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Date:
JUNE 7, 2000

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Dear

This is in response to your submission dated February 4, 2000, and supplementary submissions requesting on behalf of Taxpayer certain rulings regarding the tax treatment of certain amounts received in connection with annuity policies issued by Taxpayer and whether the proposed contract qualifies as an immediate annuity for purposes of section 72 of the Internal Revenue Code ("Code").

FACTS

Taxpayer is a life insurance company subject to taxation under Part I of subchapter L of Chapter 1 of the Code. Taxpayer is a member of an affiliated group of corporations filing life/non-life consolidated returns.

Taxpayer proposes to issue a single-premium immediate annuity policy ("Policy"). Under the terms of the Policy, the owner of the Policy is required to pay a single premium of B dollars and receives a fixed payment of C dollars per month. The Policy is non-participating and has a period certain based on the interest rates guaranteed at issue. The Policy has no cash value. The Policy does have a commuted value, however, which is at least equal to the present value of the future guaranteed monthly payments under the Policy. Taxpayer expects to credit various amounts of excess interest under the Policy to this commuted value.

The Policy has a minimum permanent guaranteed interest rate of D percent and an initial interest rate of E percent, which is guaranteed for at least one year. After the first policy year, Taxpayer may change the current interest rate at any time on F days prior notice, and the new rate will be guaranteed for at least G months.

The period certain is determined by the initial interest rate for one year and thereafter by the guaranteed interest rate. At the end of each policy month, Taxpayer calculates the excess interest credits, which reflect the excess of the current interest rate over the guaranteed interest rate, and adds such credits to the commuted value. At the end of the period certain, the commuted value is immediately paid to the owner as a lump sum.

Upon issuance of the Policy, the owner of the Policy can add an endorsement form which will limit the excess interest credit that is added to the commuted value if the excess interest rate exceeds an excess interest payment rate (which is also E percent). In that case, any excess interest exceeding E percent shall be distributed immediately under this endorsement.

During the early commutation period (the first H policy years), the Policy's owner has a right to commute the future guaranteed monthly payments to a lump sum payment of the commuted value only if Taxpayer declares a current rate that does not exceed an early commutation rate of J percent and the owner exercises such commutation right during the first K days such new rate applies. After the early commutation period, the owner may elect during the first K days of any policy year to take the commuted value as a lump sum payment. Also, upon the death of the annuitant during the period certain, the owner or beneficiary may request commutation within L days after such death.

LAW AND ANALYSIS

I. REQUESTED RULING 1 (EXCLUSION RATIO)

The first issue is whether the owner of the Policy is entitled to an exclusion ratio for the guaranteed fixed monthly payments of C dollars during the period certain.

Section 72(b) of the Code provides for an exclusion ratio which is to be used to determine how much of amounts received as an annuity are included in gross income. Specifically, section 72(b)(1) states that the part of the amount received as an annuity under an annuity contract that bears the same ratio to such amount as investment in the contract (as of the annuity starting date) bears to the expected return under the contract shall be excluded from gross income. In other words, the numerator of this ratio is the investment in the contract, and the denominator is the expected return.

Thus, in order for the exclusion ratio to apply to the guaranteed monthly payments during the period certain in an amount determined by the initial single premium and the duration of the period certain, those monthly payments must qualify as amounts received as an annuity. Treasury Regulation section 1.72-2(b)(2) provides that amounts subject to section 72 are considered “amounts received as an annuity” only in the event that all of the following tests are met:

> (i) They must be received on or after the “annuity starting date” as that term is defined in section 1.72-4(b);
> (ii) They must be payable in periodic installments at regular intervals (whether annually, semiannually, quarterly, monthly, weekly, or otherwise) over a period of more than one full year from the annuity starting date; and
> (iii) . . ., the total amounts payable must be determinable at the annuity starting date either directly from the terms of the contract or indirectly by the use of either mortality tables or compound interest computations, or both, in conjunction with such terms and in accordance with sound actuarial theory.

Section 1.72-4(b) states that the annuity starting date is generally the first day of the first period for which an amount is received as an annuity.

The monthly payments to be made by Taxpayer become contractual obligations at the date the Policy is signed and begin one month after that date. Consequently, these amounts are received on or after the annuity starting date, satisfying the first requirement of section 1.72-2(b)(2) of the regulations. Also, the fixed payments are to be received monthly over a period of more than one year, so the second requirement of periodic payment under Treasury Regulation section 1.72-2(b)(2) is satisfied.

Under the Policy, the annuitant is guaranteed to receive monthly payments for a period certain. Such fixed monthly payments are established at the Policy’s inception and cannot be altered. The total amount to be paid to the annuitant is determinable at the annuity starting date, thus satisfying the third requirement of section 1.72-2(b)(2) of the regulations.

Because all three criteria are satisfied, the guaranteed fixed monthly payments are amounts received as an annuity. Therefore, the owner of the Policy is entitled to use the exclusion ratio for the amounts received as monthly payments during the period certain in an amount determined by dividing the investment in the contract by the expected return under the contract.

II. REQUESTED RULING 2 (EXCESS INTEREST)

The next issue is whether excess interest is includible in the policyholder's gross income when received under section 72.

As noted in Ruling 1, Treasury Regulation section 1.72-2(b)(2) establishes the requirements for amounts to be considered "amounts received as an annuity." If a payment fails one or more of these requirements, it is an amount not received as an annuity. That section also applies to a situation in which an amount is to be paid periodically until a fund plus interest at a fixed interest rate is exhausted. Any amount later received as the result of earnings at a greater interest rate is treated as a dividend received after the annuity starting date. Regulation section 1.72-11(b)(2) states that if a dividend is received on or after the annuity starting date, such payments shall be fully includible in the gross income of the recipient.

Under the Policy, excess interest amounts may be paid. Since these amounts pertain to interest that may or may not be earned on the investment, the amounts may not be made periodically and cannot be determined at the annuity starting date. Therefore, these amounts do not satisfy the requirements of section 1.72-2(b)(2) of the regulations and are not amounts received as an annuity. Instead, the amounts must be treated as amounts not received as annuity payments under section 72(e).

Section 72(e)(2) provides the general rule for amounts not received as an annuity. That subsection states that amounts not received as an annuity shall be included in gross income if received on or after the annuity starting date. With respect to the proposed Policy, excess interest will be applied to the commuted value. Such interest will be received by the annuitant on or after the annuity starting date either when the Policy is commuted or at the end of the period certain. Thus, the amount of excess interest shall be included in income when received under section 72.

The terms of a Policy endorsement that may be added to the Policy require that any amount of interest earned over E percent will be added to the month's payment following the accrual of that interest. The interest earned above E percent is a dividend and is included in income under section 72 when received because it is received after the annuity starting date.

III. REQUESTED RULING 3 (IMMEDIATE ANNUITY CONTRACT)

The next issue is whether the Policy qualifies as an immediate annuity contract under section 72(q) and section 72(u)(4).

Subject to certain exceptions and limitations, section 72(q) of the Code imposes a ten-percent penalty for premature distributions from annuity contracts. Section 72(q)(1) provides that a taxpayer's tax on any amount received under an annuity contract shall be increased by an amount equal to ten percent of the portion of such amount which is includible in gross income. Section 72(q)(2), however, provides a list of distributions that will be exempt from this ten percent penalty. Specifically, section 72(q)(2)(I) states the penalty will not apply to distributions under an immediate annuity contract within the meaning of section 72(u)(4).

Section 72(u) provides that, in general, an annuity contract held by a person who is not a natural person shall not be treated as an annuity contract for income tax purposes (except in subchapter L) and the income on the contract is treated as ordinary income to the owner of the Policy. As stated in section 72(u)(3)(E), this general rule does not apply to immediate annuities. Section 72(u)(4) defines an immediate annuity for purposes of annuity contracts not held by natural persons. That subsection defines "immediate annuity" as an annuity that meets three requirements. First, it must have a starting date commencing no later than one year from the date of purchase. Second, the annuity must be purchased with a single premium or annuity consideration. Third, the annuity must provide for a series of substantially equal periodic payments made at least annually during the annuity period.

With respect to the proposed Policy, the monthly annuity payments of C dollars commences one month after the Policy is purchased, satisfying the first requirement under section 72(u)(4). In addition, the owner pays a single premium of B dollars at the Policy's contract date, so the second requirement for immediate annuities is satisfied. The amount of the monthly payments remain unchanged. Consequently, the payments satisfy the requirement that the payments be substantially equal and made periodically at least annually during the annuity period. Thus, the Policy meets the definition of "immediate annuity" under section 72(u)(4).

HOLDINGS

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

1. The owner of the annuity is entitled to an exclusion ratio for the monthly payments under the Policy during the period certain equal to the investment in the contract divided by the expected return.

2. The amount of excess interest that may be credited to the commuted value of the Policy shall not be includible in gross income until actually received under section 72. The excess interest which may be added to the monthly payment pursuant to an endorsement to the Policy shall be includible in gross income when received under section 72.

3. The Policy qualifies as an immediate annuity contract for purposes of sections 72(q) and 72(u)(4) of the Code.

No opinion is expressed as to the tax treatment of the Contract under the provisions of any other sections of the Code and Income Tax Regulations that may also be applicable thereto.

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(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter should be attached to the next federal income tax return to be filed by Taxpayer.

Sincerely,
Assistant Chief Counsel
(Financial Institutions & Products)
By: Donald J. Drees, Jr.
Senior Technician Reviewer
Branch 4

cc: