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Contact Person:

Telephone Number:

In Reference to:
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Legend

Rider 1	=
Taxpayer	=
Policy	=
Rider 2	=
Spouse	=
Company	=
State	=
a	=
c	=
Date 1	=
d	=
e	=
f	=
g	=

h	=
i	=
j	=
k	=
Formula 1	=

m	=
n	=
o	=
p	=
q	=
r	=
Formula 2	=

s	=
State Law 1	=
u	=

v	=
w	=
the y conditions	=

z =

State Law 2	=
Formula 3	=

aa	=
bb	=
cc	=
dd	=
method 1	=
method 2	=

Formula 4 =

Formula 5 =

ee =

State Law 3 =

Formula 6 =

State Law 4 =

Dear

This is in response to your June 18th, 1999 letter requesting a series of rulings (and to your subsequent correspondence providing supplemental information respecting those requests) regarding: the tax status of certain amounts received on death pursuant to Rider 1; the status of certain charges as distributions includible in Taxpayer's gross income under § 72(e)[1]; and whether the exchange of Taxpayer's existing deferred annuity contract will be treated as an exchange described in § 1035(a)(3).

FACTS

A. Taxpayer

Taxpayer and his spouse are cash basis taxpayers. They file their Federal income tax returns on a calendar year basis.

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[1] Unless otherwise stated, all statutory references in this letter are made to the Internal Revenue Code of 1986, as amended (the "Code").

B. The Company

The Company is a stock life insurance company organized and operated under the laws of State. Company is licensed to engage in the life insurance business in a. It is a life insurance company within the meaning of § 816(a).

C. The Policy

The Policy will be issued as an individual single premium deferred annuity contract which will be known under the marketing name c. The Policy may be issued with two optional riders, i.e., Riders 1 and 2.

Taxpayer proposes to acquire Riders 1 and 2 at the time he acquires the Policy. Specifically, Taxpayer intends to assign to the Company all rights under an existing individual deferred annuity contract that he owns solely in exchange for the new Policy.

Under the Policy, the Company will make monthly payments (herein referred to as "Income Payments") to a payee designated by the "Owner" of the Policy. In this case, Taxpayer will be the Policy's Owner as well as the designated payee. Under certain of the payment options available under the Policy, described further below, the duration of the Income Payments may depend upon the continued life of an "Annuitant" named in the Policy, who in this case will be Taxpayer. Although the Company permits the Owner and Annuitant to be different individuals, the Company assumes that the Owner and the Annuitant will be the same individual unless the Owner indicates otherwise. Such payments will begin on the Annuity Date appearing in the Policy and will continue for the period provided under the payment option chosen. The original payment option and Annuity Date are specified by the Owner in executing the application for the Policy. The Owner may change the payment option as well as the Annuity Date at any time before payments begin, although the new date may not be later than the Annuitant's attained age of 90. Taxpayer proposes to apply for the Policy with an Annuity Date of Date 1, i.e., when Taxpayer reaches the age of d years.

There are two basic types of payment options available under the Policy, i.e., the e and f options. The e options provide for a monthly income for a term or amount selected by the Owner. The f options provide for a monthly income for any certain period selected by the Owner and then for as long as the Annuitant is alive. The payments made under the f options are determined on the basis of a mortality table and interest rate, with the minimum guaranteed payments specified in the Policy being based upon the g Table and interest at h.

If all persons receiving e option payments or guaranteed payments under an f option should die before all of the payments have been made, the Owner may name a new person to receive the benefits. If no one has been named, the payments will be made to the estate of the person receiving benefits.

The amount of each of the Income Payments will depend in part upon the amount of the i as of the Annuity Date. The i is defined as the greater of the j or k. For this purpose the j is computed pursuant to Formula 1. In computing the j, interest will be added each day at the m announced by the Company at the beginning of a specified n and guaranteed for the duration of the n. The n of Taxpayer's Policy will be o, during which the m will be p. At the conclusion of a Policy's n, the Owner may elect a new n from those offered by the Company at the time, provided that the new n does not expire after the Annuity Date. If the Owner does not elect a new n, the duration of the new n will be the same as the previous n, if offered by the Company at the time; otherwise, it will be the next shortest n offered. Only n's of a q will be offered by the Company.

