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Taxpayer =
Individual =
Y =
Z =

Dear :

Taxpayer has requested several rulings regarding whether and how § 72 of the Internal Revenue Code applies to a certificate that Taxpayer plans to issue to, or for the benefit of, Individual ("Contract"). This letter ruling is being issued electronically in accordance with section 7.02(2) of Rev. Proc. 2023-1, 2023-1 I.R.B. 1.

FACTS

Taxpayer is a life insurance company within the meaning of § 816(a).

Individual will own assets in a taxable brokerage or similar investment account ("Account"). The Account will be established and maintained by an unrelated entity that Taxpayer approves for use with the Contract ("Financial Institution"). Taxpayer will have no legal or equitable ownership in the Account or any of the assets in the Account, and Taxpayer will not treat the Account or any of the assets in the Account as assets of Taxpayer for any purpose. Taxpayer expects that most purchasers of the Contract will be between ages Y and Z, inclusive.

When the Contract is linked to the Account, the Contract will be issued to Individual or to a trust for Individual's benefit.[1] The Contract will be issued under a group contingent deferred annuity contract that will have been issued to an entity serving as the group contract holder.

Taxpayer will issue the Contract in consideration for the payment of periodic charges ("Contract Charges"). Contract Charges will be paid with after-tax money, either by liquidating assets in the Account and remitting the after-tax cash proceeds to Taxpayer, or by Individual using another after-tax source of funds to pay the Contract Charges.

The Contract is designed to support Individual's retirement needs by guaranteeing Individual's ability to receive a specified amount of retirement income each year for Individual's life. The Contract provides this longevity protection in the form of two benefits.

The first benefit generally guarantees Individual the ability to withdraw a guaranteed amount from the Account each year for Individual's life. The guaranteed withdrawal amount generally varies with the initial account value, certain contributions during the first Contract year, certain positive investment returns, early withdrawals, excess withdrawals, and Individual's age when Individual first makes a withdrawal that is not considered an early withdrawal. Such age is used to select a percentage multiplier from a fixed list set forth in the Contract; the percentage multiplier, once selected, does not vary.

If the Account is reduced to zero during Individual's lifetime for reasons other than an early withdrawal, excess withdrawal, or the use of the Account proceeds to pay for the second Contract benefit discussed below, the Contract provides for periodic payments to be made each year for the remainder of Individual's life ("Guarantee Payments"). Generally, each of the Guarantee Payments is equal to the guaranteed withdrawal amount in effect at the time the Account is reduced to zero.

The second benefit, which may be included in the Contract, would generally permit Individual, before the Account is reduced to zero, to "convert" the Account to a series of periodic payments for life or another specified period that Taxpayer permits ("Conversion Annuity Payments") without a right of commutation. The Conversion Annuity Payments will be calculated using the greater of the minimum guaranteed annuity purchase rates set forth in the Contract or the purchase rates that Taxpayer is currently offering in connection with newly issued immediate annuities. Taxpayer represents that, in all events, the Conversion Annuity Payments will comply with § 72(s).

If the Contract includes this benefit and Individual elects it, Individual must liquidate the Account and transfer the proceeds to Taxpayer as consideration for the Conversion

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[1] Taxpayer represents that, if issued to a trust, the Contract will be issued to the trust in a manner such that § 72(u)(1) will not apply to the Contract.

Annuity Payments (“Conversion Premium”). The Conversion Premium is to be deducted from the Account and remitted directly to Taxpayer in cash by the Financial Institution.

The Contract requires Individual to invest the assets of the Account consistently with one of several portfolios approved by Taxpayer (“Investment Portfolios”).

The Contract may provide benefits in the form of joint life benefits. If the Contract provides joint life benefits, the benefits will be available only to Individual and Individual’s spouse under federal law (determined with reference to the youngest).

If Individual dies before the Guarantee Payments have commenced, then the Contract terminates, unless it is continued by (or for the benefit of) Individual’s surviving spouse in accordance with the terms of the Contract and § 72(s)(3). If Individual dies after the Guarantee Payments commence, the Contract terminates unless there is an appropriate election under the terms of the Contract to continue the Guarantee Payments until the death of Individual's surviving spouse.

The Contract does not have a cash value. If Individual chooses to terminate the Contract, no amount will be payable by Taxpayer. Individual will not be able to receive a loan from Taxpayer or Taxpayer’s affiliates by using the Contract as collateral. Further, Individual may not assign or transfer any ownership rights under the Contract, including with respect to the Guarantee Payments.

