PLR 201120011 HIGHLIGHTS THE NEED FOR SEPP GUIDANCE ON ANNUITIES

By Mark E. Griffin

Prior to PLR 201120011 (Feb. 11, 2011), it was widely believed that annuity payments that comply with the minimum distribution requirements under section 401(a)(9)[1] can satisfy the exceptions to the 10 percent penalty tax under section 72(q)(1) (for nonqualified annuity contracts) and section 72(t)(1) (for qualified retirement plans)[2] that apply for certain distributions which are made as part of a series of substantially equal periodic payments (or "SEPPs") under section 72(q)(2)(D) and section 72(t)(2)(A)(iv), respectively. However, in PLR 201120011 the Internal Revenue Service ("IRS") ruled that lifetime annuity payments which increase annually by a constant 1, 2, 3, or 4 percent and comply with section 401(a)(9) nevertheless fail to satisfy the "SEPP exception" to the penalty tax under section 72(q)(2)(D).[3] As explained below, this interpretation by the IRS effectively means that there is no published guidance on the circumstances in which any stream of annuity payments will constitute SEPPs. This position highlights the need for published guidance addressing the treatment of annuity payments as SEPPs. The treatment of annuity payments for penalty tax purposes is very important for nonqualified annuity contract owners who want to begin taking annuity payments prior to age 59½, individuals who want to receive annuity payments under their qualified retirement plans commencing prior to age 59½, and annuity issuers.

Sections 72(q)(1) and 72(t)(1) impose a 10 percent penalty tax on the taxable portion of an amount received under a nonqualified annuity contract and a qualified retirement plan, respectively, which is received before the taxpayer attains age 59½, unless an exception applies. Sections 72(q)(2)(D) and 72(t)(2)(A)(iv) provide virtually identical exceptions for distributions which are part of a series of 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. It was widely believed that annuity payments which satisfy the section 401(a)(9) minimum distribution requirements would constitute SEPPs, and thus would not be subject to the 10 percent penalty tax that otherwise would apply prior to the taxpayer attaining age 59½.

This belief was based on Q&A-12 of Notice 89-25[4], which set forth three methods of determining SEPPs for purposes of section 72(t)(2)(A)(iv). One method, commonly referred to as the "required minimum distribution method," provides that payments under a qualified retirement plan will be treated as SEPPs "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)."[5] This method was believed to be available for annuity payments even after Q&A-12 was modified by Rev. Rul. 2002-62.[6] The SEPP methods in Q&A-12, as modified by Rev. Rul. 2002-62, also apply for purposes of applying the section 72(q)(2)(D) SEPP exception for nonqualified annuity contracts.[7]

However, in PLR 201120011, the IRS stated that the guidance in Rev. Rul. 2002-62 "replaced" the guidance in Q&A-12. The IRS explained that:

> 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. (Emphasis added.)

Accordingly, the IRS determined that since the annuity payments in PLR 201120011 were not determined using the required minimum distribution method described in Rev. Rul. 2002-62 and Notice 89-25, the annuity payments did not constitute SEPPs, even though the payments complied with section 401(a)(9).

The import of this interpretation is that the required minimum distribution method in Q&A-12 is replaced by the required minimum distribution method in Rev. Rul. 2002-62 and is limited to contracts with an "account balance" (including deferred annuity contracts). Thus, this method does not apply to contracts under which annuity payments are being made

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(or "payout" annuity contracts, which lack a conventional account balance). This effectively means that there is no published guidance addressing any circumstances in which annuity payments will constitute SEPPs. Hence, owners of nonqualified annuity contracts, individuals under qualified retirement plans, and annuity issuers are left without any published guidance on when annuity payments can be used to satisfy the SEPP exceptions to the 10 percent penalty tax under sections 72(q)(2)(D) and 72(t)(2)(A)(iv).

The insurance industry requested guidance on this issue.[8] On September 2, 2011, the Treasury Department and IRS released their joint 2011–2012 Priority Guidance Plan, which lists priority projects that they plan to work on actively during the period of July 2011 through June 2012. One of the priority projects listed is "Guidance on exceptions to additional tax under §72(t) on early distributions from retirement plans and IRAs."[9] Although this item does not specifically refer to annuities or the SEPP exception under section 72(t)(2)(A)(iv), it is hopeful that this guidance will cover the treatment of annuity payments as SEPPs.

In addition, it would be helpful for such guidance to provide comfort that an individual who satisfies a SEPP exception by taking distributions under one of the "individual account" methods described in Rev. Rul. 2002-62 can subsequently use annuity payments to satisfy the exception. This might occur, for example, if an individual begins taking SEPPs under a deferred annuity contract for a number of years and would like to continue taking SEPPs under a lifetime annuity option in the contract. The concern is that a replacement of SEPPs determined using one of the individual account methods in Rev. Rul. 2002-62 with annuity payments that satisfy the SEPP exception could be viewed as an impermissible modification of the series of payments. In this regard, sections 72(q)(3) and 72(t)(4) provide generally that if the applicable SEPP exception is used to avoid the 10 percent penalty tax, and the series of payments is modified (other than by reason of death or disability) before the close of the five-year period beginning on the date of the first SEPP or before the taxpayer attains age 59½, the previously avoided penalty tax is recaptured (with interest) in the year of the modification.

Applying the recapture rules where an individual alters a distribution method that satisfies the SEPP exception to a form that also satisfies the exception would appear to be contrary to congressional intent.

As the IRS recognized in PLR 201120011, annuity payments are determined differently than distributions under the methods described in Rev. Rul. 2002-62. Hopefully, published guidance will recognize that simply replacing SEPPs under Rev. Rul. 2002-62 with SEPPs in the form of annuity payments will not constitute a modification of the stream of payments which results in the recapture of the penalty tax. The legislative history describes the recapture rules under sections 72(q)(3) and 72(t)(4) as applying in cases in which a distribution method that satisfies the SEPP exception is changed to a form that does not qualify for the SEPP exception.[10] Applying the recapture rules where an individual alters a distribution method that satisfies the SEPP exception to a form that also satisfies the exception would appear to be contrary to congressional intent. If the recapture rules are triggered by switching from an individual account method of making payments under the SEPP exception to an annuity method of making payments under the SEPP exception, no individual who commences taking SEPPs under a method described in Rev. Rul. 2002-62 could ever annuitize their contract within five years or prior to age 59½ without incurring the penalty tax.

In short, the position of the IRS in PLR 201120011 highlights the need for published guidance addressing the application of the SEPP exceptions in sections 72(q)(2)(D) and 72(t)(2)(A)(iv) to annuity payments. The absence of such guidance has created a great deal of uncertainty for nonqualified annuity contract owners, qualified retirement plan participants and annuity issuers about (1) the circumstances in which annuity payments constitute SEPPs for purposes of these exceptions, and (2) whether distributions that satisfy a SEPP exception under an individual account method in Rev. Rul. 2002-62 can be replaced with annuity payments that satisfy the exception without incurring the penalty tax. Hopefully, the fact that the 2011–2012 Priority Guidance Plan includes an item on the exceptions to the 10 percent penalty tax under section 72(t) indicates the government's intention to issue guidance addressing these questions. ◀

END NOTES

[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.

[2] A "qualified retirement plan" is defined for this purpose in section 4974(c) to include a plan under section 401(a), an annuity under section 403(a), a section 403(b) contract, an individual retirement account under section 408(a), and an individual retirement annuity under section 408(b).

[3] A private letter ruling cannot be cited as precedent. *See* section 6110(k)(3).

[4] 1989-1 C.B. 662, 666, modified by Rev. Rul. 2002-62, 2002-2 C.B. 710.

[5] *Id.* Q&A-12 provides that payments will also be treated as SEPPs if the amount to be distributed annually is determined (1) by amortizing the taxpayer's account balance over a number of years equal to the life expectancy of the account owner or the joint life and last survivor expectancy of the account owner and beneficiary at a reasonable interest rate (commonly referred to as the "amortization method"), or (2) by dividing the taxpayer's account balance by an annuity factor which is derived using a reasonable mortality table and using a reasonable interest rate (commonly referred to as the "annuitization method"). *Id.*

[6] Rev. Rul. 2002-62, 2002-2 C.B. 710, modifying Q&A-12 of Notice 89-25, 1989-1 C.B. 662, 666.

[7] Notice 2004-15, 2004-1 C.B. 526, 527; INFO 2000-0226. An information letter, like INFO 2000-0266, 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. An information letter, like a private letter ruling, cannot be cited as precedent. *See* section 6110(k).

[8] Letter from Davis & Harman LLP written on behalf of the Committee of Annuity Insurers, to Internal Revenue Service (June 1, 2011) (on file with author); Letter from American Council of Life Insurers (ACLI), to Internal Revenue Service (June 1, 2011) (on file with Tax Analysts).

[9] U.S. Dep't of Treasury, 2011-2012 Guidance Priority Plan (2011), http://www.irs.gov/foia/article/0,,id=181687,00.html.

[10] H.R. Rep. No. 99-841, vol. II, at 400-403, 455-457 (1986) (Conf. Rep.); S. Rep. No. 99-313, at 567-568, 615 (1986); Staff of Jt. Comm. On Tax'n, 99th Cong., General Explanation of the Tax Reform Act of 1986, 659-660, 717-718 (1987).