

IRS Letter Ruling 201120011 (Feb. 11, 2011)

This is in response to your request seeking a ruling regarding substantially equal periodic payments within the meaning of § 72(q)(2)(D) of the Internal Revenue Code (the "Code").

FACTS

Taxpayer A is a ***** life insurance company organized and operated under applicable state law and is a life insurance company within the meaning of § 816(a) of the Code. Taxpayer B is a ***** life insurance company organized and operated under applicable state law and is a life insurance company within the meaning of § 816(a) ***** (hereafter Taxpayer A and Taxpayer B are referred to jointly as "the Taxpayers") and the Taxpayers join in the filing of a consolidated federal income tax return.

The Taxpayers plan to issue non-qualified single premium immediate annuity contracts (the "Contracts"). The Contracts are available in several different forms, including a straight life annuity, a life annuity with a guarantee period, and a life annuity with various types of refund features. In addition, the Contracts can be payable for a single life or for joint lives, and include both a cash withdrawal feature and an acceleration feature.

Neither the cash withdrawal feature nor the acceleration feature can be exercised by a Contract owner if the owner is under age 59 1/2.

The payments made under the Contracts are generally fixed, level periodic payments unless a Contract owner selects Option U at the time a Contract is issued. Under Option U , a Contract owner can elect to have the fixed annuity payments increase annually for the life of the Contract by a constant percentage equal to 1, 2, 3, or 4 percent. If a Contract owner makes such an election, the percentage chosen cannot be changed after the Contract is issued. The amount of the single premium paid for a Contract is unaffected by whether the Contract owner chooses Option U . Rather, if the Contract owner elects Option U , the initial payments made under the Contract will be lower than if Option U is not elected.

The Taxpayers represent that the annuity payments made under the Contracts in cases where Option U is not elected would be substantially equal periodic payments within the meaning of § 72(q)(2)(D). In addition, the Taxpayers represent that when Option U is elected payments made under the Contracts pursuant to Option U would satisfy the minimum distribution requirement of § 401(a)(9) and § 1.401(a)(9)-6 of the Income Tax Regulations (Regulations).

RULING REQUESTED

The Taxpayers request a ruling that payments made under the Contracts pursuant to Option U are "substantially equal periodic payments" within the meaning of § 72(q)(2)(D).

LAW AND ANALYSIS

Section 72 of the Code sets forth rules for the taxation of amounts received under an annuity contract. Section 72(q)(1) imposes a penalty tax on certain premature or early distributions under annuity contracts equal to ten percent of the amount that is includible in gross income. The penalty tax under § 72(q)(1) will not be imposed, however, if the distribution satisfies one of the exceptions set forth in § 72(q)(2). Section 72(q)(2)(D) provides that a distribution will not be subject to the penalty tax if it is "part of a series of substantially equal periodic payments (not less frequent 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."

Similarly, § 72(t)(1) imposes an additional ten percent tax on early distributions from qualified plans (as described in § 4974(c)). The additional tax is imposed on that portion of the distribution that is includible in gross income. Section 72(t)(2)(A)(iv) provides that the additional tax under § 72(t)(1) shall not apply to distributions 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 such employee and his designated beneficiary.”

Q&A-12 of Notice 89-25, 1989-1 C.B. 662, provided that payments will be considered to be substantially equal periodic payments within the meaning of § 72(t)(2)(A)(iv) if they are made according to one of three methods — (1) the required minimum distribution method, (2) the fixed amortization method, or (3) the fixed annuitization method.

Notice 89-25 described the first of those methods as follows —

Payments shall be treated as satisfying section 72(t)(2)(A)(iv) if the annual payment is determined using a method that would be acceptable for purposes of calculating the minimum distribution required under section 401(a)(9). For this purpose, the payment may be determined based on the life expectancy of the employee or the joint life and last survivor expectancy of the employee and beneficiary.

Rev. Rul. 2002-62, 2002-2 C.B. 710, modified Q&A-12 of Notice 89-25. Under sections 3 and 4 of Rev. Rul. 2002-62, the guidance in Rev. Rul. 2002-62 replaced the guidance in Q&A-12 of Notice 89-25 for any series of payments commencing on or after January 1, 2003.

Under Rev. Rul. 2002-62 and Q&A-12 of Notice 89-25, payments are considered to be substantially equal periodic payments within the meaning of § 72(t)(2)(A)(iv) if they are made in accordance with one of three methods— (1) the required minimum distribution method, (2) the fixed amortization method, or (3) the fixed annuitization method.

Rev. Rul. 2002-62 further describes the three methods described in Q&A-12 of Notice 89-25. Rev. Rul. 2002-62 describes the required minimum distribution method as follows —

The annual payment for each year is determined by dividing the account balance for that year by the number from the chosen life expectancy table for that year. Under this method, the account balance, the number from the chosen life expectancy table and the resulting annual payments are redetermined for each year. If this method is chosen, there will not be deemed to be a modification in the series of substantially equal periodic payments, even if the amount of payments changes from year to year, provided there is not a change to another method of determining the payments.

Notice 2004-15, 2004-1 C.B. 526, states, “The IRS and Treasury believe that because [sections 72(q)(2)(D) and 72(t)(2)(A)(iv)] were enacted for the same purpose it is appropriate to apply the same methods to determine whether a distribution is part of a series of substantially equal periodic payments.” Notice 2004-15 goes on to conclude, “Therefore, taxpayers may use one of the methods set forth in Notice 89-25, as modified by Rev. Rul. 2002-62, to determine whether a distribution from a non-qualified annuity contract is part of a series of substantially equal periodic payments under § 72(q)(2)(D).”

The Taxpayers in this case quote from Q&A-12 of Notice 89-25 to argue that payments which are “determined using a method that would be acceptable for purposes of calculating the

minimum distribution required under section 401(a)(9)" are substantially equal periodic payments. The Taxpayers then rely on Regulations under § 401(a)(9) that provide that certain annually increasing annuity payments to people over age 70 1/2 will satisfy the requirements of § 401(a)(9).

The Taxpayers' argument disregards Rev. Rul. 2002-62, which replaced the guidance provided in Q&A-12 of Notice 89-25 with a more detailed description of the three methods than the description provided in Q&A-12 of Notice 89-25. Rev. Rul. 2002-62 makes it clear that the required minimum distribution method involves an annual recalculation of the payments determined by dividing the account balance for that year by the number from the chosen life expectancy table for that year. Under this method, the annual payments may increase or decrease based on the account balance and the remaining life expectancy from the chosen table.

In contrast, the annual payments under the Contracts with Option U would automatically increase by a fixed percentage over the prior year's payments, rather than increase or decrease based on the account balance and the remaining life expectancy from the chosen table. Thus, the payments under the Contracts with Option U would not be determined using the required minimum distribution method described in Rev. Rul. 2002-62 and Notice 89-25.

The description of the required minimum distribution method in Rev. Rul. 2002-62, states that it is one of the methods described in Q&A-12 of Notice 89-25. Thus, we believe Rev. Rul. 2002-62 merely provides further explanation of the required minimum distribution method described in Notice 89-25. However, to the extent that the two descriptions of the method might vary, the description in Rev. Rul. 2002-62 controls.

The Taxpayers raise an alternative argument based on the legislative history of the Tax Reform Act of 1986 (H.R. 3838, P.L. 99-514) which suggests that a stream 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 certain cost of living adjustments. See, e.g., S. Rep. No. 99-313, at 615 (1986). However, the annual increase in payment amounts provided under Option U is at a fixed rate chosen by a Contract owner. Therefore, the series of payments provided under Option U do not vary on account of cost of living adjustments.

HOLDING

Payments made under the Contracts pursuant to Option U are not "substantially equal periodic payments" within the meaning of § 72(q)(2)(D).

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 Taxpayers 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 representatives.

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

Sincerely, Donald J. Drees, Jr.
Senior Technician Reviewer
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