Taxpayer’s actuaries have analyzed the actuarial and economic characteristics of the Guarantee Payment features of the Contract, reaching the following conclusions:

1. Like a traditional payout annuity, the cost of the Contract to Taxpayer and its value to Individual increase as life expectancy increases.

2. From an actuarial pricing and annuity reserving perspective, the longevity risk protection under the Contract is indistinguishable from that of a traditional variable annuity contract with a life-contingent fixed annuity payout.

3. The Guarantee Payments protect primarily against longevity risk, rather than market risk.

Taxpayer will hold reserves for its liabilities under the Contract. It will report these reserves on the National Association of Insurance Commissioners (“NAIC”) annual statement that Taxpayer files with the insurance regulatory authorities in each of the states and other jurisdictions in which Taxpayer conducts its insurance business. Taxpayer will determine the reserves under the applicable requirements of state law and regulation. The reserves will reflect the liabilities that Taxpayer has with respect to both Guarantee Payments and Conversion Annuity Payments, if applicable. Such reserves will reflect the fact that Taxpayer does not own the assets in the Account. If

Taxpayer did own the assets in the Account, the aggregate amount of reserves it would be required to maintain with respect to the Contract would be substantially larger.

Taxpayer makes the following additional representations:

1. The Contract will comply with § 72(s).

2. The Contract will be treated as an annuity contract under state law in all states in which it is offered.

3. Individual will have legal title in, and full control over, the assets held in the Account, although the Contract may terminate if Individual does not invest those assets in accordance with the prescribed Investment Portfolios.

4. Taxpayer will account for the Contract on its books and records as an annuity contract, and not as some other type of financial instrument.

5. Individual will purchase the assets in the Account in transactions entered into for profit.

6. Individual will include income associated with the Account in gross income, including income from any gain realized upon disposition of assets in the Account.

7. For purposes of Taxpayer's federal income tax returns, annual regulatory statements and filings to the NAIC, and state premium tax obligations, Taxpayer will (1) treat Contract Charges in the same manner as charges for guaranteed lifetime withdrawal benefits under a traditional deferred annuity contract, and (2) treat any Conversion Premium in the same manner as premiums received for a single premium immediate annuity.

8. The marketing materials for the Contract will not include any explicit or implicit representations that changes in the fair market value of the Account or any assets therein are expected to approximate, directly or inversely, changes in the fair market value of the Contract.

REQUESTED RULINGS

Taxpayer requests the following rulings:

1. The Contract will be treated as an annuity contract under § 72.

2. The Guarantee Payments and Conversion Annuity Payments, if applicable, will be taxable as "amounts received as an annuity" under § 72(b).

3. The Account will not cause the Contract to have a “cash value” or “cash surrender value” for purposes of § 72, and will not otherwise be part of the Contract for federal tax purposes.

4. For purposes of § 72(c)(1) and § 72(e)(6) (each defining “investment in the contract”), the “aggregate amount of premiums or other consideration paid” for the Contract will equal the sum of all Contract Charges plus any Conversion Premium paid to Taxpayer.

LAW AND ANALYSIS

Requested Ruling # 1

Section 72(a) provides that, except as otherwise provided, gross income includes any amount received as an annuity (whether for a period certain or during one or more lives) under an annuity, endowment, or life insurance contract.

Section 72(b)(1) provides that gross income does not include that part of any amount received as an annuity under an annuity, endowment, or life insurance contract which bears the same ratio to such amount as the investment in the contract (as of the annuity starting date) bears to the expected return under the contract (as of such date).

Section 72(b)(2) provides that the portion of any amount received as an annuity which is excluded from gross income under § 72(b)(1) shall not exceed the unrecovered investment in the contract immediately before the receipt of such amount.

Section 1.72-2(a)(1) of the Income Tax Regulations provides that the contracts under which amounts paid will be subject to the provisions of § 72 include contracts which are considered to be life insurance, endowment, and annuity contracts in accordance with the customary practice of life insurance companies. Under § 1.72-1(b) and (c), as a general matter “amounts received as an annuity” are amounts which are payable at regular intervals over a period of more than one full year from the date on which they are deemed to begin, provided the total of the amounts so payable or the period for which they are to be paid can be determined as of that date, a proportionate part of which is considered to represent a return of premiums or other consideration paid.

Under § 1.72-2(b), amounts are considered as “amounts received as an annuity” only if all of the following tests are met: 1) the amounts must be received on or after the annuity starting date; 2) the amounts must be payable in periodic installments at regular intervals over a period of more than one full year from the annuity starting date; and 3) the amounts payable must be determinable either directly from the terms of the contract or indirectly from the use of either mortality tables or compound interest computations, or both (if the contract is a variable contract, § 1.72-2(b)(3) provides an alternative formulation of this requirement).

Under § 1.72-4(b)(1), the annuity starting date is the first day of the first period for which an amount is received as an annuity. The first day of the first period for which an amount is received as an annuity shall be the later of 1) the date upon which the obligations under the contract became fixed or 2) the first day of the period which ends on the date of the first annuity payment.

Explaining the imposition of an "income-out-first" rule under § 72(e) for withdrawals prior to the annuity starting date, the Senate report described a commercial annuity as

> a promise by a life insurance company to pay the beneficiary a given sum for a specified period, which period may terminate at death. Annuity contracts permit the systematic liquidation of an amount consisting of principal (the policyholder's investment in the contract) and income . . . . An individual may purchase an annuity by payment of a single premium or by making periodic payments. A deferred annuity contract may, at the election of the individual, be surrendered before annuity payments begin, in exchange for the cash value of the contract . . . . The committee believes that the use of deferred annuity contracts to meet long-term investment goals, such as income security, is still a worthy ideal.

S. Rep. No. 97-494 at 349-50 (1982) (footnote omitted). The report also explains § 72's utilization of an exclusion ratio regime: "[a] portion of each amount paid to a policyholder as an annuity generally is taxed as ordinary income under an 'exclusion ratio' (§ 72(b)) computed to reflect the projected nontaxable return of investment in the contract and the taxable growth on the investment." Id. As described in Samuel v. Commissioner, 306 F.2d 682, 687 (1st Cir. 1962), aff'g Archibishop Samuel Trust v. Commissioner, 36 T.C. 641 (1961), acq., 1964-2 C.B. 3:

> Inherent in the concept of an annuity is a transfer of cash or property from one party to another in return for a promise to pay a specific periodic sum for a stipulated time interval . . . . Again, in the normal annuity situation, once the annuitant has transferred the cash or property to the obligor and has received his contractual right to periodic payments, he is unconcerned with the ultimate disposition of the property transferred once it is in the obligor's hands.

In Life Insurance, Black and Skipper state that "[i]n general financial terms, an annuity is simply a series of periodic payments" and while "[l]ife insurance has as its principal mission the creation of a fund[, t]he annuity, on the contrary, has as its basic function the systematic liquidation of a fund." Kenneth Black, Jr., Harold D. Skipper, and Kenneth D. Black, III, Life Insurance, 144-45 (15th ed. 2015). Accordingly, "[e]ach payment under a life annuity is a combination of principal and interest income and a survivorship element. Although not completely accurate, one can view the operation of an annuity as follows: If a person dies precisely at his or her life expectancy, he or she would have neither gained nor lost through utilizing a life annuity." Life Insurance at 46.

Elsewhere an annuity has been described as "a right to receive fixed, periodic payments, for a specified period of time" and an annuity contract as

> a contract under which, in exchange for payment of a premium or premiums, the recipient thereof is bound to make future payments, typically at regular intervals, in amounts, to payees, and on conditions specified in the parties' agreement. The determining characteristic of an annuity is that the annuitant has an interest only in the periodic payments and not in any principal fund or source from which they may be derived. Although an individual who purchases an annuity remains the technical owner of the asset, such individual does not retain total control over that asset and does not have unfettered access to the full amount of the individual's own property.

4 Am. Jur. 2d Annuities, § 1 (2024). Moreover, "[t]he purchaser of an annuity surrenders all rights to the money paid, and therefore installment payments of a debt, or payments of interest on a debt, do not constitute an annuity." Id., § 2.

Whether an annuity contract allows the owner to access the value of the contract through other than periodic ("annuity") payments is a product of the terms of the contract. 8 New Appleman on Insurance Law Library Edition § 91.02[6][b] (2009).

Here, on balance, the Contract possesses the essential attributes of an annuity. It is true that the Contract may not, "at the election of [Individual], be surrendered before annuity payments begin, in exchange for the cash value of the contract," S. Rep. No. 97-464 at 349. It is also true that because the annuity starting date for the Guarantee Payments is contingent upon the value of the Account being exhausted while Individual is alive, it is not the case that "if [Individual] exactly lives out his or her life expectancy, he or she would have neither gained nor lost through utilizing the annuity contract," Life Insurance at 46. However, these conditions are not dispositive.

