IRS RULES LONGEVITY CONTRACT IS ANNUITY UNDER SECTION 72

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In September 2009, the Internal Revenue Service (IRS) released a private letter ruling (PLR 200939018 (June 18, 2009)) addressing a contract in which the right to receive annuity payments and otherwise access a contract's cash value is contingent upon the annuitant living to a specified age. The ruling holds that the contract is an annuity contract for purposes of section 72 of the Internal Revenue Code (the "tax code"). While the conclusion of PLR 200939018 is not surprising to the authors, the release of the PLR should put an end to questions that were being asked in some quarters about the status of such contracts under the tax law. Before reviewing the specifics of the recent ruling, some background may be helpful.

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In the early to mid-1900s, a number of life insurance companies offered a form of deferred annuity contract that began payment of a life annuity if the annuitant was alive on a specified date, *e.g.*, his or her 75th birthday. These contracts provided no cash surrender value and if the annuitant died before the specified time, there was no death benefit. Such contracts provided pure longevity protection to individuals, *i.e.*, they were the annuity analog of term life insurance. Under such a contract, the purchaser obviously assumes the risk of losing his or her premium in the event of a premature death. The lack of a cash value and death benefit, however, allows the insurer to provide significant amounts of retirement income cheaply in comparison to the purchase, for example, of an immediate annuity. Over time, these "pure" deferred annuities gradually all but disappeared from the retirement market place, perhaps because of the growth of the defined benefit plan system, followed by the focus in the last 20 to 30 years on asset accumulation rather than longevity protection.[1] In recent years, however, a few companies have once again begun to offer these types of contracts, often using the label of "longevity insurance" to describe the contracts.[2]

Historically, pure deferred annuity contracts have been viewed by the insurance industry as a type of annuity contract.[3] As a result, there has been a presumption in the industry that the contracts were also annuities for federal tax purposes. Somewhat surprisingly, however, in the last couple of years some IRS officials raised the question of whether a contract that lacked a cash value should be treated as an annuity contract for tax purposes. The question arose both in the context of longevity insurance as well as with respect to other forms of "contingent" annuity contracts that have been introduced by a few insurers.[4] While most observers did not give much credence to the idea that a contract's status as an annuity could be affected by whether or not it possessed a cash value,[5] there was a paucity of guidance on the issue. As a result, PLR 200939018 provides a useful statement from the IRS confirming the treatment of longevity insurance as a form of annuity for tax purposes.

The Facts. The key feature of the contract considered in PLR 200939018 is that no cash value or death benefit is available for a period of time after issue, which is referred to in the ruling as the "Deferral Period." The duration of the Deferral Period, subject to certain constraints, is chosen by the owner when the contract is issued and cannot be changed thereafter. One such constraint is that the Deferral Period must always end on or before the "Maturity Date," on which date the annuity payments must commence if the contract has not been annuitized prior to such date.

The contract is issued after the payment of an initial premium and the owner may pay additional premiums thereafter subject to certain restrictions, including a prohibition on paying premiums for a specified period of time at the end of the Deferral Period. All premium payments, net of taxes and charges, are credited to a "contingent account value." The ruling—due to deletions presumably requested by the taxpayer—is vague on the specifics of how the contingent account value is determined, but it appears that certain amounts are credited to the contingent account value and certain charges are deducted from it. During the Deferral Period, the owner cannot surrender the contract, take any withdrawals, or annuitize the contract. Further, no death benefit will be paid if the annuitant dies during the Deferral Period. If the annuitant dies or the contingent account value is reduced to zero during the Deferral Period, the contract will terminate without value.

If the annuitant is living and the contract is still in force at the end of the Deferral Period, the contingent account value will become the contract's cash value which thereafter functions like a conventional cash value, *i.e.*, the owner has the right to take partial withdrawals from the cash value, surrender the contract for its cash value, and apply the cash value to an annuity payment option. In addition, following the Deferral Period, the contract provides a death benefit equal to the cash value on the death of the annuitant. After the Deferral Period, the contract will terminate if the cash value is reduced to zero, the owner surrenders the contract, or the contract is annuitized, which must occur on or before the contract's Maturity Date.

Lastly, the contract is an annuity contract under the laws of the states in which it will be issued.

The IRS Analysis. The need for guidance on this type of product stems from the fact that neither the tax code nor its regulations define an annuity contract for tax purposes. As noted in the ruling, the tax code and regulations provide certain definitional rules and limitations on what types of products can be treated as an annuity, but there is no all encompassing definition of an "annuity contract." The ruling sets forth this background and then discusses Treasury regulation section 1.72-2(a)(1), which states that the contracts to which section 72 applies include those that are considered to be life insurance, endowment, and annuity contracts "*in accordance with the customary practice of life insurance companies*."

