annuitization methods were determined at the outset of the stream, based on the account balance when the determination was made, and each payment in the stream was the same amount. This payment of SEPPs in equal amounts could result in significant hardship to a taxpayer if his account balance was reduced by unfavorable investment performance of the assets underlying the account. If the taxpayer continued to take SEPPs in the originally determined amounts, his account balance would be liquidated prematurely, and payments likely would be made for a period less than life or life expectancy (or joint lives or joint life expectancies) as required under the SEPP exception. However, the taxpayer generally could not redetermine the SEPP amounts without the recalculation being treated as a modification of the stream of payments, which would trigger the recapture rule and subject the taxpayer to the 10 percent penalty tax (plus interest) on the previous payments. The IRS provided relief from this problem in Rev. Rul. 2002-62.

Rev. Rul. 2002-62 modified the three methods in Q&A-12 of Notice 89-25 for calculating SEPPs under section 72(t)(2)(A)(iv) as follows:

- *The required minimum distribution method.* As described in Q&A-12 of Notice 89-25, payments under this method were treated as satisfying the SEPP exception if the annual payment is determined using "a method that would be acceptable for purposes of calculating the minimum distribution required under section 401(a)(9)."[16] The regulations under section 401(a)(9) provided rules for satisfying the minimum distribution requirements with respect to individual accounts and annuities. The modified required minimum distribution method described in Rev. Rul. 2002-62 oddly makes no mention of section 401(a)(9). Rather, the annual payment under the modified required minimum distribution method is determined each year by dividing the account balance for that year by the appropriate number for the year as listed in the applicable life expectancy table. A change in the amount of the SEPP payments from year to year under this modified method will not be a deemed modification in the series of SEPPs that would trigger the application of the recapture rule.[17] Rev. Rul. 2002-62 addressed the problem of decreasing account balances due to unfavorable investment performance by allowing a one-time switch to the modified required minimum distribution method.[18]
- *The fixed amortization method.* Under the fixed amortization method of Notice 89-25, payments were treated as satisfying the SEPP exception if the amount to be distributed annually was determined by amortizing the taxpayer's account balance over the life expectancy of the owner, or the joint life and last survivor expectancy of the owner and the owner's beneficiary, at an interest rate that did not exceed a "reasonable" interest rate on the date payments commence. Life expectancies and joint life and last survivor expectancies were determined in the same manner as under

[11] Section 72(t)(2)(A)(ii).
[12] Section 72(t)(2)(A)(iii).
[13] Section 72(t)(3)(B).
[14] 1989-1 C.B. 662, 666.
[15] *See* INFO 2000-0226. An information letter, like INFO 2000-0226, is a statement issued by the IRS National Office that calls attention to a well-established interpretation or principle of tax law without applying it to a specific set of facts. *See* section 2.04 of Rev. Proc. 2002-1, 2002-1 C.B. 1, *Doc 2002-924*, *2002 TNT 11-3*. It should be noted that an information letter does not constitute legal precedent that can be relied on. This is also the case for a private letter ruling. *See* section 6110(k).
[16] 1989-1 C.B. at 666.
[17] *See* section 2.01(a) of Rev. Rul. 2002-62.
[18] *See* section 2.03(b) of Rev. Rul. 2002-62.

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the required minimum distribution method. Payments under this method generally were determined using the account balance, life expectancy, and interest rate at the time the determination was made.[19] However, the IRS indicated that it would in some circumstances permit the account balance, life expectancy, and interest rate to be redetermined annually.[20]

Similarly, under the fixed amortization method as modified by Rev. Rul. 2002-62, the annual payment for each year is determined by "amortizing in level amounts the account balance over a specified number of years determined using the chosen life expectancy table and the chosen interest rate." The revenue ruling states that the account balance, the number from the chosen life expectancy table, and the resulting annual payment under this method "are determined once for the first distribution year and the annual payment is the same amount in each succeeding year."[21] Notwithstanding this apparent prohibition against the annual recalculation of SEPP amounts under this method, the IRS has in some circumstances approved the use of a fixed amortization method under which the SEPP amounts are recalculated annually.[22]

