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Date:
March 17, 2011

Taxpayer =
Contract =

Sponsor =

Dear :

This is in response to your request for a letter ruling regarding the application of the Internal Revenue Code to a transaction you contemplate undertaking.

FACTS

The following is represented:

The Taxpayer is a corporation taxable under part I of subchapter L of the Internal Revenue Code. The Taxpayer intends to offer the Contract to individuals[1] (Customer) who have an ownership interest in an investment account (Account) established at a financial institution.[2] In exchange for a Fee, the Contract obligates the Taxpayer to pay the Customer a benefit (Contract Benefit) for the life of the Covered Life if the value of the Account falls below a Specified Minimum Account Value while the Contract is in force. The Covered Life is the Customer or, if joint lives are elected, the Customer and the Customer's spouse.[3] The Contract has a specified expiration date, on which the Contract will terminate unless the Customer elects the annuity purchase option.

The Customer will deposit money in the Account. Consistent with a permitted investment profile established by the Taxpayer and the Sponsor,[4] the Account will be

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[1] Consistent with § 72(u).
[2] This institution may or may not be an affiliate of Taxpayer.
[3] Distributions under the Contract will be consistent with § 72(s).
[4] Sponsor is an affiliate of Taxpayer within the meaning of § 1563(a).

invested in certain regulated investment companies ("mutual funds"); the profile may be limited to funds advised by the Sponsor.

To keep the Contract in-force, the Customer must pay the Fee and the Account must at all times be invested consistent with then current permitted investment profile; the profile will specify the eligible mutual funds and the portion of the Account permitted in each such fund.

The Contract Benefit is determined by reference to a Value Marker. At the time of issuance of the Contract, the Value Marker is the value of the Account. The Value Marker is increased by additional deposit(s) into the Account (subject to the Contract's limit on the amount deposited) and decreased by certain withdrawals from the Account (explained below). On each anniversary of the Contract, the Marker Value is redetermined to be the greater of the current Value Marker and the value of the Account at the close of the business day prior to the anniversary.

The Customer is allowed to access the value of the Account at any time. Withdrawals from the Account are classified as either Permitted Annual Withdrawals or Forbidden Withdrawals; Forbidden Withdrawals are any withdrawal other than a Permitted Annual Withdrawal decrease the Value Marker by the percentage that the amount of the Forbidden Withdrawal bears to the value of the Account.

At any time after the younger of the covered lives attains the minimum age specified in the Contract, the Customer can elect to begin Permitted Annual Withdrawals of the Permitted Annual Withdrawal Amount, which is determined by a two-step process. First, the Value Marker is redetermined to be the greater of the current Value Marker or the value of the Account at the close of the business day prior to the election. Second, a Withdrawal Factor is applied to this redetermined Value Marker. If less than the Permitted Annual Withdrawal Amount is withdrawn, the untaken balance is not added to a subsequent year's Permitted Annual Withdrawal Amount. The Permitted Annual Withdrawal Amount is redetermined on each Contract anniversary by another two step process. First, if in the prior Contract year more than the Permitted Annual Withdrawal Amount is withdrawn – a Forbidden Withdrawal – the Permitted Annual Withdrawal Amount is reduced by the percentage that the amount of the Forbidden Withdrawal bears to the value of the Account. Second, the value of the Account at the close of the business day prior to the anniversary is multiplied by the greater of the Withdrawal Factor used in the prior year and the Withdrawal Factor that would apply to the current year. The Permitted Annual Withdrawal Amount for the next year will be the greater of the amounts determined by the two steps, with a corresponding adjustment to the Value Marker.

The Taxpayer will notify the Customer if the value of the Account falls below the Specified Minimum Account Value before the expiration date. The Customer will have a specified period of time to increase the value of Account above the Specified Minimum Account Value.[5] If at the expiration of the specified period the value of the Account remains below the Specified Minimum Account Value, the Account will be liquidated and proceeds remitted to the Taxpayer[6] and the Taxpayer will begin paying the Contract Benefit to the Customer. If the Customer has not yet elected to begin Permitted Annual Withdrawals, the annual Contract Benefit equals the Value Marker at the end of the prior business day multiplied by the current Withdrawal Factor. If the Customer has elected to begin Permitted Annual Withdrawals, the annual Contract Benefit equals the Value Marker at the end of the prior business day multiplied by the Withdrawal Factor used to determine the current Permitted Annual Withdrawal Limit; i.e., the annual Contract Benefit equals the Permitted Annual Withdrawal Amount, assuming no Forbidden Withdrawal that year.

At any time prior to the commencement of payment of the Contract Benefit or the Contract's specified expiration date, the Customer may apply the Account Value to the purchase of annuity payments for the life of the Customer (or the later of the Customer's spouse, if elected) based on an annuity purchase rate guarantee specified in the Contract (Annuity Benefit).

The Fee for the Contract is imposed quarterly resulting from the application of a formula and is a function of the Value Marker. The Fee may increase, in which case the Customer has the option of cancelling the Contract rather than pay the increased Fee. The Fee is paid out of the Account, but such payment is not counted as either a Permitted Annual Withdrawal or a Forbidden Withdrawal.

The Contract terminates upon the earliest of, among other things:

1. the date the Customer notifies the Taxpayer of intention to cancel the Contract;
2. closing of the Account;
3. failure to timely correct allocation of the Account consistent with the permitted investment profile;
4. failure to timely pay the Fee;
5. the Account Value is reduced to zero by a Forbidden Withdrawal;
6. the death of the Customer; or,
7. the specified expiration date.

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5 This can be done by either returning that year's Permitted Annual Withdrawal or making an additional deposit.

6 This, and all other transactions involving the Account, are taxable consistent with the tax rules applicable to the Account.

The Contract does not have any cash value and the ownership rights, including the right to the Contract Benefit or right to purchase annuity payments, cannot be assigned or transferred.

REQUESTED RULINGS

Taxpayer requests rulings that:

1. the Contract will be treated as an annuity contract within the meaning of § 72 of the Internal Revenue Code;
2. the activities of the Taxpayer in offering and issuing the Contract will be within the scope of the "life insurance products" exception form the "mark-to-market" rules of § 475 that is set forth in § 1.475(c)-1(d) of the Income Tax Regulations;
3. the Fee will be included in the Taxpayer's gross income under § 803(a)(1);
4. the Fee paid to the Taxpayer will be taken into account in the determination of the Customer's "investment in the contract" for the Contract under § 72 and the Customer's adjusted basis in the Contract under § 1011; and,
5. if the Taxpayer becomes liable to pay the Contract Benefit or the Annuity Benefit, such payments will be "amounts received as an annuity" under § 72(a).

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. The Code does not otherwise define an annuity contract or "any amount received as an annuity."

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 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

> [i]nherent 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 & Health Insurance, Black and Skipper state that "[i]n the broadest sense, 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." Accordingly,

> [e]ach payment under an annuity may be considered to represent 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 exactly lives out his or her life expectancy, he or she would have neither gained nor lost through utilizing the annuity contract.

Kenneth Black, Jr. and Harold D. Skipper, Jr., Life & Health Insurance 161-62 (13th ed. 2000).

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 the payment of a premium or premiums, the recipient thereof is bound to make future payments, typically at regular intervals, in amounts, to payees, and 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, he or she does not retain total control over that asset and does not have unfettered access to the full amount of his or her own "property".

4 Am. Jur. 2d Annuities, § 1 (2008). 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 state statute, Appleman on Insurance § 182:05[B][7] and [8] (2d ed. 2008).

Here, on balance the Contract possess the essential attributes of an annuity. It is true that the Contract may not, "at the election of the [holder], 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 is contingent upon the value of the Account being reduced while the Customer is alive, it is not the case that "if [Customer] exactly lives out his or her life expectancy, he or she would have neither gained nor lost through utilizing the annuity contract", Life & Health Insurance, at 162, but 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 annuity contracts 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. The Customer 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)[7].

Accordingly, the Contract will be treated as an annuity contract within the meaning of § 72.[8]

Requested Ruling #2

Section 1.475(c)-1(d) provides that:

> (d) *Issuance of life insurance products*.–A life insurance company that is not otherwise a dealer in securities within the meaning of section 475(c)(1) does not become a dealer in securities solely because it regularly issues life insurance products to its customers in the ordinary course of a trade or business. For purposes of the preceding sentence, the term

[7] The Certificate is not a debt instrument because it is issued by an insurance company subject to tax under subchapter L in a transaction in which there is no consideration other than cash. Section 1275(a)(1)(B)(ii).

[8] Customer is considered the owner of the Account. Rev. Rul. 2003-92, 2003-2 C.B. 350; Rev. Rul. 81-225, 1981-2 C.B. 12.

> *life insurance product* means a contract that is treated for federal income tax purposes as an annuity, endowment, or
>
> life insurance contract. See sections 72, 817, and 7702. (emphasis original)

The Contract is an annuity contract under § 72 and therefore the Taxpayer, as the contract issuer, will not be subject to the “mark-to-market” rules of § 475 by reason of its issuance of the Contract. The activities of the Taxpayer in offering and issuing the Contract will be within the scope of the “life insurance products” exception from the “mark-to-market” rules of § 475 that is set forth in § 1.475(c)-1(d).

Requested Ruling #3

Section 803(a)(1) provides that for purposes of part I of subchapter L, the term “life insurance gross income” means the sum of, among other things, the gross amount of premiums and other consideration on insurance and annuity contracts.