Citing to a number of authorities, including law review articles, treatises, and a 1947 government report, the ruling observes that during the first half of the 20th century insurance companies issued deferred annuities that did not provide for any cash value or death benefit during the accumulation phase. Further, the IRS notes that nothing in the tax code, the income tax regulations or any other authority indicates that a cash value or death benefit is a predicate for annuity treatment under section 72 of the tax code. Thus, the IRS concludes that, "[i]n light of the fact that the contracts are substantially similar to typical deferred annuities," the lack of a cash value or death benefit during the Deferral Period is not inconsistent with the "customary practice" of life insurance companies.

The ruling also cites to a number of cases in which courts have described an annuity as a contract under which the issuer, in exchange for consideration, promises to pay a stated sum of money periodically over a term of years or for life. The IRS states in the ruling that periodic payments of interest under a contract, which do not liquidate principal, are distinguishable from periodic payments under an annuity, which liquidate a principal sum over the payment term. In addition, the ruling cites to IRS guidance which provides that if a contract lacks guaranteed annuity purchase rates it should not be treated as an annuity contract. The ruling concludes that, under each of these criteria, the contract should be treated as an annuity contract for federal tax purposes.

The Ruling's Reach. PLR 200939018 does not speak directly to the use of the contract in various types of qualified arrangements, such as IRAs, but the use of longevity contracts with IRAs presents some interesting challenges. There are two basic ways in which deferred annuity contracts are used with IRAs. In some cases, annuities are issued as a stand-alone "individual retirement annuity" under the rules of section 408(b) of the tax code. In other cases, an annuity is held as an investment of an IRA account under the rules of section 408(a) of the tax code. One obstacle to the use of longevity contracts in connection with IRAs is the need for the IRA to comply with the required minimum distribution (RMD) rules under section 401(a)(9). In general terms, the RMD rules require that beginning at age 70½ the account balance of an individual's IRA must be distributed over the individual's life or life expectancy.[6] For purposes of determining the RMD from an IRA account for a year, the account balance of an IRA account is typically the fair market value of the account as of December 31 of the prior year.[7]

The RMD regulations applicable to IRA annuities provide that prior to the time the contract is "annuitized," the "entire interest" of the owner in the annuity contract is treated as the "account balance."[8] The regulations explain that the "entire interest" under an annuity contract consists of 1) the dollar amount credited to the owner under the contract, plus 2) "the actuarial present value of any additional benefits" provided under the contract.[9] As a result, if an individual wished to use a longevity contract with, *e.g.*, a maturity date of age 85, as an IRA annuity, he or she would need to take an annual RMD starting at age 70½ equal to the actuarial present value of the contract divided by the applicable factor from the Uniform Lifetime Table. However, since the contract has no cash value prior to age 85, a

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prospective purchaser would not be able to pay RMDs prior to age 85. It is unclear whether such a contract could qualify as an IRA annuity under section 408(b), even if the individual possessed other IRA assets from which the RMD attributable to the IRA annuity could be taken.[10]

What about holding the longevity contract as an investment in an IRA account? In that circumstance, the fair market value of the contract would need to be taken into account along with the fair market value of any other assets in the account in computing RMDs. In that regard— even though the longevity contract has no cash value—the contingent obligations of the insurer under the contract would have value, which would be used to determine the amount of the RMD attributable to the annuity. To illustrate, assume Ann Jones is 72 and has an IRA account, the sole asset of which is a longevity contract which will commence a life annuity on Jones's 85th, birthday. Also assume the contract has a fair market value of $50,000 on Dec. 31, 2011. Under the RMD regulations, Jones would be required to take an RMD in 2012 of $1,953.13, but the contract has no cash value from which to take the RMD.[11] The obvious way to address this problem is for Jones to hold liquid assets in the IRA account along with the longevity contract and to make the RMD payments from the liquid assets.

Such an approach, however, would require careful planning. First, the value of the longevity contract will increase as Jones approaches her 85th birthday, the date on which payments will begin under the contract.[12] Second, the RMD distribution period decreases as an individual ages,[13] which, combined with the increase in the value of the longevity contract, means that the RMD attributable to the longevity contract will increase each year as the maturity date of the longevity contract approaches. This will require a corresponding increase in the amount of liquid assets available in the IRA to fund the RMD. Finally, the IRA will also need to hold sufficient assets to pay the annual RMD attributable to the value of the liquid assets because the RMD for the IRA account is based on the value of *all* of the assets in the account. In Jones's case, let's assume she has lived a healthy lifestyle and, on Dec. 31, 2024, the eve of the year in which she will turn 85, the fair market value of the contract is $100,000. The RMD for 2024 attributable to the longevity contract will be $6,756.76.[14] However, at that time the IRA account will need to hold sufficient assets to pay not only the $6,756.76, but the RMD on the asset generating the $6,756.76, *i.e.*, the IRA will need to hold at least $7,246.38.[15]

In view of the RMD barriers to the use of longevity insurance in an IRA, legislation has been introduced in Congress to facilitate the use of longevity insurance in an IRA account or a qualified plan. A bill introduced by Representatives Earl Pomeroy (D-ND) and Ginny Brown-Waite (R-FL), for example, would disregard the value of longevity insurance held in a plan or an IRA account in applying the applicable RMD rules until the date that annuity payments begin, subject to certain limitations, *e.g.*, payments could not commence under the longevity contract later than 12 months following the date the employee attains age 85.[16] The prospects for this legislation to be enacted in the next few years are uncertain, but given the societal needs for this type of product, the longer term prospects are better.

Conclusion. While the holding of PLR 200939018 that a pure deferred annuity is an annuity for federal tax purposes is not surprising, it is welcome, and it should lay to rest the occasional questions that were being raised about whether such contracts are annuities for federal tax purposes. It remains to be seen, however, how these products will be received in the marketplace, particulary for use with IRA assets.

END NOTES

[1] As early as 1929, MacLean noted that even though there is no benefit payable if the annuitant dies prior to the date the first annuity payment is due, "there is . . . no real forfeiture since the purchaser receives exactly what he pays for, but the popular distaste even for an apparent forfeiture renders such simple deferred annuities unattractive to most purchasers." MacLean, LIFE INSURANCE 62 (2d ed. 1929).

[2] Longevity contracts are also sometimes referred to as "contingent" annuities because the annuity payments are contingent upon the survival of the annuitant to a stated age.

[3] These contracts are described in a number of texts and other sources as a form of annuity. *See, e.g.*, S.S. Huebner, LIFE INSURANCE 59, 115 (1919); MacLean, LIFE INSURANCE 62 (2d ed. 1929); Robert Meisenholder, *Taxation of Annuity Contracts under Estate and Inheritance Taxes*, 39 Mich. L. Rev. 856, 860 (1941).

[4] These other forms of "contingent" annuities, sometimes referred to as "stand alone withdrawal benefits," also lack a traditional cash value. These contracts promise to provide an annual payment based on the value of an account referenced by the contract for as long as the annuitant lives, even if the account value is reduced to zero, provided annual withdrawals are not made from the account in amounts exceeding a stated percentage (*e.g.*, 5 percent) of the amounts deposited in the account. The assets in the account are owned not by the insurer but by the individual who purchases the contract. These forms of contracts raise a number of interesting income tax questions, including whether the contract is an annuity and whether the assets in the account are taxed the same as other assets owned independently of the contract (*e.g.*, subject to capital gains treatment) or whether ownership of the contract might cause loss of capital gains treatment (*e.g.*, under the straddle rules). As this edition of *TAXING TIMES* was being prepared for publication, the IRS released two private letter rulings addressing these contracts. *See* PLR 200949007 (July 30, 2009) and PLR 200949036 (July 30, 2009). These rulings will be discussed in the May 2010 issue of *TAXING TIMES*.

[5] For example, an immediate annuity contract typically does not provide a cash value, but it is obviously an annuity contract for Federal income tax purposes. *See, e.g.*, IRC § 72(u)(4).

[6] IRC §§ 401(a)(9)(A)(ii) and 401(a)(9)(C); *see also* Treas. Reg. § 1.401(a)(9)-2. For most taxpayers, life expectancy is determined using the Uniform Lifetime Table set forth in Treas. Reg. § 1.401(a)(9)-9, Q&A-2.

[7] Treas. Reg. § 1.401(a)(9)-5, Q&A-3; T.D. 9130, 2004-1 C.B. 1082 (June 14, 2004) (stating that the "IRS and Treasury believe that it is generally appropriate to reflect the value of additional benefits under an annuity contract, just as the fair market value of all assets generally must be reflected in valuing an account balance under a defined contribution plan."); Instructions for Forms 1099-R and 5498, at 15 (stating that the fair market value of the account on December 31 should be entered in Box 5 on Form 5498).

[8] Treas. Reg. § 1.401(a)(9)-6, Q&A-12.

[9] *Id.*; Joseph F. McKeever, III & Mark E. Griffin, *How to Value an "Additional" Annuity Benefit (Whatever That Is)*, Vol. 1, Issue 2, TAXING TIMES, September 2005, at 1.

[10] Treas. Reg. § 1.408-8, Q&A-9, allows the annual RMDs for one IRA of an owner to be made from a different IRA of the owner.

[11] $50,000 divided by 25.6 (the distribution period for a 72-year-old per the Uniform Lifetime Table in Treas. Reg. § 1.401(a)(9)-9, Q&A 2).

[12] As Ms. Jones ages and the time the longevity contract will begin payments approaches, the present value of the annuity benefits due under the longevity contract (and thus the contract's value) is steadily increasing.

[13] The distribution period for a 70-year-old is 27.4 years, but that for an 85-year-old is only 14.8 years. Treas. Reg. § 1.401(a)(9)-9, Q&A 2).

[14] $100,000 divided by 14.8 (the distribution period for an 85-year-old. Treas. Reg. § 1.401(a)(9)-9, Q&A 2).)

[15] The amount of liquid assets required in the IRA, represented by the variable 'X,' can be solved by using the following equation: X = ($100,000 + X) divided by 14.8. In this example, X = $7,246.38.

[16] Retirement Security Needs Lifetime Pay Act of 2009, H.R. 2748, 111th Cong. § 3 (2009).

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