The k provides an r for the i computed pursuant to Formula 2. s in Formula 2 is calculated at the end of each n of the Policy.

No cash withdrawals may be made from the Policy, whether by complete or partial surrender, borrowing from the Company or a third party, or commutation of Income Payments. Thus, consistent with the requirements of the Standard Nonforfeiture Law for deferred annuity contracts, the sole nonforfeiture benefits available under the Policy will consist of the Income Payments commencing at the Annuity Date, as described above, and the death benefit described below. The relevant provisions of the Standard Nonforfeiture Model Law for deferred annuity contracts, as promulgated by the National Association of Insurance Commissioners (the "NAIC"), are found in § 3A thereof. These provisions are in effect in State. See State Law 1. Sections 3B and 6 of the Model Law, respectively requiring a cash surrender value at all times and a death benefit at least equal to the cash surrender value at the time of death if the deferred annuity contract provides for a cash surrender value, are by their terms inapplicable to the Policy.

The Death Benefit provisions of the Policy come into effect, and the Policy beneficiaries are entitled to make the choices described below, under three circumstances each of which must occur while the Policy is in effect. First, those provisions apply if the Owner of the Policy dies before the Annuity Date. Second, they apply if the Owner is not a natural person and the Annuitant dies. And third, they apply if the Owner of the policy is not a natural person, and the annuitant is changed. In those three circumstances, each beneficiary must choose to receive his entire interest in the death benefit (i.e., an amount equal to the single premium paid for the policy) either as a lump sum, or if the death benefit is $5000 or more, as a series of payments under a payment option that meets the following conditions: (a) the first payment must be made no later than one year after the date of death; (b) payments must be made over the beneficiary's life expectancy or over a period not exceeding the beneficiary's life expectancy; and (c) any payment option that provides for payments to continue after the death of the beneficiary will not allow the successor payee to extend the period of time over which the remaining payments are to be made. Under Taxpayer's Policy, the beneficiary will be Spouse.

The beneficiary, or if there is more than one beneficiary, each beneficiary, must choose to receive his or her entire interest in the Policy death benefit under one of two provisions in the Policy. Under the u provision, a lump sum payment will be made equaling the death benefit plus interest from the date of death to the date of payment, with the rate of interest being set by the Company at not less than h percent or any higher minimum rate required by the state in which the Policy is issued. Under the v provision, instead of receiving a lump sum, the beneficiary may request death benefit proceeds that equal or exceed w to be paid under a payment option that meets the y conditions.

If the Owner dies after the Annuity Date, or if the owner is not a natural person and the Annuitant dies after that date, no death benefit will be paid. Any remaining Income Payments will be paid to the payee, or if the payee is the Annuitant, they will be paid to the beneficiary. Upon such a death, the Company will not allow a change in the payment option to extend the period of time over which the remaining payments are to be made.

The Owner of the Policy may name a new owner or annuitant before the Annuity Date, and may name a new payee at any time. The Owner may also name a contingent annuitant who will become the Annuitant if the Annuitant dies while the Policy is in effect. In the case of Taxpayer's Policy, Taxpayer has no plans to name a contingent annuitant or to transfer ownership of the Policy to any other party, and Taxpayer expects to remain the payee.

D. Rider 1

The Company offers Rider 1, which may be acquired either at the time of the Policy's purchase or soon thereafter. The Company's practice will be to allow Rider 1 to be added at any time within six months of the Policy's purchase. Rider 1 also may be terminated at any time without affecting the continuation of the Policy. Taxpayer proposes to acquire Rider 1 simultaneously with the Policy, as other purchasers of the Policy typically are expected to do. However, the Company is willing to issue the Policy without Rider 1, and some of its marketing materials will indicate the benefits of owning the Policy alone. Also, Rider 1 is designed so that it may be attached to another annuity issued by the Company. Taxpayer plans to hold Rider 1 only in connection with the Policy.

Rider 1 provides annually renewable term life insurance. Under it, the Company will pay a specified term life insurance death benefit (the “Term Insurance Benefit”) to the beneficiary when it receives proof that the insured died while the Rider was in force and prior to the Annuity Date under the Policy. Taxpayer will be the insured under the Rider, and Spouse will be named as the beneficiary of the Rider death benefit. Upon the insured’s death, the Term Insurance Benefit will be paid in one lump sum unless a payment option is chosen.

Due to its premium structure, the Standard Nonforfeiture Law for Life Insurance may require Rider 1 to provide small cash surrender values at some durations. See §§ 2 and 9 of the Standard Nonforfeiture Model Law for Life Insurance, as promulgated by the NAIC and State Law 2. Because the Rider charges guaranteed under method 2 grow more slowly than under the Commissioners 1980 Standard Ordinary Mortality Tables, cash values may be created under the Standard Nonforfeiture Law in certain situations. Since term insurance is involved, the cash values emerge (if required) and then diminish over time; they do not rise to equal the contract’s face amount as in the case of whole life coverage. The methodology for determining Rider 1’s cash surrender value is set forth in that Rider’s “Basis of Values” provision, and the amount of the cash surrender value for each duration, if any, is shown on the Rider 1 specifications page.

The amount of the Term Insurance Benefit is defined in the Rider 1 as the greatest of the three amounts calculated under Formula 3. The Rider is intended to qualify as a “life insurance contract” under § 7702 by meeting that statute’s cash value accumulation test. Taxpayer and the Company represent that the Rider so qualifies.

The Term Insurance Benefit, which generally increases over time and potentially changes each month, is set forth in a schedule shown on the Rider 1 specifications page. The Company provides a selection of aa progressively greater amounts of Term Insurance Benefits from which an applicant may choose. The maximum Term Insurance Benefit amount that may be selected is the greater of (1) bb percent of the premium paid for the Policy or (2) cc percent of the i under the Policy at the time of death, minus such premium. The minimum amount is the greater of (1) dd percent of the premium paid for the Policy or (2) cc percent of the i under the Policy at the time of death, minus such premium.

The Company assesses a periodic charge for Rider 1 (herein also referred to as the “Rider charge” or “Rider charges”) in an amount calculated to cover the cost of Term Insurance Benefit payments expected to be made, related expenses, and an element of profit for the Company. By virtue of this charge the Rider is “self-supporting,” i.e., it is not supported by the premium collected by the Company for the

Policy. The Owner of the Policy may elect, before the beginning of each n, to pay the periodic Rider charge in cash. If cash payment is not chosen, the Rider 1 charge will be assessed against the j of the Policy. Rider 1 charges will become the property of the Company's z. The Company will be obligated to pay the Term Insurance Benefit under all Riders. Taxpayer has no plan to pay the charges for Rider 1 out of pocket.

The Rider charges, if Rider 1 is attached to the Policy, will be determined using either method 1 or method 2 as follows:

> If method 1 is in effect and an annual Rider 1 charge is levied at the start of each year under the Rider (a "Rider year"), it will equal the amount computed pursuant to Formula 4.
>
> If method 2 is in effect and an annual Rider charge is levied at the start of each Rider year, it will equal the amount computed pursuant to Formula 5.

If Rider 1 is not attached to an annuity, method 1 will be used to determine the Rider charges. The Company may change the Schedule of Current Term Rider Insurance Rates at the beginning of each n, if Rider 1 is attached to an annuity, or otherwise at the beginning of each Rider year. In either case, the rates imposed under Rider 1 may never exceed the ee shown on the Rider specifications page.

Since the Company understands that the Rider charges, when assessed against the Policy's j , will be treated as distributions includible in the gross income of the Owner of the Policy as provided in § 72(e), Rider 1 contains a notice to this effect. The Company plans to report such amounts on a Form 1099-R.

