Internal Revenue Service

Department of the Treasury

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Date: December 29, 2000

Legend

Taxpayer	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Company	=
X	=
Y	=

Dear

This is in response to the request of your representative dated August 25, 2000 and subsequent correspondence which asked for a ruling on your behalf as to whether certain proposed distributions from a variable annuity contract are part of a series of substantially equal periodic payments and are therefore not subject to the 10% penalty on premature distributions from annuity contracts under § 72(q) of the Internal Revenue Code.

FACTS

Taxpayer was born on DATE 1**.** On DATE 2, he invested a lump sum of money into a variable annuity contract issued by COMPANY. The money invested was not a rollover from a qualified plan or from an IRA; it was from personal savings.

Under the contract, purchase payments may be allocated between a variable account and a fixed account. Under the fixed account, the Company will credit interest daily to the amounts allocated to the fixed portion at a rate equal to or in excess of the minimum guaranteed interest rate in the contract. Amounts not allocated to the fixed portion are allocated to the variable account and then are further allocated among the seven different sub-accounts which comprise the variable account. The sub-accounts each constitute a separate fund with defined investment objectives, and when purchase payments are first allocated to them, the payments are used to buy accumulation units in each sub-account to the extent of the amounts allocated to that sub-account.

Annuity payments must begin by the contract's annuity date. The annuity date of Taxpayer's contract is Date 3. Prior to the annuity date, the contract allows Taxpayer to choose among a variety of annuity payment options, all of which can be made in the form of a fixed, variable or combination fixed and variable annuity. After annuity

payments have begun, the annuity payment option may not be changed.

Prior to the time annuity payments have begun, the contract allows Taxpayer to surrender the contract or withdraw a portion of the contract's surrender value. In order to withdraw a portion of a contract's surrender value, a holder of the contract must make a written request to the Company. Additionally, the Company subjects the withdrawal to the charges outlined in the contract. Requests for withdrawals should specify from which sub-account the withdrawal is to be made (treating the fixed portion of the contract as a sub-account). If no sub-account is specified, the Company will withdraw, on a pro-rata basis from each sub-account, the amount requested.

Taxpayer proposes making a series of monthly withdrawals under the contract beginning Date 4, prior to his being 59½. In the year of the first withdrawal, the amount to be withdrawn for that year and for each following year would be calculated by using the amortization method described in Notice 89-25, 1989-1 C.B. 662, 666, Q&A-12, to be used in calculating substantially equal periodic payments for the purposes of § 72(t). Under this amortization method, the amount to be distributed annually is determined 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 (with life expectancies determined in accordance with proposed § 1.401(a)(9)-1) of the Income Tax Regulations at an interest rate that does not exceed a reasonable interest rate on the date payments commence. Proposed Regulation § 1.401(a)(9)-1, Q&A E-3&4, specifies that life expectancies are to be determined in accordance with Tables V and VI of Regulation § 1.72-9. Taxpayer intends to use the life expectancy for his own life only, and thus will use Table V of Regulation § 1.72-9. As for an interest rate, Taxpayer proposes using a rate of X%. Taxpayer represents that he would calculate his payments for his life expectancy by amortizing his account's prior year December 31 closing balance over his life expectancy (determined under Table V of Regulation § 1.72-9), assuming an interest rate of X%.

LAW AND ANALYSIS

Section 72 sets forth rules for the tax treatment of amounts received under an annuity, endowment, or life insurance contract, and it distinguished between "amounts received as an annuity" and "amounts not received as an annuity."

Section 1.72-2(b)(2) of the Income Tax Regulations provides that amounts subject to § 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 § 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 of the 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 72(c)(4) states that the annuity starting date is generally the first day of the first period for which an amount is received as an annuity. Section 72(e) applies to any amount which is not received as an annuity. Regulation 1.72-11(a)(1)(i) describes "amounts not received as an annuity" as amounts received under an annuity contract if Regulation § 1.72-2(b) is inapplicable to such amounts.

Section 72(e)(2)(B) provides that, if a distribution not received as an annuity is received before the annuity starting date, then the amount allocable to the income on the contract shall be includible in gross income and the amount allocable to the investment in the contract (as defined by § 72(e)(6)) shall not be includible in gross income. Section 72(e)(3) explains how amounts subject to § 72(e)(2)(B) are allocated between income and the investment in the contract. Section 72(e)(3)(A) provides that they are treated as income on the contract to the extent of the excess (if any) of the cash value of the contract (determined without regard to any surrender charge) immediately before receipt, over the investment in the contract at such time. Section 72(e)(3)(B) provides that they are treated as allocable to the investment in the contract to the extent that they are not allocated to income on the contract under § 72(e)(3)(A).

Subject to certain exceptions and limitations, § 72(q) imposes a penalty on premature distributions from annuity contracts. Section 72(q)(1) sets forth the broad rule that a taxpayer's tax on any amount received under an annuity contract shall be increased by an amount equal to 10% of the portion of such amount which is includible in gross income. Section 72(q)(2) excepts from this rule several types of distributions, the first of which is that the 10% additional tax shall not apply to any distribution made on or after the date on which the taxpayer attains the age of 59½. Also excepted from the rule of § 72(q)(1) are distributions that are part of "a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of such taxpayer and his designated beneficiary." Section 72(q)(2)(D). If distributions from an annuity contract are not subject to the 10 percent penalty because of the equal payment exception of § 72(q)(2)(D), the penalty tax will nonetheless be imposed in the event that the individual changes the distribution method at any time before attaining age 59½ to a method that does not qualify for the exception, or if the individual changes the distribution method within 5 years after the receipt of the first payment.

The equal payment exception of § 72(q)(2)(D) was one of the annuity early

withdrawal rules modified by the provisions of the Tax Reform Act of 1986 (TRA ’86), § 1123, 1986-3 C.B. (Vol. 1) 389. Prior to the TRA ‘86 amendments, a distribution from an annuity contract was not subject to the 10 percent penalty under § 72(q) if the distribution was 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, or was allocable to an investment in the contract before August 14, 1982. Under the TRA ‘86 amendments, the provisions of § 72(q)(2) were changed to provide that the distribution must be received as part of a series of substantially equal periodic payments payable over a duration not less than the life expectancy of the annuitant in order to avoid the 10 percent penalty tax. In addition, the language of the equal periodic payment exception of § 72(q)(2)(D) was modified somewhat to conform to the language used in the penalty tax provisions applicable to early distributions from qualified retirement plans (including IRA’s). *See* § 72(t)(2)(A)(iv).

The legislative history relating to the TRA ‘86 amendments to § 72 indicates that, in both modifying the existing penalty tax for early withdrawal rules from nonqualified annuity contracts and adopting a 10 percent penalty tax for early distributions from qualified retirement plans, Congress intended that the additional income tax on early withdrawals should be the same for all tax-favored retirement savings arrangements and should be increased so that the additional tax serves, in most cases, to recapture a significant portion of the benefits of deferral of tax on income. *See* H. Rept. No. 99-426, 99th Cong. 1st Sess. 703-04 (1985), 1986-3 C.B. (vol. 2) 703-04; S. Rept. No. 99-313, 99th Cong. 2d Sess. 567 (1986), 1986-3 C.B. (vol. 3) 567.

Notice 89-25, 1989-1 C.B. 662, provides guidance in the form of questions and answers with respect to the effect of certain provisions of the Tax Reform Act of 1986 on the taxation of distributions from qualified employee plans, section 403(b) annuity contracts, and individual retirement arrangements. Notice 89-25 states that the Service will apply these questions and answers in issuing rulings and in examining returns with respect to taxpayers and plans.

One of the TRA ‘86 provisions addressed in Notice 89-25 is the equal payment exception of § 72(t)(2)(A)(iv), and the methods of distribution that may be used to qualify for this exception. Under § 72(t)(2)(A)(iv), the penalty tax on the portion of early distributions from qualified retirement plans includible in gross income does not apply to distribution which are part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and beneficiary. Notice 89-25 at Question and Answer 12 addresses the question of what constitutes “substantially equal periodic payments” and sets forth three methods for determining what satisfies that requirement. Taxpayer has elected to use the second method in that Notice.

The test of whether distributions under an annuity contract satisfy the substantially equal payment exception of § 72(q)(2)(D) also requires that the interest rate utilized does not exceed a reasonable interest rate on the date payments commence. Although the second method set forth in Answer 12 of Notice 89-25 does

not explain what constitutes a reasonable interest rate, the method cited with approval utilizes an 8% interest rate. Additional guidance can be found in § 7520 which states the general rule for valuation of “any annuity, any interest for life or a term of years, or any remainder or reversionary interest” and utilizes “an interest rate . . . equal to 120 percent of the Federal midterm rate in effect under section 1274(d)(1) for the month in which the valuation date falls.” The 120 percent of the Federal midterm rate prior to Date 4, the annuity date, was between X% and Y%. In addition, the interest rate used in this case is a one time calculation and will not vary from year to year. The X% interest rate that Taxpayer has chosen to use is a reasonable interest rate.

CONCLUSION

Based solely upon the information and representations submitted concerning Taxpayer’s plan to withdraw equal amounts annually from his annuity contract, we hold that those withdrawals will qualify as substantially equal periodic payments under § 72(q)(2)(D) and will not be subject to the application of the 10% penalty for premature distributions from annuity contracts under § 72(q).

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. 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.

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.

A copy of this letter must be attached to any income tax return to which it is relevant.

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

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