Internal Revenue Service

Number: **200818018**
Release Date: 5/2/2008

Index Number: 72.20-04

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:FIP:B04
PLR-143384-07
Date:
January 29, 2008

Taxpayer:
Contract A:

Contract B:

Number 1:

Dear :

This responds to your letter of September 26, 2007, requesting a ruling under § 72 of the Internal Revenue Code.

Facts

Taxpayer represents as follows:

Taxpayer is a stock life insurance company organized and operated under the applicable state law. Taxpayer is a life insurance company as defined by § 816(a) hence is taxed under § 801.

Taxpayer proposes to issue certain non-qualified life annuity contracts in consideration for a single premium. The contracts will be issued as either an immediate variable annuity (Contract A) or a deferred variable annuity modified at issuance by a rider requiring periodic payments to begin within a year of issue (Contract B). Both Contract A and Contract B operate identically in all material respects. (Hereafter Contract A and Contract B are referred to jointly as “the Contract”.)

The Contract will constitute an annuity under the law of each state or other jurisdiction in which it is issued and will comply with §§ 72(s) and 817(h) (and the regulations thereunder).

The Contract will have two 'phases': Phase I and Phase II. At issuance, the Contract owner must make irrevocable selections of 1) an assumed interest rate for determining the amount of periodic payments, 2) the modality of the periodic payments (i.e., monthly, quarterly, semi-annually or annually) and how subsequent periodic payments are determined (explained below), and 3) the length of Phase I (which cannot be changed after the Contract is issued). The Contract owner may also select a minimum payment option; this option may be terminated after the Contract is issued. Once periodic payments begin, they will cease only upon the earliest of the payment of the Contract's death benefit, the death of the annuitant during Phase II, or the owner's surrender of the Contract. If the minimum payment option was selected, the amount of any periodic payment will not be less than a specified minimum amount which is less than the first payment. This minimum payment will apply for the life of the annuitant and will be reduced in proportion to any withdrawal during Phase I.

Phase I is the period after the commencement of periodic payments during which the Contract owner may take withdrawals from or surrender the Contract. If the annuitant dies during Phase I, the account value will be payable in either a lump sum or as continued periodic payments.

The first periodic payment is determined on a date that is no more than Number 1 days before that payment is due. It is the product of the account value as of the payment starting date and an annuity factor divided by 1,000. The annuity factor is based on the age and gender of the annuitant, the payment frequency, the length of Phase I, the assumed interest rate, and an accepted mortality table. Subsequent periodic payments are determined using one of two alternatives chosen by the Contract owner. Under one alternative, each subsequent periodic payment determined by reference to the then-current investment performance of the account value in relation to the assumed interest rate. Under the other alternative, periodic payments are level throughout the year and are modified once a year to reflect the current investment performance of the account value in relation to the assumed interest rate. Irrespective of the chosen alternative, the same basic formula is used to calculate the amount of the payment.

Taxpayer's method of using the account value in calculating the periodic payments during Phase I differs somewhat in form from the method more traditionally used to calculate variable annuity payments, commonly described as an "annuity unit" approach. The methodology Taxpayer will use to calculate periodic payments during Phase I is based on the same actuarial principles as an annuity unit methodology and is actuarially indistinguishable from such a methodology. Taxpayer desires to use its methodology rather than an annuity unit approach for several non-tax reasons. First, because the Contract allows for withdrawals during Phase I, the number of annuity units for every variable sub-account would need to be adjusted, and if the withdrawal were taken between valuation dates, the timing of the withdrawal would need to be reconciled with the timing of the periodic payment. Second, Taxpayer believes the use of the account value aids marketing the Contract because it better communicates to the Contract owner the amount of the current surrender value and death benefit.

Taxpayer illustrates that its methodology yields payments that fluctuate in exactly the same manner as if the annuity unit methodology were used. For any given rate of actual investment performance, the payment-to-payment variance will be identical under Taxpayer's methodology or an annuity unit method. (The amount of each payment under Taxpayer's methodology is approximately one half of one percent less than under the annuity unit methodology. However, this difference is not a product of the methodology but rather reflects the fee Taxpayer charges for the Phase I withdrawal/surrender feature.)

Upon the expiration of Phase I, Phase II commences and periodic payments continue for the life of the annuitant. Periodic payments during Phase II derived from the variable sub-accounts are determined using an "annuity unit" methodology and those from the fixed account are determined using an actuarially equivalent methodology. Phase II periodic payments reflect the actual net investment returns and actual interest crediting rates in relation to the assumed interest rate. Phase II periodic payments are redetermined in the same manner as the subsequent periodic payments during Phase I. Despite the differences in form with respect to the way the periodic payments are calculated during Phase I and Phase II, all of the methodologies used to calculate such payments are actuarially equivalent to one another.

The Contract provides for a death benefit, the precise mechanics of which depend on the time of death (i.e., prior to the commencement of periodic payments, during Phase I, or during Phase II) and whether the Contract is held by a natural person.

Requested Ruling

Taxpayer requests a ruling that the Contract constitutes an immediate annuity within the meaning of § 72(u)(4).

Law and Analysis

Section 72(u)(1) provides that if any annuity contract is held by a person who is not a natural person (A) such contract shall not be treated as an annuity contract for purposes of subtitle A (other than subchapter L) and (B) the income on the contract for any taxable year of the policyholder shall be treated as ordinary income received or accrued by the owner during such taxable year; holding by a trust or other entity as an agent for a natural person shall not be taken into account.

Section 73(u)(3)(E) provides that § 72(u) shall not apply to any annuity contract which is an immediate annuity.

Section 72(u)(4) provides that for purposes of § 72(u), the term "immediate annuity" means an annuity (A) which is purchased with a single premium or annuity consideration, (B) the annuity starting date (as defined in § 72(c)(4)) of which commences no later than one year from the date of the purchase of the annuity, and (C) which provides for a series of substantially equal periodic payments (to be made not less frequently than annually) during the annuity period.

The requirement that the annuity provide a series of substantially equal periodic payments (to be made not less frequently than annually) was added by § 1011A of the Technical Corrections Act of 1988, P.L. 100-647. The purpose of this requirement was

> to prevent the structuring of a contract that appears to be an immediate annuity contract, but that is in substance a deferred annuity. Accordingly, … an annuity is an immediate annuity only if the annuity provides for a series of substantially equal periodic payments (to be made not less frequently than annually) during the annuity period.

S. Rep. No. 10-455 at 149 (1988). See also H.R. Rep. 100-795 at 143 (1988).

Section 72(q)(2)(I) provides that the ten percent penalty imposed by § 72(q) shall not apply to any distribution under an immediate annuity contract (within the meaning of § 72(u)(4)).

Here, Taxpayer represents that the Contract will require a single premium or annuity consideration and will have an annuity starting date which commences within one year from the date of the purchase of the annuity, and that periodic payments will be made not less frequently than annually. Accordingly, the issue is whether the Contract satisfies the requirement of providing for a series of substantially equal periodic payments.

No clear guidance was provided as what qualifies as "substantially equal" payments for purposes of § 72(u)(4)(C). The phrase is used elsewhere in the Code, however: § 72(q)(2)(D) excepts any distribution which is a part of a series of substantially equal periodic payments made for life (or life expectancy) from the 'penalty' imposed by § 72(q)(1) and § 72(t)(2)(A)(iv) excepts distributions which are part of a series of substantially equal periodic payments made for the life (or life expectancy) from the additional tax imposed by § 72(t)(1).

As originally enacted, § 72(q)(2)(D) described a distribution "which is one of a series of substantially equal periodic payments made for the life of the taxpayer or over a period extending for at least 60 months after the annuity starting date." See § 265(b) of the Tax Equity and Fiscal Responsibility Act of 1982, P.L. No. 97-248 (1982). The Conference Report merely recites the Senate amendment as describing "a payment under an annuity for life or at least 5 years". H. R. Rep. No. 97-760 at 647 (1982).

As discussed during consideration of the Tax Reform Act of 1986 with respect to the additional income tax on early distributions from an individual retirement account, the concept of substantially equal periodic payments was described thusly:

> A series of payments under a defined contribution or defined benefit plan will not fail to be substantially equal solely because the payments vary on account of (1) certain cost of living adjustments, (2) cash refunds of employee contributions upon a 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.

S. Rep. No. 99-313 at 615 (1986).

Rev. Rul. 2002-62, 2002-2 C.B. 710, specifies three different methods that yield substantially equal periodic payments for purposes of § 72(t)(2)(A)(iv), which the Service later indicated can be used for purposes of § 72(q)(2)(D) in Notice 2004-15, 2004-1 C.B. 526.

The Code and the Service's administrative pronouncements must be viewed against the backdrop of the extant actuarial methodologies for computing periodic payments. It was understood that a methodology utilized by a variable annuity under which substantially the same number of annuity units is withdrawn to make each periodic payment provided substantially equal periodic payments.[1] Accordingly, a methodology that replicates this effect should be viewed as providing substantially equal periodic payments.

Here, the methodology Taxpayer will utilize to compute the periodic payments to be made during Phase I and Phase II of the Contract is either the annuity unit method or its actuarial equivalent. Accordingly, the methodology Taxpayer will utilize will provide substantially equal periodic payments.

---

[1] See, e.g., Staff of the J. Comm. On Tax'n, 97th Cong., General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982 at 364 (1982).

Because the Contract (A) is purchased with a single premium or annuity consideration, (B) has an annuity starting date (as defined in § 72(c)(4)) which commences no later than one year from the date of the purchase of the annuity, and (C) provides for a series of substantially equal periodic payments (to be made not less frequently than annually) during the annuity period, the Contract is an immediate annuity within the meaning of § 72(u)(4).

Ruling

The Contract constitutes an immediate annuity within the meaning of § 72(u)(4).

The rulings contained in this letter are based upon information and representations submitted by the 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.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

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

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

/S/

Donald J. Drees, Jr.
Senior Technician Reviewer, Branch 4
(Financial Institutions & Products)