The Rider will terminate on the earliest of: (1) the date the Policy terminates; (2) the Annuity Date; (3) the end of the Rider year in which the Owner timely requests termination of the Rider; (4) immediately after a Term Insurance Benefit is paid under the Rider; or (5) upon failure to pay the Rider charge, if the Owner has elected to pay the Rider charge in cash.

E. Rider 2

Rider 2 is also offered with the Policy. Upon notice to the Company of the terminal illness of the insured prior to the Annuity Date, the Company will pay a death benefit to the beneficiary of the Policy subject to the terms of Rider 2. Payment of benefits under this rider will terminate the Policy and any other benefit riders attached to the Policy, including Rider 1. Hence, upon payment of benefits under Rider 2, neither Income Payments under the Policy nor the Term Insurance Benefit will become payable. Terminal illness is defined as an illness or physical condition that can reasonably be expected to result in the death of the insured within 24 months, and has been certified as such by a physician.

The benefit paid under Rider 2 at any time will equal the death benefit then payable under the Policy and Rider 1, discounted by the accelerated benefit interest rate then in effect for a time period equal to the expected future lifetime of the insured as determined by the Company (but not more than 24 months). For this purpose, the discount rate will be determined by the Company and will not exceed an amount computed pursuant to Formula 6.

The Company has designed Rider 2 with the intent that the acceleration of the Term Insurance Benefit will be governed by § 101(g). The Company understands that § 101(g) would not apply to the acceleration of the death benefit payable under the Policy. Accordingly, upon acceleration of the Term Insurance Benefit and the Policy death benefit, the Company plans to report the Term Insurance Benefit portion of that payment on a Form 1099-LTC, and to report the Policy death benefit portion of that payment on a Form 1099-R.

REPRESENTATIONS

In connection with this request for rulings, Taxpayer and the Company make the following representations:

(1) The states in which the Policy and Rider 1 are sold will allow the Policy to be issued without Rider 1.

(2) The Company is willing to issue the Policy without Rider 1.

(3) The states in which the policy and Rider 1 are sold will allow Rider 1 to be sold with another deferred annuity contract.

(4) The Company is willing to issue Rider 1 in connection with another deferred annuity contract.

(5) The Policy is considered an individual annuity contract under the law of Taxpayer's state of domicile and of all other jurisdictions in which it will be issued.

(6) The Policy satisfies the requirements of § 72(s) and otherwise is treated as an annuity contract within the meaning of § 72.

(7) Taxpayer's existing deferred annuity contract, and the Policy that Taxpayer proposes to acquire, are annuity contracts within the meaning of § 1035.

(8) Rider 1 is considered a life insurance contract under the law of Taxpayer's state of domicile and of all other jurisdictions in which it will be issued, and complies with the cash value accumulation test of §§ 7702(a)(1) and (b).

(9) State requires that the reserves maintained with respect to the Policy be maintained under State's valuation law for individual annuities. See State Law 4. The other jurisdictions in which Company does business and in which it will sell Policy require that the reserves maintained with respect to the Policy be maintained under their comparable reserving laws with respect to annuity contracts.

(10) State requires that the reserves maintained with respect to Rider 1 be maintained under State's valuation law for life insurance. See State Law 3. The other jurisdictions in which Company does business and in which it will sell Policy require that the reserves maintained with respect to the Policy be maintained under their comparable reserving laws with respect to life insurance contracts.

(11) Neither State nor any other jurisdiction in which Company does business and in which it will sell Policy and Rider 1 will permit it to maintain the entire amount of reserves it is required to maintain in connection with its liabilities under both either as life insurance reserves, or as annuity reserves.

(12) The Policy and Rider 1 do not provide a single integrated death benefit under State law, and together they do not constitute a single integrated life insurance contract under State law; rather they are two separate contracts under State law.

(13) The Policy can be annuitized at the same attained ages as other deferred annuity contracts which the Company issues can be annuitized (consistent with the Company's and with industry practice generally.)

(14) Taxpayer, as the applicant for and Owner of Rider 1, possesses an insurable interest in the life of the insured under that Rider pursuant to state law.

LAW AND ANALYSIS

Ruling Request Number 1

Section 101(a)(1) generally provides that "gross income does not include amounts received (whether in a single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of the death of the insured." Hence, for the death benefit under the Rider to be excludable from gross income as provided in § 101(a)(1), the Rider must, in addition to being separate and distinct from the Policy, satisfy the definition of the term "life insurance contract" under § 7702. To satisfy that definition, a contract must be a life insurance contract under "applicable law" and meet the requirements of either (1) the cash value accumulation test of § 7702(a)(1) and (b), or (2) the guideline premium and cash value corridor tests of § 7702(a)(2), (c) and (d).

Taxpayer and the Company have represented that Rider 1 is considered a life insurance contract under the law of Taxpayer's state of residence (and of all other jurisdictions in which it will be issued), and that Taxpayer, as applicant for and Owner of the Rider, possesses an insurable interest in the life insured under the Rider (i.e., his own). The Rider must also be considered separate and distinct from the Policy. If that were not the case, the Rider death benefit, even though technically payable under the Rider instead of the Policy, would merely constitute an extension of the death benefit payable under the Policy, i.e., an annuity death benefit not excludable under § 101(a)(1). See Rev. Rul. 55-313, 1955-1 C.B. 219; see also Helvering v. Le Gierse, 312 U.S. 531 (1941).

The Rider and the Policy represent two distinct contractual relationships between the Company and Taxpayer (or any other Owner). As represented by Taxpayer and the Company, the Policy is subject to the state law statutes and associated rules relating to Policies issued as individual annuity contracts; and those rules differ from the rules applicable to life insurance. Rider 1, on the other hand, is subject to the statutes and associated rules relating to life insurance contracts, i.e., the legal requirements and constraints relating to life insurance forms, nonforfeiture values, and reserves. While Rider 1 will be acquired with the Policy by Taxpayer (and by the typical purchaser), the Policy may be acquired without the Rider. Rider 1 could be acquired as a rider on any policy the Company issues, and need not be acquired solely in connection with the Policy. Further, Rider 1 may be acquired up to six months after the Policy's issue date, and may be discontinued at any time without affecting the status of the Policy. Also, an owner can obtain Policy without providing any evidence of insurability. But for an Owner to obtain the Rider, satisfactory evidence of insurability must be provided to the Company.

From an economic standpoint, the Rider is funded, independently of the Policy, from charges paid in after-tax dollars. Taxpayer represents that such charges, on average over all years and for all issue ages, are economically sufficient to support the Term Insurance Benefit provided for those years, in the same manner as any other charges for annually renewable term life insurance.

By virtue of the formula used by the Company to determine the minimum amount of the Term Insurance Benefit which an Owner may elect, that benefit will in any event be greater than the growth in the i of the Policy to which it is attached. The Rider thus will provide a life insurance benefit, separate from the benefit under the Policy, at all times.

The legislative history of § 7702 indicates that:

> The term “life insurance contract” does not include that portion of any contract that is treated under state law as providing any annuity benefits other than as a settlement option. Thus, although a life insurance contract may provide by rider for annuity benefits, the annuity portion of the contract is not part of the life insurance contract for tax purposes. . . . Thus an insurance arrangement written as a combination of term life insurance with an annuity contract . . . is not a life insurance contract . . . because all of the elements of the contract are not treated under State law as providing a single integrated death benefit. As a result, only the term [insurance proceeds] . . . can . . . be treated as life insurance proceeds upon the insured’s death. However, any life insurance contract that is treated under State law as a single, integrated life insurance contract and that satisfies . . . [the § 7702] guidelines will be treated for Federal tax purposes as a single contract of life insurance and not as a contract that provides separate life insurance and annuity benefits. See S. Prt. 98-169, (Vol.1) 98th Congress, 2d Session, p. 572.

Taxpayer has represented that the Policy and Rider 1 do not provide a single integrated death benefit under State law, and together they do not constitute a single integrated life insurance contract under State law; rather they are two separate contracts under State law.

Since the Rider constitutes a life insurance contract under applicable law, separate and apart from the Policy, within the meaning of § 7702(a), and also meets the cash value accumulation test of § 7702(b), the Rider qualifies for treatment as a life insurance contract under § 7702.

Ruling Request Number 2

Taxpayer and the Company have represented that the Policy is considered an annuity contract within the meaning of § 72. Section § 72(e)(2)(B) provides that any amount received under an annuity contract before the annuity starting date is includible in gross income to the extent of the “income on the contract.” For this purpose, § 72(e)(3)(A) indicates that income on the contract is the excess of the contract’s cash value (determined without regard to any surrender charge) over the investment in the contract at such time.

Rider 1 is a separate contract from the Policy, and the charges supporting that Rider, if not paid by the Owner out of pocket, are assessed against the j (an element of the i) under the Policy. Whenever a Rider charge is assessed, Taxpayer will be deemed to have received a distribution from the Policy before its annuity starting date.

In the case of the Policy, the i represents the single premium paid for the Policy increased by interest credited, less any applicable charges, which may be transferred at the end of a term in an exchange for a replacement annuity (albeit with no surrender value). The entire amount of the i is available to fund the purchase of an annuity. The i also funds the Income Payments due under the Policy beginning on the Annuity Date. While it is true that the i cannot be reduced to cash by virtue of a surrender or borrowing, § 72(e)(3)(A)(i) refers to a “cash value,” and determines that amount without regard to any surrender charge, thus distinguishing it from the cash surrender value of an annuity contract.

Ruling Request Number 3

Taxpayer and the Company have represented that Taxpayer’s existing deferred annuity contract, as well as the Policy Taxpayer proposes to acquire, are each considered an annuity contract within the meaning of § 1035. Further Taxpayer represents that he intends to assign all rights under his existing deferred annuity contract solely in exchange for the new Policy. Hence, apart from the presence of Riders 1 and 2 on the Policy received at the time of the exchange, Taxpayer’s proposed exchange would be treated as an exchange described in § 1035(a)(3).

When the proposed exchange occurs, the entire cash surrender value of Taxpayer’s existing deferred annuity contract will be transferred to the Company and credited as the i under the new Policy. Then a portion of the j equal to the initial charge for Rider 1 will be applied to acquire the Rider.

Taxpayer’s acquiring Rider 1 and 2 on the Policy issued in the exchange does not preclude or in any way alter the application of § 1035(a)(3). Those Riders are acquired for a portion of the j of the Policy, and not for all or any portion of Taxpayer’s deferred annuity contract.

HOLDINGS

Based on the facts and representations made, we hold that:

(1) The proceeds payable under Rider 1 upon the death of the insured will be excludable from the gross income of the beneficiary thereof as provided in §101(a)(1).

(2) All Rider charges, (including the initial charge) when assessed against the j under the Policy, are treated as distributions includible in Taxpayer's gross income as provided in § 72(e) and for that purpose the i is treated as the cash value of the Policy within the meaning of that section.

(3) The exchange of Taxpayer's existing deferred annuity contract for the Policy will be treated as an exchange described in § 1035(a)(3).

Taxpayer has sought no ruling regarding the potential application of the penalty imposed by § 72(q) to any amounts deemed distributed to Taxpayer to acquire Rider 1 and/or Rider 2. We note that that penalty will apply to the receipt of any amount under an annuity contract except the amounts specified in § 72(q)(2).

We are not ruling on the tax consequences or effects of the addition of Rider 1 or Rider 2 to any other product offered by the Company; nor should the holdings herein be construed to apply to the issuance of either Rider 1 or Rider 2 or the Policy in combinations other than as described in this ruling.

Further, Taxpayer has sought no ruling regarding the applicability of § 101(g) to any portion of the proceeds payable under Rider 2, and no ruling regarding the applicability of that section is being issued.

The rulings contained in this letter are based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

This ruling is directed only to the Taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,
Assistant Chief Counsel
(Financial Institutions and Products)
By: Donald J. Drees
Senior Technician Reviewer

Branch 4