- *The fixed annuitization method.* Under the annuitization method of Notice 89-25, payments were treated as SEPPs if the amount to be distributed annually was determined by dividing the taxpayer's account balance by an annuity factor: the present value of an annuity of $1 per year beginning at the taxpayer's age attained in the first distribution year and continuing for the life of the taxpayer. Payments under this method are computed generally using the account balance and an annuity factor determined at the time the computation is performed.[23] However, the IRS indicated that it might permit the account balance and annuity factor to be redetermined annually.[24]

  Similarly, under the fixed annuitization method as modified by Rev. Rul. 2002-62, the annual payment for each year is determined by dividing the account balance by an annuity factor that is the present value of an annuity of $1 per year beginning at the taxpayer's age and continuing for the life of the taxpayer (or the joint lives of the individual and beneficiary). The annuity factor is derived using the mortality table set forth in Appendix B of the revenue ruling, and using the chosen interest rate. The revenue ruling states that under this method, the account balance, the annuity factor, the chosen interest rate, and the resulting annual payment are determined once for the first distribution year and remain the same in each succeeding year.[25] However, in private letter rulings, the IRS has permitted SEPP amounts under this method to be recalculated annually.[26]

Unlike the original required minimum distribution method in Q&A-12 of Notice 89-25, which permitted methods of making distributions (including annuity payments) that would be acceptable for purposes of calculating the required minimum distributions under section 401(a)(9), none of the three modified methods described in Rev. Rul. 2002-62 addresses the treatment of annuity payments as SEPPs.

Rev. Rul. 2002-62 states that it "replaces" the guidance set forth in Q&A-12 of Notice 89-25 for any series of payments commencing on or after January 1, 2003.[27] Rev. Rul. 2002-62 claims to merely modify Q&A-12 by supplementing them while retaining their original content. Also, Notice 2004-15[28] clarified that the IRS and Treasury will treat a distribution as satisfying the section 72(q)(2)(D) SEPP exception applicable to non-qualified annuity contracts "if the taxpayer uses one of the methods described in Notice 89-25, 1989-1 C.B. 662, as modified by Rev. Rul. 2002-62, 2002-2 C.B. 710, to determine whether the payment is part of a series of substantially equal periodic payments."[29] The IRS has indicated that these three modified methods are not the only acceptable methods of satisfying the section 72(t)(2)(A)(iv) SEPP exception.

4. Consistent application of the SEPP exceptions. Notice 2004-15 states the "IRS and Treasury believe that . . . if the provisions of section 72 are designed to achieve the same purpose whether or not the annuity is qualified or non-qualified, it is appropriate to apply that provision in the same manner to both qualified and non-qualified annuities."[30] The guidance says that the legislative history of section

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[19] *See, e.g.*, LTR 200203072, *Doc 2002-1472*, *2002 TNT 14-34*.

[20] *See, e.g.*, LTR 200222036, *Doc 2002-13046*, *2002 TNT 106-34*; LTR 200106039, *Doc 2001-4019*, *2001 TNT 29-11*.

[21] Section 2.01(b) of Rev. Rul. 2002-62.

[22] *See, e.g.*, LTR 200616045, *Doc 2006-7658*, *2006 TNT 78-26*; LTR 200432021, *Doc 2004-16051*, *2004 TNT 153-20*; LTR 200432023, *Doc 2004-16053*, *2004 TNT 153-21*; LTR 200432024, *Doc 2004-16054*, *2004 TNT 153-22*.

[23] *See, e.g.*, LTR 200122048, *Doc 2001-15548*, *2001 TNT 107-24*.

[24] *See, e.g.*, LTR 200051052, *Doc 2001-52*, *2000 TNT 248-21*.

[25] Section 2.01(c) of Rev. Rul. 2002-62.

[26] *See supra* note 22.

[27] 2002-2 C.B. at 711.

[28] 2004-1 C.B. 526.

[29] 2004-1 C.B. at 527.

[30] *Id*.

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72(q)(2)(D) indicates that Congress intended for the 10 percent penalty tax on premature distributions to be the same for all tax-favored retirement savings arrangements.[31] The IRS and Treasury believe, the notice adds, that because the 10 percent penalty tax provisions under section 72(q) and 72(t) were enacted for the same purpose, it is appropriate to apply the same methods to distributions under non-qualified annuity contracts and qualified retirement plans for purposes of determining whether they are part of a series of SEPPs.[32] Therefore, the methods set forth in Notice 89-25, as modified by Rev. Rul. 2002-62, may be used to determine whether a distribution from a non-qualified annuity contract is part of a series of SEPPs under section 72(q)(2)(D).[33]

Put differently, the IRS and Treasury agree that it is appropriate to apply the SEPP exceptions under section 72(q)(2)(D) and 72(t)(2)(A)(iv) in the same manner. Hence, distributions that constitute SEPPs under section 72(t)(2)(A)(iv) should be recognized by the IRS and Treasury as constituting SEPPs under 72(q)(2)(D).

D. The Increasing Annuity Payments as SEPPs

1. In general. The phrase ''substantially equal periodic payments'' is not defined in section 72(q)(2)(D), section 72(t)(2)(A)(iv), or the income tax regulations under those subsections. The history of section 72(q)(2)(D) indicates that the requirement that an amount be paid out as one of a series of SEPPs is met whether it is paid as part of a fixed annuity, or as part of a variable annuity under which the number of units withdrawn to make each distribution is substantially the same.[34] Hence, it seems clear that Congress contemplated that annuity payments can qualify as SEPPs.

The legislative history of section 72(t)(2)(A)(iv) provides that payments will not fail to be SEPPs solely because they vary on account of (1) specific cost of living adjustments, (2) cash refunds of employee contributions on an employee's death, (3) a benefit increase provided to retired employees, (4) an adjustment due to the death of the employee's beneficiary, or (5) the cessation of a Social Security supplement.[35] The legislative history also states:

> Congress intended that the Secretary may prescribe regulations setting forth other factors (consistent with the factors prescribed under sec. 401(a)(9)) that will not cause payments to fail to be considered substantially equal.[36]

No such regulations have been promulgated. Certainly, however, in light of this legislative history, the IRS is not at liberty to determine whether payments constitute SEPPs in a manner that is inconsistent with section 401(a)(9). Like the SEPP exceptions, section 401(a)(9) is designed to provide methods of distributing a taxpayer's entire interest over life or life expectancy (or joint lives or joint life expectancy of the taxpayer and his designated beneficiary).[37] This legislative history indicates that a stream of payments for the life of the taxpayer (or joint lives of the taxpayer and his designated beneficiary) or life expectancy (or joint life expectancies of the taxpayer and his designated beneficiary) that satisfies the minimum distribution requirements under section 401(a)(9) should be treated by the IRS as SEPPs. This is consistent with the original required minimum distribution method in Q&A-12 of Notice 89-25, which permitted SEPPs to be determined under an acceptable method for satisfying section 401(a)(9).

Hence, in accordance with this legislative history, the increasing lifetime annuity payments under the contracts in LTR 201120011 should be treated as SEPPs if they (1) satisfy the section 401(a)(9) minimum distribution requirements, or (2) are treated as varying on account of cost of living adjustments.

2. The increasing annuity payments satisfy section 401(a)(9). The IRS explained in Notice 2004-15 that taxpayers may use one of the methods set out in Notice 89-25, as modified by Rev. Rul. 2002-62, to determine whether a distribution from a non-qualified annuity contract is part of a series of SEPPs under section 72(q)(2)(D). Annual payments must be treated as SEPPs, according to Q&A-12 of Notice 89-25, if they are determined using a method

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[31]*Id.*

[32]*Id.*

[33]*Id.*

[34]JCT, ''General Explanation of the Tax Equity and Fiscal Responsibility Act of 1982,'' at 364 (1982) (TEFRA blue book).

[35]S. Rep. No. 99-313, at 615 (1986); TRA 1986 blue book, *supra* note 8, at 717.

[36]*Id.* It should be noted that the regulations under section 402(c) address whether a distribution from an ''eligible retirement plan'' constitutes an ''eligible rollover distribution'' that can be rolled over tax free to another similar plan. The term ''eligible rollover distribution'' is defined in section 402(c)(4)(A) to exclude some SEPPs. The regulations under this section refer to the ''principles of section 72(t)(2)(A)(iv)'' in discussing whether some payments constitute a series of SEPPs. Those regulations under section 402(c) address whether certain Social Security supplements, payments that change in amount, payments computed periodically based on a declining account balance, payments that include independent or supplemental payments, payments that are administratively delayed, and some other amounts are treated as SEPPs for this purpose. *See* reg. section 1.402(c)-2, Q&A-5, Q&A-6.

[37]*See* section 401(a)(9)(A)(ii); reg. section 1.401(a)(9)-2, Q&A-1(a); T.D. 8987, 2002-1 C.B. 852, 853, *Doc 2002-9210*, *2002 TNT 74-7*.

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that is acceptable for purposes of calculating the minimum distribution required under section 401(a)(9).

The regulations under section 401(a)(9) require that for annuity payments to satisfy the minimum distribution requirements, they must be non-increasing, subject to some exceptions.[38] Under one exception, annuity payments paid from an annuity contract purchased from an insurance company will not fail to satisfy the non-increasing annuity payment requirement merely because the payments increase by a constant percentage applied no less frequently than annually, if specific conditions are met.[39] These conditions limit the amount by which annuity payments may increase.

The regulations also provide an exception for annuity payments from a defined benefit plan qualified under section 401(a) (other than annuity payments paid under an annuity contract purchased from an insurance company). Under this exception, annuity payments will not fail to satisfy the non-increasing annuity payments requirement merely because they are increased in accordance with a constant percentage, applied no less frequently than annually, at a rate that is less than 5 percent per year.[40] Hence, the IRS and Treasury clearly contemplated that annuity payments that increase annually by 5 percent can satisfy the section 401(a)(9) minimum distribution requirements.

The taxpayers in LTR 201120011 represented that the annuity payments under the contracts that increase by 1, 2, 3, or 4 percent annually satisfy the requirements of section 401(a)(9). The taxpayers argued that under Q&A-12 of Notice 89-25, as modified by Rev. Rul. 2002-62, and the legislative history of section 72(t)(2)(A)(iv), these increasing annuity payments should be considered SEPPs for purposes of the section 72(t)(2)(A)(iv) SEPP exception. Based on the IRS's position in Notice 2004-15 that the SEPP exceptions under section 72(t)(2)(A)(iv) and 72(q)(2)(D) should be applied in the same manner, the increasing annuity payments under the contracts in LTR 201120011 also should be treated as SEPPs for purposes of the section 72(q)(2)(D) SEPP exception.

3. SEPPs may increase by a constant stated percentage annually. Alternatively, the taxpayers in LTR 201120011 argued that the annual increases in annuity payments under the contracts should be viewed akin to cost of living adjustments. The legislative history of section 72(t)(2)(A)(iv) provides that payments will not fail to be SEPPs solely because they vary on account of some cost of living adjustments.[41] The IRS has maintained in several private letter rulings that SEPPs may increase annually by a constant stated percentage of 3 percent, rather than by reference to a particular cost of living index.[42] Based on this IRS position, together with the fact that the average rate of inflation since 1940 has been over 4 percent,[43] it seems appropriate to conclude that annuity payments under the contracts in LTR 201120011, which increase annually by a constant stated percentage of 1, 2, 3, or 4 percent, should be treated as SEPPs for purposes of section 72(t)(2)(A)(iv) and 72(q)(2)(D).

E. The IRS's Interpretation

1. The increasing annuity payments do not satisfy a distribution method described in Rev. Rul. 2002-62 and Notice 89-25. The IRS rejected the taxpayers' argument that the increasing annuity payments under the contracts in LTR 201120011 satisfy an acceptable method of calculating minimum distributions required under section 401(a)(9), and thus should be treated as SEPPs in accordance with Q&A-12 of Notice 89-25, as modified by Rev. Rul. 2002-62. The IRS reasoned that:

> The Taxpayers' argument disregards Rev. Rul. 2002-62, which replaced the guidance provided in Q&A-12 of Notice 89-25 with a more detailed description of the three methods than the description provided in Q&A-12 of Notice 89-25. Rev. Rul. 2002-62 makes it clear that the required minimum distribution method involves an annual recalculation of the payments determined by dividing the account balance for that year by the number from the chosen life expectancy table for that year. Under this method, the annual payments may increase or decrease based on the account balance and the remaining life expectancy from the chosen table.

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[38]Reg. section 1.401(a)(9)-6, Q&A-1.

[39]Reg. section 1.401(a)(9)-6, Q&A-14(c)(1), (e)(1), and (e)(3).

[40]Reg. section 1.401(a)(9)-6, Q&A-14(d)(1).

[41]S. Rep. No. 99-313, at 615 (1986); TRA 1986 blue book, *supra* note 8, at 717.

[42]LTR 9816928; LTR 9747045, *Doc 97-31845*, *97 TNT 226-16*; LTR 9723035, *Doc 97-16535*, *97 TNT 110-32*; LTR 9536031, *95 TNT 177-16*. It should be noted that the rate of inflation for 1994 through 1998 (that is, the year during which the IRS considered these private letter rulings) was equal to 2.6 percent (1994), 2.8 percent (1995), 3 percent (1996), 2.3 percent (1997), and 1.6 percent (1998). *See* U.S. Department of Labor, Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers (U.S. City Average, All Items), *available at* ftp://ftp.bls.gov/pub/special.requests/cpi/cpiai.txt.

[43]Tim McMahon, "How Much Inflation Have We Had Since 1913?" InflationData.com (May 16, 2008), *available at* http://inflationdata.com/inflation/Inflation/Cumulative_Inflation_by_Decade.asp.

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> The description of the required minimum distribution method in Rev. Rul. 2002-62 states that it is one of the methods described in Q&A-12 of Notice 89-25. Thus, we believe Rev. Rul. 2002-62 merely provides further explanation of the required minimum distribution method described in Notice 89-25. However, to the extent that the two descriptions of the method might vary, the description in Rev. Rul. 2002-62 controls.

The IRS observed that the annuity payments under the contract in LTR 201120011 will increase automatically by a fixed percentage each year, rather than increase or decrease based on the account balance and the remaining life expectancy from the applicable table. For this reason, the IRS concluded that the increasing annuity payments would not be determined using the required minimum distribution method described in Rev. Rul. 2002-62 and Notice 89-25, and thus should not be treated as SEPPs for purposes of section 72(q)(2)(D).

In short, the IRS apparently interprets Notice 2002-62 narrowly, as replacing Q&A-12 of Notice 89-25. However, unlike the original required minimum distribution method in Q&A-12, which permitted methods of making distributions (including annuity payments) that would be acceptable under section 401(a)(9), none of these three modified methods described in Rev. Rul. 2002-62 addresses the treatment of annuity payments as SEPPs. The IRS's interpretation seems inconsistent with the statement in Notice 2002-62 that Q&A-12 is only ''modified,'' and the statement in Notice 2004-15 that taxpayers may use one of the methods set forth in Notice 89-25, as ''modified'' by Rev. Rul. 2002-62. Also, the IRS's interpretation seems inconsistent with the Tax Court's reasoning in *Graham v. Commissioner*,[44] in which the court considered the methods described in Q&A-12 in considering whether some distributions made in 2006 (after the effective date of Rev. Rul. 2002-62) constituted SEPPs. The IRS's interpretation in LTR 201120011 effectively means there is no published guidance addressing how annuity payments can qualify as SEPPs.

Even if the distribution methods described in Q&A-12 are no longer available and increasing annuity payments are not determined under a method described in Rev. Rul. 2002-62, the IRS nevertheless should have treated the increasing annuity payments in LTR 201120011 as SEPPs. The IRS has repeatedly stated that the methods for determining SEPPs described in Rev. Rul. 2002-62 are safe harbor methods that constitute permissive, rather than the exclusive, methods of determining whether a stream of distributions constitute SEPPs. In a news release accompanying the issuance of Rev. Rul. 2002-62, the IRS described the three calculation methods described in Rev. Rul. 2002-62 and Q&A-12 of Notice 89-25 as safe harbor methods.[45] Also, the IRS has posted on its website a series of questions and answers on Rev. Rul. 2002-62, including the following:

> Are these methods contained in Rev. Rul. 2002-62 the only acceptable ways of determining substantially equal periodic payments? No. Another method may be used in a private letter ruling request, but, of course, it would be subject to individual analysis.[46]

The IRS did issue a private letter ruling after the effective date of Rev. Rul. 2002-62 that looked to the legislative history of the SEPP exception to determine whether some variable annuity payments not covered under any of the methods described in Rev. Rul. 2002-62 nevertheless constitute SEPPs within the meaning of section 72(u)(4)(C). In LTR 200818018 the IRS considered whether a nonqualified single premium life annuity contract constitutes an ''immediate annuity'' within the meaning of section 72(u)(4). This section defines an ''immediate annuity'' as an annuity that (1) is purchased with a single premium or annuity consideration, (2) has an annuity starting date commencing no later than one year from the date of the purchase of the annuity, and (3) provides for a series of SEPPs (to be made not less frequently than annually) during the annuity period.

In determining whether the variable annuity payments in LTR 200818018 constitute SEPPs for section 72(u)(4) purposes, the IRS referred to the methods described in Notice 2002-62 and mentioned that these methods can be used for purposes of determining SEPPs under the section 72(q)(2)(D) SEPP exception. The IRS reasoned that the ''Code

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[44]T.C. Summ. Op. 2009-139, *Doc 2009-20103*, *2009 TNT 172-49*.

[45]IR-2002-104, ''IRS Helps Taxpayers Preserve Retirement Savings by Allowing a Change to Pension Distribution Amounts'' (Oct. 3, 2002), *Doc 2002-22460*, *2002 TNT 193-8*.

[46]*See* Question 10, ''Retirement Plans FAQs regarding Substantially Equal Periodic Payments,'' *available at* http://www.irs.gov/retirement/article/0,,id=103045,00.html. Also, Notice 2004-15 uses similar permissive language by providing that taxpayers ''may'' use one of the three safe harbor calculation methods set forth in Notice 89-25, as modified by Rev. Rul. 2002-62, to determine whether payments are SEPPs for purposes of section 72(q). Further, the IRS has concluded in several private letter rulings that payments determined under methods that differ significantly from the safe harbor calculation methods set forth in Rev. Rul. 2002-62 nevertheless constitute SEPPs. *See* LTR 200818018, *Doc 2008-9825*, *2008 TNT 87-7*; LTR 200432024; LTR 200432023; and LTR 200432021.

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and the [IRS's] administrative pronouncements must be viewed against the backdrop of the extant actuarial methodologies for computing periodic payments.'' The IRS then took notice of the history of section 72(q)(2)(D) providing that variable annuity payments will be considered SEPPs if they are paid out as part of a variable annuity under which the number of units withdrawn to make each distribution is substantially the same (the ''annuity unit method'').[47] The IRS reasoned that ''a methodology that replicates this effect'' of the annuity unit method should be viewed as providing SEPPs.

The variable annuity payments in LTR 200818018 were not determined under a method described in Rev. Rul. 2002-62. Also, variable annuity payments might not be paid out in a manner described in the legislative history — that is, annuity payments might not be paid out as part of a variable annuity under which the number of units withdrawn for each distribution is substantially the same. However, the method used to compute the variable annuity payments was actuarially equivalent to the annuity unit method. Accordingly, the IRS found that the method used to determine the variable annuity payments provided for SEPPs, and that the contract constitutes an immediate annuity within the meaning of section 72(u)(4). This ruling seems to indicate that annuity payments not determined under a method described in Rev. Rul. 2002-62 nevertheless should be considered SEPPs if they are determined under a method that replicates a method recognized in the legislative history as producing SEPPs.

In this regard, the legislative history of section 72(t)(2)(A)(iv) provides that if regulations are issued addressing whether a series of payments constitute SEPPs, Treasury should consider factors ''consistent with the factors prescribed under sec. 401(a)(9)'' that will not cause the payments to fail to be considered substantially equal.[48] Although regulations interpreting the SEPP exceptions have not been issued, it is clear from this legislative history that Congress intended for the IRS and Treasury to look to standards under section 401(a)(9) for purposes of determining whether a series of distributions should be treated as SEPPs. Obviously, Congress did not intend to give the IRS or Treasury license in the absence of regulations to administer the SEPP exceptions in a manner that is inconsistent with section 401(a)(9). Hence, annuity payments that satisfy the requirements of section 401(a)(9) should be considered SEPPs for purposes of the SEPP exceptions.

As explained above, the increasing annuity payments at issue in LTR 201120011 satisfy the requirements of section 401(a)(9), including the nonincreasing annuity payment requirement. Therefore, the IRS should have treated the increasing annuity payments in LTR 201120011 as SEPPs. The IRS's holding to the contrary is at odds with congressional intent.

2. The increasing annuity payments do not vary on account of cost of living adjustments. The IRS also rejected the taxpayers' alternative argument that the annual increases in the annuity payments under the contracts by 1, 2, 3, or 4 percent should be viewed as cost of living adjustments. The IRS concluded that the annuity payments would not be affected by cost of living adjustments because the contract permitted the owner to select the percent by which annuity payments would increase annually. This conclusion is at odds with the IRS's position in other private letter rulings concluding that annuity payments that increase each year by 3 percent constitute SEPPs. Although the law has not changed since the IRS issued these private letter rulings, the position of the IRS appears to have changed considerably.

3. Troubling implications. The IRS's position in LTR 201120011 is troubling in several respects. First, the IRS's narrow interpretation that Notice 89-25, as modified by Rev. Rul. 2002-62, no longer applies, leaves no published guidance under which annuity payments can qualify as SEPPs. Second, although the holding in LTR 201120011 only addresses SEPPs under section 72(q)(2)(D), it appears that the IRS will apply its reasoning in considering whether distributions constitute SEPPs for other purposes. Extrapolating the IRS's reasoning in LTR 201120011, annuity payments that are made over life or life expectancy (or over joint lives or joint life expectancies) and satisfy the section 401(a)(9) minimum distribution requirements could be subject to the 10 percent penalty tax.

> **Example:** If an individual IRA owner who is under age 59½ elects to begin taking annuity payments, the annuity payments must satisfy the requirements of section 401(a)(9).[49] The individual may wish to begin taking his IRA interest in a manner that will provide for payments for life. Under the IRS's interpretation in LTR 201120011, the individual will be

[47]*See* TEFRA blue book, *supra* note 34, at 364.

[48]S. Rep. No. 99-313, at 615 (1986); TRA 1986 blue book, *supra* note 8, at 717.

[49]Reg. section 1.401(a)(9)-6, Q&A-10.

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unable to elect the increasing annuity payments without incurring a 10 percent penalty tax, even though the payments satisfy the minimum distribution requirements.

Presumably the IRS also will not treat increasing annuity payments, like those in LTR 201120011, as SEPPs within the meaning of section 72(u)(4)(C). In LTR 200818018 the IRS looked to the SEPP exceptions for purposes of determining whether some variable annuity payments constitute SEPPs within the meaning of this section, and thus whether the contract was an immediate annuity contract within the meaning of section 72(u)(4). It follows from the IRS's reasoning in LTR 201120011 that the IRS will not treat an annuity contract with increasing annuity payments as an immediate annuity within the meaning of section 72(u)(4). This is important because (1) section 72(q)(2)(I) provides an exception to the 10 percent penalty tax for distributions from a non-qualified immediate annuity, and (2) section 72(u)(3)(E) provides an exception for immediate annuity contracts to the general rule in section 72(u)(1) that an annuity contract held by a nonnatural person is not treated as an annuity contract for federal income tax purposes. Hence, the IRS's treatment of the increasing annuity payments in LTR 201120011 under section 72(q)(2)(D) has implications well beyond that section.

More generally, the increasing annuity payment option under the contracts in LTR 201120011 was designed to address legitimate consumer inflation concerns associated with annuities for life or life expectancy. The IRS's holding in this private letter ruling is inconsistent with the policy objective of encouraging Americans to use annuities for retirement savings.

F. Conclusion

The IRS's ruling that the increasing annuity payments in LTR 201120011 are not SEPPs within the meaning of the section 72(q)(2)(D) SEPP exception is disappointing and troubling. The IRS's narrow interpretation of the SEPP exception and rationale for its ruling effectively leaves no published guidance under which annuity payments can qualify as SEPPs. Also, the ruling does not comport with congressional intent that the SEPP exception be interpreted in a manner consistent with the minimum distribution requirements of section 401(a)(9). That position unnecessarily limits the availability of annuity products before age 59½ that provide annuity payments reflecting reasonably expected long-term cost of living increases.

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