Prior to the revision of the life insurance company tax provisions by the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494 (1984), the controlling provision was § 809(c)(1). This provision was interpreted by § 1.809-4(a)(1)(i), which provided that

> The term “gross amount of all premiums” means the premiums and other consideration provided in the insurance or annuity contract. Thus, the amount to be taken into account shall be the total of the premiums and other consideration provided in the insurance or annuity contract without any deduction for commissions, return premiums, reinsurance, dividends to policyholders, dividends left on deposit with the company, discounts on premiums paid in advance, interest applied in reduction of premiums (whether or not required to be credited in reduction of premiums under the contract), or any other item of similar nature. Such term includes advance premiums, premiums deferred an uncollected and premiums due and unpaid, deposits, fees, assessments and consideration in respect of assuming liabilities under contracts not issued by the taxpayer (such as a payment or transfer of property in an assumption reinsurance transaction as defined in paragraph (a)(7)(ii) of § 1.809-5). The term also includes amounts a life insurance company charges itself representing premiums with respect to liability for insurance and annuity benefits for its

> employees (including full-time life insurance salesmen within the meaning of section 7701(a)(20)).

The Contract echoes a transaction described in Rev. Rul. 77-85, 1977-1 C.B. 12, which held that old § 809(c)(1) required the company to include in premium income the amounts received by the insurance company as

> an annual market value premium equal to a specified percentage of the year-end value of the account. The market value premium compensates the insurance company for its cost and for its risk assumed in guaranteeing to the policyholder an annuity rate under the contract.

Rev. Rul. 92-94, 1992-2 C.B. 144, notes that "the regulations issued under pre-1984 §§ 809(c)(1) and (d)(11) of the Code continue to provide guidance for the interpretation of § 803(a)(1) and 805(a)(8)."

Here, as explained with respect to Requested Ruling #1, the Contract will be treated an annuity contract for purposes of § 72. Hence the Fee should be included in the Taxpayer's gross income under § 803(a)(1).

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.

Section 1011(a) provides that the adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under § 1012 or other applicable sections), adjusted as provided in § 1016.

Accordingly, the Fee paid to the Taxpayer will be taken into account in the determination of the Customer's "investment in the contract" for the Contract under § 72 and the Customer's adjusted basis in the Contract under § 1011. See, e.g., Rev. Rul. 2003-76, 2003-2 C.B. 355 (addressing the allocation of the investment in the contract and the basis in the contract after the exchange of a portion of an annuity contract under § 1035(a)(3)).

Requested Ruling #5

Section 72(a) provides that 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(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:

a. they must be received on or after the 'annuity starting date' as that term is defined in § 1.72-4(b);
b. 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
c. 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:

a. the date upon which the obligations under the contract became fixed, or
b. 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 Contract Benefit, when the Contract Benefit becomes payable the obligations under the Contract become fixed: no additional Fee is due and the benefit obligation of the Taxpayer is fixed at paying the Contract Benefit until the annuitant(s)' demise. Hence, the Contract Benefit will be received on or after the annuity starting date.

Second, the Contract Benefit 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 Contract Benefit will be an "amount received as an annuity."

With respect to the Annuity Benefit, if the Customer exercises that option the obligations under the Contract become fixed: no additional Fee is due and the benefit obligation of the Taxpayer is to pay the annuity settlement option consistent with the rate guarantee. Hence, the Annuity Benefit will be received on or after the annuity starting date.

Second, the Annuity Benefit will be paid periodically at regular intervals over a period of more than one full year from the annuity starting date, consistent with the annuity settlement option.

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

Accordingly, the Annuity Benefit will be "an amount received as an annuity."

Either the Contract Benefit or the Annuity Benefit[9] will be taxable under § 72(a) as an amount received as an annuity, subject to the exclusion of the amount allocable to the investment in the contract determined under § 72(b).

RULINGS

Based on the foregoing,

1. the Contract will be treated as an annuity contract within the meaning of § 72 of the Internal Revenue Code;
2. the activities of the Taxpayer in offering and issuing the Contract will be within the scope of the "life insurance products" exception form the

[9] The Customer cannot receive both.

"mark-to-market" rules of § 475 that is set forth in § 1.475(c)-1(d) of the Income Tax Regulations;

3. the Fee will be included in the Taxpayer's gross income under § 803(a)(1);
4. the Fee paid to the Taxpayer will be taken into account in the determination of the Customer's "investment in the contract" for the Contract under § 72 and the Customer's adjusted basis in the Contract under § 1011; and,
5. if the Taxpayer becomes liable to pay the Contract Benefit or the Annuity Benefit, such payments will be "amounts received as an annuity" under § 72(a).

The ruling 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. This office has not verified any of the material submitted in support of the request for rulings and 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 Taxpayer. 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/

Sheryl B. Flum
Chief, Branch 4
Office of the Associate Chief Counsel
Financial Institutions & Products