The Contract and the amounts paid under the Contract meet the requirements of §§ 1.72-1(b) and (c), 1.72-2(a)(1) and (b)(3), and 1.72-4(b)(1) as an annuity contract and annuity payments. Additionally, the Contract is purchased "by making periodic payments" of premium for "a promise by a life insurance company to pay the beneficiary a given sum for a specified period, which period may terminate at death," and is "used to provide long-term income security." S. Rep. No. 97-464 at 349. Moreover, it has "the determining characteristic . . . that the annuitant has an interest only in the periodic payments and not in any principal fund or source from which they may be derived." 4 Am. Jur. 2d Annuities, § 1 (2024). Individual will have "surrender[ed] all rights to the money paid," thereby distinguishing the Contract from "installment payments of a debt, or payments of interest on a debt," which are not annuities. Id.

The Contract is not a contract to pay interest. See § 1.72-14(a).

Accordingly, the Contract will constitute an annuity contract for purposes of § 72.

Requested Ruling # 2

Section 72(a) provides that, except as otherwise provided, gross income includes any amount received as an annuity (whether for a period certain or during one or more lives) under an annuity, endowment, or life insurance contract.

Section 72(b)(1) provides that gross income does not include that part of any amount received as an annuity under an annuity, endowment, or life insurance contract which bears the same ratio to such amount as the investment in the contract (as of the annuity starting date) bears to the expected return under the contract (as of such date).

Section 72(b)(2) provides that the portion of any amount received as an annuity which is excluded from gross income under § 72(b)(1) shall not exceed the unrecovered investment in the contract immediately before the receipt of such amount.

Section 72(c)(4) defines "annuity starting date" as the first day of the first period for which an amount is received as an annuity under the contract.

Section 1.72-2(b)(2) defines "amounts received as an annuity" as only those amounts that meet all of the following tests:

> (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) Except as indicated in § 1.72-2(b)(3), 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 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) defines "annuity starting date" as the first day of the first period for which an amount is received as an annuity; the first day of the first period for which an amount is received as an annuity shall be whichever of the following is the later:

> (i) The date upon which the obligations under the contract became fixed, or
>
> (ii) The first day of the period (year, half-year, quarter, month, or otherwise, depending on whether payments are to be made annually, semiannually, quarterly, monthly, or otherwise) which ends on the date of the first annuity payment.

Here, with respect to the Guarantee Payments, when the Guarantee Payments become payable the obligations under the Contract become fixed: no additional Contract Charges are due, and Taxpayer is obligated to pay the Guarantee Payments until Individual's death (or, possibly, the death of Individual's spouse). Hence, the Guarantee Payments will be received on or after the annuity starting date.

Second, the Guarantee Payments will be paid periodically at regular intervals over a period of more than one full year from the annuity starting date (unless death occurs).

Third, the total amount payable is determinable from the Contract using mortality tables and sound actuarial theory.

Accordingly, the Guarantee Payments will be "amounts received as an annuity."

With respect to the Conversion Annuity Payments, if Individual exercises that option, then the obligations under the Contract become fixed: no additional Contract Charges are due, and Taxpayer is obligated to pay the Conversion Annuity Payments consistent with the rate guarantee. Hence, the Conversion Annuity Payments will be received on or after the annuity starting date.

Second, the Conversion Annuity Payments will be paid periodically at regular intervals over a period of more than one full year from the annuity starting date.

Third, the total amount payable is determinable from the Contract's rate guarantee using mortality tables and sound actuarial theory.

Accordingly, the Conversion Annuity Payments will be "amounts received as an annuity."

Either the Guarantee Payments or the Conversion Annuity Payments[2] will be taxable under § 72(a) as amounts received as an annuity, subject to the exclusion of the amount of each payment allocable to the investment in the contract determined under § 72(b).

Requested Ruling # 3

Section 72 does not define the terms "cash value" or "cash surrender value" with regard to an annuity contract. With regard to a life insurance contract, § 7702(f)(2)(A) defines "cash surrender value" as "cash value determined without regard to any surrender charge, policy loan, or reasonable termination dividend." Section 1.7702-2(h)(2) of the Proposed Income Tax Regulations defines "cash surrender value" of a life insurance contract as generally equaling its "cash value," which in turn is defined by proposed

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[2] Individual cannot receive both Guarantee Payments and Conversion Annuity Payments; if Individual elects to receive Conversion Annuity Payments, then Guarantee Payments are not available.

§ 1.7702-2(b)(1) as the greater of "(i) [t]he maximum amount payable under the contract (determined without regard to any surrender charge or policy loan); or (ii) [t]he maximum amount that the policyholder can borrow under the contract."[3] See also H.R. Rep. No. 98-432 at 1444.

The term "cash value" commonly connotes the amount available to a policyholder for withdrawal or upon surrender of the contract. See, e.g., Life Insurance at 41-42; see also John H. Magee, Life Insurance 599 (3d ed. 1958) ("The cash value represents the amount available to the policyholder upon the surrender of the life insurance contract.")

Rev. Rul. 77-85, 1977-1 C.B. 12, addressed an arrangement involving an "investment annuity policy" that has some features similar to Taxpayer's proposed arrangement. In the ruling, the policyholder could not receive any amount directly from the account and could not receive a distribution of assets in kind. At any time prior to the annuity starting date, however, the policyholder could make a full or partial surrender of the policy to the insurance company. If such a surrender were made, the custodian was directed by the agreement to sell all or part of the assets as appropriate and to pay over the necessary proceeds to the insurance company. The insurance company in turn would make the full or partial cash surrender payment to the policyholder in an amount equal to the proceeds received by the insurance company from the account, less any cash surrender charges.

The ruling does not address whether the underlying account created any "cash value" or "cash surrender value" for the investment annuity policy. Nonetheless, the contrast in the mechanics illustrates the loose connection between the Account and the Contract. The Contract cannot be monetized at the discretion of Individual other than through receipt of Guarantee Payments or exercise of the option to receive Conversion Annuity Payments. It cannot be assigned, cannot be surrendered in whole or part in exchange for cash, and cannot be used as collateral against a loan from Taxpayer. The connection to the Account is unlike that in the ruling - the Account's value is used only to pay the Contract Charges or to purchase the Conversion Annuity Payments if that option is exercised. Individual can access the Account's value without operation of the Contract, though with consequences if, for example, such access produces a withdrawal that exceeds the maximum withdrawal amount (an excess withdrawal) or if the assets selected by Individual are not consistent with the Investment Portfolios approved by Taxpayer.

Although the Contract (1) has utility only in conjunction with an eligible Account, (2) controls, to some extent, Individual's activities with regard to that Account, and (3) cannot be alienated or otherwise monetized, the Account is not so intertwined with the Contract as to be effectively part of the Contract. Cf. Rev. Rul. 77-85; Rev. Rul. 2003-97, 2003-2 C.B. 380.

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[3] Cf. proposed § 1.7702-2(b)(2), which provides certain exclusions from cash value, none of which are relevant to this discussion.

Accordingly, the Account will not cause the Contract to have a “cash value” or “cash surrender value” for purposes of § 72, and will not otherwise be part of the Contract for federal income tax purposes.

Requested Ruling # 4

Section 72(c)(1) provides that, for purposes of the exclusion ratio under § 72(b), the “investment in the contract” as of the annuity starting date is the aggregate amount of premiums or other consideration paid for the contract, minus the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income. Under § 72(c)(2), this amount is then reduced by the value of the refund feature, if any.

Section 72(e)(6) provides that for purposes of § 72(e), the “investment in the contract” as of any date is the aggregate amount of premiums or other consideration paid for the contract before such date, minus the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income.

As mentioned, Rev. Rul. 77-85 addressed an arrangement with some similar features. That ruling held that the issuer should include in its premium income only the premiums and charges paid each year.

Accordingly, with regard to Guarantee Payments, the Contract Charges should be taken into account in the determination of Individual’s “investment in the contract” for the Contract under § 72; with regard to Conversion Annuity Payments, both the Contract Charges and the Conversion Premium should be taken into account in the determination of Individual’s “investment in the contract” for the Contract under § 72.

RULINGS

1. The Contract will be treated as an annuity contract under § 72.

2. The Guarantee Payments and Conversion Annuity Payments, if applicable, will be taxable as “amounts received as an annuity” under § 72(b).

3. The Account will not cause the Contract to have a “cash value” or “cash surrender value” for purposes of § 72, and will not otherwise be part of the Contract for federal tax purposes.

4. For purposes of § 72(c)(1) and § 72(e)(6) (each defining “investment in the contract”), the “aggregate amount of premiums or other consideration paid” for the Contract will equal the sum of all Contract Charges plus any Conversion Premium paid to Taxpayer.

CAVEATS

The rulings contained in this letter are based upon information and representations submitted by Taxpayer and accompanied by penalty of perjury statements executed by appropriate parties. 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, including but not limited to issues under Subchapter D (§ 401 et seq.), the computation of the exclusion ratio under § 72(b), the characterization of the reserve under § 816(b), or the computation of the amount of any reserve.

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

Taxpayer must attach a copy of this letter ruling to any tax return to which it is relevant.

In accordance with a power of attorney on file in this office, a copy of this ruling is being furnished to your authorized representatives.

Sincerely,

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John E. Glover
Senior Counsel, Branch 4
Office of Associate Chief Counsel
(Financial Institutions & Products)

Enclosure: